building shock resistant portfolios

portfolio construction

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Killing the Sacred Cows

A Primer on Building Better Portfolios

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August 2010

BT Investment Management

Agenda

1. The Good and Bad Of An Ugly GFC
2. Slaughtering Some Sacred Cows
3. Building Better Portfolios

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A typical diversified fund over the last 10 years

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

→ The GFC has been very difficult for investors.

→ Beyond the huge volatility and roller-coaster returns different investors have experienced different returns depending on their entry point.

→ The experience for pure equity investors has been even more unpleasant.

→ What have the problems been and what can we do about them?

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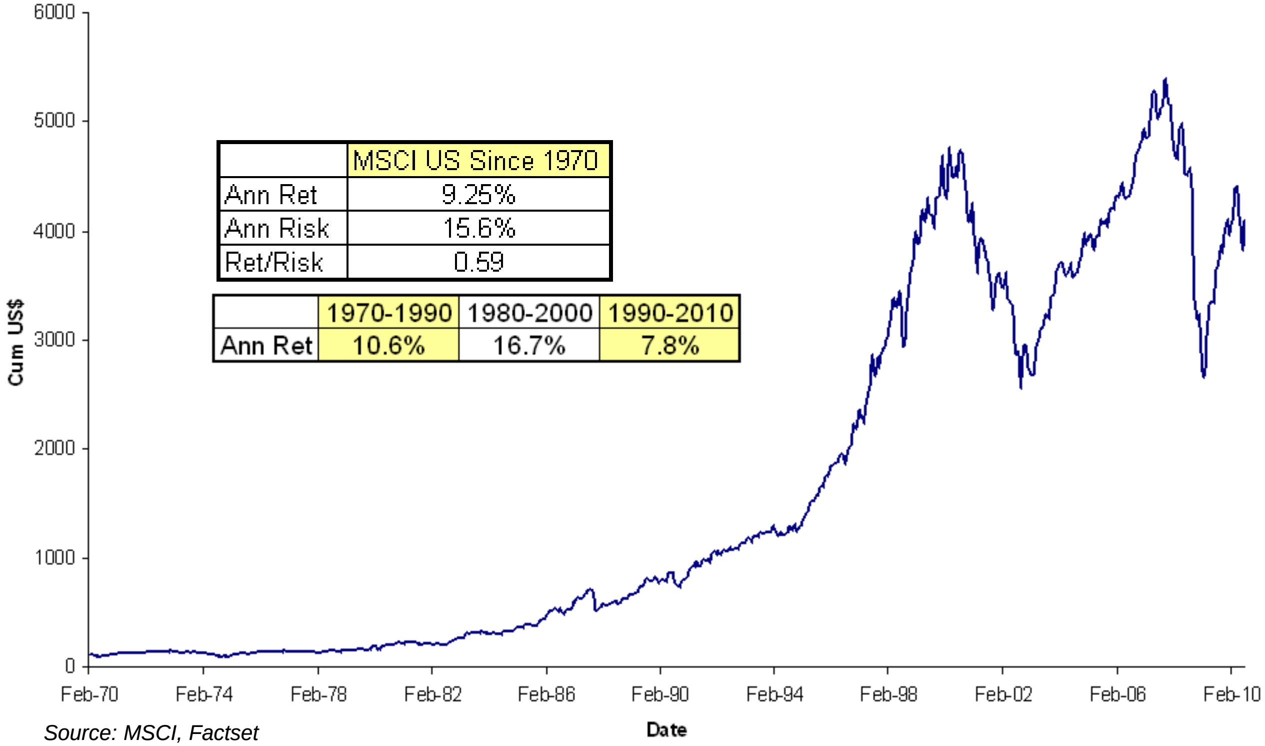
Challenge the Dogma!

- Equities for the long run!
- Bonds are boring but safe.
- Alternatives are too risky and the devils work!

The 'Cult' of equity

- Much of the financial press and media concerned with stock investing. Investing in stocks is almost a religion.
- So are stocks a good investment?

Equities for the long run....sort of!



	MSCI US Since 1970
Ann Ret	9.25%
Ann Risk	15.6%
Ret/Risk	0.59

	1970-1990	1980-2000	1990-2010
Ann Ret	10.6%	16.7%	7.8%

Source: MSCI, Factset

- Over time stocks give you c. 8-10% per year regardless of the market invested in.
- These great returns are generated at the price of some risk. As in the previous example your starting point is very important.
- Note that while returns vary considerably risk does not.

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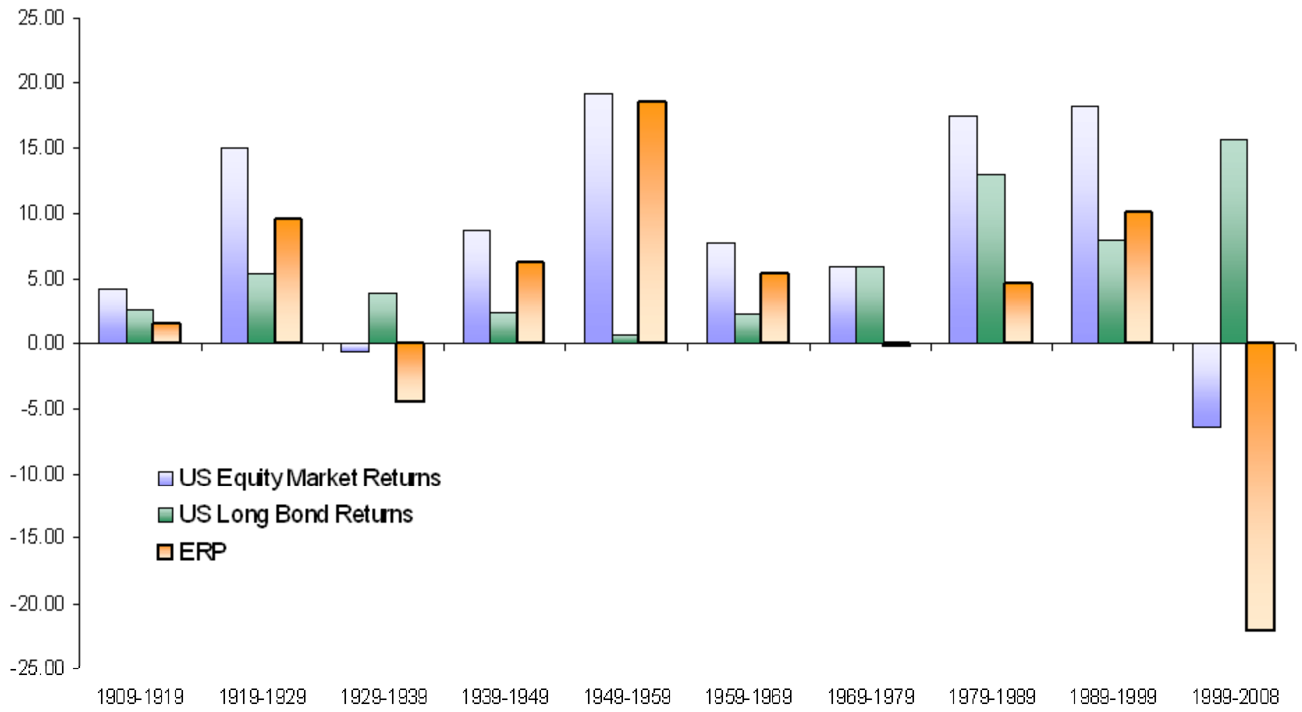
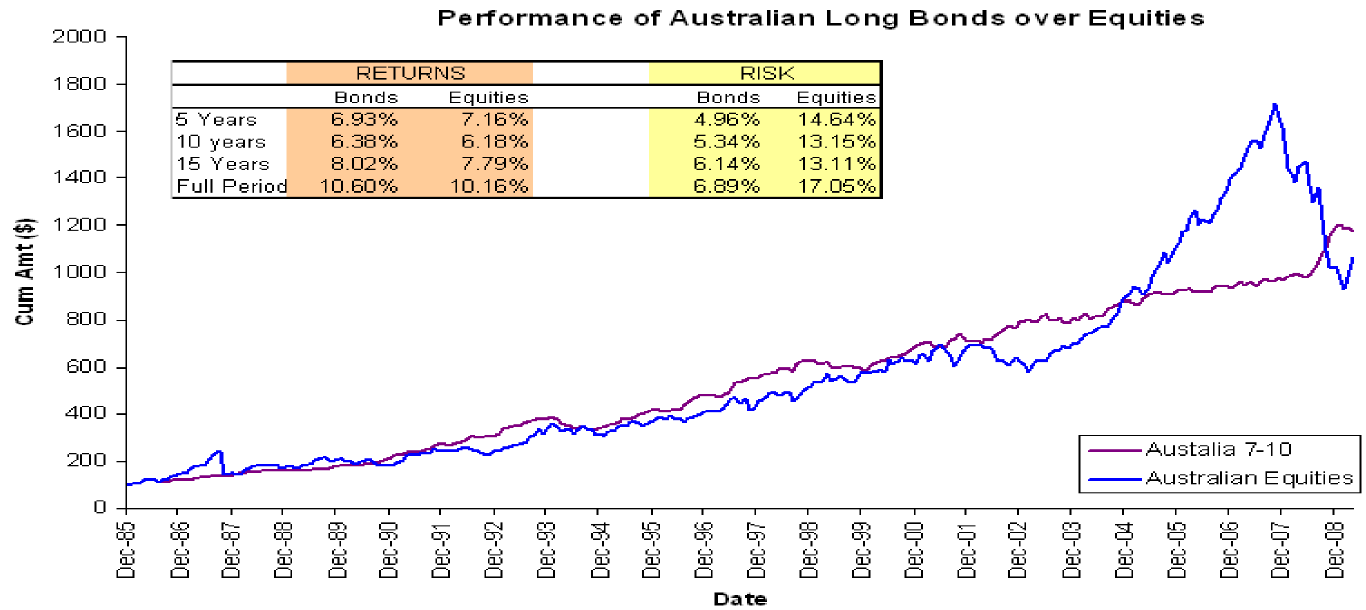
Do Stocks Always Beat Bonds?



Source: Federal Reserve

- The ERP varies considerably over time.
- Stocks do beat bonds over time but not by as much as people think and not as consistently as they assume.

Bond investing over time



Source: Bloomberg, FactSet

- Over many periods simply buying a basket of long Australian bonds outperforms equities. This is true outside Australia as well.
- They also take on much less risk to do this.
- But are they a ‘safe’ investment?

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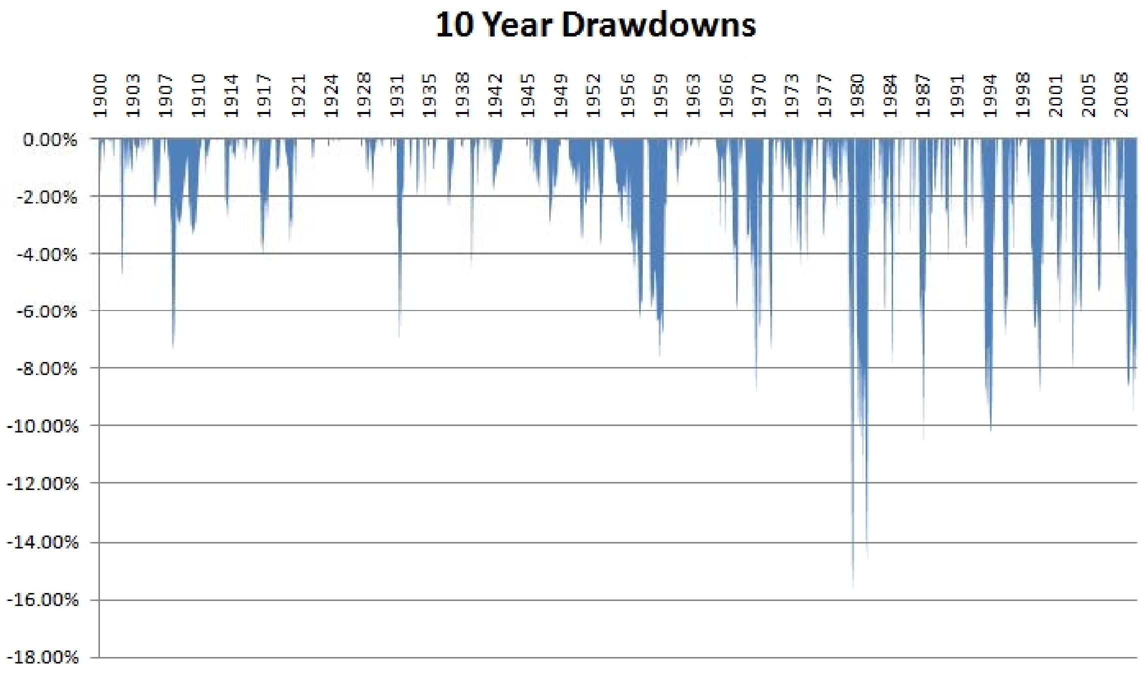
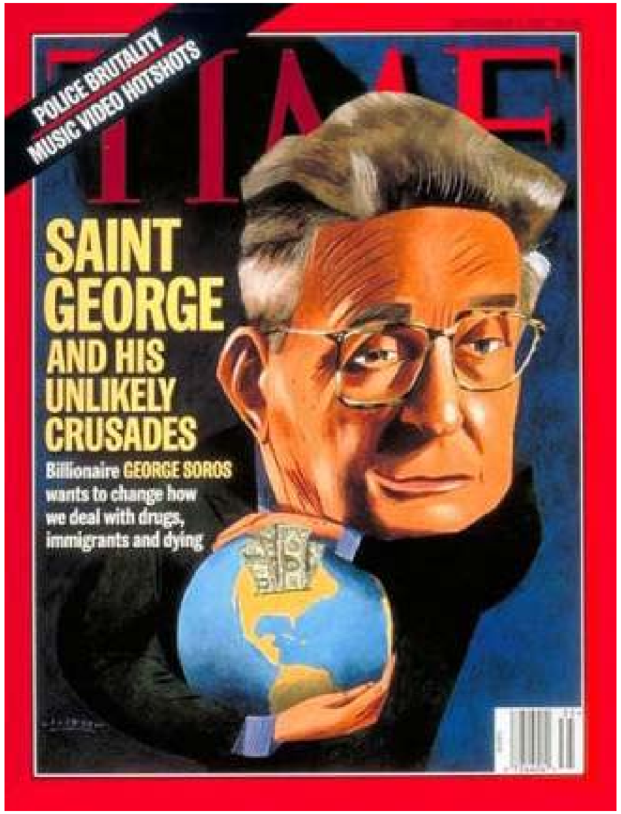
Bonds the safe option.....sometimes



Source: Mebane Faber

- While bonds are less volatile than equities they are far from safe.
- Since they are ‘fixed’ income high growth or inflationary periods will really impact your bond portfolio.
- The early ’80s saw bond holders really suffer.

Abs. Return funds are scary!!



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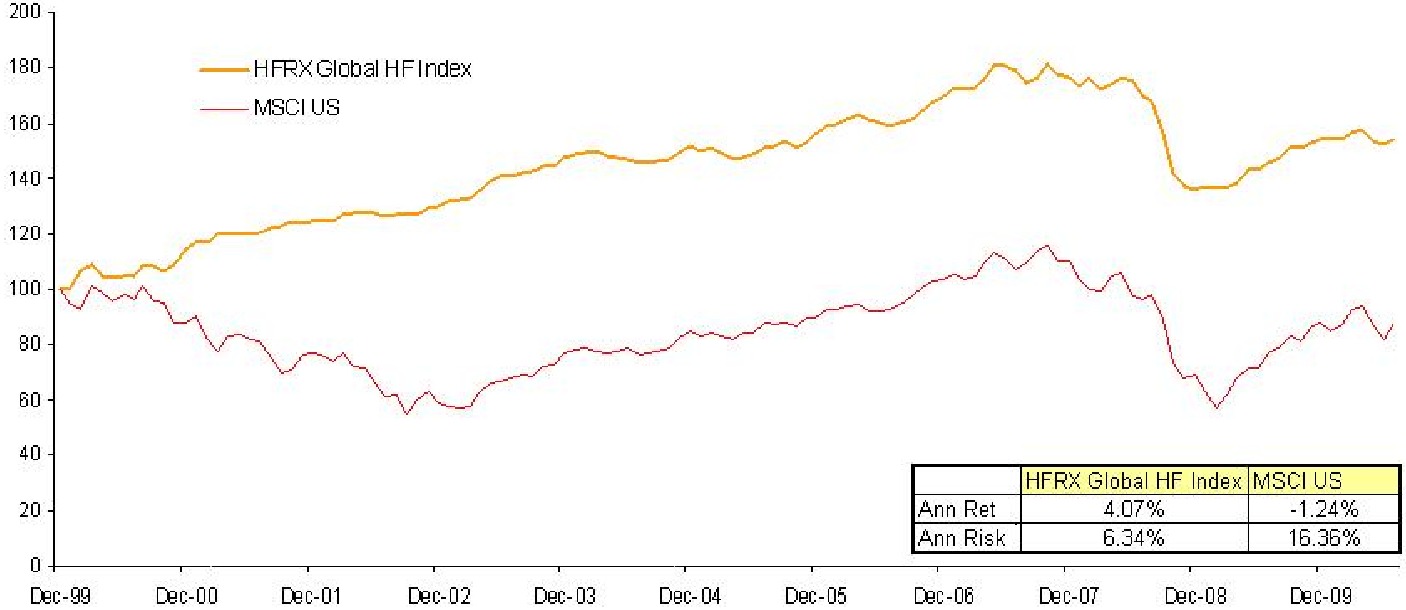
Actually risk is what alternatives do well



	HFRX Global HF Index	MSCI US
Ann Ret	4.07%	-1.24%
Ann Risk	6.34%	16.36%

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

→ While equity investors are subject to the volatility of the equity markets Abs. Ret. funds try to smooth out their risk as much as possible.

→ On most measures Abs. Ret. funds appear to be much less risky than a similar investment in equities.

But not all HFs are created equal!!

	HFRX Global HF Index	HFRX Macro Index	HFRX Conv Arb Index	HFRX Mkt Dir. Index	MSCI US	WGBI US (7-10)
HFRX Global HF Index	100%	59%	71%	87%	50%	-11%
HFRX Macro Index		100%	11%	40%	2%	11%
HFRX Conv Arb Index			100%	71%	42%	-11%
HFRX Mkt Dir. Index				100%	65%	-23%
MSCI US					100%	-26%
WGBI US (7-10)						100%

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

- Many HFs take on beta risk to generate returns.
- As a third asset class you should select only those funds that offer you diversification benefits.
- We chose Global Macro as it is lowly correlated with both bonds and equities.

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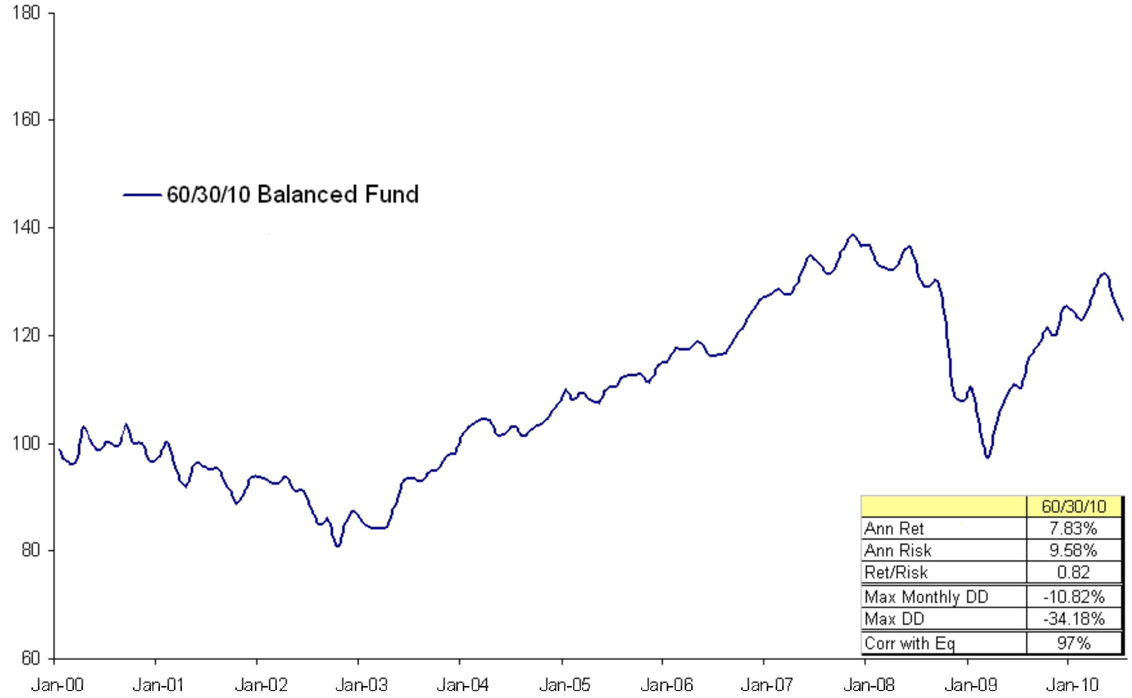
Unbalanced balanced funds



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

→ The classic 60/40 balanced portfolio is ‘balanced’ in name only.

→ During the GFC this imbalance in risk proved to be very costly.

→ As equity markets trended downwards diversified fund returns were highly correlated with those markets.

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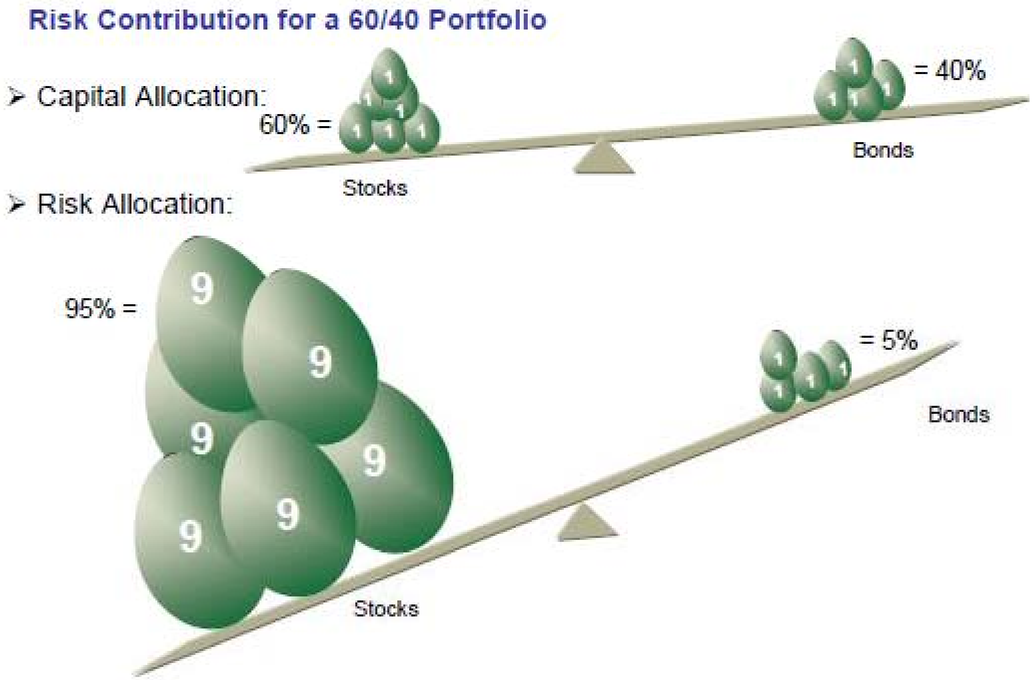
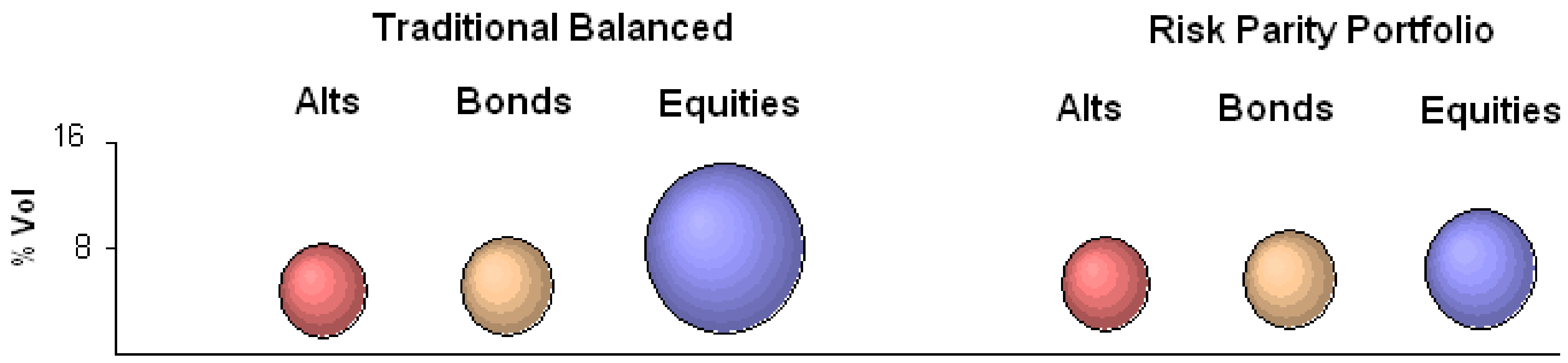
Portfolio Construction – A different perspective



Source: AIC Conference 2006, "Multiple Alpha Sources and Active Management", Edward Qian, Panagora Asset Management

- The primary problem revolves around misallocation of risk
- While the capital allocation is fairly even the risk allocation is lop-sided in favour of equities
- This is fine when equities are going up but…

The Risk Parity Way



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

- A risk parity approach allocates the risk of the portfolio equally across the different asset classes.
- This means a smaller equity exposure and a larger alternatives slice.
- The resulting portfolio should not be overly dependent on any one asset class for its returns and this should result in a smoother P+L.

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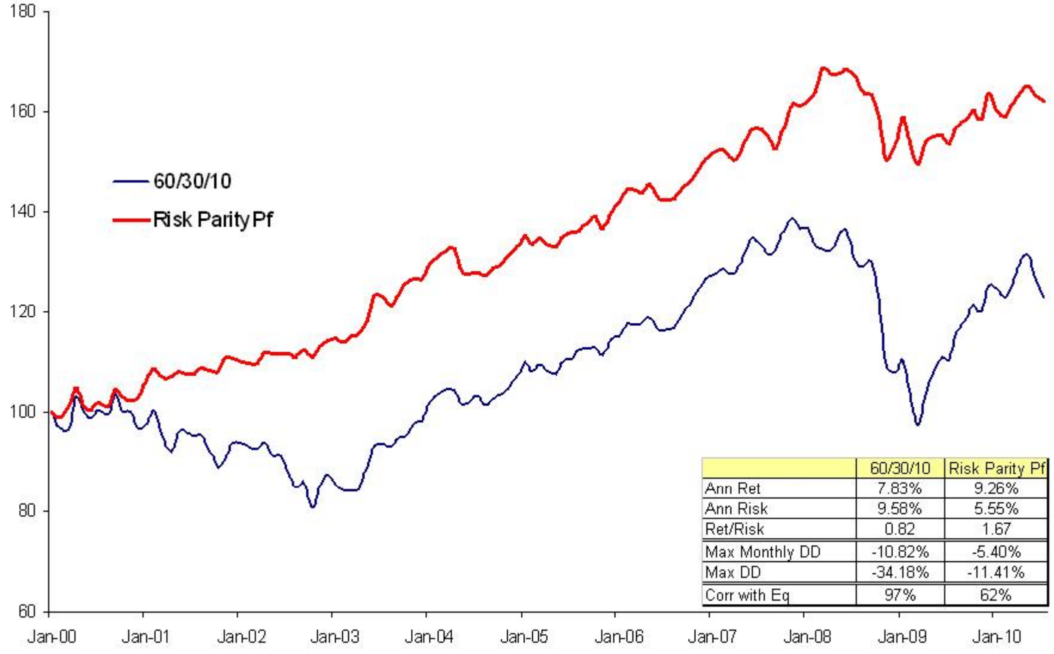
Towards a shock-proof portfolio

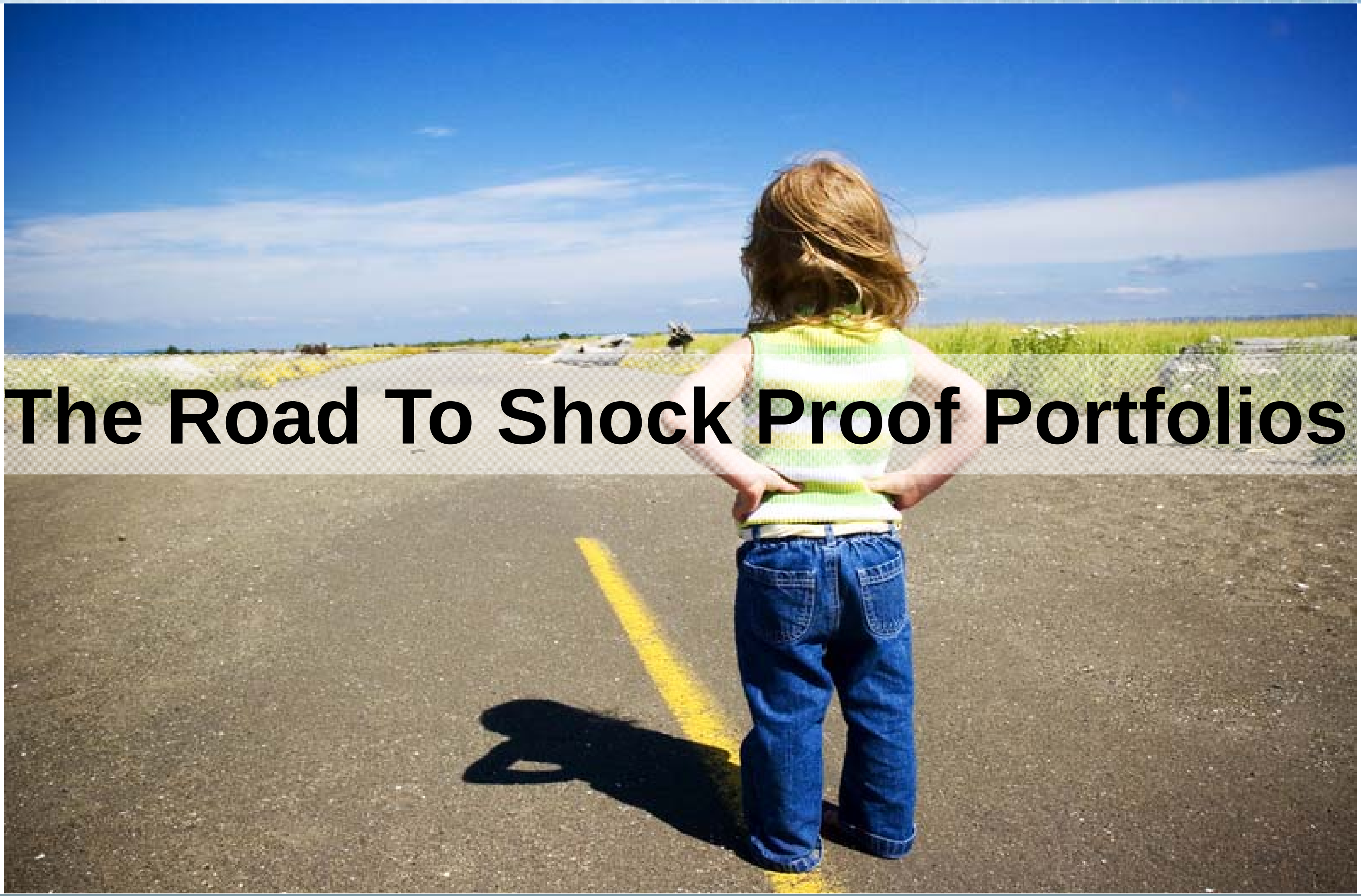


	60/30/10	Risk Parity Pf
Ann Ret	7.83%	9.26%
Ann Risk	9.58%	5.55%
Ret/Risk	0.82	1.67
Max Monthly DD	-10.82%	-5.40%
Max DD	-34.18%	-11.41%
Corr with Eq	97%	62%

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

- → The risk parity portfolio has a higher return for a lower risk than the traditional portfolio.
- → It also has a much lower correlation with equity market beta since the returns are no longer swamped by the equity allocations.
- → The resulting portfolio gives a much smoother P+L with similar investing experiences for all investors regardless of their entry points.

The Road To Shock Proof Portfolios



Summary

- → **Question the Dogma!**
- → **Diversification works so use it.**
- → **Take a second look at what Alternatives work in your portfolio.**
- → **Think about better ways to balance up the risks in portfolio construction.**
- → **Emphasise T.L.C. –**
  - **Transparency – Don't buy what you can't understand**
  - **Liquidity – Have daily liquidity if possible**
  - **Control – Keep an eye on risk**

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QUESTIONS?

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