September 2012 Alvine Capital Newsletter

September Newsletter – Asset Allocation in an Uncertain World

Key issues---asset allocation has come a long way from simple fixed income or equity long only. Central bank induced ultra low interest rates have complicated the business of matching liabilities.

Key recommendation---investors need to work harder both with realistic aspirations and with diverse portfolio construction to achieve acceptable results. Inevitably, high returns will only come with greater risk.

Asset allocation is the division of an investor's portfolio by asset classes rather than individual investments. This may take the form of geographical, currency or corporate sector but, for the purpose of this article, we will focus on macro divisions. Over the past few years it has been shown that investors ignore the broad sweep of macro-economic forces at their peril. Much talked about studies by Brinson Beebower in 1986 and Yale finance professor Roger Ibbotson concluded that 90% of an investor's returns are due to correct asset allocation (Source: www.ibbotson.com).

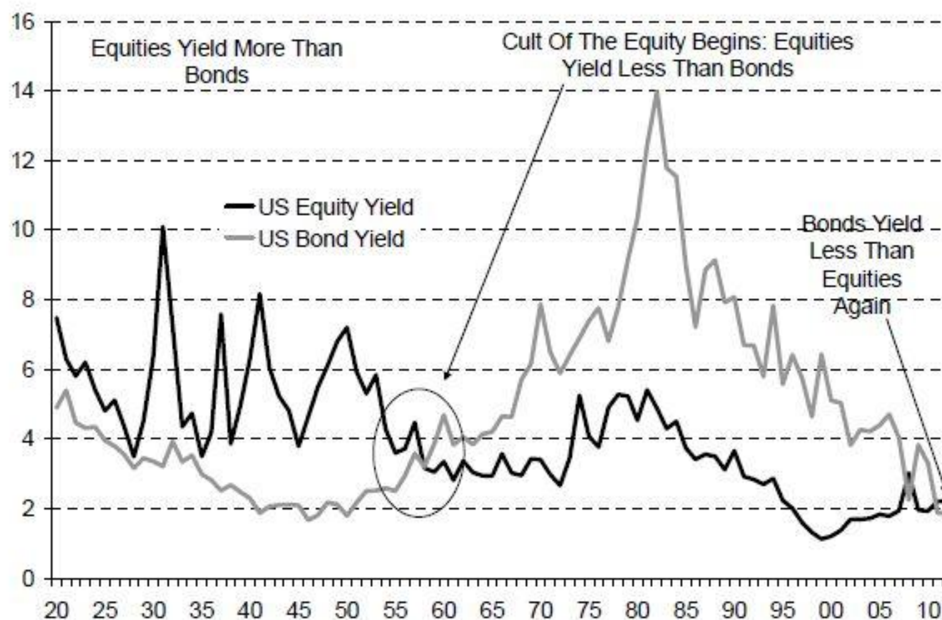
'The market always goes up' JL Collins (Source: www.jlcollinsnh.wordpress.com)

For most investment professionals born into the good times of the post war baby boom, this simple often repeated maxim was as good counsel as any. Although caveats about volatility and risk would be added, the belief was that historical data supported the view that the market always bailed you out. For the previous pre-war generation, used to a lower inflationary and interest world, this had not been such a simple truth.

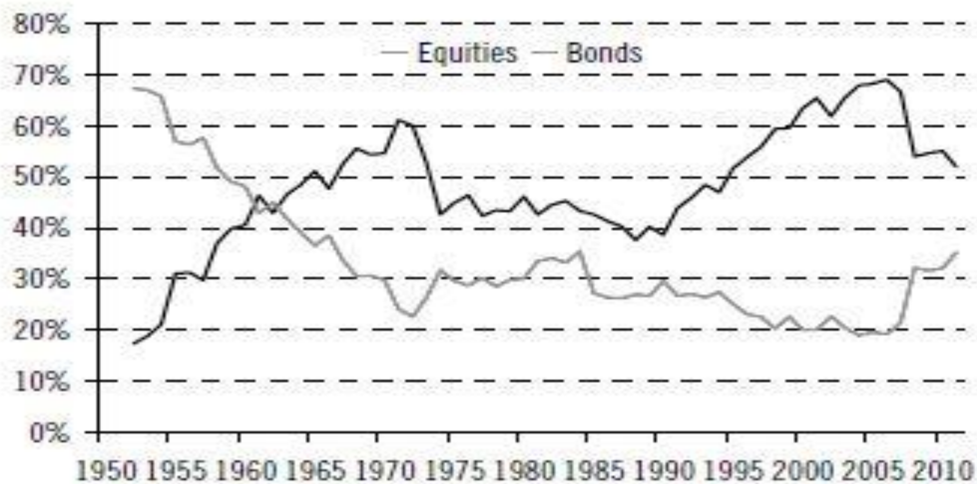
The rise of the equity cult can be attributed to ground breaking work by Ross Goobey who headed the pension fund of Imperial tobacco in the 1950's. His analysis challenged the official orthodoxy that prevailed requiring a heavy weighting towards gilt edged government stock. While it was true that these bonds were very likely to mature at par, and hence maintain capital for periods of rising interest, rates bonds would suffer on a mark-to-market basis. A broad based portfolio of dividend paying stocks not only had (at that time) **a *higher* yield,** but would be likely to rise in price as earnings grew.

Just as crucially Goobey saw the link between his liability pension costs spread over decades, and the assets. In speaking to the 1956 Conference of the Association of Superannuation & Pension funds he explained;

'stocks were a proxy of having a share in the economy and the growth of the country, in parallel with wages and salaries' (Source: www.pensionsarchive.org) A reasonable understanding for the sort of expectations his future pensioners would have, and thereby matching his asset with his liability. This created a perfect asset allocation for the next 50 years.



As equity markets took off, this approach gained followers across the pond. Warren Buffet has become the poster boy for this value, buy and hold strategy that has made him the third richest man in the world.



A man called Ralfe

John Ralfe former head of corporate finance The Boots Company (Source: www.johnralfe.com)

When the bull market for equities had run for fifty years notions of value had become stretched. In particular dividend yields had long ago declined below corporate bond rates. While this did not matter during those heady days of rising prices, at least some of the rationale for blindly following a buy and hold strategy was lost.

Ralfe challenged the prevailing asset allocation orthodoxy. Between 2000 and 2001 he switched the £2.3bn Boots pension fund from a previous 75% equity weighting to a revolutionary 100% bonds. This was heresy to most fund managers, and caused an unprecedented outcry amongst the investment community. Not only had Ralfe called nearly the top in equity valuations, he understood how much better bonds would be in matching his pensioner's liabilities.

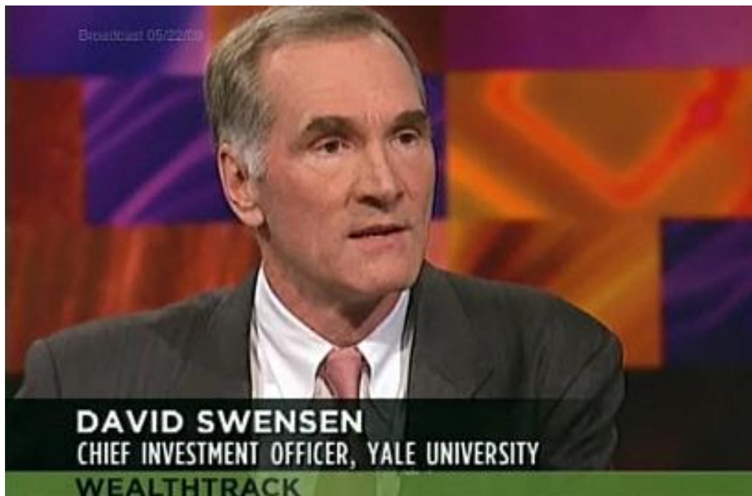
'The **bonds**, which are all AAA/Aaa sovereign issuers, **are a very close match for the maturity and indexation of accrued pension liabilities**....matching pension assets and liabilities has reduced risk for Boots' shareholders and creditors---they no longer face the possibility of increased company contributions' Ralfe wrote (Source: The Times letters 29/11/01).

Irrespective of how the various asset classes were likely to perform, the investment he had made would deliver the returns required, deriving perfect asset allocation.

The Yale model---for the longer term

The Boots pension scheme had a clear objective - to pay the accruing liabilities. For many investors, like family offices or University endowments, there is no matching requirement for investment return. Rather a desire over, perhaps a very long term horizon of many decades, to ensure growth of the assets.

While the 'Harvard model' has often received the accolades, it was at its arch rival the Yale endowment where the concept of a widely spread portfolio was born.



Devised by CIO David Swensen, the strategy suggested that investors should look beyond publically traded stocks and bonds. By participating in real estate, private equity, hedge funds, commodities and other alternative investments the portfolio would look more like the real world. **If the investment horizon was truly long term, then why would investors pay a price for liquidity that would not be used?** Further, these longer term plays would help to even out short term volatility and reduce high frequency trading transaction costs. 'The policy portfolio differs from a traditional stock/bond portfolio, includging allocations to less traditional and less-liquid asset categories, such as private equity, real estate and absolute return strategies' Robert Etti COO Harvard endowment (Source: www.hmc.harvard.edu).

Evolution of the Policy Portfolio by Fiscal Year

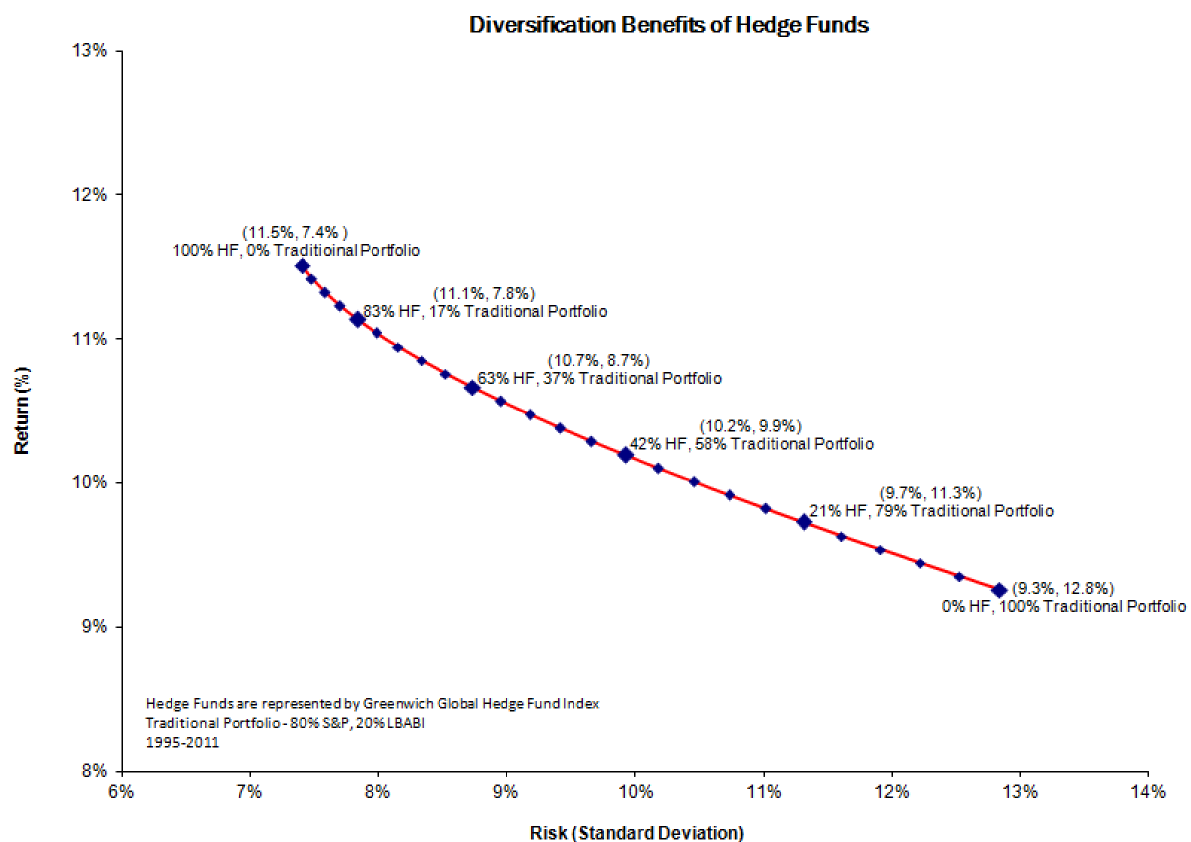
	1995	2005	2012
Domestic Equities	38%	15%	12%
Foreign Equities	15	10	12
Emerging Markets	5	5	12
Private Equities	12	13	12
Total Equity	**70**	**43**	**48**
Absolute Return	**0**	**12**	**16**
Commodities	6	13	14
Real Estate	7	10	9
Total Real Assets	**13**	**23**	**23**
Domestic Bonds	15	11	4
Foreign Bonds	5	5	3
High Yield	2	5	2
Inflation-Indexed Bonds	0	6	4
Total Fixed Income	**22**	**27**	**13**
Cash	**-5**	**-5**	**0**
TOTAL	**100%**	**100%**	**100%**

Harvard portfolio mix and changes (Source: Harvard University website)

By varying the mix and taking advantage of many different asset classes the portfolio has been successful. Asset allocation at work in the most sophisticated way.

Diversification reduces risk, but is no guarantee to performance

The first twelve years of the new century have ushered in a whole new world of volatility with investors bruised by several punishing cycles. While 2012 promises to be a more successful one for those with a 'risk on' many investors crave a less demanding environment.



Greenwich Alternative Investments (Source: www.greenwichai.com)

The appeal of alternatives has been in a large measure to iron out these swings. While questions have arisen about the final performance, *net of fees,* undoubtedly material reduction in risk has been achieved.

Multi-asset classes are no guarantee of success, far from it, as investors risk missing or being whipsawed by dramatic movements in performance. **'Reading about the Yale model does not make a Yale like returns, just as reading about Tiger Woods does not turn a mediocre golfer into a professional'** Forbes contributor Rick Ferri (Source: www.forbes.com 16/4/12)

Conclusion—this is not going to be easy in a low yield world

If all of us possessed the skill and resource of Ivy League giants then maybe we would enjoy similar investment success. The fact that even they need to employ legions of consultants and advisors, attests to the difficulty all find in judging the correct asset allocation. Of course any evaluation of risk must correspondingly require a similar consideration of aspirations and needs.

Irrespective of the skill sets required, the collapse in interest rates over the last five years in all western financial markets has made our lives much more difficult. The ending of the spectacular post-war bull market in 2000 has also closed off the buy and hold model.

Ross Goobey's analysis was good, but the opportunities were present for him. Likewise, it was a simple decision for Boots to back the switch into bonds, as this strategy was clearly going to deliver the investment returns their pensioners needed.

No such simple 'magic bullet' allocation exists today.

Asset allocation models can help investors to balance risks that have become all too correlated in fast moving markets. For instance CALPERS has revised the classification of investments into five categories—income, growth, real, inflation-linked and liquidity. This has given rise to placing corporate bonds and stocks in the same category, believing that they may have similar performance characteristics.

As the IMF concludes ' the global financial crisis changed longer-term asset allocation strategies, chiefly by making investors more risk conscious and prompting greater **focus on portfolio risk management'** (Source: IMF September 2011 Long-term investors and their asset allocation: where are they now?)

Model Portfolio

We may have waited for some time, but the Fed hardly disappointed! Not only was the size of QE3 impressive, its scope reinforced the message that central banks around the world are deadly serious. With the action by the ECB, these two moves should dispel the notion that aggressive, and prolonged monetary easing is out of bullets.

Some commentators have expressed a concern that all this stimulation may not in fact help the 'real' economy. This remains to be seen. The key fact for investors is to understand that one of the desired effects is to see higher asset prices.

A bullish 'risk on' financial world will help enable corporates to borrow more cheaply, and hence it is hoped they will invest. For Europe the same conditions can allow far greater financing conditions for the continent's hard pressed governments.

As the Fed/ECB/BOE/SNB hoover up assets this acts as a sort of '*market ramp'* propelling prices higher.

Some commentators have repeatedly feared that without this, 'sugar high' markets will fall quickly back. It is our proposition that this largesse will continue, and will surprise markets. See comments from Fed' Williams already staking out a claim for 'operation twist' to be renewed in 2013 **http://www.bloomberg.com/news/print/2012-09-24/williams-says-fed-to-pursue-qe3-until-job-market-rebounds.html**

For this reason we remain bullish and will make no change to our investments.

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