After The Descent, What Colour The Phoenix?

A perspective on the development of integrated wealth management processes in the Canadian Retail Financial Services Industry

Part 2 a – Financial/Economic Crisis Related Issues - Market timing/buy and hold

As markets have collapsed, we have seen a growing interest in the rear view mirror, most notably a greater interest in market timing. Many investors are concerned that their advisors have let them down with the long term buy and hold mantra: this is largely because it is clear that the fundamentals underlying the crisis, which have been evident for some time, were ignored.

It is clear that the current crisis has eclipsed many of the messages and tools used by advisors: they no longer apply to the situation. Advisors own experiences and expertise (*including service and business processes*) regarding markets may also be largely irrelevant to the current crisis, rendering communications meaningless.

Despite the increasing interest in market timing, one thing should be clear, the future of the wealth management industry does not lie in an increasing focus on market timing: it is physically impossible for every investor to sell all their stock market investments - money supply is fixed (*at a point in time*) and the only way investors can increase their % holdings of cash is to cause equities to fall in value.

There is a large body of academic and practitioner sourced literature that argues that market timing for the average investor is counter productive and extremely difficult to orchestrate on a consistent basis. In Capitalism in Crisis 3, the TAMRIS Consultancy looked at the physical realities of market timing and concluded that market timing per se is not only impractical for the average investor to execute but also runs counter to efficient allocation and management of capital in the capitalist market and economic framework: en masse market timing is destabilising and a risk to the capitalist system.

> While this interest in market timing (selling to avoid a fall, buying to take advantage of a rise) may provide some leeway for service and product providers to take advantage of a "sales opportunity" there are significant longer credibility risks for those who stand on the wrong side of market timing costs and mistakes.

However, this document (*Capitalism in Crisis 3*) also argued that there is a clear rationale for portfolios with significant income and capital liabilities to manage cyclical market and economic risks (*risks posed by excessive demand/supply imbalances for financial, real and productive assets*). The document recommended an asset dedication approach[1] with the allocation to shorter term lower risk asset classes increased as market and economic cycles mature[2] (*over and above an allocation designed to manage*

[1] This issue will be detailed in further perspectives in the current series.

[2] Not for trading purposes but for guaranteeing short to medium term expenditure – sell highly valued assets (risk) for future consumption. The object is not to expose yourself to market timing risk, but to manage liability risks: this focus of this document is not on the detailed physics of this issue.

significant market and economic risk[3]) and that such actions were consistent with the efficient allocation and management of capital in a capitalist market and economic framework[4],[5].

While such actions could be construed as market timing within a strict modern portfolio theory framework (*where market and economic relationships are at equilibrium and future price movements are random and independent*), it does have a valid rationale where market and economic relationships are at times far removed from an equilibrium position and move to and from cyclical extremes[6] and where short term market and economic risk is a natural and frequently occurring risk[7].

If investors are concerned about the management of significant cyclical risks to financial security, and if these risks are greatest at economic and market peaks, then the industry must look to providing service processes that manage these risks.

> If you believe that asset dedication approaches are better able to manage the risks of a market and economic system that is not at equilibrium, then you would need to adopt in whole or in part integrated asset and liability management platforms to deliver wealth management (including retirement income planning).

Since managing these risks requires full knowledge of total inflows to and outflows from an individual's financial situation, as well as the disposition, liquidity and maturity structure of existing assets, higher levels of information and more sophisticated systems and service processes will be needed; minimum industry standards and associated structures are insufficient to deliver "retirement income planning" expectations. Implementing such a change is not without problems as it would represent a change in focus and process for much of the industry impacting all areas.

> One of the reasons for strict buy and hold disciplines (*that is make no changes to asset allocations irrespective of market and economic risks*) is that most advisors do not possess the expertise, discipline, resources or time to do this themselves: a constant proportion asset allocation approach reduces the risks associated with excessive market timing. As more sophisticated systems are introduced these barriers will be easily transcended.

There are of course numerous ways to manage these risks: through partial or complete hedging, or other form of risk transfer[8]; through a dedicated/quasi dedicated structure (*dedicated low risk assets structured to mature to meet income and or capital liabilities*), or a combination of structure and hedging – dependent on investment discipline, client/advisor/firm risk and performance preferences.

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[3] With adjustment for risk aversion: in fact, investors should be able to choose how much short term market and economic risk they want to take and adjust portfolio strategy accordingly – all outcomes should be based on risk/return decisions taken at outset.

[4] Asset values should to a certain extent reflect future consumption and that the management of this consumption of capital risk should be reflected in the demand for asset classes in the market place.

[5] TAMRIS documents on "The Fundamentals of Asset Allocation, Weaknesses of M.P.T. & A Fundamental Framework for the Management of Assets and Liabilities" and "Magic Numbers & Safe Withdrawal rates" discusses this issue in greater depth.

[6] One could argue that markets will only be efficient once they look to manage longer term liability risks within asset allocation and security selection.

[7] Such an approach is also consistent with efficient allocation, consumption and management of capital within the capitalist system for reasons discussed in Capitalism in Crisis 3 and documents noted in page reference 4.

[8] For which transparency of the risk management of this transfer will be important.

Designing a structure to incorporate all or only a small part of the portfolio solution spectrum in a manner that can be easily communicated and implemented will be important. Future perspectives in the series will look at the design options and the decision rule universe of such systems and approaches.

“Your” world view (*portfolio theory fundamentals*), is important in determining your risk management framework and liability management discipline[9]. Those who believe that valuation relationships move out of equilibrium will note that long term risks to financial security are much lower at market and economic troughs than at market and economic peaks, and that such risk/return relationships should influence risk management processes. “Your” world view will determine your risk management methodology: it is probable that future integrated wealth management platforms will need to incorporate a range of disciplines and options if they are to appeal to their end users (both advisors and their clients, and direct on line investors[10]).

There are of course a number of caveats.

- Structure and planning can mitigate significant short term volatility risk without the need for complex and costly hedging or insurance: this means that a) greater focus on structure (relative to liabilities) and planning is the optimum first port of call, and, hence, b) that many of today’s products may be defunct in a sophisticated platform environment.

- Relative to lower cost solutions, higher cost solutions are more exposed to volatility and valuation risks: this means that a) high costs are an important risk factor and a barrier to effective wealth and retirement income planning, and b) that sophisticated low cost systems have significant competitive market advantages that could be leveraged as investors react to the impact of costs on returns in today’s difficult return environment.

- Long term total portfolio hedging is expensive: if you believe that valuation relationships move in and out of equilibrium, then equities need only be partially hedged within a proper structure[11], and certainly not throughout the market and economic cycle[12]. Hedging, risk transfer and other forms of guarantees are expensive which means structure and planning relative to liabilities and cyclical/extreme market and economic risks is the optimum first point of call. Integrated asset and liability management structures not only obviate the need for “market timing” to manage downside risk but actually make risk management simpler.

- Where significant short term market and economic risk are managed via structure, the low risk dedication and the amount of hedging applied to each portfolio will also be a function of risk

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[9] All world views must relate directly to the structures and platforms used to deliver wealth management/retirement income planning and must be capable of being communicated and differentiated in the market place.

[10] More sophisticated systems will be suited to online delivery and use by experienced investors as well as providing low cost delivery to smaller investors.

[11] A portfolio need not hedge the entire equity allocation for a number of reasons in a dedicated asset management structure: cash and bonds cover what would normally be considered short term market and economic risk and even the equity allocation would be partitioned in terms of when capital would be needed for consumption.

[12] A portfolio with a fixed interest exposure is already partially hedged and depending on the matching of liabilities and maturities, could meet income and capital expenditure for part of the time frame of risk. Not all equity capital will be needed at a point in time: in fact, in a balanced portfolio equity capital should not need to be relied upon for some time and only part of the equity capital

aversion, market and economic valuation and hedging costs[13]: long term hedging is more a function of risk aversion but can be used to create flexibility within structure and planning frameworks[14]. Moving towards a liability management framework that mitigates significant market and economic risk simplifies risk management but will require changes to existing processes and methodologies.

- Well structured and planned relatively low cost portfolios are capable of managing the risks usually transferred via options or insurance policies for higher cost structures: structure should be the first port of call for risk management, with hedging/portfolio insurance secondary. In an industry where knowledge and experience are a core component of suitability, simple risk management structures are a bonus.

- Where risks of running out of capital are transferred (as in variable annuities) there is in fact an exchange of risks; these exchange of risks need to be communicated and their management transparent. The ability to easily communicate risk relationships in integrated asset and liability management platforms aids the ability to align brand with investor expectations and actual outcomes. Far too many products are too complex to properly understand and systems and approaches that can aid better transparency and understanding of risk can only enhance credibility in the market place.

- The current crisis has highlighted the limitations and risks of the current raft of risk management products: PPNs and their protection events, Variable Annuities and the impact of their guarantees on the financial viability of their parent companies to name but a few. It appears that there are undisclosed risks for both consumers of products and shareholders of producers[15].

A change in the attitudes toward risk, the structures used and the cost of managing risk, may likely happen as a result of current risk events; financial institutions have also been shown to be poor managers of risk in the current downturn and the true cost of insuring risk has also been underestimated. The costs of managing risk via wholesale risk transfers (*on which many of the current range of products have been based*) from here on in may turn out to be too expensive for individual investors to accept. Many of today's risk management products could therefore be supplanted by systems and services that deliver lower costs, structure, planning and management of structure, and sensible and conservative risk/return modelling.

Institutions are going to have to look long and hard at the value proposition of total risk mitigation, as are individuals. Reducing costs, paying attention to structure and market and economic excess are a number of ways in which institutions can better mitigate investment risk on behalf of their investors. Systems and processes that allow more efficient management of liability risk (*the impact of significant and sustained declines on the ability of a portfolio structure to manage*) also require a direct relationship between an

[13] For new money, increased low risk allocations for conservative investors at cyclical highs, higher use of hedging at market troughs (depending on costs); for liability risk management for ongoing clients less use of derivatives and greater use of structure.
[14] These frameworks are discussed later in this perspective series.
[15] Insurance costs are based on the probabilities of events, if well structured portfolios are capable of managing the risk of most events then there is little sense in paying for a risk transfer relative to these events: it makes more sense to insure against outlying risk events, events which insurers or sellers of options may not actually be able to insure against.

institution's asset and liability risk management and the tools and software used to provide output (*security recommendations and asset allocations for the advisor*).

What the issue of market timing is saying is that many portfolio and wealth management strategies are not adept at managing extreme market and economic risks, and that investors want these extremes managed. Because investors want these risks managed, good advisors should also want to be able to provide services and solutions that manage these extreme risks.

While market timing strategies are not considered to be in the interests of the average investor, asset allocation strategies that look to manage significant market and economic risks via structure and the management of structure are clearly going to be of interest to investors going forward. It is nevertheless worth noting that these structures need to be able to accommodate the wide universe of investor (and advisor) risks and performance preferences and the need to be able to provide more or less exposure to risk in portfolios. .

The issues discussed in this perspective with be explored further and in greater depth in the current series of perspectives.

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