

Perspective

**The Financial Crisis of
Lessons To Be Learned**

Thomas Schneeweis

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Winston Churchill is reported to have said “Never let someone put a good Crisis to Waste”. More importantly if you can find one or if one is not dropped on you, you have the obligation to make one up. While the last of these are not easy, investment management firms have come close to making up a crisis that does not really exist into an art form. For example, we create scenarios where the asset allocation decision process has become so enwrapped with the firm underlying business model that the asset allocation approach is not a true ‘independent assessment’ but merely a way of encouraging the use of the firm’s underlying asset products and risk management tools.

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The Financial Crisis of Lessons To Be Learned

The recent market disturbances have brought into sharp relief the failure of past beliefs--and the facts upon which they rest-- relating to financial models, the institutions that create and distribute these models, and the regulatory and legislative oversight designed to protect investors as well as the financial system as a whole. As such, the recent market disturbances provide investors with what may be a second bite at the apple (the first was the 2008 financial crisis) where once again we have an opportunity to re-examine the changing nature of risk based asset allocation approaches and the importance of manager and/or investor discretion in creating and managing the preservation of wealth.

Certainly, the recent crisis has taught investors that dangers exist in the use and presentation of various asset allocation and risk management approaches. However, despite investor concerns, risk based asset allocation is perhaps the only investment tool that provides investors with an inherent “free lunch”. It focuses on proven practices where equal type assets with less-than-perfect common sensitivity to informational changes lead to higher long term returns than if those assets are held individually (remember the expected benefits of diversification arise not from some statistical correlation but knowledge of how unexpected changes in information (e.g., GDP growth, liquidity (market and security based) impact assets differently). What recent history has shown is that many of the benefits of asset allocation have been lost due to oversimplified approaches (e.g., simple desktop based suggested portfolios) and a less-than-rigorous understanding of the risks and sources of return of differing asset classes. This is particularly true of “new” asset classes such as hedge funds, private equity, real estate, and commodities, as well as so-called structured products. Moreover, the asset allocation decision process has become so enwrapped with the firm underlying business model that the asset allocation

approach is not a true ‘independent assessment’ but merely a way of encouraging the use of the firm’s underlying asset products and risk management tools.

Investors often fail to take into account that the underlying business models of the firms offering asset allocation advice directly impact their product mix, their approach to asset allocation, and the relative return and risk scenarios they use in their asset allocation processes.

Issues in Asset Allocation and Risk Management

The limited space we have in this article prevents us from fully exploring many of the issues in asset allocation and risk management we have come more fully to appreciate during the recent financial crisis. The following highlight several of these concerns.

The Risk of Risk Measurement

At its heart, excellence in risk management and asset allocation requires that asset managers and their investors jointly come to appreciate the fundamental concept that an asset’s or a portfolio of asset’s expected return is based on expected risk; and that investors must actually confront and contemplate the concept of risk. However, each investor has a different definition of risk. Most academics describe risk in terms of standard deviation and beta while most practitioners have little real understanding of either concept, and risk becomes some amorphous concept based on past experience or the reliance on mathematical models and company practice. Differences among investors as to what risk is and how risk

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measurement affects asset allocation means that there is no one definitive approach to risk measurement and risk based asset allocation. In addition, since we monitor only what we can measure, most approaches to risk measurement as asset allocation continue to rely on simplified measures of security and market risk (alpha and beta) as the principal tools governing the determination of fundamental asset risk as well as the ability of managers to create value. However, we have now learned that both the simple world of single-factor risk models (standard deviation, skewness, market beta) as well as in more complex models of risk and return determination, may impede or limit our understanding of the fundamental risks we face (what of counterparty risk, liquidity,) . In short, there is risk in assuming we know what risk is, as well as risk in the actual models used for risk estimation. Numerous examples exist of investor's using historical data to approximate expected return and risk relationships between assets when the fundamental trading aspects of the assets have changed, or the historical indices used to capture asset return distributions have little to do with the construction of current indices, or when the historical data has little if any relationship to current expected returns (e.g., use of historical fixed income returns as a basis for future expected return rather than correctly using the expected return imbedded in current yield curves is but one example of faulty use of historical data).

Other examples include the use of historical asset returns reflected in various asset indices when the underlying investible portfolio which an investor holds does not fundamentally reflect the data used in portfolio risk or return estimation). Investors must come to appreciation, that the expected risk and return of an asset (any asset) simply reflects the informational sensitivity of the fundamental risk factors contained in a portfolio. For instant academic research (Ingram, 2010) has shown that hedge funds are not absolute investment vehicles in that they are not able to provide a positive expected return in all market environments Results show that correlations of the various hedge fund strategies with traditional stock and bond investments often depend on the security markets in which hedge fund managers' trade.

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The expected correlation relationships of various hedge fund strategies with a range of market factors simply reflect the expected relationships between equity and bond market factors and hedge fund returns. Investors now realize that hedge fund or any asset performance changes over time such that the benefits of the asset as standalone or as additions to traditional portfolios depend on the unique investment environment of that period. Therefore, one can think of active asset managed returns as a combination of manager skill and an underlying return to the strategy or investment style itself.

The Building blocks of Risk Based Asset Allocation

The recent financial crisis has raised doubts about the fundamental benefits of asset diversification. Investors must be reminded that in fact most assets acted as expected during the recent investment crisis. Equity funds and high yield debt funds responded equally to increased perceptions of market uncertainty and the negative returns to commodities reflected reduction in global demand. In short there were few if any surprises to the knowledgeable investor. Thus the potential addition of a range of other investment classes should at least offer one answer to the inability of simple stock/bond portfolios to provide adequate diversification. Moreover, the answer to the benefits of asset allocation in a multi-asset universe may simply be that “more is better than less.” Additional assets may provide investors with access to return opportunities that may not exist in other states of the traditional stock and bond world. Many of the limitations of the current asset allocation approaches is that they concentrate primarily on investment in a limited number of assets (stocks, bonds, and real estate). Today, investment in a larger range of investable assets is being addressed through more active asset construction. The increase in potential investment opportunities increases the potential benefit of strategic asset allocation opportunities as well as tactical and dynamic approaches to asset allocation.

Where To From Here

There are of course numerous approaches to asset allocation and risk management. At the heart of asset allocation remains the fundamental set of decisions centered on what and how much to buy, given risk preferences. Most books on asset allocation continue to emphasize the return and risk characteristics of traditional stock and bond investments. Today, major forms of alternative investments, their source of returns, and their recent performance are well understood. Individuals and investors who do not take the time to educate themselves as to the fundamental risks and expected returns have really no one to blame but themselves. However, here, as in most questions of asset management, the devil is in the details. For many portfolios, it is necessary to back into the asset allocation decision by first determining a reasonable set of investment vehicles with the desired liquidity and return characteristics. For most, traditional asset allocation remains the simple choice of mixing various asset classes to provide a mix of assets that offers increased expected return for a particular level of risk tolerance. However, as discussed previously there is no one definition of risk. Before risk can be managed, the fundamental risks impacting a particular investor must be understood as well as some common methods of managing them. In many books on asset allocation, the systematic model driven approach is emphasized. The importance of manager discretion is emphasized. Most investors simply fail to take to heart the axiom that unusual returns can only be obtained from holding unusual risks or paying for means of managing that risk (systematic or discretionary).

The Future: One Perspective

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Asset allocation exists in an evolving marketplace. There will certainly be a series of choices and each of those choices will have ripple consequences. The existence of a multi-asset world is of benefit only if we can take advantage of it. As these choices are constrained by market forces, government forces, or personal choice, the potential benefits are perhaps reduced. At the end of the day, asset choices have to be made. Investors, however, must know the basis for these decisions as well as the basis for disinvesting from these assets.

Throughout the recent crisis, extreme events have occurred. If history is to be a teacher, we know that the future will provide additional crises and despite the best efforts by regulatory bodies investors will lose money (in the recent crisis many mutual fund investors lost 20% to 30% since many fund managers (forced by government regulation or market order to follow a prescribed market index) continued to track the MSCI Emerging Fund Index for which returns fell as volatility increased from 20% to 40%. Managers could have, perhaps should have, focused on keeping a constant risk focus (e.g., 20%) in line with original expectations rather than simply following a prospectus bound representative index.

What have we learned? Hopefully, investors are wary of historical data, historical thoughts, and historical performance. History rarely repeats itself in the same manner; and one of the failings of modern portfolio and risk management design as well as some of the recent academic and quantitative research is the presumption that it will. Just as important, given the dynamic aspects of the markets, any asset allocation and risk management approach requires both a full understanding of the benefits and risks of various strictly quantitative approaches as well as a discretionary overlay to provide additional insight and experience to the asset allocation and risk management process. Since one cannot avoid the next crisis, perhaps it is best to be prepared for it.

Independent Advisors in the World of Post-Modern Investments

One of the principal issues that investors need to determine in the new world as asset and risk management is just where to go for professional advice and what the potential cost and benefits of that advice. It is not the purpose of this brief section to detail all the potential pros and cons of Independent Advisors compared to the suggested benefits of alternative means of investment management including the recent rise of Passive Index Investing including the growth of ETFs and the popularity of web based asset allocation models including the introduction of Robo-Investing. There are numerous articles citing the potential pros and cons of passive fund and computer based asset allocation models versus more active manager based investment. The one con that passive index based and computer based asset allocation and investment models is the relative cost of active investment management. For instance, while costs of various passive index funds including ETFs may vary the cost for standard equity funds are often under 25 basis points in contrast to active mutual funds often charging up to 50 basis points. Similarly, while active independent advisors often charge up to 100 basis points many of the computerized Robo-investment models charge between at least 25 basis points. In short, while differences occur the “out-of-pocket” cost of a truly ETF/Robo-based investment may be about 50 basis points in contrast to a charge of almost 150 basis points for more active asset management. Investors are asking what are they getting for the additional cost.

I cannot speak for all advisors or all Robo-investment models, but when addressing the costs of various alternatives be sure one addresses the real benefits one is receiving from the “low cost” provider and the potential costs from such advice or service. In the case of Robo-investing, I reviewed one of the primary Robo-investment alternatives: What did it provide/suggest for a single 35 year old male with about \$300,000 in savings who was earning about \$150,00 per year and in answering the risk profile questionnaire accepted a decline of 10% in the value of the portfolio. Mind you the computer also asked

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me if I wanted to outperform the market – I gasped. Any knowledge advisor knows that one cannot consistently out-perform the market especially since the primary investment tool offered was ETFs (passive index products). The risk questionnaire was so basic as to provide no real insight as to my risk profile. The portfolio created for me included a large percentage of municipal bonds with a quarterly rebalancing to help with risk management. If I had any questions, I could ask for the help of an advisor. This time I gagged. Whatever the cost it was too much. The model only used ETFs which left out many of the newly created alternative investments and/or risk managed products (e.g., risk parity) that offer real asset and risk management. It offered quarterly rebalancing when any advisor realizes that asset management has to be dynamic and respond to current market conditions. I asked for an advisor and asked some basic questions as to duration of the bond ETF and how they came up with the suggested alternatives. If this was an educated advisor (I had no knowledge of who he/she was or what his or her background was) I would hate to see the uneducated one. I further asked questions as to how often I could change the modeling process myself and if I wanted additional services how could I get them. Of course we have a premium service but that would cost more. I had heard enough. My conclusion. When looking for someone to help manage your assets, the low cost provider could be the highest cost one in terms of the actual risk of investment. Most Robo-investing platforms fail at personal risk assessment, fail in product or investment diversity, fail in terms of modern risk management, caveat emptor.

Active management may in fact offer some benefits in contrast to a strict passive/ETF based approach. They should offer a more involved personal assessment of an individual's risk capacity, they should offer a wide variety of potential investment alternatives (ETFs, fund based product which offer unique risk/return exposures), they should offer direct means of risk management and asset allocation, they should provide detailed investment advice including back office reporting which track tax and risk profile. They should not emphasize individual security base asset allocation (extreme security risk, lack

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of multi asset allocation ...), they should not receive payment based on number of amount of individual trades (e.g., broker), they should not use individual mutual funds that are based on only on their own fund family or assume a single mutual fund offers asset class diversification. Their advisor should show high level of education (what is risk parity, what are the 5 option Greeks, what are alternative investments (ELS) and how are they managed. In short, even active investment advisors differ dramatically in background and experience. What they all do provide are services that without them you would have to provide yourself. The cost of doing active management yourself could easily exceed \$15,000 for a \$ 1 million dollar portfolio (52 weeks and 2 hours a week (at 100 per hour of personal time) + \$5000 firm costs (computer, Morningstar) not to mention Bloomberg Machines educational courses, contacts.... In short, even if an advisor provides little information that provides alpha (index outperformance) their back office activities cover the costs that any individual would have to replicate. In short, fee cover service not performance.

But what to I get from an active advisor. An active advisor is a type of option that provides some level of risk protection; that is, when things go south they often have the right to move to cash or adjust the risk structure of one's portfolio. In the best of cases they act as a type of fire alarm response manager for which you pay a constant fee that may never be used. Their over sight may only happen in severe and unusual cases. Their real worth as in any option based market is best in periods of high volatility. The problem is, as with any insurance payment, you have to pay it even if it is never used. So what questions should I ask my advisor to ascertain the back office and front office services I deserve.

Do they have access to necessary data (Bloomberg, Morningstar)?

Do they have access to the following products and how they fit?

Do they.....?

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What is Risk?

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“It’s Turtles All the Way Down”

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What is Risk?

There is a story that a brilliant physicist was explaining how the earth moved through the heavens. A woman in the back of the room, raised her hand. “No” she responded, “it rides on the back of a Turtle”. “What does the Turtle ride on?” he asked. “You can’t fool me” she said. “It is Turtles all the way down”. Same thing on investment risk. Every brilliant investor says they know what risk is, but in truth it is risk all the way down; that is investment risk, operational risk, firm risk, management risk, risk all the way down. So if one cannot control all risks does one have any answers? For the most part, we have come up with two. 1) Diversify among multiple assets so that we hold a lot of different assets so that the risk of one does not impact the risks of the others and 2) buy insurance from others who have the will or the ability to take on risks we do not wish to take.

But there is risk in believing that either of the two answers eliminates risk. Let’s take a quick look.

1. Diversification: Diversify among multiple assets so that we hold a lot of different assets so that the risk of one does not impact the risks of the others.

Answer: Investors often look to “Modern Portfolio Theory” as the support for diversification as the basic approach to risk management. Remember diversification does not eliminate risk. A stock with a 7% expected return and an expected 10% standard deviation has a 15% chance of a return greater than 14% and a 15 % chance of a return less than -3%. “No Free Lunch”. But even then, Modern Portfolio Theory is now over sixty years old, so it is really APT (Ancient Portfolio Theory). Nasim Talib wrote several books on this. All of which comes down to this. There are risks we do not even know exist (e.g., Black Swans), they often come at the worst times, and they affect all assets such that diversification benefits based on past data is a fool’s errand. In short when things go bad, they may go bad for everything and just holding a lot of things does not eliminate risk. Are there any other choices?

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2. Go for the Gold: Do not hold Assets based on their Derived Value (Firm, etc.) but buy Gold (or any other Real Asset) and Bury it

Answer: The trouble with it “is” that it, the gold, could also be worthless since all the money that anyone else had has also declined. In short there is no one left with any money to buy the gold (and that which they have may be used for things like food and clothes). Lastly, any power that exists after the crash could merely declare gold a non- asset. “Poof”.

3. Find a Friend: Who Will Protect You. In short, “Buy Government Bonds”.

Answer: See Russia, China, Argentina, Venezuela, Turkey, Greece

4. Past the Risk to Others: You pay others to get others to take on your risk

Answer: If the Government cannot protect you from all risks what makes you think your Friend can, but as in all cases what is the cost of that insurance. Here is that word again (Insure) but like everything else in insurance it is turtles all the way down.

One has a limited amount of time and paper to discuss all the various turtles. Here are some of them and the “Risk” in all of them.

Buy Insurance From “Insurance Companies”. It is insurance all the way down, Insurance companies, re-insurance companies, re- Re-insurance companies. Often Called Annuities, they have all the risk of the company they are bought from which have the same investment risks you have – (See previous discussions on Diversification).

Insurance from Others - Hold Options – We have created a series of “Mark to Market” as a means to reduce counter party risk – but when bad things happen there is no one left at the party. The other issue is cost. Let us take a look. You have 100 and want to lose no more than 5%. An option may cost you 5%. So that if the market falls 5% then you have really lost 10%. (Note you can pay for this by selling calls above 105 and below let us say 90 and get about 5% - if all goes south you only lose 5% - Of course if the market goes up beyond 105 you fail to make all of the upside - so in the end you pay.

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Self Insure

- a. Hold Cash: Hold 90% in Cash (earn 1.5%) and 10 in Stock. If the Stock portion loses 10% you at least have the \$91.5 in cash.
- b. Hold Stocks and Bonds: Hold 80 in Stocks and \$20 in cash. You feel that on a daily basis the most you can lose is 2% of the value of your stocks. If stocks start to lose and you see the value of your portfolio fall to near \$90. Get thee out of stocks (Assuming there is someone to buy them).

In short there is no free lunch. No risk free IRA or 401 k. No risk free diversification. There is risk in any and every choice. The biggest risk is to talk to someone who says “Don’t Worry. I have covered all your risks”. Embrace that risks exist everywhere in life and find how you best feel about coping with it. So if your investment advisors says “Don’t Worry” I have you covered. You better start worrying big time - He or she is simply not telling you the truth. Someone has to cover you and for that there is always a cost. Oh, there is another approach to risk control, I forgot about.

5. Pray to God and Hope for the Best. The problem to No. 5 - There is probably a long line in front of you.

Looking forward to your comments.

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The Enemy Within US

Thomas Schneeweis

September 2018

As darkness falls on Friday I am still out in the yard putting the final pieces together. I finish at midnight and proceed to begin my article on 'American Productivity in a Global Culture'. The central focus of which is how America is losing its productivity edge to East Asia. It may be late but I can assure you the article is going to be great, if only I can get this computer made in Asia to work.

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The Enemy Within Us

Often failure follows us and takes us from behind, often failure is thrust upon us, but rarely do often we seek out failure ourselves and even more rarely do we see it before it is too late to send it back from whence it came. As I sit in my office attempting to put together the facts of the day that led to my full awareness of the danger that outside forces are slowing wrecking upon us, I can only laugh at how I failed to understand the menace until it was too late.

In order to set the scene, I may be worthwhile for the reader to know that on Sunday of that week my wife informed me that she has set about to have a summer get together the following Saturday for her family and a few friends. She also asked that I order a set of teak patio chairs and a table for use on the outside patio so that the guests could enjoy the summer afternoon. She also asked that, while I was at it, to please place an order for a traditional Adirondack chair (to give the patio table and chairs a little class, in her words). Her requirement was, I thought, a simple one and one that should have been easy enough to complete. This was only Sunday, certainly enough time to locate the proper order site, to place an order, get the chairs delivered and set up and still leave me with enough time to dispense of my required weekly Saturday deadline on 'The American Home'.

No worry I thought, I would simply wake up early enough on Monday morning to finish what was required by my wife and still, I thought, have the time to meet my self imposed deadline for submitting my weekly article to my editor by Friday. By the end of the day, I had already reviewed my options over the internet. I had the internet site of the firm that I wanted to work with as well as their telephone number. I had the model numbers of the patio chairs and table as well as the Adirondack

chair. On Monday, I was up by eight, at the desk by nine with coffee in hand, and a credit card at the ready. The only problem was that the site that I wished to purchase the items from was (I found out) based on the West Coast which meant I could not call them until noon - Minnesota Time. OK, a small error in judgment but not one my wife had to know (at this time I should point out that I could have simply gone to the 'IKEA teak emporium' about an hour away but knowing what the party would cost me, I felt the necessity of keeping the cost to a minimum.

When my wife asked if all was settled I of course said - No Problem - and spent the next three hours surfing the net. I called at twelve to the cheery sound of a salesperson with an accent I could not quite decipher. Welcome to the international house of teak. I proceeded to go over my list and point out the website where I had located the merchandise. Note the site had promised plenty in stock.

No problem he assured us, we have plenty in stock. The only problem is that the stock is currently at our warehouse in Indonesia. We can get it to you in two weeks. The problem, I pointed out, was that I needed it in two days (giving myself plenty of time leeway in case of any problems). Impossible he said, it takes that long to grow the trees. Did I have any alternative I asked? Of course, we have some in the United States but only our top-of-the-line products are available there. Two hours later and several hundreds of dollars poorer, I had ordered their premier 'prestige collection' U.S. teak chairs and tables. OK I could still look good on this. Paying more for a higher grade style often convinced my wife that I really cared about this family thing. But, having gone over the teak budget, I attempted to recover with the Adirondack chair. I mean where else than the mountains of Virginia can they be built.

No those too (if they are made of teak) are made in the mountains of Malaysia (only cheap pine or plastic ones are made in the good old USA). Here was the good news; they had plenty of the Malaysian Adirondack chairs coming in shortly. But to be sure they requested that I call back at five o'clock. At 5 PM Minnesota time, I had the order in hand and the credit card ready. I called back only to be told that the earlier order taker had left for breakfast (at five o'clock at night I thought). Five o'clock 'drink time' Monday in Minnesota I was told was seven o'clock 'breakfast' time Tuesday in East Asia. I had promised the individual I would work with him and said I would call back the next day. I went back to my computer to work on my article, comforted that I still had four days (Tuesday and counting) to complete my task.

I spent the morning of the next day (Tuesday) taking a drive over to the "IKEA Teak Emporium" just to check out the competition. I was surprised to see the line of individuals overlooking the sets of teak Adirondack chairs, tables and the like. A sign above them read; will assemble, check within. I proceeded to ask the salesperson what the time frame was on having the chairs and tables assembled. He responded that it generally took two weeks and the cost; equal to the cost of the chairs and table themselves. He added, however, that in this case, it did not matter since the two individuals who put the chairs together were from Bangladesh and had just been deported back to the homeland by homeland security (ours or theirs I asked). I pointed out that I NEEDED them to be assembled by Friday. Well maybe if you had come in yesterday we could have helped but Tuesday - no way. Somewhere in the back of the store, I could swear I could hear someone laughing. I refused to buckle under. What is a man if not the provider of the feast, the master of his lawn.....

Out of options, I returned home, to call Tom at 'Teak International' before he went to breakfast. No problem Tom will be here as soon as prayers are over. I did not know Tom as a religious man, but praying is important especially since I was starting to think of doing it myself. I finally got a hold of Tom and had his assurance that the U.S. order, quality Adirondack chairs as well as the tack patio chairs and tables, would be delivered by end of day Thursday.

Wednesday morning night arrived with my wife asking where the chairs and tables were because I had promised to go shopping with her on at IKEA for party accessories (she wanted to make sure the dishes and table cloths went with the wood). I, of course, lied. I point out that heavy rains on the west coast had delayed shipments and that after hours of effort, I found a way to get them by Thursday noon. But I was told not to worry the colors on the website were true. The rest of Wednesday was spent following my wife in her effort to outdo Outdoor Magazine but at an IKEA price. (Did you notice that An IKEA and Al Qaeda sound alike)? Again being the person who writes a 'finance' column on the American family for the very same, somewhat left of center we care about the world, "Outdoor Magazine", I understand that it is our personal responsibility to import goods from less developed nations and send them dollars in return which they immediately sell driving down the value of the dollar and increasing the cost of everything we buy from them. Regardless, I ended the day with enough bought in East Asia to support a small village in Borneo and topped it off with several hand made rugs from Afghanistan which would just make the entry way just perfect. I at least thought that perhaps I could take this off as a tax-deductible expense since most of my tax money is going to support our Afghan effort.

I awoke Thursday with my wife asking me to double check on the noon delivery. No problem. Since I had the delivery codes all I had to do was call UPS. Of course, UPS had no such numbers on record. They said this happens often with orders from firms based in Asia. I said it was a US Firm. (I heard a laugh as said I had to call their office when it opens at 5PM Minnesota time). At 5 PM, with drink in hand I called Teak International and asked, somewhat joking if he was still at prayers. As a matter of fact, Tom had left and to cover his past sins had joined a cult dedicated to saving the rain forest. In any event, they found the order, I got the number, and located the shipment. Of course, it was in White Bear MI not White Bear MN but they would have it here first thing Friday morning. I woke up stiff on Friday from sleeping on the coach but ready to redeem myself. At ten the UPS van showed up. I asked the driver where was the additional help? Read the small print he pointed out. Orders left at curbside and curbside it was.

I paid half a summer's wages to the next-door kids to take all of the boxes from in front of the Garage and put them on the front lawn. By noon they were all unpacked and ready to assemble. I even got the kids to feel sorry for me and had them put all the packaging material back in the garage (for twice what I paid them to put the very same boxes on the front lawn). No problem, four hours to put them together and an hour left to put together my weekly editorial for 'Outdoor'.

Writing for 'Outdoor' does not mean being "outdoor". I soon find out that Teak is not Teak at least not until you buy and apply Teak restorer – found where else – IKEA. Upon my return three o'clock was upon us. I started the assembly process; the patio table, then one chair, two chairs, three chairs, four chairs. I was Mr. Assembly. The task was made easier in that they only provided three of

every four screws. No worry my wife's friends were on the thin side. Onto the 'Teak' restorer. After the first application I had more teak on me than in the tables and chairs. Not quite the color my wife expected but as I tell my wife, the contrast will be 'a conversation starter. I started to panic when I realized that I was out of teak restorer with one Malaysian/American Adirondack chair to go – keep cool I thought– the sun was setting and I could see my wife at the door with computer in hand and with a blanket over her shoulder. Reality set in as I heard the backdoor lock. Not to worry, I will simply put the 'Afgan' blanket over the American/Malaysian Adirondack (I obviously was using it that night).

As darkness falls on Friday I am still out in the yard putting the final pieces together.

I finish at midnight and proceed to begin my article on 'American Productivity in a Global Culture'. The central focus of which is how America is losing its productivity edge to East Asia. It may be late but I can assure you the article is going to be great, if only I can get this computer made in Asia to work.

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The Grass Harp: The 60/40 Portfolio

Thomas Schneeweis

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For many, as many investment strategies come and go (risk parity, smart beta), the 60/40 portfolio continues as the story of investment life. Moreover, its history is intertwined with the many characters who have come to damn it and those who come to praise it. As I often do, the 60/40 portfolio is the ‘investment’ tree house evoked in Truman Capote’s the Grass Harp in which the many characters come and go while learning the story of life.

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The Grass Harp: The 60/40 Portfolio

How often in life is one given a simple solution to an often difficult question? In the investment world, the question is whether there is a natural asset allocation among investible asset classes that offers the investor the best of all worlds; that is, an acceptable return at an acceptable risk. For many, the 60/40 portfolio is just that simple solution; that is, according to its proponents, it provides the just the necessary diversification among competing assets (e.g., stocks and bonds) such that as the economic winds blow it provides reasonable return for a wide range of investors. For many, as many investment strategies come and go (risk parity, smart beta), the 60/40 portfolio continues as the story of investment life. Moreover, its history is intertwined with the many characters who have come to damn it and those who come to praise it. As I often do, the 60/40 portfolio is the ‘investment’ tree house evoked in Truman Capote’s the Grass Harp in which the many characters come and go while learning the story of life.

While I have certainly read too much into Capote’s Grass Harp (which has been roundly criticized) I still like the story. For those who have not read it, it centers on a treehouse in which many characters come and go and around which the struggles of life’s questions are discussed and enacted. In the end, it is decided that the confrontations are simply to be forgotten. Through time, life tells its own story, people come, people go, and things happen so sit back and listen. As mentioned, if that story could be written for investments it might be for many the 60/40 portfolio. Times come and time goes and it remains timeless. It is a simple story and even

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somewhat inspiring story but as for the most of us it remains incomplete (perhaps as Capote's own story). Nowhere does the 60/40 tell us what stocks to own or what bonds; that is for stocks U.S. or non U.S., value or growth, large or small. For bonds, low risk or high risk, short maturity or long, high or low ratings.

As important, where did the commonly accepted 60/40 stock bond portfolio come from? While it is impossible to track down completely, a search of the literature seems to focus on the research conducted in the 1970's and 1980's which used data from the newly available Ibbotson and Sinquefeld data bases. These and other data bases around the time provided for the first time a historical data base going back to the 1930s. To this day for many the period since 1930 forms the basis for the results that for a manager whose main goal was to provide a reasonable return to risk tradeoff would hold a 60/40 portfolio.

It did not take long, of course, for many investment personnel to realize the potential issues in using this simple portfolio as a common benchmark by which all other managers would be judged. First of all, concentrating only on the return side of the investment question left unanswered the liability risks of an investor (profit or non-profit alike). Thus, the simple risk side was largely misunderstood in a larger context. Second, concentrating on the U.S. markets from the 1930 on missed the opportunities available in many other emerging as well as non-emerging markets. The portfolio also had little to say about modern developments in asset allocation including portfolio optimization models which attempted to fix an asset allocation based on desired risk and expected return and risk relationships among securities.

Thus the 60/40 portfolio had many ups and downs. While many are aware of its historical basis as well as its lack of a theoretical basis, it does provide for many the benchmark by which

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other decisions are made. In short, if not 60/40 what? For those raised on the fairy tale of the Goldilocks and the three Bears, it is like the porridge (not too hot and not too cold) or like the beds (not too hard and not too soft).

The biggest concern, however, is that each bed and each bowl of porridge is taste specific and may change with time and age. Moreover, markets change quickly. What is just right can become cold very quickly and sometimes someone wants or needs a soft bed. If recent behavioral research has confirmed anything about investments, is that we often overweight recent events. The call to the 60/40 portfolio evoked a unique time and place in the historical returns of the United States. That having been said, portfolio managers are faced with the fact, that if their portfolios are substantially different and the investment god's work against them, they will be asked by their investors and often 12 men and women true why they acted against history and put their judgement above those of the past. Faced with this reality, many investors and investment managers remain wedded to the 60/40 portfolio. If not quite right, at least it can be shown historically to be not quite wrong.

For years, I have been writing articles and books around the central thesis that one should not simply use the past as a forecast of the future, that for the modern investors the traditional 60/40 stock bond portfolio should be D.O.A.; that is, dead on arrival. Today the existence of a wide new range of investment vehicles (futures and options); investment techniques (dynamic and non-path dependent portfolio insurance), a changing global investment environment and trading environment in which a range of new alternative investments exist and deserve at least a foot at the table or a place in the discussion are available.

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Still talk is cheap and whiskey costs money. The most recent discussion centers on understanding the underlying risks of the 60/40 stock bond portfolio. These risks have changed based on the current factors driving markets (interest rates, regulation). One is now obligated to understand the fundamental factors in a portfolio and their sensitivity to anticipated market conditions. If one has no idea what those are and what there affects may be, then the simple naïve 60/40 historical based portfolio is an alternative, but a simple solution does not mean reduced risk. Sometimes the simplest solution is the one carrying the biggest risks. If one has to pay more to reduced risk and complexity then there should be a cost to simplicity. If I remember that was the conclusion to “The Grass Harp”.

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