The TAMRIS Consultancy

Shorts – April 2009

A series of brief comments on relevant issues

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24 April – Naïve investors: does it make a difference whether they take an advisory or discretionary service?

The industry is supposed to accord a far higher level of responsibility to advisors operating discretionary accounts than an advisor operating an advisory account.

For some reason, while a discretionary account accords a fiduciary responsibility, an advisory account does not. Advisory accounts are deemed to be ones where brokers recommend narrowly defined transactions, and where responsibility for these transactions are assumed to be taken by the investors accepting them. Naturally it is more complex than this and TAMRIS documents detail more advanced dissection of the fundamentals.

However to get back to the point I want to make: there is quite often little or no difference between the solutions recommended by a broker operating on an advisory basis and one operating on a discretionary basis. Just because your broker is deemed to have a fiduciary responsibility does not mean he or she will act as one.

It is also possible for naïve investors to be at much greater risk of receiving bad advice within a discretionary framework, where they have much greater reason to believe that an advisor is making decisions with their interests in mind, and where they are much less likely to be aware of issues that may negatively impact the efficacy of the wealth management solution.

When making a complaint, they have to go through the same process as an advisory client and while the probability of restitution is much higher (discretionary accounts are accorded much higher legal standards governing advisor conduct) this does not make the path any easier. It is almost as if discretionary services provided by SRO regulated firms are regulated in accordance with minimum standards governing the outdated transaction based business.

Needless to say, many investors are suffering a rude awakening.

24 April - A must read! – "Why I Fired M y Broker"

http://www.theatlantic.com/doc/print/200905/goldberg-economy

23 April – When models no longer work

A great many advisors have been reliant on efficient markets, modern portfolio theory, mean variance optimisation tools and Monte Carlo modelling for portfolio construction and investment planning. The current market and economic environment lies outside the parameters of modern portfolio tools and disciplines, tools and disciplines which allowed advisors to ignore valuations and economic analysis in constructing portfolios and performing investment planning. While in my opinion we have always operated in an environment where attention to valuations and cyclical market and economic risks is necessary, many will be realising this for the first time. Mean variance optimisers, Monte Carlo modelling and benchmark rebalancing no longer have the ground beneath their feet. The problem is that vast swathes of the industry are reliant on these models and hence their solutions have little or no connection to or understanding of the structural imbalances in the financial, market and economic worlds. Now that we are here how to do we get out? If you only have models that are irrelevant, what do you do?

23 April – Efficient markets and efficient economies

When we talk of efficient markets, we forget that a condition of efficient markets is an efficient economy. If an economy is out of equilibrium, in other words it is characterised by excess, then exchange based prices need to reflect this: that is prices need to reflect the position of economic relationships relative to equilibrium relationships.

That prices failed to reflect the risks implied by structural imbalances in the global economy is another reason why markets could not be deemed to be efficiently pricing information that was known with respect to these imbalances. Many of those who believe in efficient markets fail to grasp this important condition.

22 April - Efficient markets!

What is an efficient market?

An efficient market is where all prices reflect all available information about demand and supply and time and the various dimensions within.

An efficient market needs to be transparent; the information needs to be correct: the right amount of goods is being produced for the right amount of costs which represents the most efficient allocation of resources.

Everything is in equilibrium: not too much and not too little risk is being taken; not too much/too little assets/goods/services are being produced; consumers are carefully managing their own balance sheets with respect to current and future assets, expected asset returns and incomes and liabilities and businesses are carrying the amount of debt and making the right amount of investment needed to meet expected future production and the costs and supply of factors of production.

Shocks may impact the system, but because a) the market is not inefficiently structured and b) because all new information becomes immediately known and c) all economic agents are rationale, the economy quickly adjusts and the market place reaches a new equilibrium.

Compare that to the situation before the current crisis hit: historically high excess broad money supply growth; historically high excess consumer debt; historically imbalanced consumer spending dependent on an asset bubble; lack of transparency about asset prices, supply and risks with respect to off balances sheet vehicles and bank balance sheet liabilities; global economies over dependent on consumer demand in economies with large structural imbalances etc, etc.

And now, well the market is so efficient it cannot survive without unparalleled global fiscal stimulus and effective socialisation of the banking system. We were not in an efficient market place and we certainly do not remain in one and when we will ever get there, who knows.

Those who still believe in efficient markets risk being hanged by their own dogma as the noose of those assumptions tighten yet further.

22 April - Efficient markets and the retail financial services market place

One thing is clear, efficient markets depends on economic and market agents being knowledgeable about factors impacting price, which means economic and market valuation focus as opposed to the belief that because markets are efficient you can invest blindly in an allocation structure derived from past returns and still expect historic risk return profiles to unfold in the future.

21 April – Should you be rebalancing, that is selling low risk and buying equities?

If you are dependent on your portfolio to meet your income and capital expenditure, or are closing in on retirement, then the answer is probably no.

Retired individuals' portfolios should be structured in accordance with their short and long term financial needs and the time of risk affecting the assets' ability to do so. Reducing low risk allocation to take advantage of low market valuations will reduce the short term security of the portfolio and its ability to deal with short term uncertainty.

Those who are closing in on retirement, 5 to 10 years to the start of withdrawal, are also likely to be progressively increasing their low risk asset allocations and in the current crisis may be forced to reduce savings and increase precautionary cash holdings.

Those most likely to be holding excess low risk allocations are also likely to be the more conservative client, unlikely to wish to rebalance in favour of higher risk equity based investments. Again, based on what I see, a great many retail investors were likely holding excessive and aggressively concentrated (often leveraged) allocations to equity based investments.

There will be investors who hold higher cash levels, whose savings out income allow them to increase allocations to equity markets, but these are unlikely to be the majority in the current environment.

The full document is available for a fee – please contact the TAMRIS Consultancy.

18 April - Do not pay attention to long term averages in the current crisis

We see many commentators point to current valuation levels and then compare current valuation levels with historic average price earnings, yields and other measures to arrive at the assumption that markets are wildly under valued.

We must remember that an average does not represent a framework of reference for all points in time, but an average of historical reference points, each with their different frameworks: just like a short person is unlikely to grow tall because of the genetics of others, so the genetics of an economic point in time determine the path and its characteristics and not the genetics of other times. Today's P/E or yield does not therefore relate to an average of the past and their individual frameworks, but to today's point of reference.

We have had excess for some time and this excess is being taken out of the economic, market and financial system. What is more likely than a rebound to historical averages is a gradual normalisation of the present and growth from a lower base. As such, instead of basing projections on a recovery to the past which might see a market recovery to previous nominal highs (in the US) by the end of 2012 and long term capital returns of 11% plus, we may see a market that only provides capital returns of 6% and a return to previous nominal highs by 2020. At an inflation rate of 3% and dividend yield of 3%, this totals a real return of 6%, well in excess of lower risk asset class returns and which would be considered value. But even this 6% depends on average historical rates of profits growth post the transition period.

We really need to get our hands on the framework of reference and appreciate that we have not yet settled into this framework: excess consumer debt/weak demand and excess capacity/weak investment will hamper growth for some time in a large number of developed economies.

15 April – How far are you from your ISP/Modern portfolio theory risk/return crunch time?

I have long been critical of modern portfolio theory, its oversimplification of risks and returns and its portfolio tools. It is likely that portfolio theory will be reshaped in the years to come, but until then we are seeing a rearguard action by many of those who have strongly adhered to many of its strict assumptions.

One of the biggest pressures on MPT advisors will be their ISPs and investment plans that were based on expected rates of return that are becoming increasingly divergent from reality. To build portfolios and plans on the expected returns from mean variance optimisers based often on long term historical time series data, is looking increasingly ignorant and reckless. Many global markets were at insane valuation levels in 2000, yet expected rates of return were not adjusted to take account of this risk. Now, ten years on, most markets are well below their 2000 levels and further still below the expected returns of their ISPs.

8 April – Margin! Is it not time to put the old dog down?

One of the not so quaint characteristics of the Canadian retail financial services industry, and definitely one of the seamier sides of the industry, is the all too easily "accepted" use of margin. Quite why the regulators allow the industry to use margin so indiscriminately, without the very strong risk warnings that should be accompanied by margin use, is beyond me!

Yes, over a long period of time, if returns exceed the cost of debt, providing you can meet the interest payments and tax in the interim, and there are no other calls on your assets, then yes margin may have value. But, it should be clear to anyone and everyone that the use of margin can be extremely dangerous when one or more of the requirements for margin to work, no longer apply: as in the current financial, market and economic crisis.

There are likely to be many investors suffering from the after effects of inappropriate margin use, and much of this use will have been recommended by their advisors.

Will the current financial carnage be the straw that broke the camels' back and force proper regulation of the use of margin by advisors? I think yes: everyone's eyes will have been opened, and those with margin, much wider and more painfully still.

Regulators, in fact, any one with an ounce of integrity and common sense, please put margin into its proper place and out of mainstream Canadian retail financial services usage.

7 April - Are we in a depression?

I have held from the start that the scale and magnitude of the current crisis was the worst since the 1930s and that the scale and complexity of the problems underpinning the crisis was greater than those that led to the 1930s' depression. Much of this analysis is provided in "In Capitalism in Crisis 1, 2 and 3".

Recent work from Eichengreen and O'Rourke provide analysis that states that the current global downturn is every bit as bad (and worse in many cases) than the global downturn experienced in the "Great Depression".

> http://voxeu.org/index.php?q=node/3421 - A Tale of Two Depressions, Barry Eichengreen Kevin H. O'Rourke - 6 April 2009

2 April – The retail financial services industry will be changing beyond recognition – get ready for a gut wrenching 10 more years

It is likely that the next 10 years will be a gut wrenching ride for financial planners, investment advisors, portfolio managers and investors combined.

It is desperately important that institutions and advisors have the sophisticated systems and support that will be needed to guide their business and their clients through this tortuous journey. It is desperately important that investors select their advisors with extreme care.

The current transaction based retail financial services framework will come under increasing pressure as the financial, market and economic crisis evolves: the current service and distribution framework that has been used to deliver retail financial services, especially in the Canadian financial services' market, is inadequate to deal with the needs and demands of advisors and their clients going forward.

The current phase has shaken the boat and many are hanging on for dear life; the second phase will wipe out those who have not made adjustments to the current crisis and the third phase, the final recovery, will see those survivors capitalise on the positions they will have established in the market place.

The retail financial services' industry is about to change beyond recognition: get ready for a gut wrenching 10 more years. The choice for firms, institutions and advisors is whether to find out how to deal with such change, after the fact, or to prepare in advance. The TAMRIS Consultancy is developing a series of documents looking at all the critical aspects of such change.

2 April – Gut feeling

I have had two apparently divergent gut feelings over the last few weeks: the first was that as the S&P 500 dipped below 700 that markets were standing at extremely attractive long term valuation levels; the second and divergent feeling is that a) we are nowhere near the end of the current crisis and that b) the current crisis will be followed by a secondary crisis, ultimately followed by a robust long term recovery substantiating the first of the two gut feelings and solving the paradox.

While we have seen a number of positive economic indicators, we must understand that considerable structural problems remain. Consumers have cut back on spending significantly (but still nowhere enough) in the latter half of 2008 and many important purchases will have been deferred. The rebound in retail sales we are seeing may be no more than the bathwater splashing back onto the opposite side as consumers make these necessary deferred purchases. Industrial production will have fallen as demand has contracted, but in the short term will have fallen below the level of output needed to meet current demand as inventories were cut. It is therefore no surprise that output and orders would see some resurgence, but since demand will continue to fall, output will surely continue to contract.

I cannot see how we are at the bottom of the current economic decline: consumer debt remains at far too high a level; there is no way that consumer debt can be pumped ever higher to finance a consumer led recovery from this point on. So my gut believes that real economic growth is set to decline still further, and for that reason the markets' current positive tone will be short lived.

There are a number of uncertainties: government spending will lift components of output and spending, and it is this which will slow the rate and limit the depth of the decline as consumers continue to de-lever, as they must. If consumers continue to de-lever, then broad real money supply growth is likely to remain subdued meaning that the narrow (BUT NOT THE BROAD) monetary base will continue to expand and the allocation to cash within the market portfolio and precautionary components will continue to accumulate. In other words people will not be borrowing to consume and higher levels of cash will be used to finance expenditure: the overall economy will produce lower returns relative to the monetary base.

This will be bad for asset prices (which will not recover as many expect) and for economic growth which will be anaemic at best for some time to come. Money supply will not be as asset focussed as it has been for the last 30 years.

This build up of the monetary base will lead to much higher inflation once the economic imbalances have gone much further towards adjustment. At some point, broad money supply growth will escalate as demand based on a stronger structural footing recovers (monetary base will circulate much faster in both the portfolio and expenditure components) and we will see very strong inflationary forces. These inflationary forces will force a second period of poor asset price returns and slow to negative economic growth as interest rates rise and output growth is forced to expand in line with the ability to increase productive capacity.

It is beyond this second period that I view the real benefit of long term returns on equities to surface and the real risks of holding excess cash and bond allocations to become evident. However, it is also this latter period which will be used to bring down debt, taxation will be higher. It may be another 10 years before we get from A, the current crisis, to C the final stable structural recovery, which may be a rather muted period compared to the growth we have seen from the 1980s to the late 1990s.

1 April - Canaccord: swimming against the tide or fighting the last war?

Independent Investment Dealer Canaccord appears to be facing the current crisis by cutting a further 75 under performing brokers, and yet more back office costs. It appears one of their solutions is to recruit brokers with larger books of business. But is the right approach? Should they not be looking to make their brokers more attractive in the market place, integrate their own business and service processes, improve service and solutions, cut costs of delivering service and solutions, and add value to the investors that use their brokers and their services? This might not allow them to cut back office costs immediately, but it would allow them to take advantage of the downturn to restructure their business and service processes for a different business environment.

Perhaps they should be looking at the viability of their business model going forward before making changes. Failure to do so could see a continuing decline in its fortunes at a time when its business model (transactions) is highly exposed to the downturn.

If I were a successful broker, the last thing I would be doing in this market environment is jumping ship for a promise but staying put. Likewise, if I wanted to keep successful brokers I would be focussing on developing services and solutions they can sell to their clients, and this is the crunch: how do you regain credibility in the current market place, where perhaps your service and product costs and service and product solutions have failed to meet client expectations? This is the real problem!

1 April – Cheerleading, wealth management demographics & brand credibility

The last two years have changed wealth management demographics and the brand credibility of many a financial institution. The landscape has likely been changing so much that the strategic plans of many firms have been laid low and rendered irrelevant. But can the thinking that pervaded the past help shape the future, or will the cheerleading that has long since stood as strategic thinking obstruct a fresh approach?

1 April - Buy and hold and the risks of oversimplification

One of the fundamental tenets of buy and hold is the implication (expressly stated or tacitly implied) that over the long term, you will achieve a return close to the long term average rate of return irrespective of the ups and downs in between. The lesson of the last 10 years (and more) is that this is not the case, and since the latter 1990s, anyone taking a buy and hold stance (especially where this has been accompanied by high costs) has been severely impacted financially.

The integrity of buy and hold over the short term (we all live in the short term to paraphrase Keynes) has been clearly degraded by events.

An investment prescription should be capable of managing the risks (as well as communicating realism over these risks) to the ability of assets to meet financial needs over time. If this prescription tells people that they can ignore short term market movements and economic cycles without risk to their financial security, and this turns out not to be the case, then we need another methodology that can allow us to take the risk of equity investment without being exposed to the often significant to extreme market and economic risks.

If we are buying risky assets we cannot ignore economic and market valuations, and the often significant to extreme market and economic risks, when managing assets to meet financial needs.

We need to pay attention to valuations and valuation risks.

At the same time, the alternative to buy and hold is not necessarily market timing, which is confusing, because it is also impossible for the market as a whole to time markets. All we can do is to adjust portfolio structure to take account of the time frame of the liabilities of a portfolio to the time frame of the risk of the investment (or the sum of investments), which means adjusting allocations to risky assets in accordance with the size and timing of financial demands and market and economic valuations. If we adjusted allocation structures in this context we would find that market movements to the extreme would be constrained.

Buy and hold has been a useful mantra for a retail based industry that very rarely looks at valuations and valuation risks (and that lacks the strength in depth needed to do so) when providing portfolio solutions.

Of course, modern portfolio theory, with its belief that markets are efficiently priced, and that historical risk/return distributions are reflective of future expected returns, has also aided and abetted a reliance on this oversimplification of the truth. If market and economic relationships were never significantly out of balance, if market and economic growth were always ultimately upward, save the impact of the occasional and brief recession, then buy and hold as a mantra would have more or less stood the test of time.

The ultimate risks of oversimplification are clear: many a retail investor no longer trusts what their advisors tell them.