Portfolio Construction in the Age of Uncertainty

Michael Chamberlain

September 2022

Portfolio construction
- allow for the expected unexpected

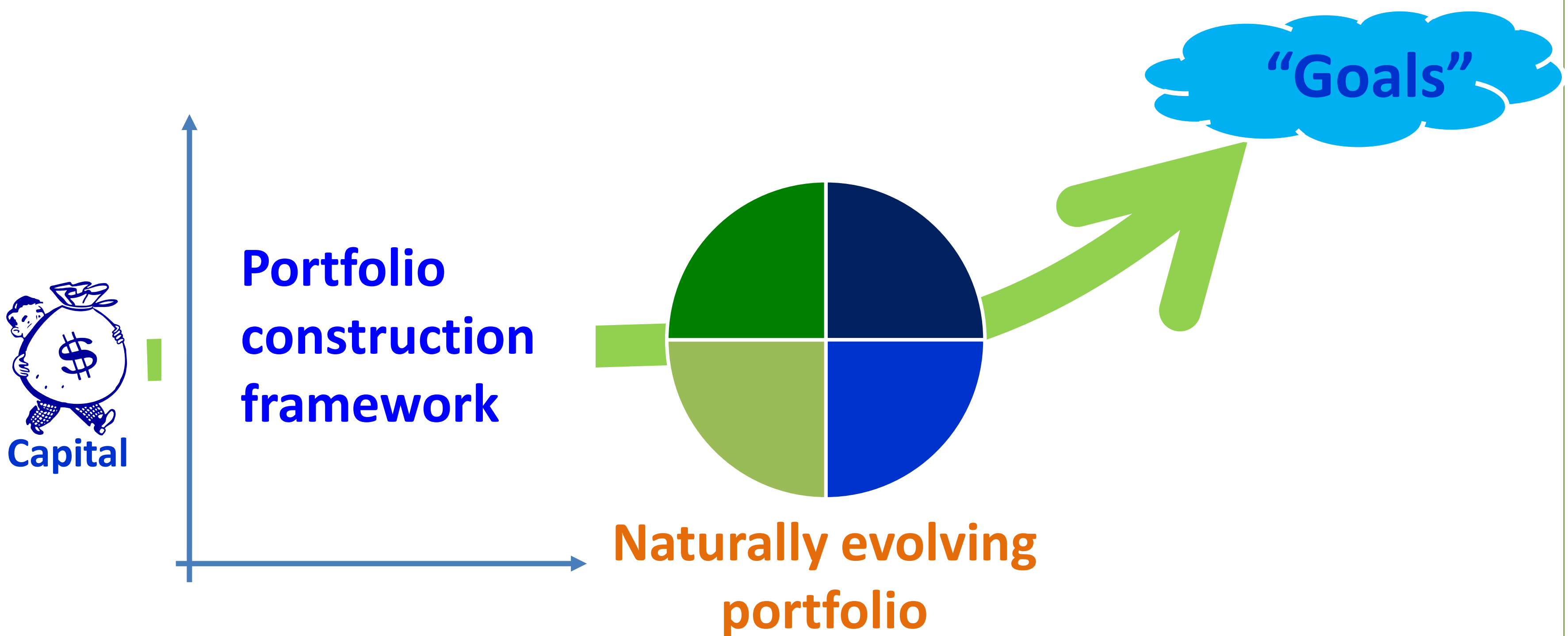
WiiiW

What if it is Wrong

Central to good portfolio construction is understanding the potential range of outcomes in the context of the liabilities

Portfolio Construction

“to the end of time”



Portfolio construction to the end of time

Three questions to ponder . . .

1. What are you trying to help your client achieve with their portfolio?

2. Is this what your client also understands and articulates?

3. Does the first page of each report to and each communication with, a client, focus on the agreed common understanding, or on the investment outcomes (returns, market environment etc)?

At the centre of most investment uncertainty is the poor understanding of the investor's true goals, a text book advisory process and limited value add, compounded by poor communication. Advisers are often their own worst enemy

The golden rule

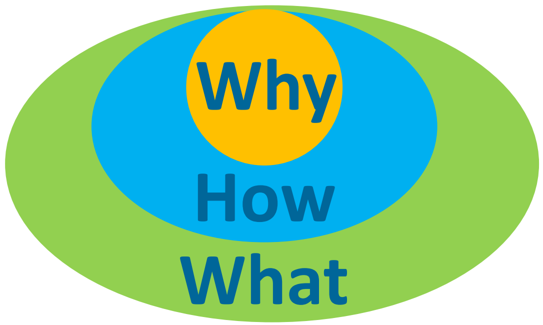
The reason we have to invest, is because there is capital

The reason there is capital, is because there are liabilities

Liabilities

Portfolio/policies & Investments/funds

Investment returns & return of capital



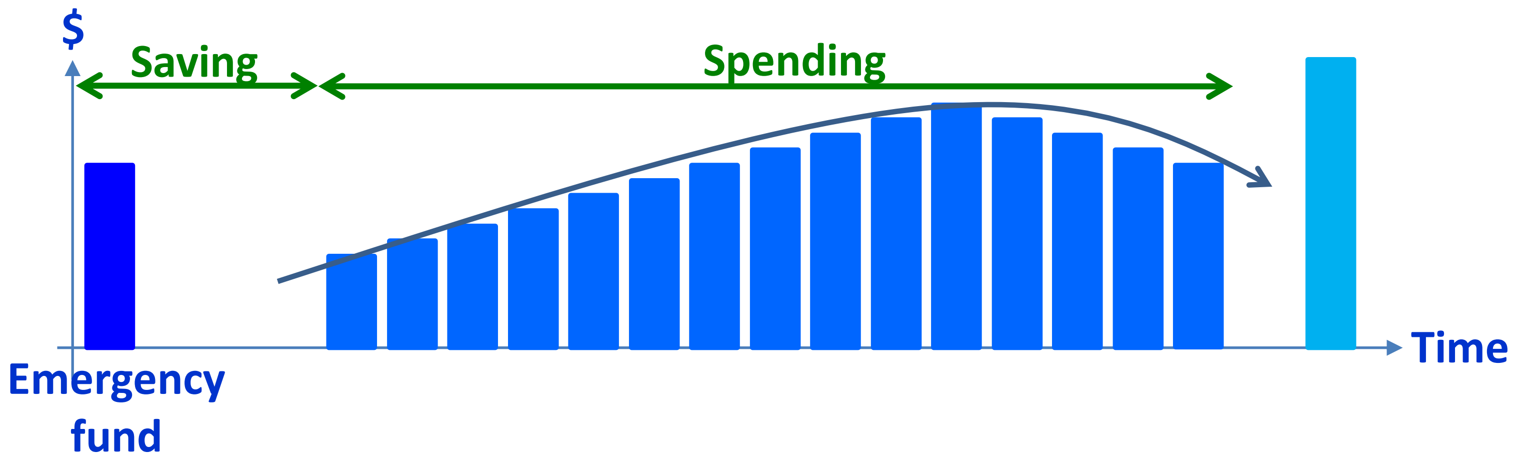
The purpose of a portfolio and the associated investment policies, is to maximise the probability the liabilities are achieved. Or better put, to minimise the probability they are not.

Portfolio construction
- setting the scene

- Text book theory is "average" on a good day
- "Conservative, balanced or growth" does not work for most people
- A balanced fund is not a balanced strategy
- Tools, eg modern portfolio theory, is at best a framework to help make relative decisions. It can't consistently give the answer
- Most people do not know their risk profile, tolerance or preference
- Few advisors articulate the value they add
- Few managers articulate how they will add value
- There is no such thing as a risk adjusted return. Risk can't be measured
- Investors with vertically integrated managers are not compensated for the conflict of interest risk
- Few advisers ask the question "who is the natural owner of this fund?"

- If the conversation is about active vs passive, growth vs value, small vs large, emerging vs developed, the client conversation is on the wrong topic.
- The important conversation is the pattern of asset returns vs liabilities

Portfolio construction
- understanding investor liabilities



How each $1 is invested should reflect when the $1 will be spent, the importance of the expenditure and the impact of inflation on the expenditure, between now and then

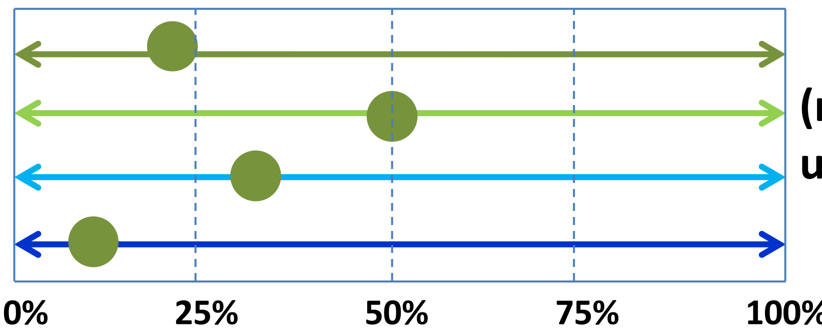
Portfolio construction
- understanding investor needs

- **All investors have a combination of 4 basic needs**
- **The combination will change over time**

Growth
- **Real growth**
- **Inflation protection**

Income

Liquidity



(must add up to 100%)

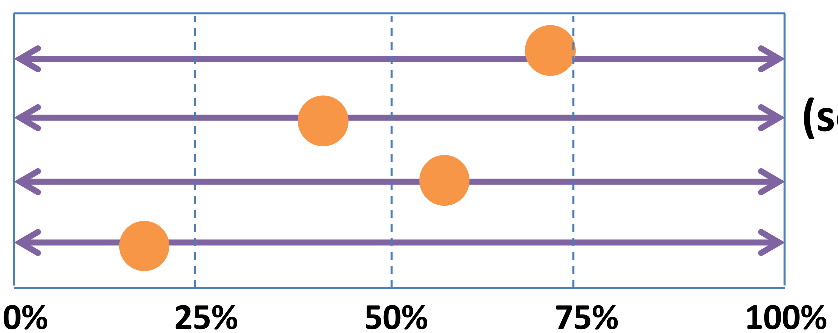
- **Other policy positions**

Marketability

Ethical considerations

Causes

Active risk



(set individually)

Portfolio construction
- a thought on returns

A portfolio should be constructed to align the investment outcomes with the liabilities

Total gross return = Income + Market movement (growth)
- Tax & fees

= Net total return (net income + net growth)

+ Value gained/lost by another investor

= Return to investor (income + growth)

Income return = Interest + Coupons + Rent + Dividends
+ Distributions

Growth return = Market movement
+ automatically reinvested income

An investor takes on risk, for which there is no compensatory additional return, when the income and growth returns, and capital maturity proceeds, are not aligned to the liabilities

Portfolio construction
- understanding the market environment

It is not today's market environment that is important, but all the environments until the liabilities have been met

Known unknowns

- 6/7 elections
- 3/4 change in governments
- 5 US elections
- 5 US mid-term elections
- 2 recessions
- 1/2 50% share market declines
- Spike in inflation
- 3/4 interest rate cycles
- etc ?

Unknown unknowns

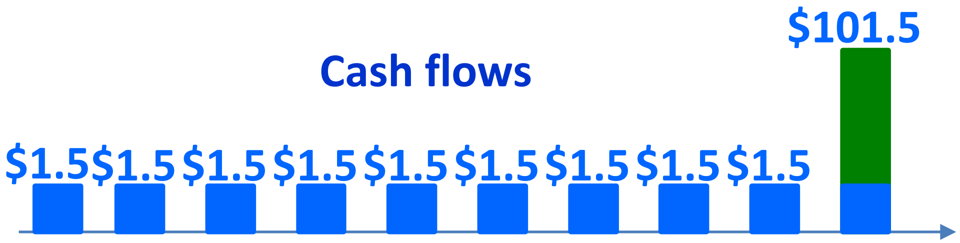
A A decision framework for always correctly guessing the investment implications and repositioning the portfolio

or

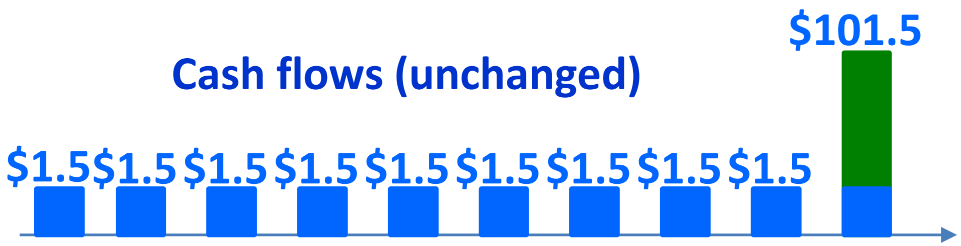
B Investment policy framework that will cope with the 'unknowns' and designed to ensure the liabilities are achieved

Portfolio construction
- the role of bonds

You buy $100 of a 5-year bond and interest rates are 3%



Interest rates increase to 4% - Market value goes to $96



Why are we concerned that the market value went to $96?

It can only be because the bond was bought without regard to the investor's liabilities, or there is stress about having to communicate a short-term negative return, even though we know it self-corrects by maturity, or we think that we should have guessed the rise correctly and acted to take advantage of the short-term opportunity

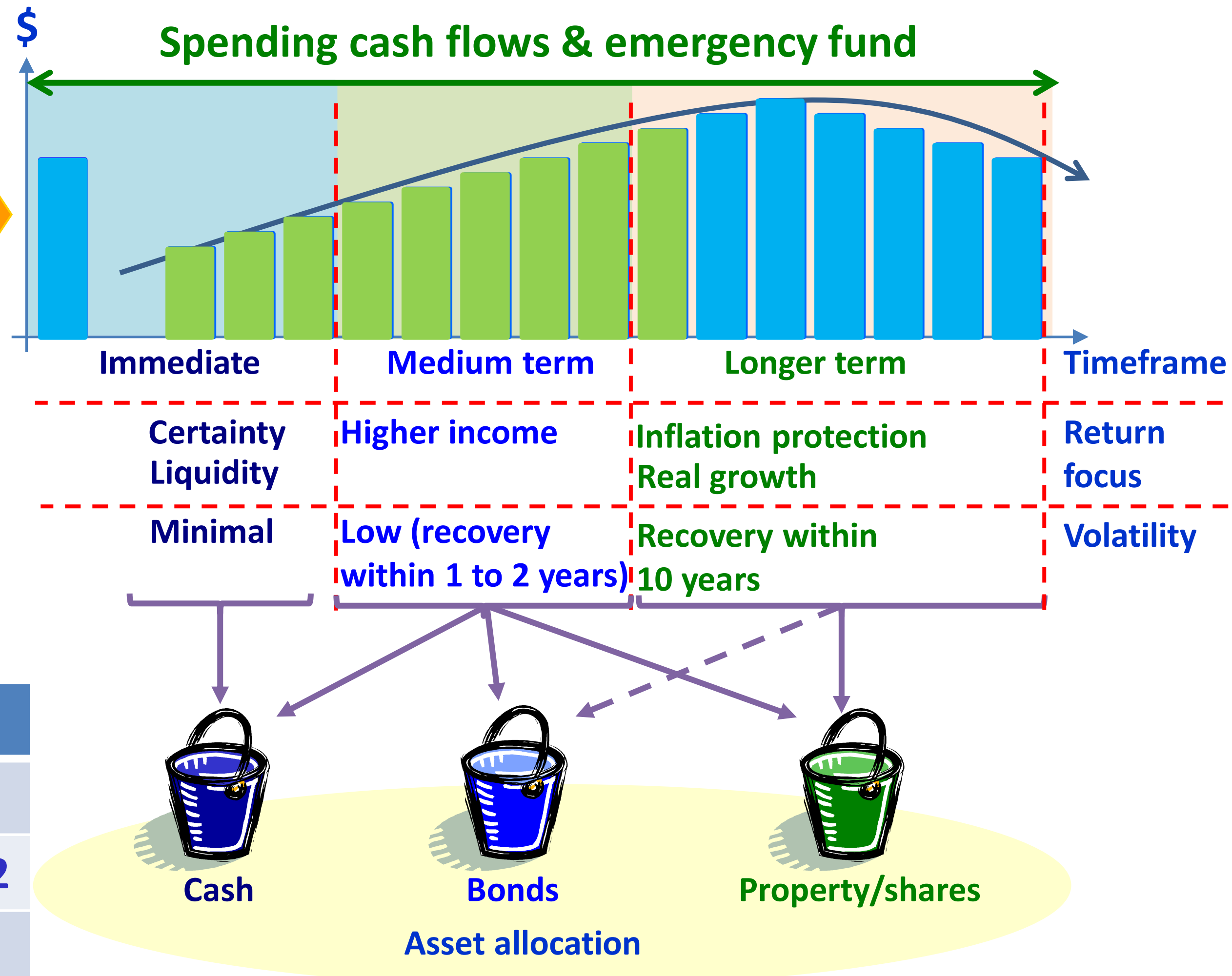
Portfolio construction
– asset classes: what is important?

A key to investment success, is to set the investment strategy to align with the liabilities, ie when the money will be spent, minimise fees & costs and manage the behavioural challenges

The important decision is not either or, but how much of each

Portfolio construction
- asset allocation framework

How a $1 is invested should reflect when the $1 will be spent, the importance of the expenditure and the impact of inflation, between now and then, on the expenditure



A rule of thumb for expenditure

Asset class	Years
Cash	0 to 3
Bonds/cash	4 to 10/12
Shares/property	10/12+

Portfolio construction
- final thoughts

- **Portfolio construction in times of uncertainty should be more about communication than changes to the portfolio**
  - How do we best communicate with clients?
  - Have you, in the last 12 months, communicated on the basis of the investor's true goals?
- **Who are the natural investors for this product?**
  - Do we understand the promise and the risks relative to the client's liabilities?
  - If all goes as promised, what additional value does it add to the client?
- **Remember WiiiW**

Questions

"Investment success is not about following the right predictions (guesses). It is about following the right principles."