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Here is Wisdom

"Another flaw in the human character is that everybody wants to build and nobody wants to do maintenance."

- Kurt Vonnegut.

The revelation came sometime during early 2000. It was in the form of Peter L. Bernstein's "Against the Gods: the remarkable story of risk" (John Wiley, 1998). Sadly, Mr. Bernstein is no longer with us – he died during the summer – but his legacy is likely to outlive most of the financial institutions who never woke up to his message. Hidden within the pages of this outstanding book is an equally remarkable quote from another 'Renaissance man', Daniel Bernoulli. In 1738 Bernoulli effectively launched the science of behavioural finance with the following insight:

For a wealthy investor, the practical utility of any gain in portfolio value inversely relates to the size of the portfolio.

Bluntly: the more you have, the less by way of return you really need. In less academically rarefied English than Bernoulli's, wealthy investors, on the whole, should be more concerned with capital preservation than capital growth, because they already enjoy a substantial pool of capital to begin with. They should by all means seek meaningful investment returns from their portfolio, but not to the extent that they jeopardise their core wealth in the process. The entrepreneurially wealthy typically divide up their attitude to risks: they are often willing to undertake significant career risk within their field of personal expertise; but their investment portfolio is typically a sleep-at-night one. When you add to Bernoulli's thesis more recent insights from the behavioural school, namely Kahneman and Tversky's finding that losses from investments carry roughly twice the emotional weight of gains, you come up with a pretty robust investment philosophy that, as always, Warren Buffett has expressed with his trademark simplicity:

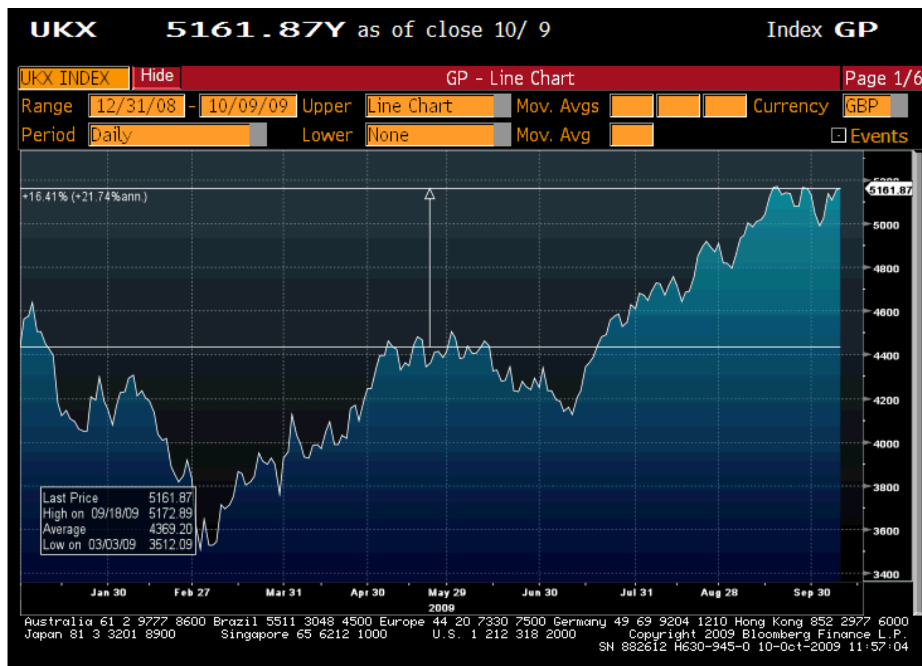
Rule Number One: Don't Lose Money.

Rule Number Two: See Rule Number One.

The problem comes when theory interacts with practice. During bull markets, investors typically crave market-relative returns – they want to beat the market, or at least come close to matching it. Everyone else is making money, they perceive, and they don't want to miss the boat. That problem is compounded by the self-interested herd-following that passes for professional investment management. During bear markets, on the other hand, investors typically crave

security and the preservation of capital. The craven focus on index-relative reporting still practised by many institutional managers (the market fell by 30%, but we only lost 25% of your money – didn't we do well ?) lives with us still, although the investing public is slowly getting wise to its lingering workings.

Where's my 46% ? (The year to date return from the FTSE 100 Index is roughly 16%; the trough-to-peak return is roughly 46%)



But when markets tumble, investors typically want out (Kahneman and Tversky again).

You lost me how much ? I could've beaten that by sitting in cash ! (The FTSE 100 Index, October 2007 to March 2009)

Sources: Bloomberg LLP

Market practitioners and investors of a certain vintage will see the problem inherent in the pursuit of relative returns during bull markets and absolute returns during bear markets. *This presumes that market-timing can be practised consistently, diligently and efficiently*. I know of no investor on the planet who can time the markets with any form of precision or consistency. When faced with something that is essentially impossible, it is rational after a while not to try. When you reintroduce Bernoulli's thesis to this now more pragmatic approach, you come to the following conclusion:

The only investment philosophy that makes sense, as a general rule, for a wealthy investor is the pursuit of absolute returns at all times.

There may be holdouts who maintain that consistently successful market timing, the ability to call the tops and bottoms of markets, is not just possible but achievable. Over time they are commonly known as bankrupt.

The pursuit of absolute as opposed to market-relative returns is complicated by at least three factors, all psychological. One of them is greed. One of them is short-termism. And one of them is the role of irrepressible cheerleader played by the investment media. There is no god-directed law that states that equities should form the cornerstone of any investment portfolio. As 2008 reminded us, equity markets have a tendency to go bang from time to time. But which other market is thrust in front of us with such relentless zeal ? It is very difficult to ignore stock markets when the media toss in front of us their most trivial meanderings on a daily basis.

So how does one endeavour to generate absolute rather than purely equity market-related returns ? There is no definitive answer, but an institutional approach that has won over many converts in recent years has been the US university endowment approach, as practised by the likes of Harvard and Yale universities. This approach has essentially broken down the opportunity set of the endowments into the following asset classes: hedge funds; private equity; domestic and foreign listed equities; real assets; and bonds. As at June 2008, the Yale endowment was invested along the following lines:

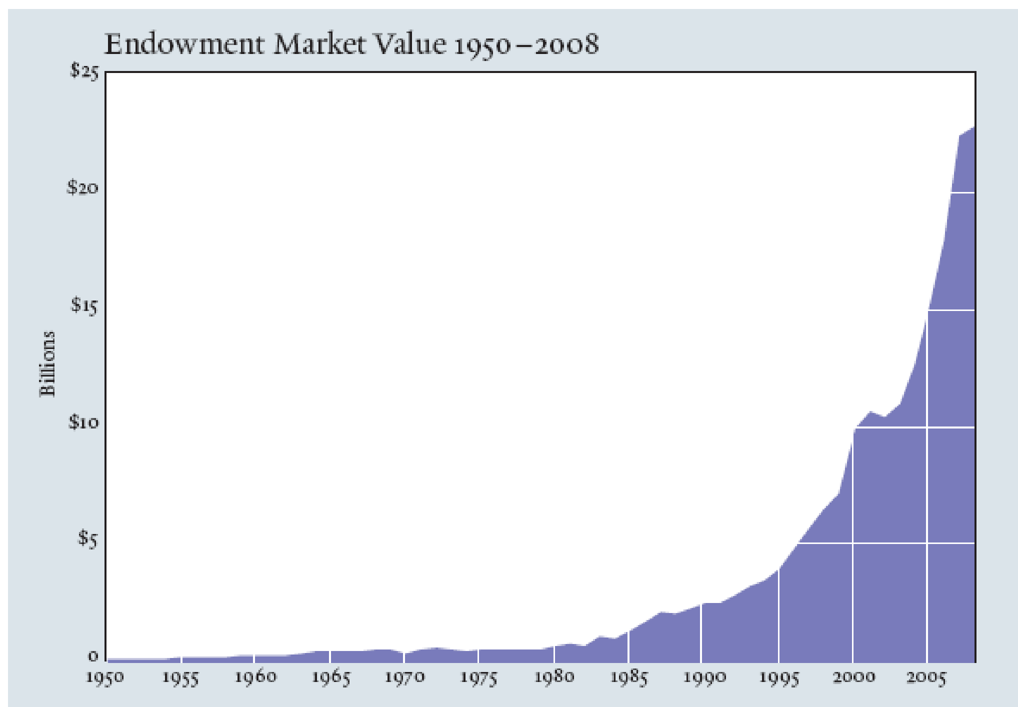
Absolute return (i.e. hedge funds):	25.1%
US equities:	10.1%
Bonds:	4.0%
International equities:	15.2%
Private equity:	20.2%
Real assets:	29.3%
Cash:	-3.9%

(The cash allocation is negative as the endowment had borrowings against its portfolio.)

When you look at Yale's investment performance over recent years, you can see how this approach has won over so many individual and institutional followers: its returns have been stellar. Over the twenty year period to 2008, the endowment returned annualised returns of some 15.9% per year. As the 2008 asset allocation shows, the Yale approach is distinct from a more 'traditional' investment approach: the commitment to so-called 'alternative investments' – namely hedge funds and private equity – is, at 45.3%, significantly larger than a more "typical" long term institutional investor, such as a pension fund or life insurance company. When you include its allocation to real assets (commodities, real estate, timber) the commitment to alternative investments comes to nearly three quarters of the entire portfolio. The Yale endowment Chief Investment Officer, David Swensen, has defended this originally unique approach on the basis that

the endowment is, in effect, a perpetual investor, and so can afford to take an approach that concentrates on the generation of meaningful long term investment returns.

Yale Endowment Performance, 1950 - 2008



Source: Yale University

So how did Yale's endowment perform during 2008 ? Interim performance reported in December last year indicated that the portfolio had fallen in value by 25%.

This is not to denigrate either Yale University or the Chief Investment Officer of its endowment, David Swensen. It is rather to show just how extraordinary the financial and investment environment of 2008 was. How the mighty, one might say, are fallen.

But it was a little disappointing to see David Swensen being interviewed by the Financial Times on Saturday and to contribute almost nothing by way of analysis, or contrition, over 2008's returns. Amid a 2,200 word article by Chrystia Freeland, Mr. Swensen offers just one word in response to the question as to whether he would, in hindsight, have managed the portfolio differently:

"No."

Being pressured he becomes mildly more expansive and gives a four-word reply:

"What's the alternative ?"

What makes this response more frustrating is his concession that Yale, in late 2007, moved all of the endowment's operational cash out of money market funds and into (essentially riskless) US Treasury bills. Yale was evidently aware of mounting tensions within the financial system.

Why Yale's endowment suffered so grievously in 2008 can also be summarised in one word:

Bonds.

The endowment had an allocation of just 4% to the one major asset class that appreciated in value during the financial firestorm of 2007-9. We do not know whether that relatively trivial holding comprised US government bonds, or corporate bonds, or emerging market bonds. If the former, it would at least have generated a positive return. If either of the latter, it would probably have generated a loss.

To repeat, this is not to denigrate either Yale or Mr. Swensen. But at the risk of appearing to immolate straw men, notwithstanding the endowment's objective of generating meaningful longer term returns, it seems extraordinary to have realised at least in part the severity of the financial system's fragility and then ***not*** to have sought greater refuge than just 4% of the portfolio's holdings in the security and ***liquidity*** of 'AAA' government bonds.

In any case, that was then, and this is now. What made sense during the banking panic of 2008 does not necessarily make sense now. Supposedly safe 'AAA' government bonds are now at the mercy of colossal sovereign indebtedness in the Anglo-Saxon markets, and their prices are being kept afloat largely through government-sanctioned purchases by both central and commercial banks. At some point such purchases must stop. But when the government is driving, who knows where we end up ? For this reason we continue to see most attraction in government bonds issued by generally creditworthy sovereign nations – and those nations are now largely outside the G7 "ex-growth" economies.

David Swensen was not the only institutional investor under some pressure in the media over the last week. Invesco Perpetual's celebrated equity income manager Neil Woodford was interviewed by Citywire who drew attention to his underperformance relative to his peer group. Invesco Perpetual Income Fund, a £6 billion juggernaut, has returned 5.9% during 2009, versus 14% for the IMA Equity Income and Growth sector. (Given his track record, Mr. Woodford would be entitled to respond: "So what ?" Over five years he remains the highest rated manager in his sector.) For once, the normally stereotypically dull and impersonal investment profession managed to generate something approaching poignancy. Responding to the implicit criticism, Mr. Woodford replied,

"The biggest challenge for me, I suppose, is holding my nerve.. But I'm afraid you are condemned by your process and what you believe in, and you have to stick to those as a fund manager, or you've got nothing to hold on to. We believe in what we're doing. I believe in what we're doing."

There was a happy confluence between the Citywire interview with Neil Woodford and the FT interview with David Swensen. As Mr. Swensen put it when asked about the most important attributes for selecting fund managers,

"The most important thing is character and the quality of people. That's also the second most important thing and the third most important thing. It's everything."

Unfortunately for fund analytics services, personal character is not a metric measurable by their analysis. And while Neil Woodford didn't say as such, the business of fund management is more of a marathon than a sprint.

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