Key messages from 2012 Portfolio Construction Conference held 22-23 August 2012

by Bruce Baker, Puzzle Financial Advice

The two centre piece speakers for the conference this year we Nick Bullman (who spoke about risk) and Michael Kitces (who re-examined Harry Markowitz's theory on diversification – and then went on to demonstrate how investors could get far smarter about investing including accepting that market timing was important – and how to be smart about that.)

Bottom line:

- Kitces pointed out:-
  - That most people implement Markowitz's theory on diversification, simply by diversifying widely between different asset classes. Kitces pointed out that, if you go back to the original paper written by Markowitz, Markowitz does indeed firstly ask investors to identify "different assets" (preferably ones that as as uncorrelated as possible), but then to apply judgement and only diversify between asset classes that have a reasonable chance of getting a good investment result.
    - In my discussion with Michael Kitces later, he agreed that there were only a few assets classes at the moment, that had attractive risk/return characteristics and therefore necessarily, this means that astute investors should have highly concentrated portfolios focused on these few good sectors.
      - This will not be news to clients of Puzzle Financial Advice.
      - However, this is foreign/new thinking for the bulk of attendees and the bulk of financial planners.
      - Nick Bullman also agreed that at times, proper application of Modern Portfolio Theory sometimes leads to very concentrated portfolios.

- Going further, Kitces demonstrated that (from history) when investments where placed in the S&P500 index through history:-
  - When P/Es at the beginning of the investment process were HIGH eg around 20, long term returns (eg 10 years) were around 3-4%pa.
  - When P/E at the beginning of the investment process were LOW eg around 7-10, long term returns (eg 10 years) were around 14%-15%pa.
  - This provides a basic timing tool for you.

- On the same theme on the Thursday afternoon, Tim Farrelly showed a table which went roughly along these lines:-

Market	Current P/E ratios	Consensus growth outlook
Developed markets	typically 17-20	Very low.
Emerging markets	typically 7-10	very high

Now Tim firstly pointed out that normally in history, high growth markets tend to have high P/Es because investors are buying future growth …. whereas low growth markets tend to have low P/Es ….. In other words, history says this table is all wrong …. and that investors are behaving totally irrationally if they are looking for high returns.

To me this table, if taken in the context of the material presented by Michael Kitces immediately above, shows why investors:-

- should be investing heavily in emerging markets now (plus related themes of course). Kitces material strongly supports the view that these markets should on average now deliver very good returns over the next 10 years for us.
- should be avoiding developed markets now. Kitces material strongly supports the view that these markets should on average now deliver very poor returns over the next 10 years.

In summary, this conference very much made the case for the Puzzle Financial Advice investment strategy. But for most financial planners attending, this is fairly new and foreign thinking. I think it is fair to say that Puzzle Financial Advice has been a long way ahead of the curve in understanding the investment environment that we are in and what the most rational investment strategy should be.

Also note: There was a fairly universal view now that the next 10 years will continue to extremely volatile.

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Key takeouts from conference:-
Tuesday morning (22/8/12):-

- David Hale.
    - David is very bullish on Africa. Sub-Saharan Africa growing at 5%-7% pa - much of which has to do with resource boom. Trade with Africa has risen from $10bn/yr 10 years ago to $170billion pa. There have been big moves towards democracy & better governance. The case for sub-Saharan Africa is strongly supported by the last conference presentation by Jonathan Pain, whose presentation I would very much like you to listen to. You might be very surprised how much Africa has progressed & evolved over the last 10-15 years. Some key speakers now regard Africa as being investable & a number of sub-Saharan countries are some of the very fastest growing countries in the world.
    - David also talked of how Portugal & Ireland were returning to health following the EURO rescues - as can be seen by interest rates in Ireland and Portugal falling.
    - Italy has returned to "primary surplus" i.e. before accounting for interest payments on government debt, Italy is now back to fiscal surplus .... so the path back to health for Italy.
    - Hale believes, like me, that the EURO will survive.
    - Japan is transitioning from deflationists to inflationist in charge as a lot of top jobs come up for renewable at the Bank of Japan. So Japan likely to pursuing policies more like USA .... to generate inflation - which will also help the Yen to fall, then helping to reinvigorate the Japanese economy.
    - On China, while GDP is slowing, China has plenty of capacity to stimulate. They are gearing up to stimulate infrastructure. So China, he believes, will have a soft landing.
    - On India, the government is paralysed and so will have low growth for the next 12 months.
    - Brazil. GDP growth has fallen from 7.5% a year ago to 1%pa in Q1CY12. Now cutting interest rates from 12% to 8%, so growth should pick up.

Panel discussion:-

- Hale. China transitioning from investment driven growth to more-consumption driven growth. Chris Watling noted that when countries in Asia have finished their 3 decades of 10%pa growth, then have transitioned to a period of about 10 years of 5%pa growth
- Watling. Norways $600billion sovereign wealth fund is shifting its investment portfolio towards much greater focus on emerging markets. (BB comment-this should help lift these markets in dues course).

- Hale. Europe looking at a "lost decade" (markets going sideways for 10 years). Germany can be different. France has major need for structural change.
- (No sure who said) Need one or more "near death experiences" to get EURO over the line for political etc changes required for EURO to survive.
- Watling - Italy is in much better shape than Spain.
- Watling. The USA has a crisis coming because still at Debt/GDP of 350%
- Watling. Commodities supercycle continues. Watling recommends buying Gold.

Tuesday afternoon.

Nick Bullman (CheckRisk).

- Investors level of anxiety rises as share price indices fall. This is in stark contrast to level of share market risk, which actually falls as share price index falls. (Remember Shiller's long-term assessment of market fundamental value, showing that underlying fundamental value in share markets actually being relatively stable and only changing slowly over time.).
    - In summary: Investors perception of risk is inversely proportional to the level of risk. That is:-
        - As share markets fall, investors become more frightened (i.e. perceive risk to be higher)
        - By contrast, as share markets fall, level of risk in investing in shares falls.
- High Vix level tends to coincide with low level of risk. Super-correlation warnings precede big share market declines.

Michael Kitces:-

- Back to basics of Modern Portfolio Theory.
    - Harry Markowitz theory of diversification really was about diversification between good assets (and asset classes) i.e. diversification between assets that have good risk return characteristics - diversification between assets that are likely to deliver a reasonable return, Sadly, the diversification practices of fund managers and advisors have typically between about diversification for the sake of it.
    - He also pointed out that if you are simply diversifying between assets which are highly correlated, then there is no point diversifying at all. Better to have fewer assets (assets in a smaller number of buckets) and getting to know those buckets better.
    - When I was talking with Michael over drink later, he agreed with me that there currently are only a few asset classes that have good risk/return characteristics at this point in time.
    - So for clients of Puzzle Financial Advice, what Michael has said should be of no

surprise.