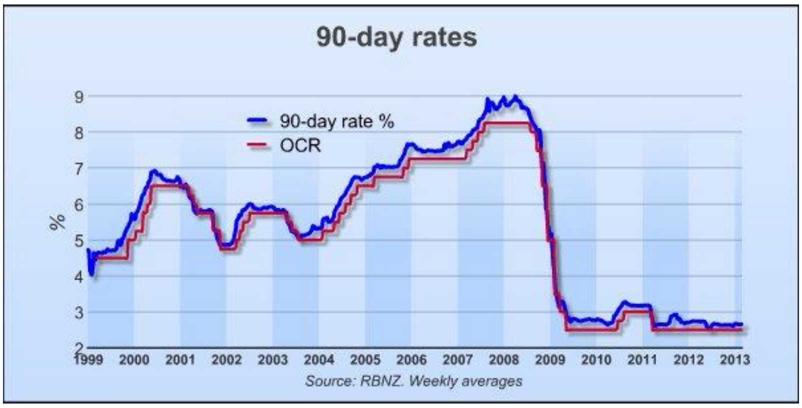
YOU REAP WHAT YOU SOW

Despite the heading, the essence of this article is not spiritual, more so to remind the New Zealand financial services community of the lasting repercussions of common sense. As investment markets drift through a relatively buoyant first quarter of 2013, it's worth challenging some of the industry misinformation that continues to be circulated, to help stimulate investor's confidence in the industry. It is equally important for the industry to recalibrate its thinking, as a significant



opportunity arises with longer term deposits rolling off the previous renewal rates of 8%pa[1], to the sobering rates on offer today. Many investors are facing the facts that low returns from traditional fixed- income sources, combined with rising costs are resulting in a significant loss of their purchasing power, and will seek advice on how to improve the yield from their investment portfolios.

The intention of this article is to create awareness around some of the common misconceptions that continue to circulate the industry, and to remind the financial services community that investors will no longer tolerate mediocrity from an industry that is ignorant of their basic expectations. The inevitable accusations that the content is promotional are unashamedly accurate, as I remain an active Promoter of the capabilities and investment solutions that are referred to throughout.

In their paper "The Risk Management Dilemma - You Can't Eat Relative Returns"[2], Griffiths and Kessler suggest that the basic needs of most investors are capital preservation plus a fair return on their capital for the risk assumed. As investment practitioners, I suspect that there are no objections from readers at this point (albeit that some Managers may be feeling slightly uncomfortable at this notion). It's worth also adding to this, an observation from Nobel laureate Daniel Kahnemann[3], who claimed that investors placed greater weight on losses than profits. Griffiths and Kessler go on to suggest that the accepted risk free rate amongst investors is the Cash Rate (in New Zealand the Official Cash Rate is 2.50% as at the time of writing), with an acceptable historic Equity Risk

[1] Source: http://www.rbnz.govt.nz/keygraphs/Fig7.html

[2] Griffiths, N. Kessler, R. (2012), "The Risk Management Dilemma - You Can't Eat Relative Returns", www.heathcoteinvestment.com/events

[3] Kahnemann, D. & Tversky, A. (1979), "Prospect Theory: An Analysis of Decision Under Risk", *Econometrica*

Premium (ie: the target return that represents a "good deal" for investors) being circa 6% above the Official Cash Rate. That suggests that an acceptable return for most local investors to take on the additional risk of equities is currently around 8.50%. This is a useful motherhood statement to note, as investors are increasingly lured away from the relative sanctuary of fixed term investments and back into the equity investments.

Those with grey-hair amongst us will recall that the above sentiment was the cornerstone philosophy of the financial services industry during its relative infancy in the mid eighties, as the newly formed concept of funds management moved from being the domain of the wealthy, and became accessible to ordinary investors. As these fledgling managed fund operators grew in size, so did the myriad of tools, language and metrics with which the industry became reliant upon. In particular, the funds management industry became acutely sensitive to risk management - both against their peer group and the universe in which they invested. The prominent support infrastructure aimed at servicing these Managers, has also required Managers to conform to certain styles, to enable an efficient method of being compared against their peers. These were catalysts for benchmarks to grow in prominence, as company management required low Tracking Errors to minimize their business risks as their Assets under Management increased. This has nurtured an increasing reliance from the industry on delivering relative returns. Today, the majority of funds' performance is measured relative to an index that represents the universe in which the fund invests (or should invest), and risk is measured as the degree to which a fund's holdings differ from that index[4]. Many of today's Managers compare their performance with an index, actively managing the possibility of underperformance relative to that index, the threat of termination and, therefore, the risk to their business.

Over the past three decades, Markowitz's Modern Portfolio Theory and Efficient Market Hypothesis, has spawned the use of index funds and the view that market prices are the best estimate of intrinsic value. This wasn't a particularly 'hard sell', as many of the active funds simply failed to deliver, and yet continued to charge investors' high ongoing fees. In short, the language and requirements of the financial services industry soon overwhelmed the underlying needs and requirements of the investor, whereas in reality (as many practitioners are well aware) investors have never subscribed to the misgivings of this theory, and continue to require portfolios that reflect reality.

By Frits Ahlefeldt

The Fallacy of Composition

Since its development in the 1950s, many theoretical and practical criticisms have been leveled against the theory of Modern Portfolio Theory. The science of risk management has developed since Markowitz's initial observation that investors and Managers should care about risk as well as return. These include the fact that financial returns do not follow a Gaussian distribution or indeed any symmetric distribution, and that correlation between asset classes are not fixed but can vary depending on external events (as was evident in the Global Financial Crisis). Further, it would come as no surprise that investors are not rational and markets

[4] Ineichen, Alexander & Silberstein, Kurt (2008) "AIMA's Roadmap to Hedge funds", Alternative Investment Management Association

are not efficient. Portfolio construction should be a prospective exercise, not an activity that is performed retrospectively and then applied

to the future. As noted by LLeo[5] "The problem with retrospective analysis is that to use it prospectively, the assumption is that the future, not only in terms of behaviour of risk factors but also in terms of the composition of the portfolio, will be identical to the past." This is a common and recurring flaw in the practice of statistically driven risk management, which is continually highlighted by many academics, including the likes of Scholes, Jenson, and Black[6], who suggested that the relationship between return and beta might be flat or even negatively correlated.

More recently Roger Lowenstein noted that "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."[7] And a regular visitor to our shores - Jonathan Pain, author of The Pain Report – continually reiterates the failings of theories such as Modern Portfolio Theory & Efficient Market Hypothesis, stating that "Life is not a simple and elegant linear extrapolation and we need to build portfolios that reflect reality"[8]. Pain notes that "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 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."

And yet – despite overwhelming evidence to the contrary – vested-interest within the financial services industry continues to espouse these dated theories as suitable mechanisms for portfolio construction. As an aside, it was with refreshing honesty that an advisor-advocate of Modern Portfolio Theory & Efficient Market Hypothesis recently stated that his support was to create simplicity within his business – knowingly at the expense to his client's portfolio construction and outcomes. This was a rare departure from those industry participants who attempt to replace their laziness, self-interest and ignorance with outdated academic research and a myopic misunderstanding of financial markets.

Back to the Future

Rather than relying solely on the declarations of notable academics and luminaries, it is useful to apply some common sense at this point by simply asking your clients what their ultimate investment objectives are. If their objectives are to preserve their capital and make a return above the available risk free cash rate, then surely that should be the industry's objective when determining their portfolio construction.

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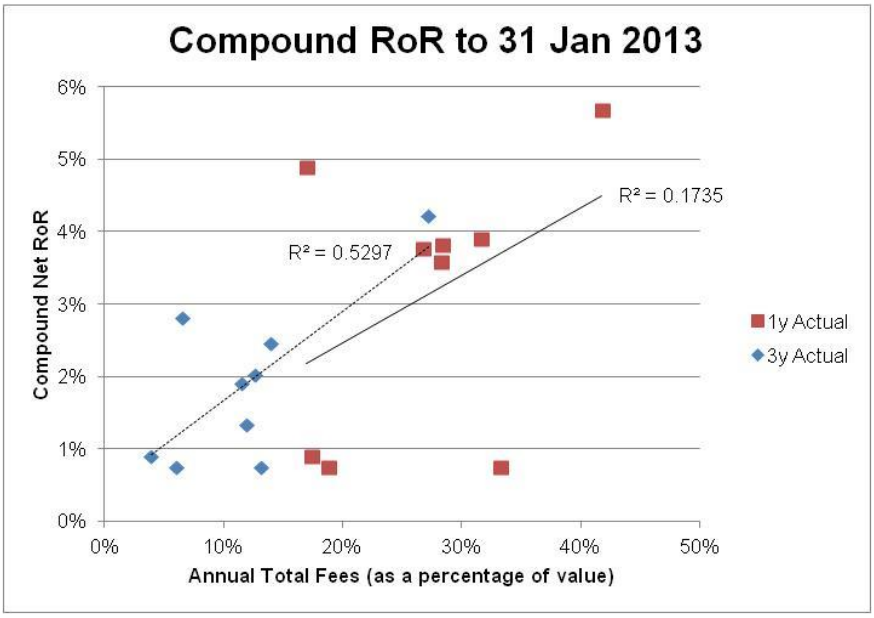
[5] Lleo, S. (2009), "Risk Management: A Review"' The Research Foundation of the CFA Institute
[6] Scholes, M., Jenson, M., Black, F. (1972), "The Capital Asset Pricing Model: Some Empirical Tests", Praeger

[7] Lowenstein, R. (2000), "When Genius Failed: The Rise and Fall of Long-Term Capital Management", Random House

[8] Pain, J. (2010), "Alice in Wonderland Meets the New Reality", The Pain Report, www.thepainreport.com.au

A small but increasing group of boutique Managers such as K2 Asset Management[9],[i] have recognized this and have broken the mould by delivering benchmark-unaware returns. These strategies, by definition, pursue returns independent of a traditional benchmark index, are unconstrained and can “go anywhere” as well as use modern tools, such as hedging strategies, in seeking to reduce risk for investors. Benchmark-unaware funds (and I’ll use this term loosely as a catch-all for many absolute return funds), are typically private, actively managed investment funds with the majority aiming to achieve a positive return on investment regardless of whether markets are rising or falling. They are not benchmark aware, and do not subscribe to the Efficient Market Theory. This benchmark-unaware style of investing is considered a modern strategy (despite being the foundation of the Managed funds industry some 30 years ago) that pursues target returns with lower volatility than traditional funds, to help diversify portfolios for most investors. Absolute-return funds come in different flavors — some are more focused on bonds, some in certain sectors or geographic regions — but the underlying idea is the same. At the heart of it is the preservation of capital.

But pursuing this benchmark-unaware business model is risky and faces practical issues due to the relative mindset that exists with many industry participants. For many Managers, it is a struggle to be included on databases and surveys, to have performance compared to the right metrics, to have performance fee structures understood, and not to be boxed into a catch all “alternatives” bucket with Managers that invest in different asset classes with different objectives. This has lead to the benchmark-unaware sector becoming a mishmash of funds encompassing a wide divergence in asset class composition, style and methodology, making comparisons a potentially dangerous exercise.



You Get What You Pay For

There has been an increased focus over recent years on the fee structure of investment products, with industry ignorance and self-interest promoting the concept of “the lower the better”. The level of hedge fund, benchmark-unaware and absolute return fund fees are often cited as a reason why the industry should support the relative mediocrity of index funds, “closet index funds”[10], Exchange Traded Funds and other low cost options. If at this point, you remain an advocate for Efficient Market Theory, then the main primary differentiator between the funds that you will support can only be price. In traditional 'commodity' funds management where the goal is to match or possibly beat a benchmark at a margin, it is clear that a lower fee structure is critical in achieving this aim. Following this logic through; it will be equally challenging for those industry participants who are stuck in this mindset to justify an ongoing intermediary fee when all that has simply been achieved is the guidance of an investor towards homogeneous investment mediocrity.

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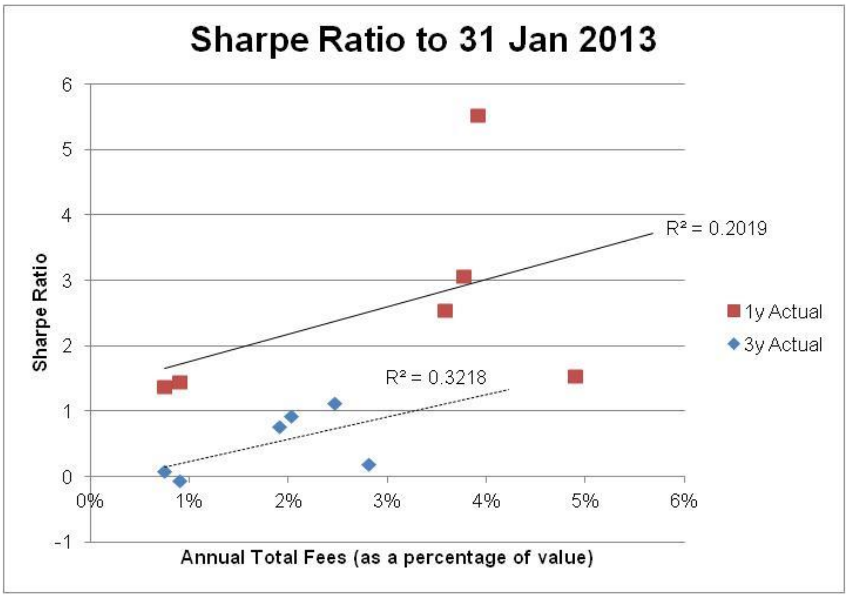
[9] Source: Morningstar Adviser Workstation

[10] “Closet indexing”, is the widespread practice whereby many Managers portray to the outside world an active investment process while closely following the index.

Benchmark-unaware Managers typically invest money of their own in the fund they manage, which serves to align their own interests with those of the investors in the fund. Investors are charged an annual management fee, which is a percentage of the assets of the fund, and a performance fee if the fund's net asset value increases during the year. The fee structure reflects the fact that benchmark-unaware funds are not vanilla products aspiring to be nothing better than average. The Managers tend to live and die by their net returns, with gross returns rarely published at all. Better Managers are able to charge higher fees and still deliver higher net returns – otherwise they will fail to retain investors and die.

A test to demonstrate how successful benchmark-unaware funds have been is to compare the compounded 1 year & 3 year net returns against the fees paid (inclusive of performance fees), of a handful of funds available for use in the NZ market[11]. Whilst I'm the first to admit that the calculation of the performance fees was a struggle, and that the sample is small, there is clearly a reasonable positive correlation and slope to indicate that funds with higher fees have tended to deliver higher levels of performance.



A further declaration is the decision to use only open ended managed funds in the comparison rather than Exchange Traded Funds (a relatively cheap mechanism to purchase Beta). Whilst the failings of Exchange Traded Funds is fodder for a follow up article, their presence tends to increase portfolio volatility, with their absence of alpha suggesting that you are tacitly agreeing to the myths of rational markets. The overweighting of Exchange Traded Funds to sectors / stocks also has a disproportionate affect on the returns (as do the underweight sectors / stocks too, but in reverse) as they are always structured in arrears and struggle to register rapid changes in indices (eg: China's exposure in the MSCI). Exchange Traded Funds continue to experience challenges in their transparency leaving investors unsure of the relevance of their underlying investments.

Getting back on track: the true test is whether these benchmark-unaware funds have been able to deliver superior returns against passive low cost alternatives. The measure here is to compare the Sharpe Ratio[12] against the fees paid. Again there is a strong correlation between the fees paid and the risk adjusted returns, reinforcing the suggestion that seeking funds with the lowest fee structure is counterproductive.

The implication is that seeking benchmark-unaware Managers with the lowest fee structure is counterproductive. The management of investor's savings can no longer be considered a commodity business. It is effectively one where investors get what they pay for, with better performing Managers able to charge higher fees and still deliver higher net returns. Relative return investing, remains devoid of investor expectations and has led to a lack of specialisation in funds management, and a

[11] All performance figures and fees used to produce the charts are sourced from the websites of each Manager, and are to the 31st January 2013

[12] Ratios produced by Lonsec as at 31 January 2013, and assume the UBS Bank Bill Rate as the Risk Free Rate

general homogeneity in investment process and philosophy. This has made it challenging to determine whether traditional fund Managers are truly adding any value, with the only remaining element to distinguish these investment commodities being price.

In Summary

When sculpting an investment portfolio, practitioners must adopt a flexible yet rigorous investment philosophy that matches the client's own expectations of capital preservation and a fair return, and ensures that the Managers are not incentivised to put client funds at risk to manage their own business risk. The extension of this is to ensure that there is an aligned vested interest between the Managers, so that clients are recognised as co-investors. This is most notably demonstrated through a fee structure that ensures that the Manager's business model is based on capital preservation, fair returns and a motivation to generate performance rather than asset growth. The argument that fund Managers are "commodities" and therefore the cheapest is the best, appears to have no evidence to support it. Put another way - the Efficient Markets Theory as applied to benchmark unaware funds and recent market events has some explaining to do. Choosing any investment option with lower fee structures is likely to be detrimental to investors' financial well-being.

None of these statements step outside of a commonsense approach to portfolio construction – albeit that vested-interest will continue to promote the status quo. By recognising and responding to expectations of investors, the financial advisory industry will establish a mutually rewarding environment for both their clients and advisory businesses.

If at this stage, you remain blinded by the obvious; then recognise that a traditional asset management approach using benchmark constrained portfolio construction is only active in a limited sense, starting with the benchmark constituents and weights and deciding which stocks to under or overweight. As a result, a large proportion of assets are invested in the benchmark, while only a relatively small portion is invested in excess return generating opportunities. The index can be bought quite cheaply, through an index fund, Exchange Traded Fund or derivative, so there is no need for investors to pay active management fees for this exposure.

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[i] Disclosure: Clayton Coplestone is a Director of Heathcote Investment Partners, who are the Promoters of K2 Asset Management in New Zealand