portfolio construction CONFERENCE
24/25/26 August 2010 | Australian Technology Park , Eveleigh, Sydney
Critical Issues Forum Research Paper

THEPAINREPORT
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Alice in Wonderland meets The New Reality

"Why, sometimes I have believed as many as six impossible things before breakfast"

Issue #14

25th August 2010

I have argued for some time now that the world faces a growing divide between those nations that are submerging and those that are emerging and have described this as 'The New Reality.' I have also suggested that the submerging nations will spend less and save more and that the emerging nations will spend more and save less; this 'great divide' is not determined by geography but by debt.

In essence the submerging world suffers beneath a mountain of debt which will necessitate a decade or more of fiscal austerity and consumer frugality whilst the emerging world is underwritten by billions of consumers eager to buy their first car, open their first bank account, be the first in their family to go to university and not live in the same house as their grandparents.

In Emerging Asia, we have 3 billion consumers who have a voracious appetite for discretionary consumer goods that for so long have been out of reach. Their savings are high and their debt levels are low. So, here we find the new drivers of the global economy-and the automobile!

Today, we see Vietnam rising Phoenix-like from the ashes of a truly brutal history, full of energy and enthusiasm and eager to engage with the rest of the world. Vietnam, to my mind, serves to illuminate the remarkable potential of developing Asian nations and it would be imperial arrogance to presume that the nation of great innovation, which gave us that Frankenstein creation, the Ninja mortgage, could drag the emerging world down with it. History teaches us that empires rise and fall and the laws of economics usually tell us why. America, the leader of the submerging world, gorged for too long at the trough of debt and now faces an 'epic' adjustment of credit contraction. Conversely, and fortuitously, Asia faces an equally 'epic' period of credit expansion and hopefully not the same conclusion.

But I have said all of this before and we now need to consider what this all means to your investment portfolio and allows me to introduce Alice to our story.

In a delightful and memorable exchange in Lewis Carroll's 'Alice in Wonderland', we have Alice in conversation with the Queen: "There's no use trying", Alice said, "One can't believe impossible things." "I daresay you haven't had much practise", said the Queen. "When I was younger, I always did it for half an hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."

It is my view that the great majority of the money management world live in an 'Alice in Wonderland' world of make believe and fantasy that is detached from reality and most certainly the 'New Reality.'

So, let's consider some of the many impossible and ridiculous 'things' that much of the investment industry practises and believes in before breakfast each day.

Let's start with that monstrosity the Efficient Market Hypothesis (EMH) and let us all please agree, once and for all, that 'bubbles' do occur and that we, and hence the market, are not at all times rational and any hypothesis that attempts to say we are, is not itself rational. Life is not a simple and elegant linear extrapolation and we need to build portfolios that reflect reality. Roger Lowenstein, author of 'When Genius Failed' and 'The End of Wall Street' perhaps put it best, when he recently said, "The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the efficient market hypothesis."

Discussion and debate about the EMH may well be a touch esoteric but I can assure you that it is at the conceptual heart of our most recent crisis, since if one believes that markets are rational then at any point in time one can validate the price of an asset or security and hence bubbles, according to this Chicago born hypothesis, can never exist.

We now need to discuss the issues of benchmarks, relative returns and that pernicious and peculiar statistical measure, tracking error.

One of the most extraordinary aspects of our industry is the massive divide between the investment objectives of much of the industry and their clients. Indeed, I know of no other enterprise where the respective interests are so misaligned. Investors expect positive returns and money managers deliver relative returns. Money managers win awards even if they lose money for their clients. How can this be? Money managers make money for themselves whilst losing money for their clients. Once again, how can this be? Well, the plain and simple truth is not pleasant, for we all know that we hide behind a benchmark called the market. We can dress this up in all kinds of market jargon and let's be frank we have done an amazing job, as we have fooled the media, the regulators, the research houses, our clients and, perhaps, even ourselves. We have managed to convince the world that losing 20% of our client's money is a commendable and outstanding result if the market has fallen 25%. We even pretend that tracking error is a measure of risk and yet we know full well that it measures risk relative to a benchmark and not actual risk. Most of us know that tracking error is a cynical tool employed to measure our business risk rather than our client's actual risk. It's our dirty little secret and it's never likely to be mentioned at any BBQ conversation. By all means sell your clients an index fund- it is what it is without any pretensions. But, please don't tell me your relative return closet indexation fund is active, because you and I both know it isn't.

In March 2000 News Corp reached $28.00 and comprised 18% of the Australian market. Every money manager in the nation thought it was obscenely expensive, and said as much ,and yet every single one of them invested in it, not for themselves of course, but for their clients; all in the name of tracking error, relative returns and being part of the pack.

This, I hope you agree, makes neither cents nor sense. So how do we stop this nonsense? Very simply, we move to a cash benchmark. If an investor's ultimate objective is to make a return above the 'risk free' cash rate available in a bank, then surely that too should be the money manager's investment objective. This simple, but profound, change would then enable the money manager to buy stocks they like and sell stocks they don't like, rather than having to own stocks they hate just because they are a significant part of their benchmark.

The practise of 'closet indexation' has led to some painful and extraordinary outcomes, such as money managers feeling compelled to have an exposure of approximately 35% of their client's portfolio invested in technology stocks, as at March 2000, given that sectors significant weighting in the benchmark.

Today the situation is even worse as we see that the great majority of international equity portfolios are benchmarked against equity indices which are heavily weighted to the submerging nations. Perhaps we should now refer to these as the Mainly Submerging Country Indices.

If you believe, as I do, that the emerging nations will grow faster than their submerging counterparts then surely this makes no sense whatsoever. Investing, and life for that matter, requires a continuing assessment of the risk reward ratio and in my view the risks lie in the submerging world and the rewards are to be found in the emerging one.

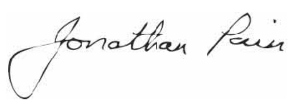
Surely, you would want your client's portfolio to reflect the undeniable reality that there is too much debt in the submerging world. Surely, you would not wish your client to have a 'set and forget' portfolio which slavishly tracks a benchmark with a 70% exposure to the submerging world. Hopefully, you blush, as I once did when telling a client how well they had done, having lost 'only' 20% of their money in contrast to the market which had fallen 30%.

If, however, you believe, as the Queen told Alice, in six impossible things before breakfast and that the Intergalactic Monetary Fund will rescue the submerging world and extinguish all of their debt, then continue as you are.

"In a world where we lurch from the inconceivable to the probable with no time to imagine the possible," (Terrence Keeley, FT, July 26th 2010), perhaps it is time to abandon a money management model which has not served us well. Perhaps it is time to build portfolios which better reflect the reality of the world we live in, rather than that of a bygone age. Moving to a cash benchmark would be a giant leap in the right direction and many money managers are now moving down this path. A majority, however, are still influenced by the 'research houses' who are the gatekeepers between the money and the managers and so often reject those who don't quite fit in their benchmark driven boxes. Such conduct, by the research houses, has no doubt helped fuel the 'relentless pursuit of mediocrity,' that is so prevalent in our industry.

In conclusion, I urge you to embrace 'The New Reality' and its implications for your investment strategy. In time, the emerging world will save the submerging world and this story has a happy ending. In the meantime, however, the submerging world faces a Japanese style deflation and I can only hope that a decade from now, having had a profound insight in hindsight, that you don't look back and say how obvious that was.

All the very best,



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