portfolio construction forum

MARKETS SUMMIT

Bubble, bubble – toil and trouble?

15 February 2011

facilitating debate on the outlook for the markets

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Agenda

1. The Problem With Bubbles
2. A Lazy Man's Asset Allocation
3. Overlaying Market Views

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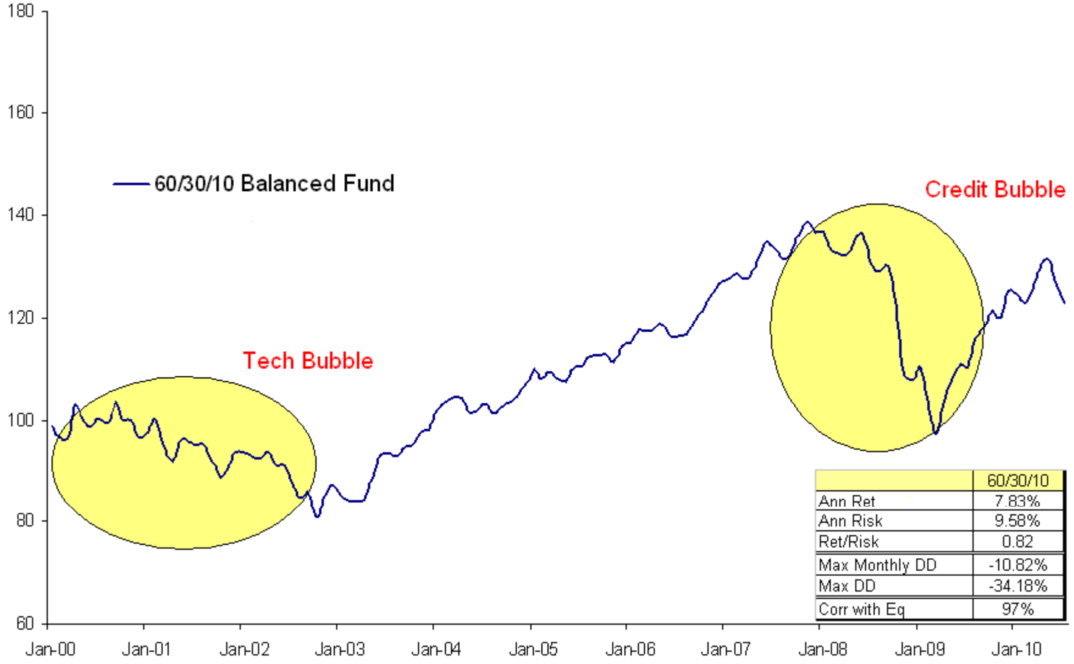
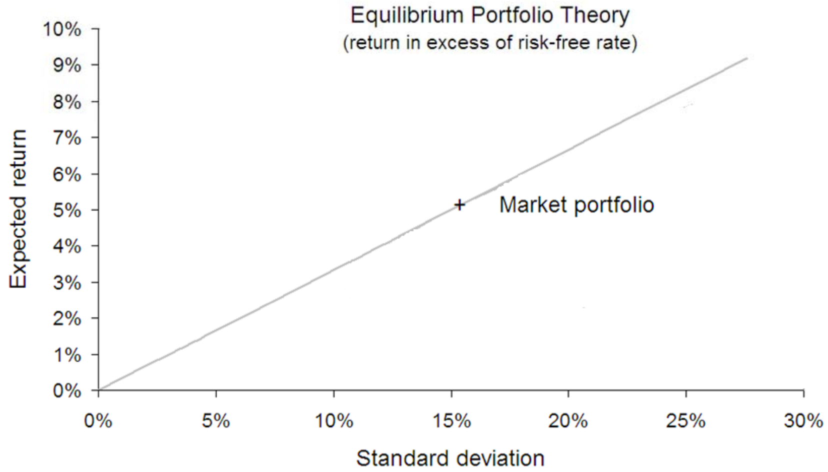
Bubbles are bad for your (financial) health!!



Source: MSCI, Factset, Citigroup, *Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com*

- → The last two financial bubbles have proved very costly for investors.
- → Some bubbles are caused by markets not being as efficient as people think they are.
- → However a large part of the problem lies in the way portfolios are constructed and the unintended risks taken.

Markowitz's big idea



- Most portfolio construction is concerned with finding an 'optimal' portfolio along the efficient frontier – an idea pioneered by Harry Markowitz in his Nobel prize winning research.

- Mean-Variance optimisation is now a standard within the industry because its (a) simple (b) easy to do and (c) sounds kind of science-like.

- However bubbles tend to play havoc with the theory since an MV optimiser will buy the asset with the higher expected return/risk trade-off. In this case it may be the asset that is currently over-priced since price runs ahead of risk in an inflating bubble.

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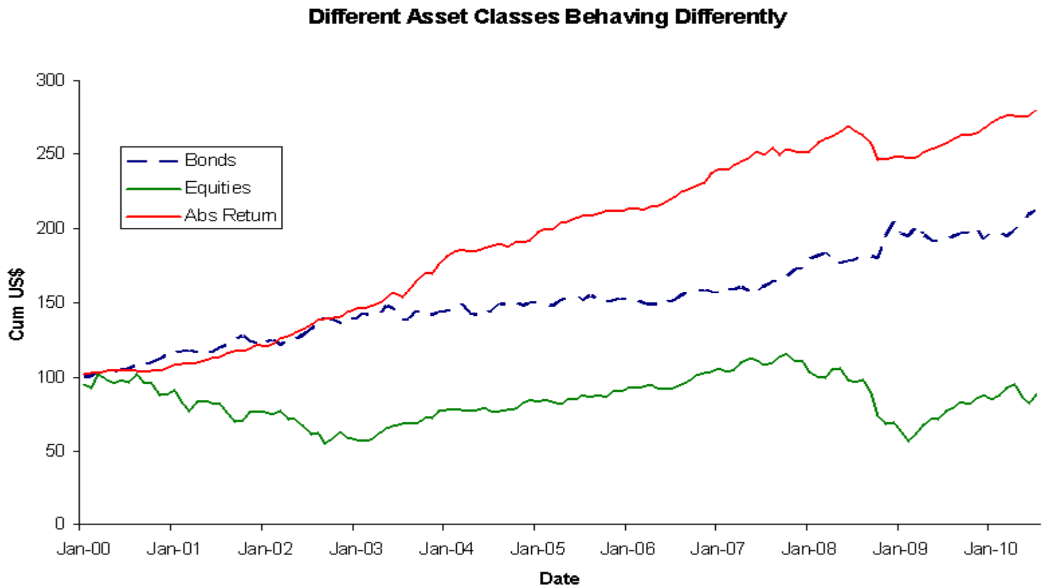
A basic approach so bubbles don't blow you up

1. Include bonds, equities and absolute returns in your portfolio – a good mix of betas and absolute return should ensure some diversification benefits.

2. Allocate equally between equity, bonds and the absolute return asset classes.

3. Add some sensible short-term (1-3 year) views on top of this simple SAA.

Step 1 – A set of asset classes



Long-Term Correlation Between Asset Classes Is Low

Correlation	Bonds	Equities	Abs Return
Bonds	100%	-26%	5%
Equities		100%	22%
Abs Return			100%

Source: MSCI, Factset, Citigroup, *Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com*

- By adding absolute return strategies we are increasing breadth since we are adding an asset class that behaves differently from equities and bonds.

- Within asset classes we might also find other diversifiers –
  - credit behaves differently to gov debt.
  - property behaves differently to equities.

The question is how stable are these relationships?

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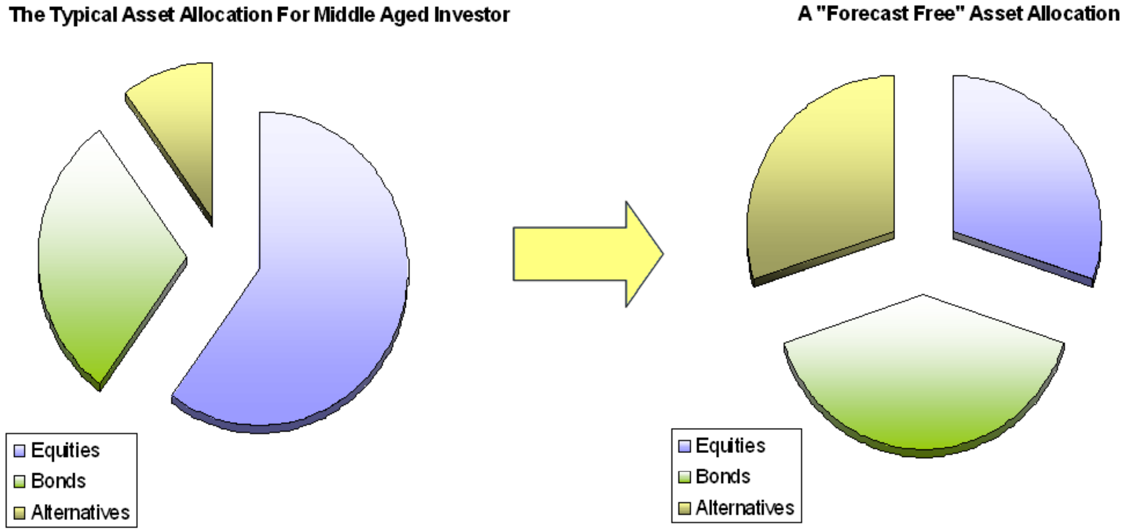
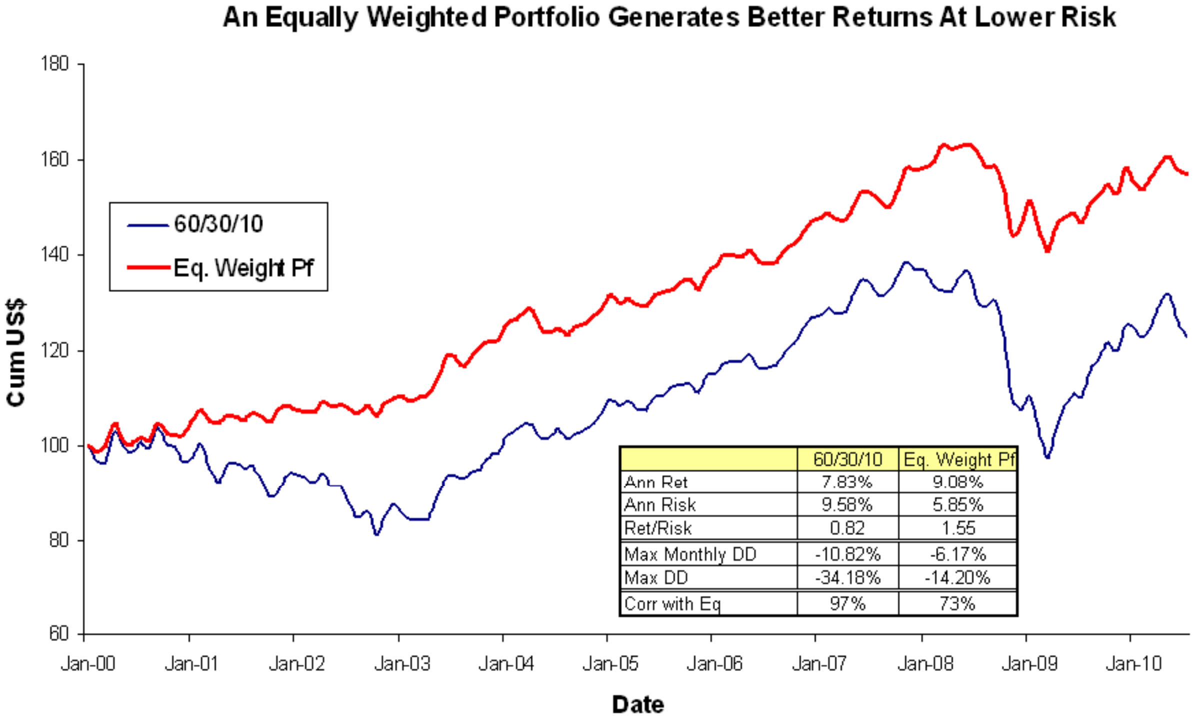
Step 2 – "Forecast free" asset allocation



- By allocating equally between the different asset classes you don't need to employ asset class forecasts to tilt the portfolio.
- This portfolio should spread both returns and risk more equally across the different asset classes and provide a smoother value generator for the conservative investor.
- We also reduce the risk of both a blow-up and dramatic outperformance by not stuffing our portfolio with equities.

Step 2 – "Forecast free" asset allocation



	60/30/10	Eq. Weight Pf
Ann Ret	7.83%	9.08%
Ann Risk	9.58%	5.85%
Ret/Risk	0.82	1.55
Max Monthly DD	-10.82%	-6.17%
Max DD	-34.18%	-14.20%
Corr with Eq	97%	73%

Source: MSCI, Factset, Citigroup, *Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com*

- Over the past 10 years a simple 'forecast free' asset allocation would have generated a higher return for a lower risk and dominated the standard (MV derived) allocation.
- Better still, the investor would experience much smaller drawdowns and be far less correlated with equity market risk.

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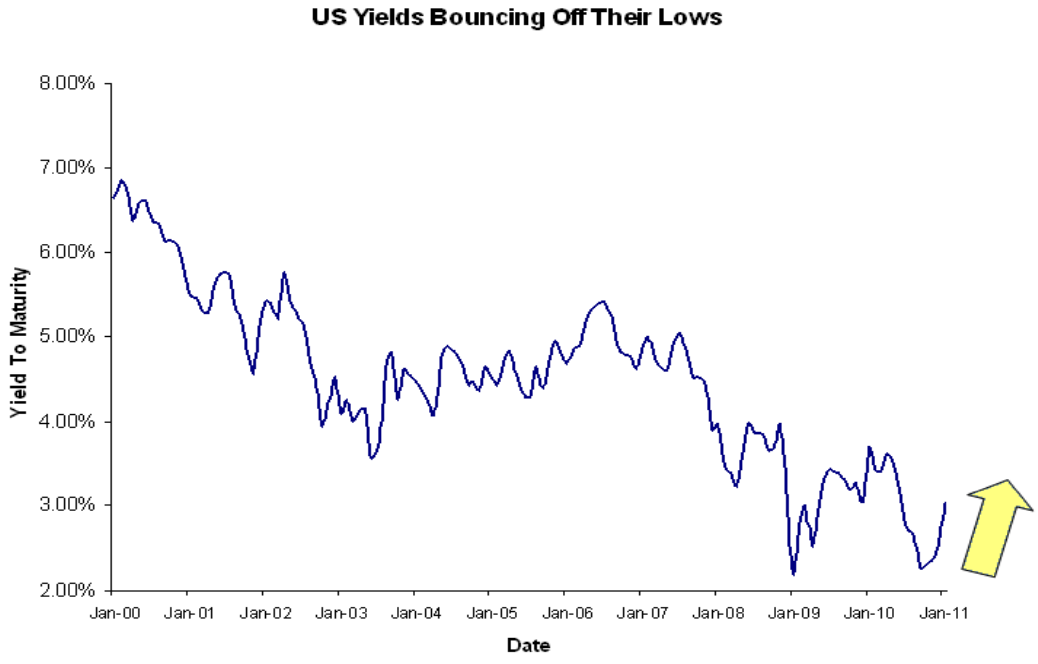
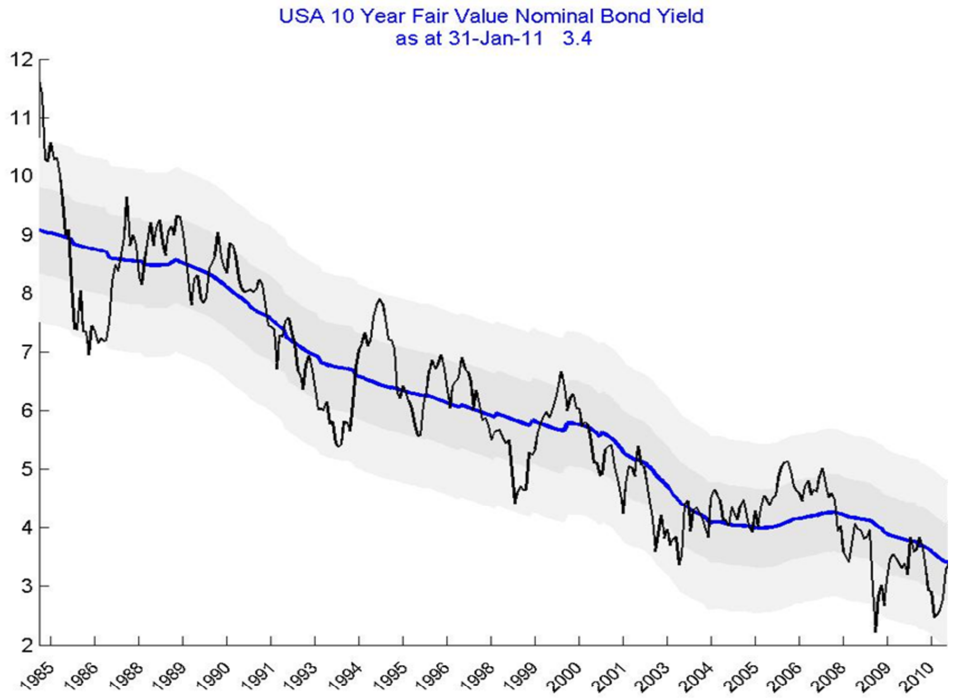
Bonds - no longer a safe haven



Source: MSCI, Factset, Citigroup

- Bond yields shrank to decade-low levels at the height of the GFC as investors were willing to pay any price for safety.
- Yields are now beginning to price in a recovery and the fear premium paid by investors is less attractive.

Bonds - not as expensive as many pundits argue



Source: MSCI, Factset, Citigroup, BTIM

- Our own fair value models argue that 10 Yr bond yields are now retracing back to fair value levels.
- As growth quickens over the next 3 years bonds may move into 'oversold' territory presenting an opportunity.

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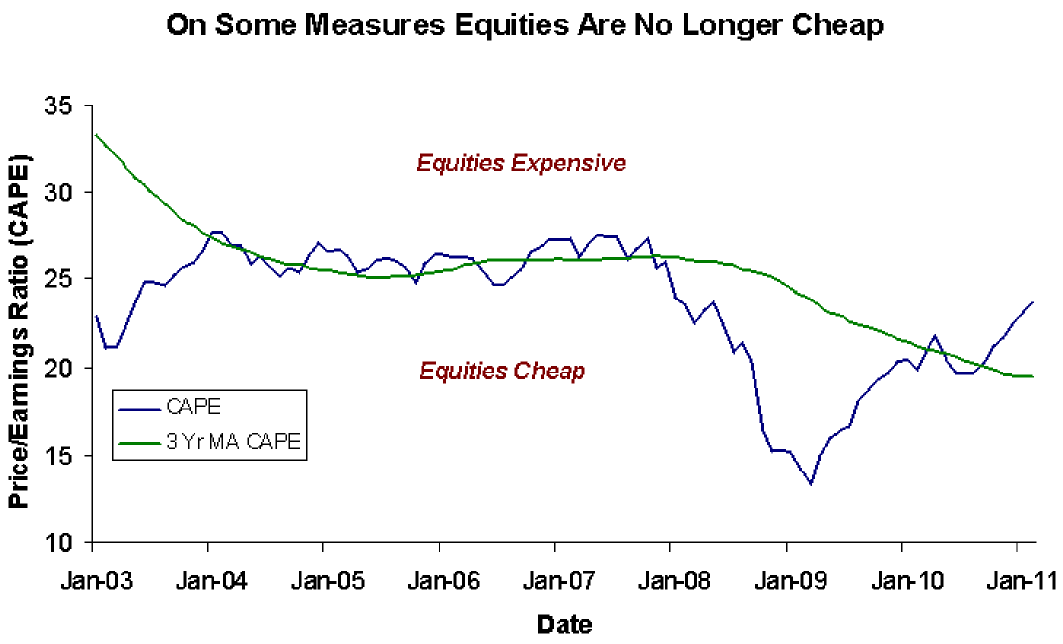
Equities - overall equity markets aren't cheap



Source: Robert Shiller, BTIM

- → Using some standard valuation ratios the equity markets are no longer the screaming buy that they were.
- → However as growth continues equities may continue to appreciate despite valuation concerns.

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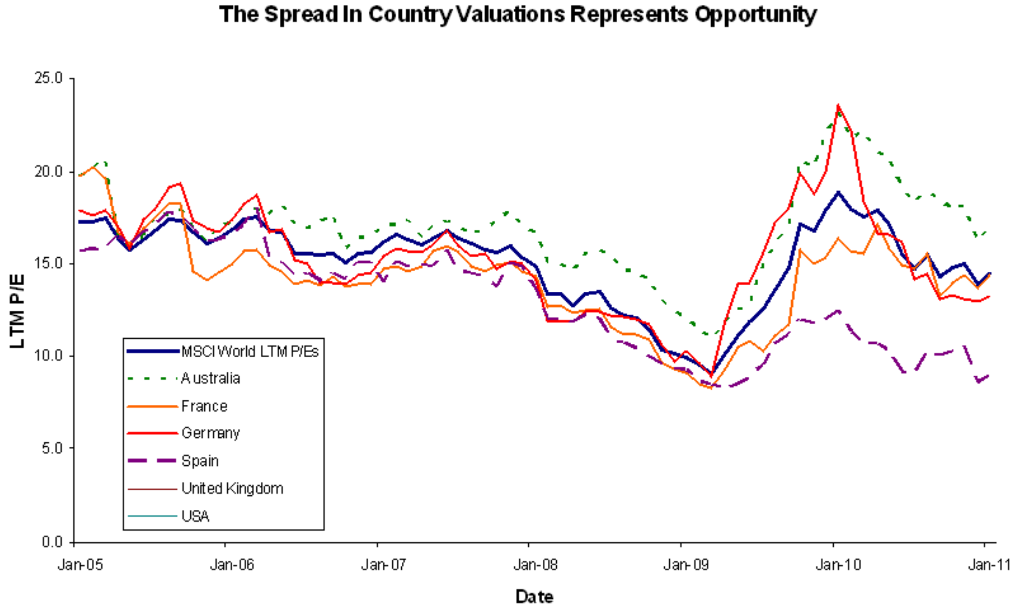
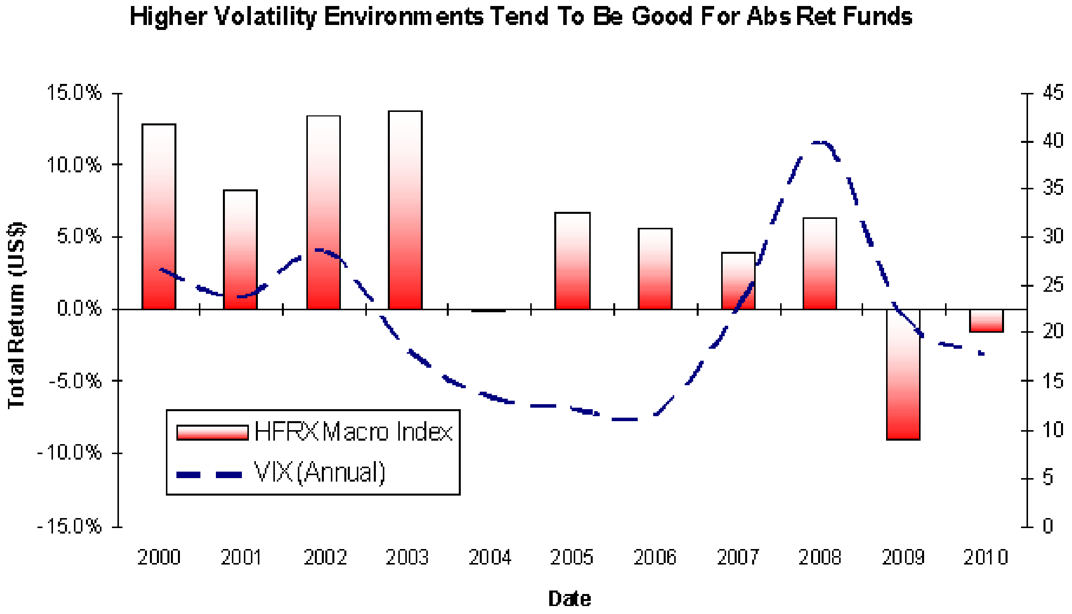
Equities - but some markets still look attractive



Source: MSCI, Factset, BTIM

- The GFC effect is still being felt in many of the European countries and is depressing their valuations.
- As the smoke clears these countries may represent a genuine opportunity for capturing growth at a cheap price.

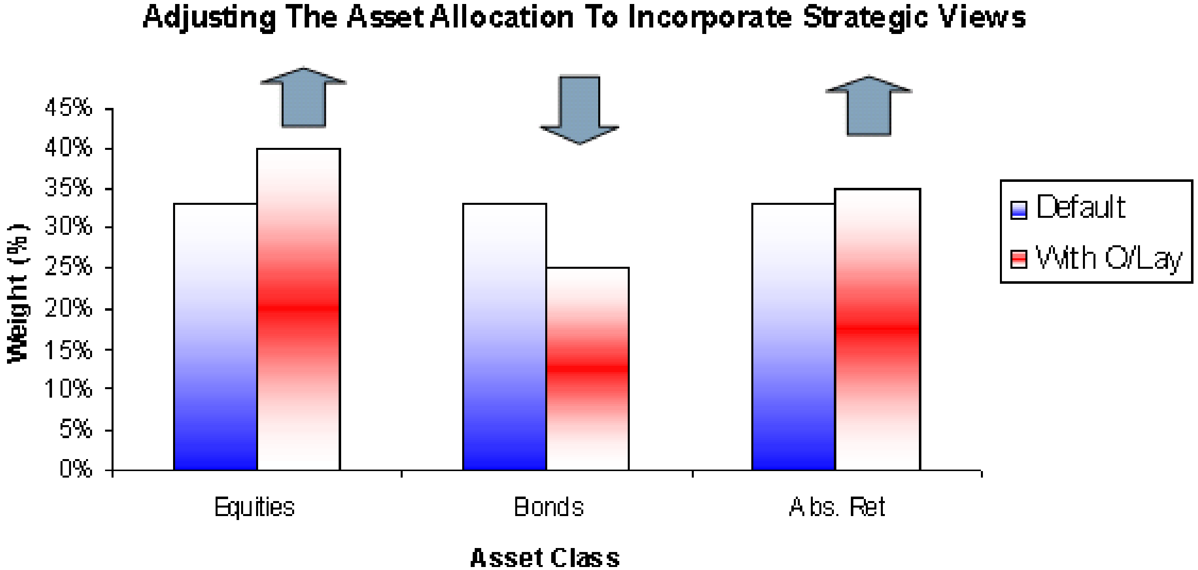
Abs Ret – fared well through the GFC



Source: Bloomberg, *Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com*

- Abs Return funds (at least the non-directional ones!) did well through the GFC.
- Abs Return funds tend to do better in higher volatility environments since higher vol = larger opportunity set.

Portfolio weighting for the conservative investor



- The net effect of incorporating strategic views into the asset allocation is to overweight equities and abs. ret funds while underweighting bonds.
- However the equal weighting starting point means that we don’t end up with a portfolio that is heavily overweight equities,

Summary

- Simple allocation practices can lower drawdowns and smooth returns over time.

- Overlaying strategic views on this simple asset allocation can exploit short-term inefficiencies.

- Keeping ‘big picture’ asset allocation in mind is as important as focussing on intra-asset class decisions.

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