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ON THE COVER



Double-Pod of Pods

Black Ash, Beads, Waxed Linen, and Paper Cord, 2010
20 × 12 × 12 inches; 50.8 × 30.48 × 30.48 cm

JoAnne Russo (American) is a basketry artist based in Saxtons River, Vermont. The artist's technique and weave is highly decorated, and inspired by Native Americans of the Northeast and Southwest regions. Each work is tightly woven with ornate detail. The artist's work is included in numerous museum collections across the United States, and has been featured in Art in Embassies. The artist's body of work leaves a lasting impression of what American folk art is in today's contemporary art scene. JoAnne Russo is represented by Cavin-Morris Gallery in New York, NY. Visit www.cavinmorris.com to view more works by this artist.

As discussed in last quarter's letter, we may be encountering a perfect storm in many investment markets, following a chain of events that are not necessarily connected.

The issues are: 1) the nature and extent of the financial crisis, 2) the determination of selected central banks and government to provide liquidity to head off what they perceive to be a looming catastrophe, 3) the superficiality often fostered by a 24/7 news cycle, and 4) the growing dominance of so-called hedge fund managers. Collectively, one could argue that these elements are behind a phenomenon that has puzzled many pundits, managers, and individual investors: Markets seem to suffer from a combination of elevated—although not necessarily record high—volatility and abnormally high correlations, the net effect of which is making successful stock or instrument selection appear to be even less achievable than in normal circumstances.

A closer look at trading suggests a relatively simple interpretation for the “surprising” phenomenon of high correlation and higher-than-normal volatility. What if investors have simply become traders? Note that what follows is not meant to be a diagnosis that evaluates and then excludes all other alternatives; rather, it is an illustration of a possible scenario to explain patterns that several observers have found troubling. I will explore this thought and draw a few conclusions as to how one might deal with them.

Without reviewing the volumes of literature on the subject, I suspect that it is self-evident to readers that the fundamental difference between a trader and an investor is the time over which an investment is to be held. In fact, in certain jurisdictions that still differentiate between trader and investor status for tax purposes, one of the “safe harbor” rules to preserve investor status is to maintain some minimum holding period for each investment. An important element of the time horizon dimension, however, is that investors are not necessarily long-term oriented; in contrast, most traders have a relatively short time horizon. Clearly, one needs to be careful establishing such a dichotomy, as one is really dealing with a continuum rather than digital points; in fact, someone could credibly argue that certain traders have a longer time horizon than certain investors. Yet, the contrast emphasizes a larger point, and I thus invite readers to accept the admittedly simplistic definition that traders deal in short-term trades whereas investors have time horizons that stretch over quarters or years.

The fact that investors as a group have multiple philosophies and multiple time horizons tends to promote diversity within markets, as individual decision makers will focus on different fundamental or tech-

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nical elements and view them over different time frames. Traders, in contrast, often tend to react to less-diversified stimuli, which, *ceteris paribus*, promote more coordinated price moves. Thus, a changed balance between investment- and trading-driven investment decisions, along with material excess liquidity and questionable short-to-intermediate-term fundamentals, could cause markets to behave in a different way, characterized by higher correlations. Further, higher overall uncertainty, combined with negligible risk-free returns, could also easily lead to an environment in which the herd moves in or out simultaneously, thus increasing volatility, potentially materially.

The next layer in this analysis relates to the proliferation of hedge funds. Once upon a time, hedge fund managers were somewhat iconoclastic figures that stayed on the periphery of markets, identifying seriously mispriced securities or combinations thereof and taking advantage of such mispricing. Although they rarely intended to “stay in the trade forever,” they were prepared to maintain positions for a while, to give markets time to correct. At times, these inefficiencies related to pricing differences between otherwise similar securities. At other times, the inefficiencies appeared to be even more basic. For example, I vividly remember Australia in 1986–1987, when short-term interest rates were around 15% or more, dividends were a fraction of that, and equity futures were trading on par with the value of the underlying index: The concept of futures fair value had not seemingly arrived in a country that in fact pioneered futures markets with the wool industry! Similarly, in Japan a few years later, it was possible to purchase equity warrants, combine them with cash, and thus recreate a form of downside-protected synthetic equity with virtually no material upside loss. Fancier traders might in fact have played this trade as an arbitrage by shorting the equity index futures, as suggested in a recent blog by John Thomas—a.k.a. the “Mad Trader”—a former hedge fund manager.

The world has dramatically changed since then. The number of managers has increased by leaps and bounds, and certain commentators argue that there are now more so-called “hedge fund managers” than traditional managers. The number and complexity of strategies has also increased in an almost exponential fashion, as smart financial engineers team up with vastly expanded computing power and databases to design and execute increasingly complex trades. The ultimate evolution in this latter trend is evident among high-frequency traders who at times execute thousands, if not tens of thousands, of trades from varied locations and

servers around the world, with nary an individual intervening in the execution picture. A substantial decline in transaction costs is the other major contributor to the trend.

Theoretically—and rhetorically—the industry will claim that more trades and traders are bound to raise pricing efficiency, increase liquidity, and possibly also control volatility. In this optical perception, volatility is created by an inefficient pricing mechanism, with unknown information potentially emerging and surprising market participants who must then act quickly to adjust their positions; accordingly, supply/demand falls out of balance, and prices move to reestablish equilibrium. Despite the validity of this claim, however, the essential question eventually revolves around orders of relative magnitude and thus degree. A possibly equivalent supply/demand imbalance could materialize, of course, if a large majority of traders suddenly and synchronously—although not in a coordinated manner—elected to weigh on markets in the same direction.

In practice, at some point in a difficult fundamental environment, particularly when risk-free rates of return are negligible, a dominating trading presence can be counterproductive for three reasons. The first is that low risk-free rates—most likely negative in real terms—force managers into thinking they must seek some return to earn their keep, whether in terms of cost of capital or to justify their fees. The second is that uncertainty and “short-termism” lead the group to react like a pack of Pavlov dogs that rush into and out of markets at virtually the same time (the so-called risk-on/risk-off trade is but a convenient sound bite to describe this process). The third is that the few fundamental investors remaining are in a precarious situation: Short-term moves can shake the confidence of clients of these fundamentally oriented investors and thus expose them to massive cash flow shifts at the worst possible time. In short, gone are the days when one could calmly wait for a sound position to mature. Note that this change is not just a function of the proliferation of hedge fund managers; individuals have been lured by lower transaction costs and online brokers to believe that they can and should be traders as well. In short, the move from investor to trader is broader than a simple shift from traditional to hedge fund managers. Yet, the risk has been created that market behavior may differ from past experience and thus require some significant adjustment by cautious investors with true medium-to-long-term time horizons.

Are these days really gone, though, or does one simply need to rethink certain parameters? One might think that

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this kind of market environment could provide plentiful opportunities. After all, the ultimate investment opportunities are often said to arise when two conditions are met—first, a fundamental change or even dislocation, and second, extreme emotions! The current environment fits both criteria. Even though opportunities may be available, however, behavioral finance warns that we are not naturally inclined, as humans, to stay the course in the face of any form of adversity. Simultaneously, the tendency toward limited framing and overconfidence, the inability to view chance events for what they are, and the fear of developing regret often prevent us from giving ample time to managers to allow opportunities to come to fruition.

The change we thus may have to consider involves three possible dimensions:

- We may need to revisit our liquidity preferences. Particularly within a goals-based strategic asset allocation framework, we cannot afford to jeopardize the required liquidity to meet our lifestyle expenses over some period of time. However, do we really need to be totally or chiefly liquid within the non-lifestyle part of our portfolios? Eschewing some liquidity and investing in strategies that have a few of the attributes of private equity might be more sensible, both to keep ourselves in the game, even if it becomes uncomfortable, and to give managers a chance to see their analyses rewarded.
- Having potentially accepted the idea of a longer time horizon for certain assets or strategies, we may need to identify upfront what critical environmental risks are present and design appropriate responses should these risks materialize. A simple example can be found in the world of distressed bank loans, in the U.S. or abroad. Even though a “trade” might make sense in nominal currency terms when allowed to mature, what if a currency dislocation or a bout of inflation changes the economics of such a trade? When executed through a liquid instrument, such a change would simply require the liquidation of the position when and if the risks became more urgent. With the required longer horizon associated with reduced liquidity, however, one needs to have determined ahead of time what needs to be done and how, because selling out is not an option; for instance, what about hedging currency or interest rate risks then?
- We may need to revisit the role of certain “alternative strategies” in portfolios, if we effectively redefine sev-

eral of them as considerably less liquid than originally anticipated. While this might not require anyone to revisit return and volatility expectations for many of these strategies, it might make sense to incorporate some required illiquidity premium into whatever threshold return one used hitherto.

The foregoing may seem controversial, particularly because to keep the thoughts to some manageable word count, one must skip over several logical layers. Yet, even more than the notion that the insight may or may not be reasonable, actionable, or even valid, it serves as a reminder of the need for original thinking. Daniel Kahneman’s recent book *Thinking, Fast and Slow* makes a number of crucial points, one of which is particularly relevant: As humans, our typical inability to appreciate what the naïve outcome—the reference or baseline, as Kahneman calls it—might actually be is a serious cause of “inside thinking,” which leads many of us to make forecasts oblivious to the knowledge we actually have and prevents us from concluding that such forecasts are not realistic; Kahneman and his late research partner Amos Tversky dubbed this phenomenon the “planning fallacy.”

This idea relates to strategic asset allocation issues as well as periodic portfolio tilting or rebalancing. At some level, Kahneman’s insight suggests that strategically and tactically, investors might want to take a broader view of the range of potential outcomes in the current environment. Thus, although the current challenges in the world are not likely to be simple replays of past dislocations, we still owe it to ourselves to look into the past and across unfamiliar geographies to question whether our current view of the range of likely outcomes is sufficiently informed by what we know can and did happen in certain circumstances. In short, what we might view as a most likely outcome may well in fact look more like the best possible outcome or our “ideally desired” outcome rather than a realistic evaluation of reasonable alternatives. Similarly, is it possible that our worst fears may be little more than the middle of some reasonable range of forecasts? Hong Kong’s equity prices fell by 75% in U.S.-dollar terms in the last quarter of 1982; Japan’s equity prices fell by more than 80% from their peak in 1989 to their 2003 low (and subsequently became worse); Sterling fell by 75% from its post-World War II peak against the dollar to its low in 1995. Such large declines in certain instances in no way suggest that the resolution of the current structural crisis will induce market moves of a similar magnitude. Yet, should our evaluation of the range of what may

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happen not be explicitly informed by other extreme events that were equally unexpected when they did happen?

In conclusion, combining what may be a structural shift in the “balance of power” between investors and traders with a wider than currently anticipated range of possible outcomes—because of an equally structural global politico-economic change—may lead families to feel a need, or even a duty, to revisit both their investment policies and the way they approach the tactical decisions that they currently need to make. Strategically, are the assumptions underpinning the way in which their different goals are addressed at the planning stage still valid? Are the assumptions underpinning the determination of the desirable balance among various strategies—their implicit diversification properties as well as their explicit return and risk expectations—also still valid? Tactically, is it appropriate to stay with well-tested and often-used decision algorithms, or should the way their parameters are set be revisited?



The Spring 2012 issue of *The Journal of Wealth Management* begins with a timely article by Kenneth Matziorinis that analyzes the causes of the sovereign debt crisis in the euro zone. The author examines the policy alternatives confronting euro area governments and concludes that pooling fiscal risks, creating an EU Treasury, and issuing jointly backed euro bonds would be the optimal solution that would lead to the economic integration project in Europe.

The next three articles share a focus on broad policy issues. The first, by Bala Arshanapalli and William Nelson, investigates the best asset allocation scheme for retirement investing or accumulating wealth. They examine seven strategies, including the “110 minus age” rule of thumb and those employed by popular retirement mutual funds. The second, by Dokyoung Lee and Seth Masters, focuses on the complexities of long-term planning, which may seem overwhelming given today’s global multiasset, multicurrency investing environment. The authors suggest the use of a rigorous, forward-looking, comprehensive tool built on the multifaceted drivers of asset returns—leavened with a dose of humility. The third, by Michael Crook, examines the challenges associated with the creation of an investment policy for a foundation. He concludes that most foundations will be unlikely to maintain the inflation-adjusted value of their corpus—in addition to meeting the 5% distribution requirement—over the next 10–20 years.

The next four articles deal with different investment instrument issues. The first, by Dominik Helberger, asks why individuals buy structured products and proposes an explanation based on behavioral finance insights. The second, by Owain ap Gwilym, Andrew Clare, James Seaton, and Stephen Thomas, focuses on tactical equity investing across bull and bear markets and shows that portfolio performance can be improved by investing tactically using market state analysis. The third and fourth articles present interesting analyses of the use of equities to achieve certain commodity exposures, although they do not necessarily offer point, counterpoint analyses. The article by William Jennings examines energy stocks in the context of a diversified investment portfolio and demonstrates that a separate allocation to energy stocks enhances portfolio efficiency and potentially hedges against inflation and inflation surprises. The article by Timothy Atwill asks whether the intuitively appealing substitution of natural resource stocks for a futures-based commodity exposure is appropriate and concludes that it results in a less effective solution for inflation protection and diversification.

The next two articles explore different aspects of the hedge fund universe. The first, by Jerome Baesel, José González-Heres, Ping Chen, and Steven Shin, investigates the effect of S&P 500 Index correlation on the performance of hedge funds. The authors provide a practical approach for optimizing allocations to hedge fund strategies that are expected to benefit from “stock-picking” skills during low equity–correlation environments. The second, by Andrei Reztsov, presents a mathematically oriented approach to short-term capital allocation when one has only limited information and data.

The final three articles fall under the miscellaneous category. The first, by frequent contributors Guntur Anjana Raju and Harsh Prabhudesai, examines the survival profile of Indian initial public offering (IPO) issuers for a period of two decades (1990–2010). The second, by Sandip Mukherji, tests for mean reversion in abnormal stock returns that deviated more than one standard deviation from the mean. The results show stronger mean reversion in abnormal returns than in all returns for large- and small-company stocks. The final piece, by Jean Brunel, is a review of *Fabulous Finds: How Expert Appraiser Lee Drexler Sold Wall Street’s Charging Bull, Found Hidden Treasures and Mingled with the Rich & Famous* by Joanne Lee Drexler and James R. Cohen.

Jean L.P. Brunel
Editor