portfolio construction

CONFERENCE

Tuesday 24 – Thursday 26 August 2010 | Sydney

[Asset Allocation Masterclass 2010]

Asset allocation – putting theory into practice

Tim Farrelly
Principal, farrelly's Investment Strategy

portfolio construction CONFERENCE

Tuesday 24 – Thursday 26 August 2010 | Sydney

Implementing asset allocation

- Philosophy is critical
- More than one way to skin a cat
- Ensure process is aligned with capabilities

Philosophy is critical

- What are you trying to achieve?
- Can you do better than passive?
- What are your strengths and weaknesses?

farrelly's

More than one way to skin a cat

- Setting long term strategy
  - Risk profilers
  - Goals based
  - Financial risk tolerance
- Ongoing management
  - Value based
  - Regular adjustments
  - Staggered implementation
  - No brainers only

farrelly's

Aligning process and capabilities

- Do you have the tools?
- How often do you do you reviews?
- Do you have the skills (or access to them)?

Implementation

- Alignment with philosophy
- Alignment with skills
- Alignment with ability to execute

[Asset Allocation Masterclass 2010]

Asset allocation – putting theory into practice

Patrick Bennett
Head of Research, Shadforths Financial Group

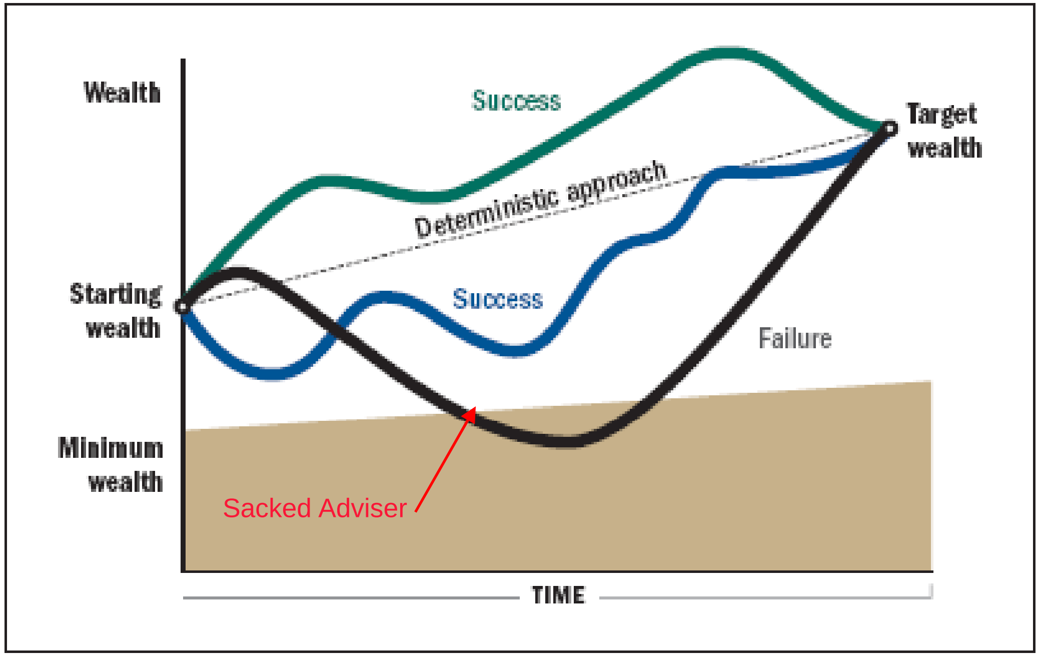
portfolio construction CONFERENCE

Tuesday 24 – Thursday 26 August 2010 | Sydney

Introduction to Goals Based Investing

- Time, Risk and Behaviour
- Shortcomings with the traditional model
- Goals Based Investing concepts
- Cashflow
- The capital allocation process
- The Benefits

Time - The journey matters



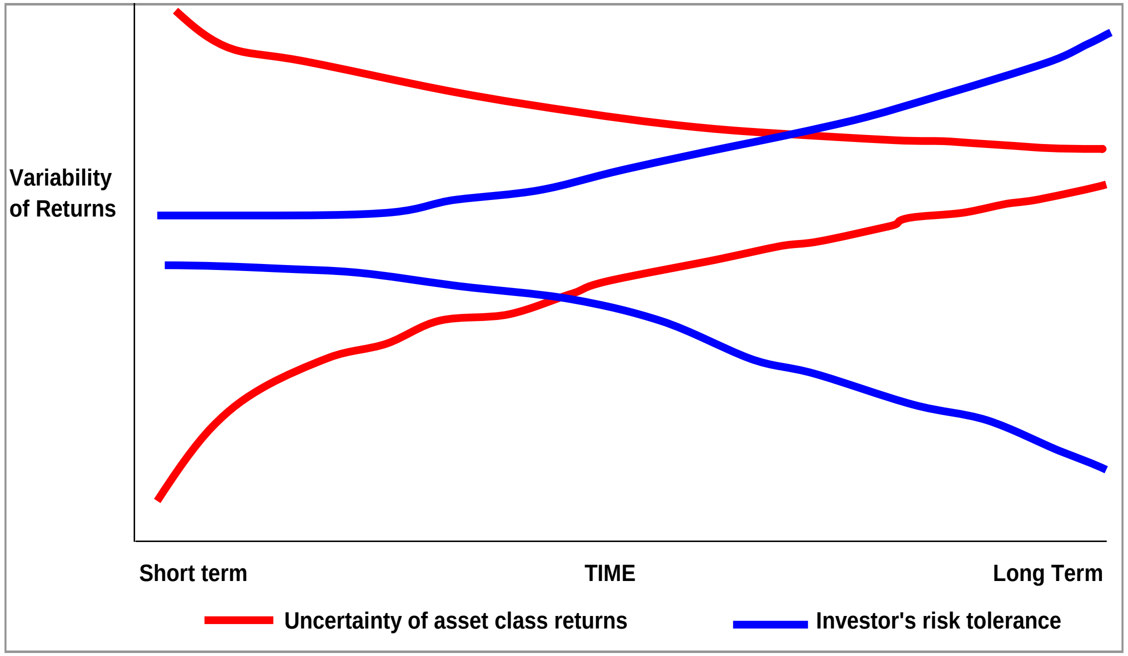
Source: Beyond Markowitz, Chhabra 2005

Short term risk tolerance may be mismatched to long term objectives

Perception of loss of wealth is important

Very long term average returns ignore the pain of cashflow volatility

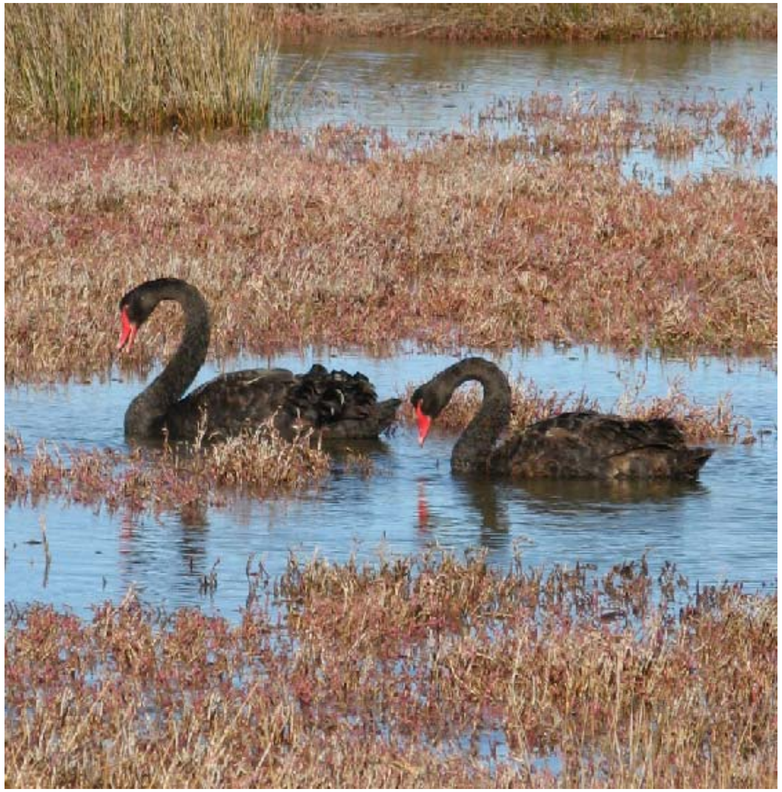
Time - The investment paradox



- Asset class risk and investor risk tolerance have diametrically opposing time horizons.
- Client time horizon is the critical factor in capital allocation decisions (more than usually thought!!)
- Wishful thinking isn't going to change the uncertainty in asset class returns.
- So, we have to change the way we manage investors' exposure to risk.

Managing extreme events

- Do we understand our clients' real capacity for 'Black Swan' events?
- Size, frequency, persistence of unexpected losses can be far more than we imagined.
- Traditional risk modelling using long-term annualised volatility fails to capture
  - multi-period events
  - non-normal distributions
- That's why 1 in 70 year events come along every 3 years or so.



Managing extreme events

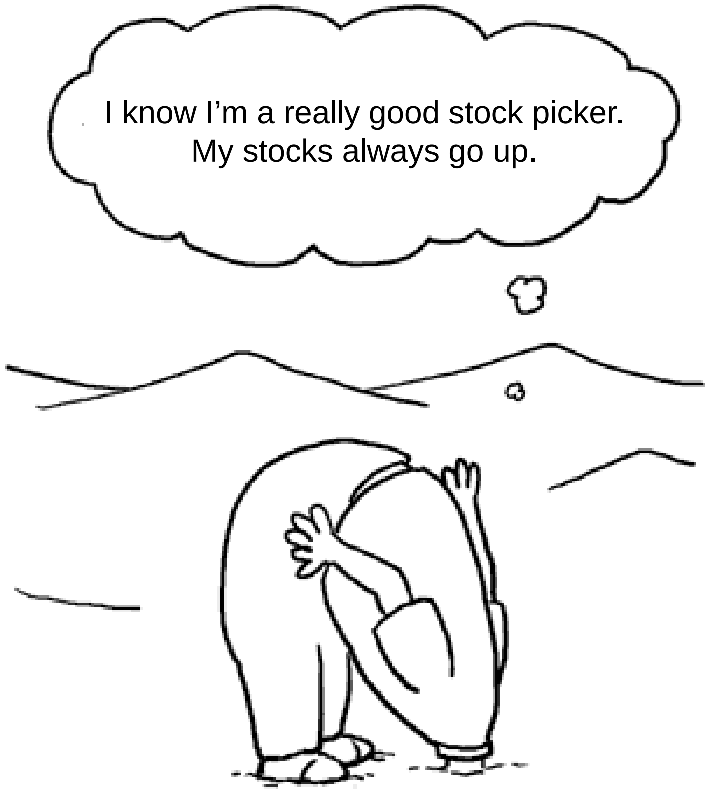
The Efficient Frontier has a flaw.

- Mean Variance Optimisation assumes long term Std Dev = Risk.
- MVO ignores:
  - Pricing risk (Markets can be extremely mispriced, Tech in 2000)
  - Fundamentals risk (Gearing in REITs, credit spreads in 2007)
  - Timing risk (Different multi-period cycles exist)
- MVO fails to capture short term spikes in correlations

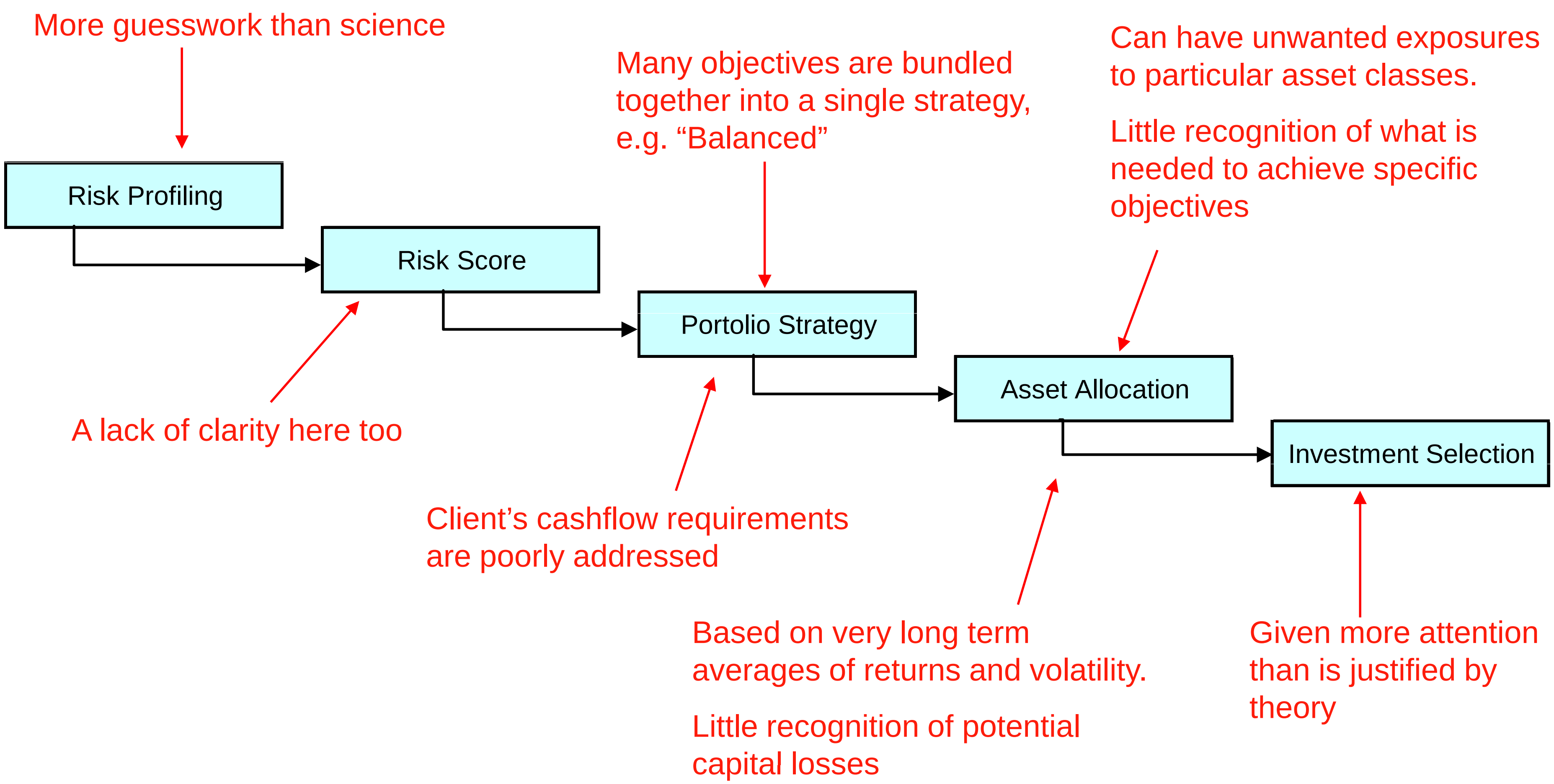
Result = A false sense of confidence about short-medium term risk

Behavioural problems

- Investors exhibit *overconfidence, over-reaction, hindsight bias, belief perseverance, regret avoidance, illusion of control, myopic loss aversion, reference dependence, mental accounting, bias towards optimism, anchoring, herding, narrow decision framing,* etc, etc.
- And those are the smart ones
- People just like us!

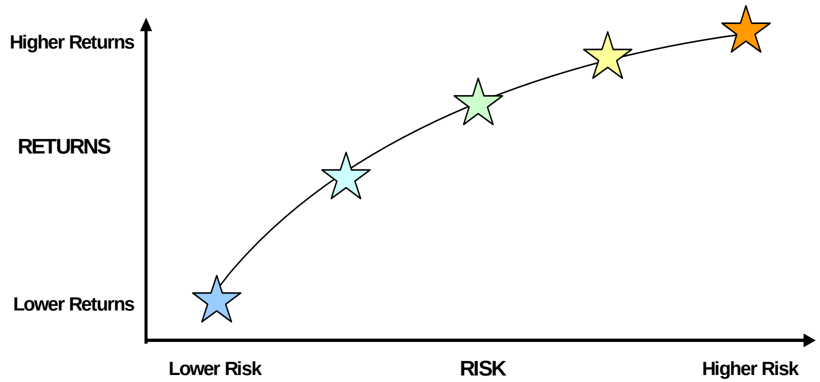


The traditional planning process



Shadforth Financial Group

The traditional portfolio model



Type of Investor	Defensive	Conservative	Moderate	Growth	Aggressive
Shares	5%	25%	50%	65%	90%
Property	5%	5%	10%	15%	10%
Fixed Interest	60%	40%	35%	15%	0%
Cash	30%	30%	5%	5%	0%

OK to a point, but….

- Doesn’t always work (2000-2003, 2007-2009)
- Very prescriptive SAA
- Limited flexibility to handle client-specific requirements
- Standard industry stuff. No differentiation
- No competitive performance advantage
- Not a compelling story for HNW clients
- Sheer luck, not good planning, determines what the client gets.

A poor understanding of risk

Conservative	Moderate	Balanced	Growth	High Growth	Aggressive
70 / 30	50 / 50	40 / 60	30 / 70	15 / 85	0 / 100

Does the client really understand what all this means?

Can they answer these basic questions?

1. *How much money might I lose in a bad year?*
2. *How often might that happen over, say, the next 15 years?*
3. *How long will it take me to recover any losses?*
4. *How much cash will I earn each year from my investment?*
5. *Will I be able to keep ahead of inflation?*

Shortcomings in traditional theory

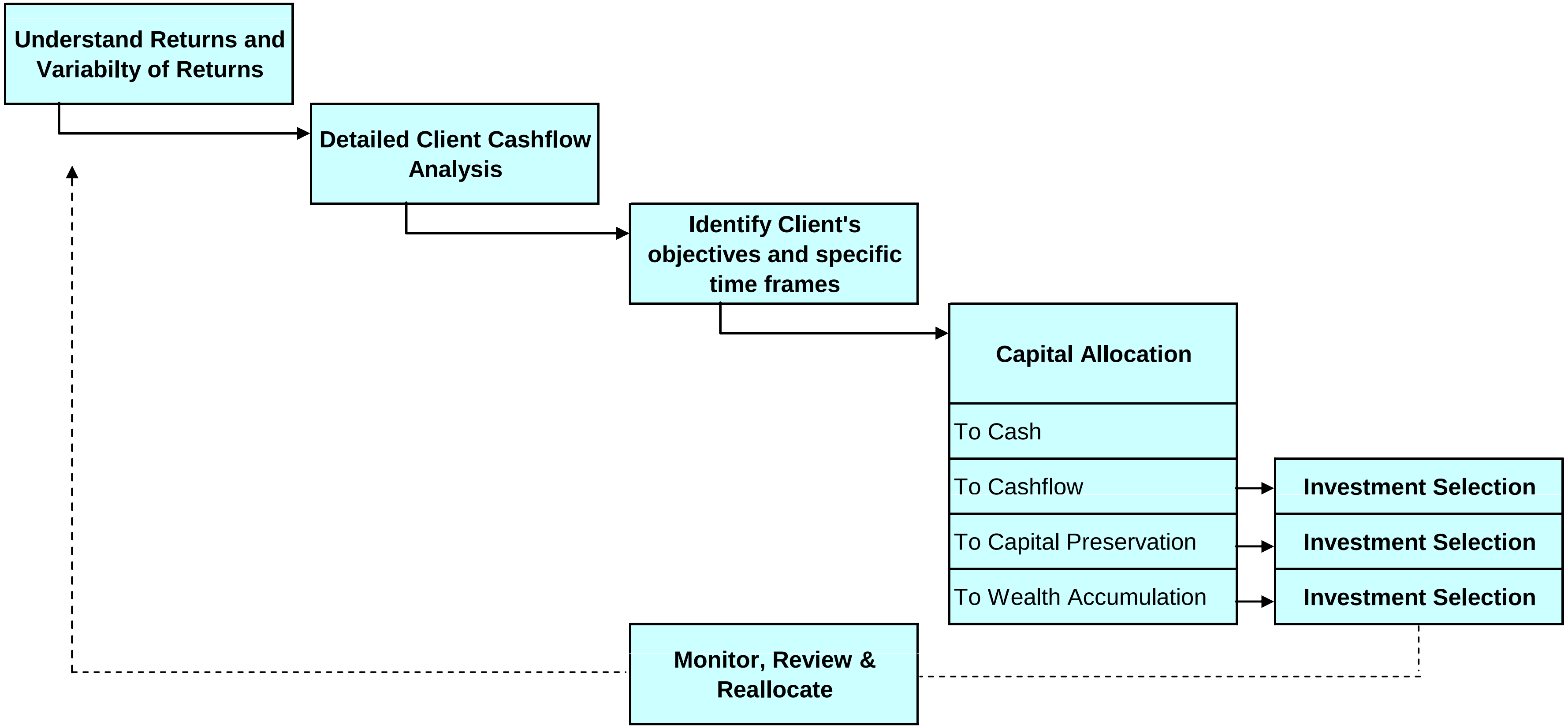
Traditional Finance Theory	The Investor's Perspective
Investors have a single objective	Investors have multiple concurrent objectives
… and are completely rational in the way they seek to achieve this objective.	… which create what may seem to be "irrational" or sub-optimal trade-offs.
Investors are not concerned by short term events. It's the long term average return that matters.	Short term lack of cash and capital losses matter enormously.
Risk tolerance can be summarised with a single risk profile.	Investors have very different ideas about what is an acceptable risk for each goal.
Risk is volatility of returns.	Risk is capital loss, or their inability to meet cashflow needs.
Investment success is defined by annualised returns vs. standard deviation.	Investment success is defined by the achievement of specific goals and absolute rather than relative returns.

We do not speak the same language!

The Concept

Client's Goal	Client Objectives	Investments
Not jeopardise my basic standard of living	Access to enough cash for my identified needs	Must have assets (safety, capital protection, little down-side risk)
	Adequate net cashflow to meet spending needs	
Maintain my lifestyle	Protect my capital against inflation	Market assets (market level performance from a diversified portfolio)
	Steady wealth accumulation for the future	
Enhance my lifestyle	Aspirations of becoming rich	Aspirational assets (increase the upside using more risky assets)
	Legacy, philanthropy	

A new advice process



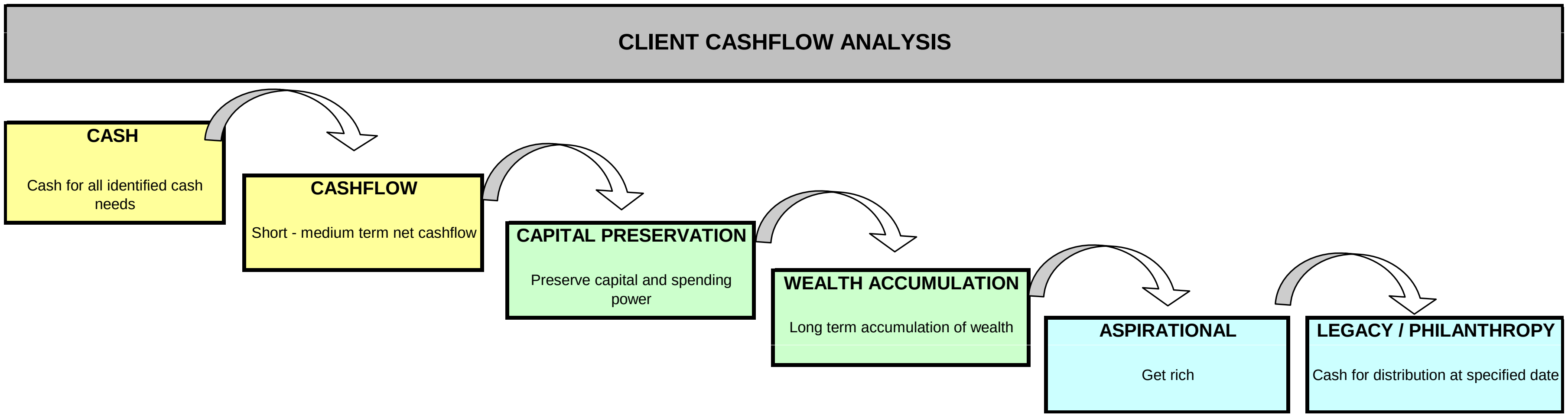
The starting point

- Invest from the clients' perspective → their goals, not their risk profile.
- Accept the fact your clients are not going to be "rational".
- Traditional risk profiling is not a good capital allocation tool.
- The key is really understanding the client:
  - What their specific goals are;
  - What their actual cashflow needs are ("must have" vs. "like to have")
  - How they think about risk for each of their objectives.

Cashflow analysis

- Cashflow is fundamental to the whole process
- Identify the projected growth and consumption of capital
- Identify priorities (cash needed now, future liabilities, etc)
- Identify shortfalls in cashflow and accumulation
- Cashflow modelling requires realistic assumptions of the expected asset class returns:
  - Take into account optimistic and pessimistic scenarios;
  - Reflect the right investment horizon for each client objective.
- Test the sensitivity to great and disastrous market conditions

Capital allocation process



Consider the capital allocation process as a cascade of priorities which will:

1. Satisfy the client's immediate requirement for cash (cash in the bank)
2. Provide for their net cashflow requirements as they fall due
3. Preserve their current lifestyle and preserve their capital (reduce market risk)
4. Grow their future wealth (get market returns); and then finally …
5. Achieve their goals to get rich or pass on their wealth (take bets)

Capital allocation process

- First allocate the amount needed to be held in cash.
- Allocate into TDs the money needed for “essential cashflow”
- The residual capital can be allocated to meet the other LT objectives.
- Each sub-portfolio has its own discrete SAA
  - Defined return objectives and sensitivities;
  - Defined acceptable risks (capital loss, volatility, liquidity, drawdown, etc).
- The client has multiple goal-specific SAAs – not just one “Balanced” SAA.

Capital allocation process

What might the clients' capital allocation look like? To generalise …..

	Need for Cash	Need for Cashflow	Need for Capital Preservation	Need for Wealth Accumulation	Desire for High Returns
Accumulator	Enough cash	Little	None	Half	Half
Mid Aged	Enough cash	Little	Some	Most	Some
Retiree	Enough cash	Most	Remainder	None	None

One client ….. several discrete needs …… several discrete portfolios

Capital allocation changes as the client's circumstances change

Each portfolio has a specific purpose, to deliver one part of the client's strategy

Implications for asset allocation

- Strategic Asset Allocation is simplified:
  - "Defensive" assets are typically held in the Liquidity, Cashflow and Capital Preservation part of the client's capital allocation.
  - "Growth" assets are typically held in the Wealth Accumulation and Aspirational part.
- Market risks can be allocated more appropriately.
- Diversification is also achieved within each of the portfolios.
- Can implement a Core + Satellite approach within each portfolio.
- Asset allocation is primarily determined by the client's goals.

Implications for risk management

	Cash	Cashflow	Capital Preservation	Wealth Accumulation	Aspirational
Client's Concern	Absolute $ value, absolute liquidity	Cashflow <$80,000 pa that I need to live on	Not preserve my capital in real terms	Underperform the compounding inflation rate.	Will I ever get my capital back?
Acceptable Risks	No capital loss whatsoever	No negative quarters I can live on about 10% less than the amount I prefer to have.	1 year in 7 can be negative. Capital losses not to exceed 10%pa	1 year in 5 can be negative. Capital recovery in 2 years	1 year in 3 can be negative. Capital recovery in 3 years

Each portfolio has its own risk profile to match its specific objective.

Underperformance in one part does not mean your whole plan has failed.

Benefits to the Investor

- Capital allocation commences with the most important – cash and net cashflow requirements - then cascades down.
- Investment solutions to achieve client specific goals.
- More understandable. Investors will be more likely to stick to their strategy.
- Performance is measured against benchmarks understood by the client.
- Portfolio objectives are now absolute (e.g. $ and time), rather than relative to annualised market returns.
- Risk is closely matched to investor’s goals.

Benefits to the Adviser

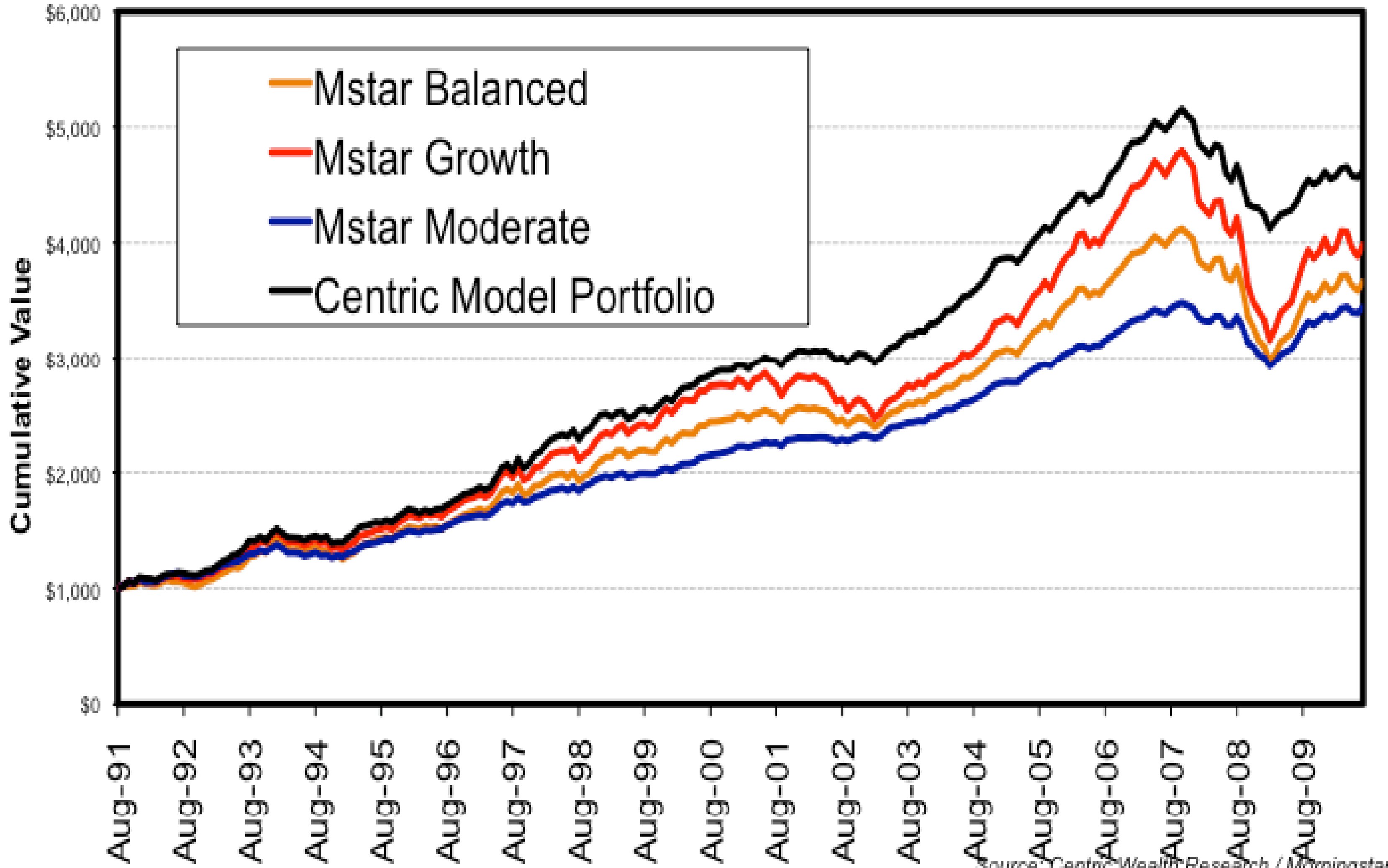
- You can focus on really understanding the client and developing their strategy, not playing at portfolio manager.
- Building block approach gives great flexibility and “stage of life” management.
- The portfolios implement the solution in the way advice is actually given.
- Underperformance in one component does not mean your entire strategy has failed.
- The concept is understandable and hence easier to sell.
- Appeal to HNW and retired engineer clients.
- Investment risk is managed, business risk is reduced.

[Asset Allocation Masterclass 2010]

Asset allocation – putting theory into practice

Robert Keavney

Centric Wealth Absolute Return Model Portfolio -v- Morningstar Indices 31 August 1991 to 31 July 2010



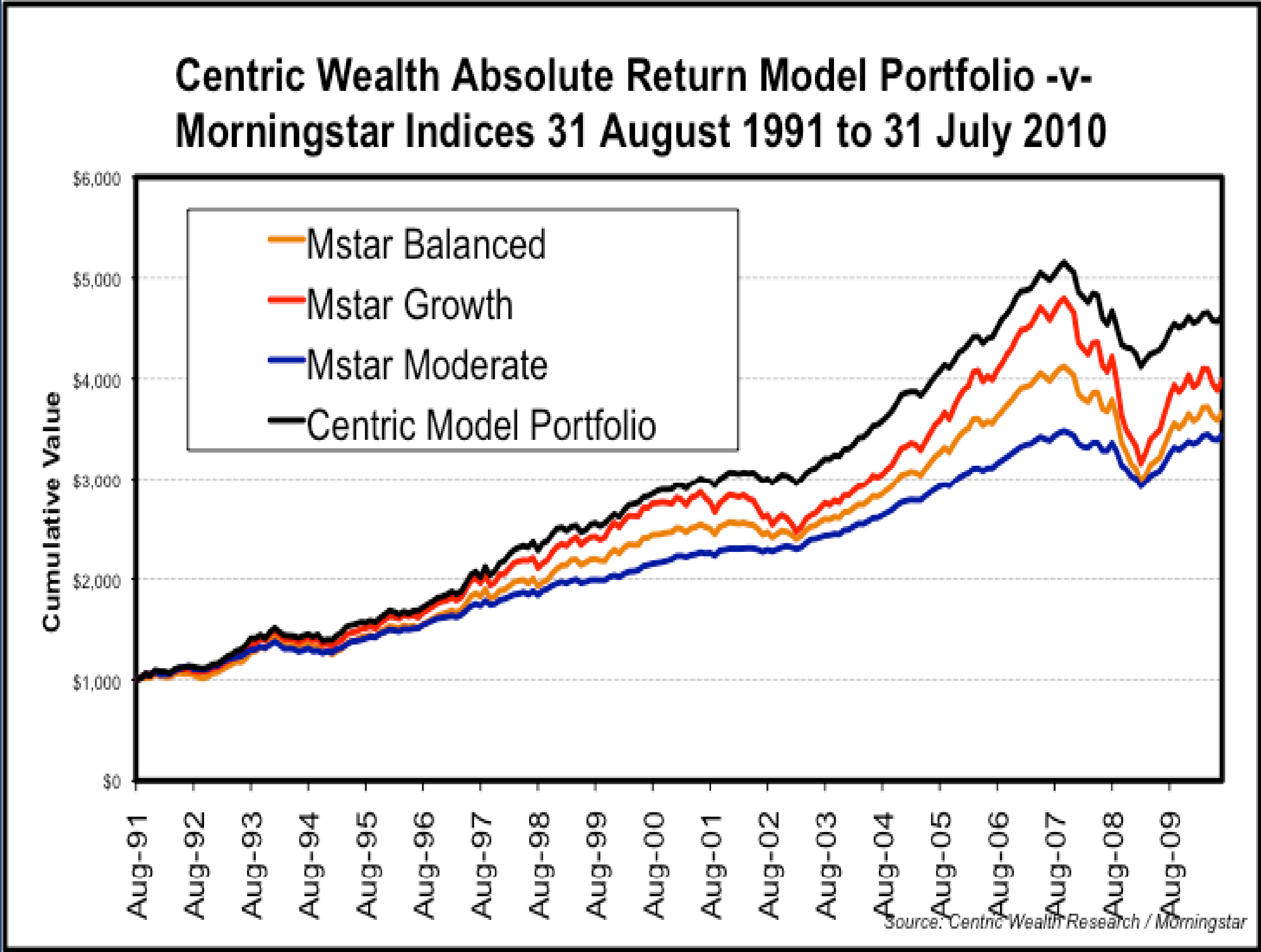
Source: Centric Wealth Research / Morningstar

The Long Term Impact of Big Declines

- 20% pa for 9 years, -50% in 10^{th} year

- 10% pa for 10 years

  Almost identical results
  (10 % pa slightly better)


Centric Wealth Absolute Return Model Portfolio -v- Morningstar Indices 31 August 1991 to 31 July 2010
Mstar Balanced
Mstar Growth
Mstar Moderate
Centric Model Portfolio
Cumulative Value
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
Aug-91
Aug-92
Aug-93
Aug-94
Aug-95
Aug-96
Aug-97
Aug-98
Aug-99
Aug-00
Aug-01
Aug-02
Aug-03
Aug-04
Aug-05
Aug-06
Aug-07
Aug-08
Aug-09
Source: Centric Wealth Research / Morningstar

Australian Investment Psychosis

Austral-equit-osis

portfolio construction

CONFERENCE

Tuesday 24 – Thursday 26 August 2010 | Sydney