i^3Cubed

Independent Perspective

A Quarterly Newsletter for Financial Advisers

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Issue 22

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Special points of interest:

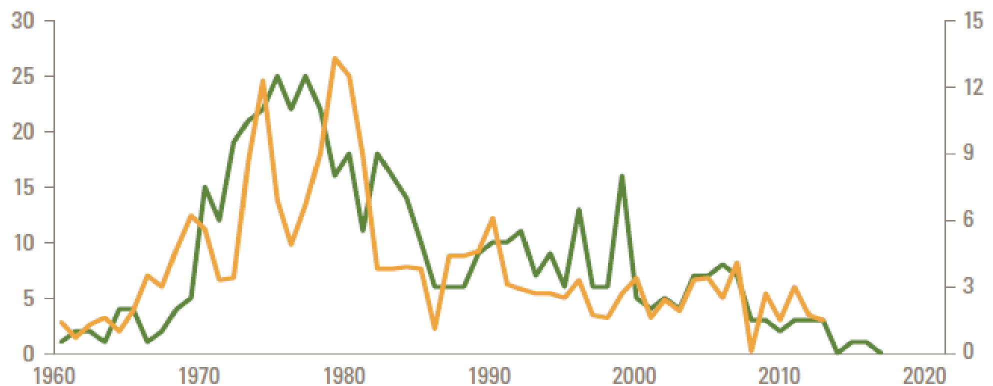
- How often are you faced with the situation in which a clients aspirations for return are unduly optimistic given their disposition for withstanding risk? (page 2).
- Your clients' trust is fragile, and even if you have a deep client relationship with well-established trust, significant underperformance can undermine this relationship (page 3).

Inflation & The Quality of Music

Some great news out of LPL Financial for the boffins at the US Federal Reserve. LPL has identified a robust predictor for inflation. LPL Financial observes that U.S. inflation simply follows the quality of music with a lag of about five years (see chart below). The obvious advice for Janet Yellen of the Federal Reserve is to simply focus on whether the music industry cranks out some better albums in the coming years.

This is of course a tongue-in-cheek piece of research, but does highlight an important investment issue. Continued on page 2…

Number of Great Albums*, Shifted Forward by Five Years *(Left Scale)*
Consumer Price Index, Year-Over-Year % Change *(Right Scale)*



Source: LPL Financial Research, *Rolling Stone*, Bloomberg data 02/13/14

* *Rolling Stone Magazine* greatest 500 albums by year of release

An Investment Manifesto

Whilst I write regularly on investment concepts and strategy, I have never complied those thoughts in to one concise form. A small number of overarching themes run through the investment articles I write. They focus on those things that are within your control as a financial adviser. After all, there is little point worrying about those things that are beyond your control.

We all too often are looking for the next best thing and a route to investment success. This only exists in the mind of the hopeful and the transcripts of the deceitful. Investors too often focus on the markets, the economy, manager ratings, or the performance of an individual security or strategy, overlooking the fundamental principles that can give them the best chance of success.

An investment manifesto is similar to an investment philosophy – a set of principles which guide the type of investment advice a firm offers. But it is more broad-based, incorporating things that are good practice for investment planning and might well be considered under a service philosophy. I have begun to document all of the principles into what I am calling an investment manifesto and will expand on each principle over a series of coming quarterly newsletters.

The third principle of my investment manifesto is about the fact there is no such thing as a legal free lunch. *Continued on page 3…*

Inflation & The Quality of Music *Contd*.

It is said that statistics is the science of producing unreliable facts from reliable data. The chart on page 1 from LPL Financial Research, highlights the ability of statistics to back-up any story one might wish to tell.

In a famous tongue-in-cheek 'experiment' on data mining it was found that 75% of the variation in the S&P 500 could be explained by butter production in Bangladesh! By adding cheese production and sheep population, correlation rose to 99%!

The link between butter production in Bangladesh and the S&P500 (or album sales and inflation) are obviously spurious. But imagine if we cloaked a strategy in terms of a something complex involving GDP forecasting, interest rates, volatility etc, it would seem more plausible. Financial markets produce a tremendous amount of reliable data. But remember they have only one history. And when one knows what that history is, it is a trifling matter to find factors that 'explain' it.

75% of the variation in the S&P 500 can be explained by butter production in Bangladesh

The investment conclusion to all of this is simple. There are lots of complex strategies that seem plausible and provide charts which 'prove' that they work. Many of the charts we are presented with are based upon data that has been optimised, so of course it looks wonderful on a back test. A lot of strategies look great on back-testing but get found out at implementation, when consideration is given to trading costs, management fees, and taxes. Accepting an inevitable tendency to be persuaded by irresistible looking returns, at least allocating to them in small doses won't blow up your portfolio.

The irony about the famous experiment I refer to above, is that following its publication, the author received enquiries from people wanting to know where they could access data on butter production in Bangladesh. A very apt saying is; Regulation will not stop a fool from losing his money, but it should at least stop the average person from being made to look like a fool. Regulation in the area of using optimised data in charts is hopelessly inadequate. Buyer beware.

Every Fund is High Risk if Misused

I was at a conference recently at which the head of pensions in AIB articulated something very well. When asked about how they deal with matching client aspirations with their risk tolerance and calibrating expectations properly, he said that they don't rate funds as being low, medium and high risk, going on to say that, "Every fund is high risk if misused". Seven simple words which illustrate certain fundamentals of investment financial planning.

How often are you faced with the situation in which a clients aspirations for return are unduly optimistic given their disposition for withstanding risk?

If I am a 35 year old funding for retirement and I have a conservative preference for risk, a low risk fund is potentially a high risk strategy. One's definition of risk is the critical issue here. Our industry (financial services) dictates that volatility is the measure of risk. It's far more complex than that. As Einstein said, "Not all that can be counted counts". Risk doesn't always lends itself to easy measurement. For the 35 year old, the risk is getting to retirement age with too little because they were too conservative. It's getting to retirement and not having kept pace with inflation. It's getting to retirement and experiencing a significant drawdown from being overly aggressive. Show me a number that will capture all of this! Every fund is high risk if misused is a theme I will be returning to regularly.

Investment Manifesto Contd.

(iii) There really is no such thing as a *legal* free lunch

Sound-bite investment strategies are dangerous – television or radio will always privilege style over substance. When I hear market pundits opine as to where markets are going next, I invariably wince. Buffett in his most recent shareholder letter observes that this practice often reminds him of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth." Indeed!

Most people in the investment business know that investing is complex and that there is no sure thing, hot tip or next best thing. Or at least not one's which will keep you on the starboard side of the law! Despite best intentions, clients can get derailed from the plans you set out for them, hitching their wagons to a star in search of the illusive free lunch.

As a financial adviser, one of your key value-ad practices is creating a detailed investment plan for your clients and helping them to follow it. Abandoning a planned investment strategy can be costly, and research has shown that one of the primary reasons for clients' derailing is behavioural: the allure of market-timing and the temptation to chase performance.

A common method of analysing investment fund investor behaviour is to compare investor returns (what the average investor actually earns) to fund returns (what performance funds actually deliver) over time, with large differences being a sign of performance-chasing.

You don't know how easy this game is until you get into that broadcasting booth

History suggests that investors commonly receive much lower returns from the funds they invest in, since cash flows tend to be attracted by, rather than precede, higher returns. In the chart below Vanguard shows the performance of funds across various categories for the ten year period ending 2013. It compares this to the return the average investor in those funds has earned. The performance drag ranges from 1.2%-2.3% p.a.

		Value	Blend	Growth
Large	Time-weighted return	6.97%	6.93%	7.60%
	Investor return	5.14	5.54	6.21
	Differential	–1.83	–1.39	–1.39
Mid	Time-weighted return	8.95	8.58	9.01
	Investor return	6.69	6.73	7.80
	Differential	–2.26	–1.85	–1.21
Small	Time-weighted return	9.25	9.04	9.15
	Investor return	8.11	7.70	6.83
	Differential	–1.14	–1.34	–2.32

Source: Vanguard. Investor returns versus fund returns for the 10 years ended Dec 2013.

The theory behind this seems reasonable. But as Yogi Berra once observed, "In theory there is no difference between practice and theory, but in practice there is". What can financial advisers do? Advisers can act as emotional circuit breakers by circumventing clients' tendencies to chase returns or run for cover in emotionally charged markets. The evidence provided by Vanguard shows that a single client intervention, could more than offset years of advisory fees.

In the last principle of my investment manifesto I discussed the importance of creating reasonable expectations for your clients.

The tendency to chase returns has its origins in listening to so-called experts make predictions. It sounds a little glib to say that your clients should just ignore the tipsters that are given airtime. But the world is simply too complex, too incomprehensible for financial experts to predict consistently.

Your clients' trust is fragile, and even if you have a deep client relationship with well-established trust, significant underperformance (whether perceived or real) can undermine this relationship. Clients need to be disabused about the notion that the free lunch exists. Expectations really do matter.

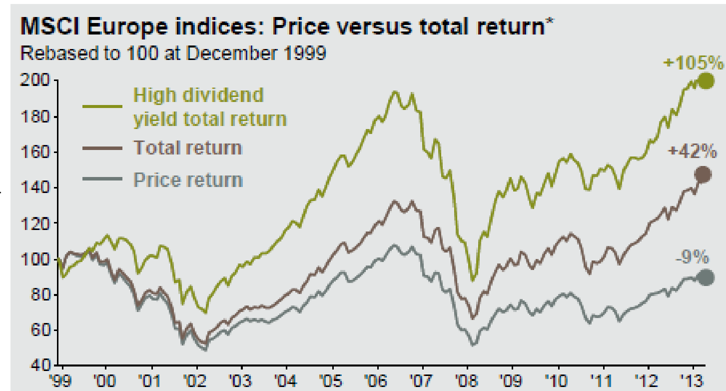
Hindsight Asset Management

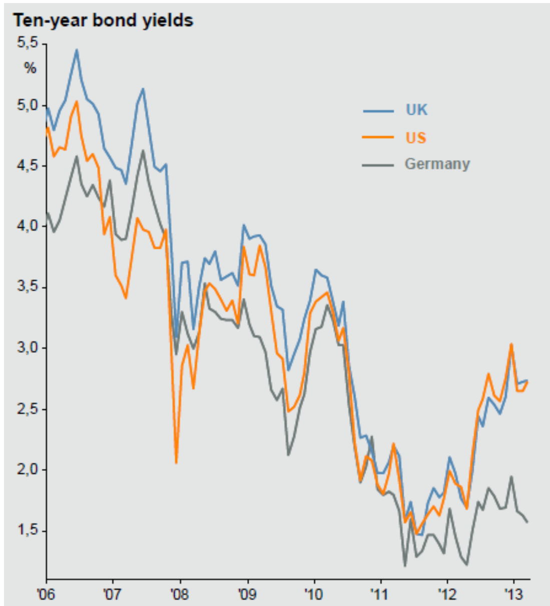
Regular readers will know my views on providing market reviews. It has become a commodity and any number of newsletters are available which offer the relevant data.

This brief section is simply aimed at providing a couple of charts of particular interest from the past quarter. I refer to this section of the report as Hindsight Asset Management to emphasise the fact that we are only reporting to clients on events that have already taken place and therefore is of less relevance to them in terms of their quest to allocate money today to investment opportunities likely to provide future returns.

Income

A salutary chart for those investing without entitlement to income (i.e. most structured products). This shows the performance of various European equity indices including and excluding dividends since 1999. European equities over the last 14 years have registered a negative 9% return in price terms, i.e. excluding dividends. The total return (including divs) over this period was 42%.





Source: JP Morgan

Bond Yields

Bond investors must be shaking their heads when they see the US 10-year note yielding 2.68 per cent, down from 3 per cent at the start of January. Given that bond prices move inversely to yields, sections of the US Treasury market have performed strongly since the year began. However, the recent decline in yields has occurred while the central bank has stepped back from buying long-term Treasuries via its taper of quantitative easing.

According to the FT, the interplay between equities and long-dated Treasury bonds has also been driven by pension funds and insurers cashing in on last year's 30 per cent rally in the S&P 500 and switching back into government bonds that back in January had experienced a hefty rise during the preceding seven months.

The equivalent UK gilt yield took a similar path to US treasuries during the quarter. German bunds declined slightly over the quarter, hovering around 1.5%.

Period Table of Asset Class Returns 2014

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	1Q14	Ten-yr Ann.
€ / Local	16,9% MSCI EM 16,4%	55,0% MSCI EM 35,8%	20,2% MSCI Europe 19,6%	26,7% MSCI Asia ex Japan 38,0%	-23,0% Japan TOPIX -40,6%	73,4% MSCI EM 62,8%	35,4% Small Caps 24,4%	5,5% US S&P 500 2,1%	20,8% MSCI Asia ex Japan 19,7%	27,2% Small Caps 35,8%	2,9% Small Caps 2,7%	10,5% MSCI EM 11,4%
	15,8% Small Caps 20,9%	45,3% Japan TOPIX 45,2%	19,6% MSCI Asia ex Japan 28,6%	26,1% MSCI EM 33,6%	-33,7% US S&P 500 -37,0%	67,2% MSCI Asia ex Japan 67,2%	28,3% MSCI Asia ex Japan 15,6%	3,5% HDY Equity 1,5%	18,1% MSCI Europe 16,4%	26,7% US S&P 500 32,4%	2,2% MSCI Europe 1,9%	10,0% MSCI Asia ex Japan 10,5%
	12,6% MSCI Europe 12,7%	41,9% MSCI Asia ex Japan 24,1%	18,6% MSCI EM 28,8%	4,6% Portfolio 11,1%	-37,9% HDY Equity -34,4%	40,2% Small Caps 40,8%	27,5% MSCI EM 14,4%	-5,7% Small Caps -8,7%	16,8% MSCI EM 17,4%	21,5% Japan TOPIX 54,4%	2,0% HDY Equity 1,9%	9,2% Small Caps 9,6%
	11,8% HDY Equity 15,6%	33,8% Small Caps 23,3%	16,0% HDY Equity 21,6%	3,2% MSCI Europe 6,5%	-38,6% Small Caps -40,4%	37,6% Portfolio 35,8%	23,9% Japan TOPIX 1,0%	-5,8% Portfolio -7,5%	16,3% Small Caps 18,4%	20,5% MSCI Europe 22,3%	1,8% US S&P 500 1,8%	8,0% Portfolio 8,5%
	10,6% Portfolio 13,4%	33,6% Portfolio 23,9%	12,5% Portfolio 19,4%	-1,0% HDY Equity 4,7%	-40,3% Portfolio -40,1%	34,0% HDY Equity 30,2%	23,1% US S&P 500 15,1%	-7,5% MSCI Europe -8,8%	15,6% Portfolio 17,1%	15,3% Portfolio 23,6%	0,7% Portfolio 0,4%	7,8% HDY Equity 8,4%
	9,2% MSCI Asia ex Japan 11,9%	27,0% HDY Equity 17,7%	5,2% Small Caps 13,6%	-4,9% US S&P 500 5,5%	-43,3% MSCI Europe -38,5%	32,5% MSCI Europe 28,6%	20,9% Portfolio 11,1%	-9,6% Japan TOPIX -17,0%	14,2% US S&P 500 16,0%	13,9% HDY Equity 20,5%	-0,4% MSCI EM -0,5%	6,9% MSCI Europe 7,1%
	8,1% Japan TOPIX 11,3%	26,7% MSCI Europe 25,5%	3,6% US S&P 500 15,8%	-8,8% Small Caps -3,8%	-49,8% MSCI Asia ex Japan -47,7%	22,5% US S&P 500 26,5%	16,2% HDY Equity 8,0%	-14,3% MSCI Asia ex Japan -14,6%	13,6% HDY Equity 14,0%	-1,1% MSCI Asia ex Japan 6,2%	-0,7% MSCI Asia ex Japan -0,8%	6,5% US S&P 500 7,4%
	2,9% US S&P 500 10,9%	20,9% US S&P 500 4,9%	-8,7% Japan TOPIX 3,0%	-14,5% Japan TOPIX -11,1%	-50,8% MSCI EM -45,7%	1,5% Japan TOPIX 7,6%	11,7% MSCI Europe 7,5%	-15,4% MSCI EM -12,5%	5,9% Japan TOPIX 20,9%	-6,5% MSCI EM 3,8%	-4,8% Japan TOPIX -6,7%	3,3% Japan TOPIX 4,0%

Source: JP Morgan

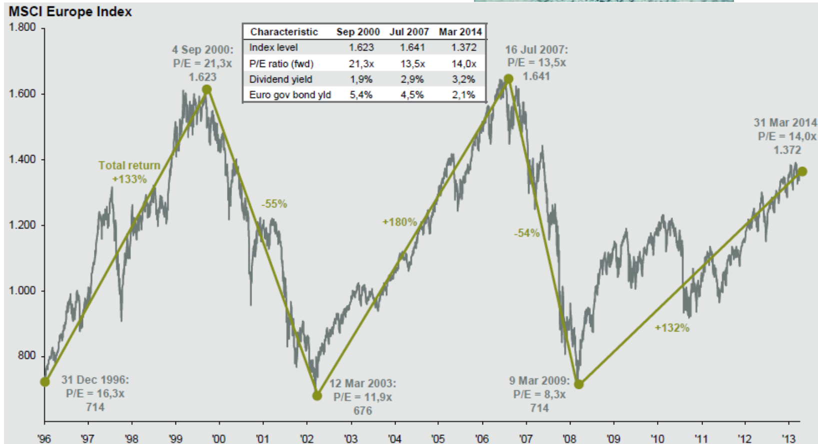
This chart is from the JPMorgan Quarterly market review which is a treasure trove of market data for anyone so inclined. Copies available upon request and with the permission of JPM.

Hindsight Asset Management Contd.

European Equities

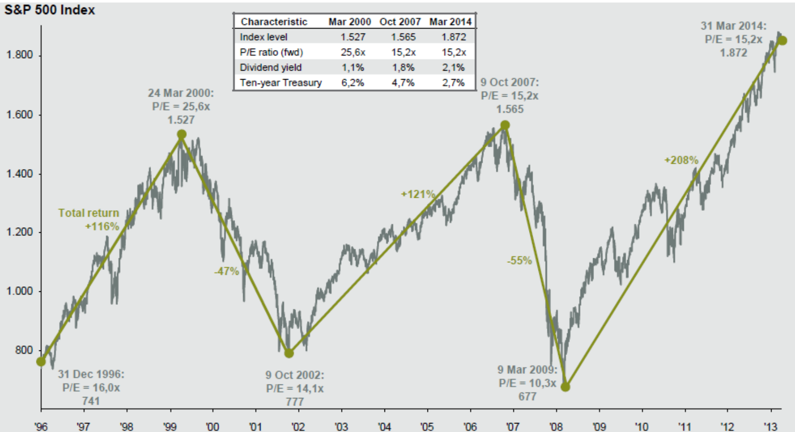
This chart shows how far European equities are from their various peak values over the last fifteen years. It is an interesting way to look at markets and shows just how far short Europe is from its high versus the US stock market which has been hitting new all time highs throughout 2013 and 2014 (see chart below left).

European Stock Market



Characteristic	Sep 2000	Jul 2007	Mar 2014
Index level	1.623	1.641	1.372
P/E ratio (fwd)	21,3x	13,5x	14,0x
Dividend yield	1,9%	2,9%	3,2%
Euro gov bond yld	5,4%	4,5%	2,1%

US Stock Market



Characteristic	Mar 2000	Oct 2007	Mar 2014
Index level	1.527	1.565	1.872
P/E ratio (fwd)	25,6x	15,2x	15,2x
Dividend yield	1,1%	1,8%	2,1%
Ten-year Treasury	6,2%	4,7%	2,7%

This tells us nothing about prospective returns, being based purely off an historic index price level with no account taken of current or historic valuation (see valuation charts below for better guidance on this.)

European Stock Market Valuation

Using an estimated earnings measure European stock markets are about in line with the 15 year average on a P/E basis. I would urge caution in drawing too firm a conclusion from this for a couple of reasons; earnings estimates by analysts are notoriously inaccurate and the time period is relatively short.

Of more relevance is the Cyclically adjusted PE Ratio (CAPE). This shows Europe is on a CAPE of just under 15x, which compares quite favourably to the US stock market which is trading on a multiple of about 24.

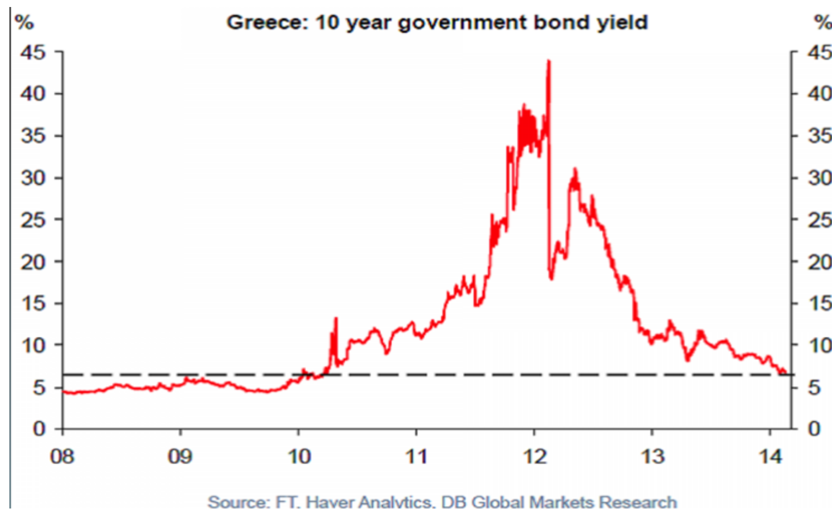
Source: JP Morgan unless otherwise stated.

Hindsight Asset Management Contd.

Charts of the quarter

You could have bought post-restructuring Greek debt in May 2012 at a yield of 30%; it's now down to 5% (see chart below). Portugal has five-year bonds trading at a yield of 2.6%. Irish five year yields fall below those of the UK...a country that can print its own currency!

The only negatives IRM could find relate to elusive eternal world peace and a world without Farrah Fawcett!



It does seem to be difficult to be negative about markets at the moment as the next chart from Ineichen Research & Management shows. As Ineichen points out; Price momentum is intact, earnings momentum is intact, valuations are not excessive, the economy is expanding, recession probability is near zero. The only negatives IRM could find relate to elusive eternal world peace and a world without Farrah Fawcett! Complacency is in itself something to be concerned about.

Bull mkt health check: The best of times?

One really needs to look hard to find something negative at the moment.

	March 2000	October 2007	March 2014
Price momentum			
Long-term momentum S&P 500 positive	✓	✓	✓
Long-term momentum Financials positive	✗	✗	✓
5Y annual S&P 500 TR Index return < 25%	✗	✓	✓
Stock market valuation			
Trailing P/E ratio < 20x	✗	✓	✓
EPS estimates rising	✓	✗	✓
Price-to-book value < 3x	✗	✓	✓
Macro			
ISM PMI > 50	✓	✓	✓
Jobless claims < 350k and falling	✓	✓	✓
Monetary policy			
Fed easing	✗	✓	✓
Yield curve positively sloped	✗	✓	✓
Risk			
High yield spreads < 450bps	✗	✓	✓
High yield spreads < 450bps and not rising	✗	✗	✓
TED spread < 50bps	✓	✗	✓
St. Louis Fed's Financial Stress Index < 0	✗	✗	✓
VIX < 20%	✗	✓	✓
Farrah Fawcett still alive	✓	✓	✗
Eternal world peace	✗	✗	✗

Source: IR&M

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Investment Training, Research & Consulting

I don't sell to fish*

Investors often buy what they think is exciting, sophisticated, and complex with the embedded assumption that all of these attributes will lead to greater returns. Careful examination of these products often reveals that these 'exotic coloured tackle' fail to hook much in excess returns.

This section aims to summarise recent investment product or industry news, and highlight any recent research that iCubed has conducted on investment products/funds.

Aviva Investors announced a change of manager for its high profile High Yield Fund. Following the Strategic Review undertaken by Aviva Investors at the end of last year, Kirill Pyshkin, who was the fund manager for the Aviva Irl High Yield Equity Fund, has left the company. David Lis, Head of Equities has been appointed as Fund Manager of the High Yield Equity Fund. He will be supported by a team of 5 specialist regional fund managers.

Facebook is making a $2bn bet that virtual reality headsets will be the next big social platform after computers and smartphones, with the sudden acquisition of Oculus, founded by 21-year-old Palmer Luckey in 2012. Indeed!

A proliferation of new additions to the **multi asset product** space was introduced during the first few months of 2014. A thorough qualitative assessment of all products will be issued in the coming weeks.

The **structured product** market (guaranteed funds) is undergoing significant change as providers adapt to the continued decline in deposit rates available from the traditional Irish banks. In my latest report only seven products were listed for sale, against an average number which is normally in excess of 20.

** The title of this section relates to a funny anecdote from Charlie Munger (Warren Buffett's partner at Berkshire Hathaway). Munger tells a story about a shopkeeper that sells exotic coloured fishing tackle. When asked by anglers as to whether these fancy coloured lures actually worked and attracted more fish, the shopkeeper's response was, "Mister, I don't sell to fish".*

The focus of Munger's ire was investment banks and he used the metaphor of trading ideas as fishing tackle. The fishing tackle salesman (read investment banker) is only concerned with whether his product works to the extent that it affects repeat business.

The relevance of this to our world of investment advice is this; The fishing tackle that Munger refers to are exotic colours to attract fisherman, not fish; equally many investment products are designed to attract investors, not necessarily investment returns. It is your job (hopefully with my help) to try and avoid the investment products that are the investment equivalent of exotic coloured fishing tackle.

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