Montecito Private Asset Management, LLC

MPAM

Where is the investment management industry headed, and why should you care?

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WHERE IS THE INVESTMENT MANAGEMENT INDUSTRY HEADED, AND WHY SHOULD YOU CARE?

I recently attended a conference entitled, '2008 Mathematics of Investing Conference' which is what sparked my interest in writing this paper. During this conference, I got a clear picture of the latest thinking regarding a host of topics directly related to investing in today's complex financial markets, using all of the latest investment vehicles, including everything from stocks and bonds, to mutual funds, ETFs, alternative investments, private equity, venture capital, etc. After completing this conference, I walked away with some very strong feelings regarding the industry as a whole, and my own position within the industry. I hope that this paper will help you make better investment decisions by anticipating the changes that I foresee occurring in the coming years.

In this booklet, I wanted to take a big-picture view of the investment management industry, in order to present an easily-understood overview of the business, so that clients could see at least one point of view from an insider as to what they can expect as the industry evolves. This is important because changes within the industry have a direct, significant impact on how assets are managed and the type of risks and returns that clients will experience. The more one can understand about the inner workings of the investment business, the better able one will be to benefit from the changes affecting the industry.

Although there are a multitude of mathematical justifications for many of the trends I see developing within the industry, I am not going to get into these specifics. I will simplify this discussion in order to make it easier to understand, and hopefully a little less boring as well. Some might feel that I am presenting conclusions without proper research or supporting data, so you feel this way, I will be happy to expand on any of the ideas I will present in this paper. With that said, I am not a lawyer, CPA, academic or mathematician. Rather, I am an investment professional that has spent every day for more than eighteen years investing money under real-world conditions. My experience is practical, extensive, and relevant, at least in my opinion. Tenured professors tend to have a somewhat skewed viewpoint, and their conclusions, while sometimes interesting and useful, are not always based on logical, usable assumptions that relate to real-world application. (More on this later).

In the following paragraphs, I will present a summary of the current state of the industry, along with my personal opinions about the pitfalls inherent in the investment approaches that most of you are being shown today. I will discuss topics such as Modern Portfolio Theory, Asset Allocation, International Diversification, Alternative Investments (Hedge Funds), how an individual investor defines risk and return, and the changes that have occurred to date within the industry to get us to where we are today. Then, I will explain my own expectations as to where I see the industry evolving to, and how, as an investor, you can use this information to improve your investing experience over the long-term.

What's wrong with the investment industry today?

I could write an entire book about what's wrong with the investment business, but I will spare you my rantings and address two main issues that strike me as fundamental to virtually all of the problems investors face when they invest.

Measurement

The first issue is that the entire industry has developed into one giant measurement machine. There are far more investment professionals who earn their living measuring what those of us who actually manage money do, than the number of actual managers. Keep in mind that you are paying the salaries of these measurement professionals—all these ancillary industry participants who spend all their time calculating performance and risk numbers.

There are two sides to this issue: One is that, as an investor, you need to know if a manager is worth his or her salt before you entrust them with your money, so there must be some way of measuring how they perform over time so you can make an informed decision. The other side is, as any statistician will tell you, in order for any series of numbers to be statistically significant, you must have at least a certain number of observations—hundreds of them—otherwise you have to make an adjustment in the calculation for small sample size, which reduces the quality of the analysis. If that sounds like Greek, all I am saying is that a money manager would have to be in business for many, many years to gather enough returns to make any statistical measurement of their performance statistically significant, and by that time, of course, the people running the money at the firm have usually turned-over, so you would have different individuals creating the returns, which again significantly reduces the quality of the analysis.

Another problem with using historical performance numbers is that the first thing any investment manager will tell you is that *past performance is no guarantee of future results*. You will find some version of that last phrase on any marketing materials for virtually any investment vehicle you can find. What that means is that, no matter how good a manager has been in the past, you can't rely on that past performance as any true indication of future performance. A great statistic (I know I said I wasn't going to use math) is that, of the 7,520 mutual funds in the top quartile (top 25%) at the start of the five-year period 2002 through 2006, only 44 of them, or 0.5%, remained in the top quartile for the entire five-year period. This is an actual, real-world example of why you cannot rely on past performance.

So if you can't rely on past performance, why does the industry spend so much time, and so much of your money, dealing with performance? Because there is no good alternative. You, as an investor, must have some way of evaluating your choices. The other things that are important to you—service, quality of process, comprehensive coordination of all of your investments, marrying your financial and estate plan to your investment approach, incorporating you and your family's unique tax structure into your investment strategy, etc, etc—are not easily measured. So, there is a huge and expensive focus on measuring performance and risk, which in the end is not adding much value to your investment management experience. Additionally, because there is such a strong emphasis on performance, especially short-term performance—quarter-to-quarter—managers are personally incentivized to manage quarter-by-quarter, instead of focusing on the long-term trends they should be focused upon.

> A word about risk: large institutional investors measure risk in a completely different way than most individual investors measure it. I would assume that almost without exception, anyone reading this paper is a lot more concerned about downside risk than upside risk. You probably couldn't care any less how much upside volatility your portfolio exhibits, as long as it is increasing in value, but you are likely very concerned with even the slightest downward moves in value.
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> Institutional investors measure risk using standard deviation (typically) which makes no distinction between upside and downside volatility. It simply measures the variability around the average (mean) return over a number of observations (reported returns). Institutions have a set return target, typically, called an expected return, and they calculate risk as the possibility of not achieving this target return over various time-periods. You probably view risk as losing money, or not having enough money at retirement, etc.
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> What this means in practical terms is that you have all of these people working in the industry measuring risk in a way that you really don't care about that doesn't help you achieve your personal financial goals, and you have managers responding to the way risk and returns are calculated, and investing money based on those methods of calculating risk and return that really do not reflect the needs of individual investors at all.

Marketing – Put it in a shiny box and ship it

Human beings like for things to fit into neat little manageable packages. We like the round peg to fit into the round hole. Nice and clean. The problem is that this characteristic of human nature has caused a monstrous problem within the investment industry, which is that investment firms feel the need to package investments into the same kind of neat little packages so that they can market them to investors. At the end of the day, none of us can do anything unless we have assets to manage, so the first and most important thing for any of us is to acquire assets. Due to the immense complexities within many of the most effective investment vehicles, it becomes essential to package them in such a way as to simplify their presentation to potential clients. Again, a large part of the entire investment industry, and therefore a large part of the costs you incur as an investor, is marketing costs.

The marketing aspect of investments also affects the industry in some serious but not well-understood ways. The industry is quick to accept new theoretical developments from the academic world, but slow to let go. Modern Portfolio Theory is a great example of this. Harry Markowitz developed Modern Portfolio Theory (MPT) in 1952 and won a Nobel Prize for it. Basically all current investment modeling is based on MPT; over fifty years after its introduction. What MPT says, and I am simplifying, is that markets are efficient, investors are rational, and returns are normally distributed, among other assumptions. This is another area where I could go on all day about the problems with these assumptions, but suffice is to say that all of them are questionable at best. But, who is going to argue with a Nobel Laureate? (Just remember that it was three Nobel Laureates that ran Long-Term Capital Management—ran it right into bankruptcy in 1998 causing billions of dollars in losses and a global currency panic).

The facts are that markets are not efficient, investors are anything but rational, and returns are not normally distributed in the real world. We can't really blame the academics. They must make assumptions because otherwise, they could never publish anything. There are simply too many variables in the real world to model and get any meaningful result. But, in the real world, you are risking real money in investments with real risks. Your investment strategy should not be based on a theory, which is based on faulty assumptions designed to win academic recognition, rather than making you profits.

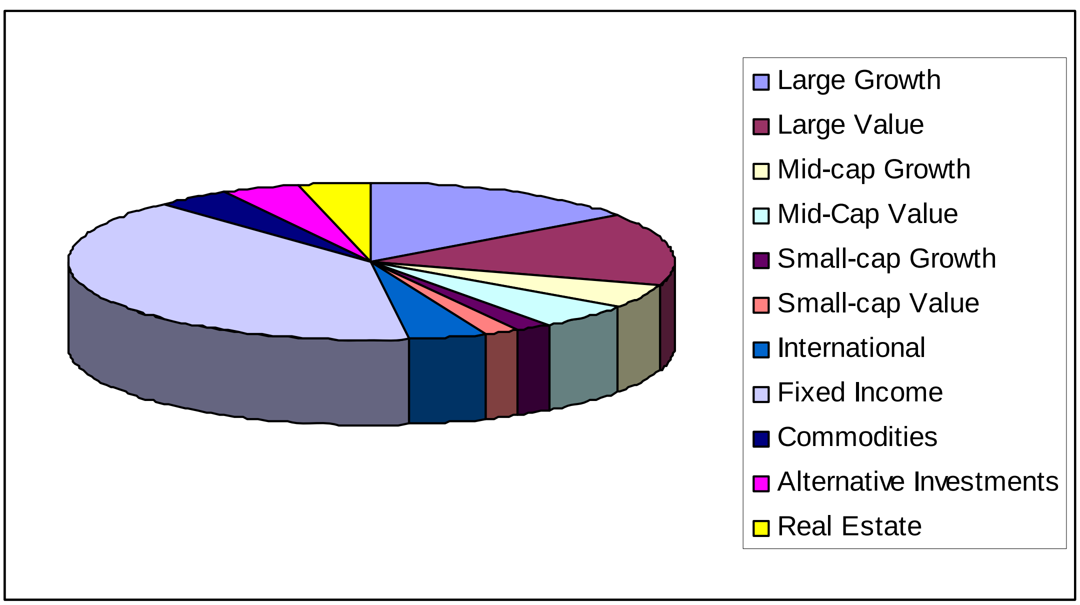
Let me just make a quick point here and we'll move on. If you think I may be wrong about these assumptions, ask yourself this question: If markets are efficient, why then do we have bubbles like the tech bubble, the real estate bubble, the bubble we are in for commodities right now, the bubble in foreign markets like China and India, etc, etc? If markets were efficient, meaning that all information that is knowable is always incorporated into prices, you would never have bubbles because investors would act rationally (another faulty assumption) and would realize that a bubble was forming, and would sell, avoiding the formation of the bubble in the first place. Yet we have bubbles form in markets all the time. There would never be corrections, bear markets, or takeovers at premiums, if markets were efficient.

Asset Allocation

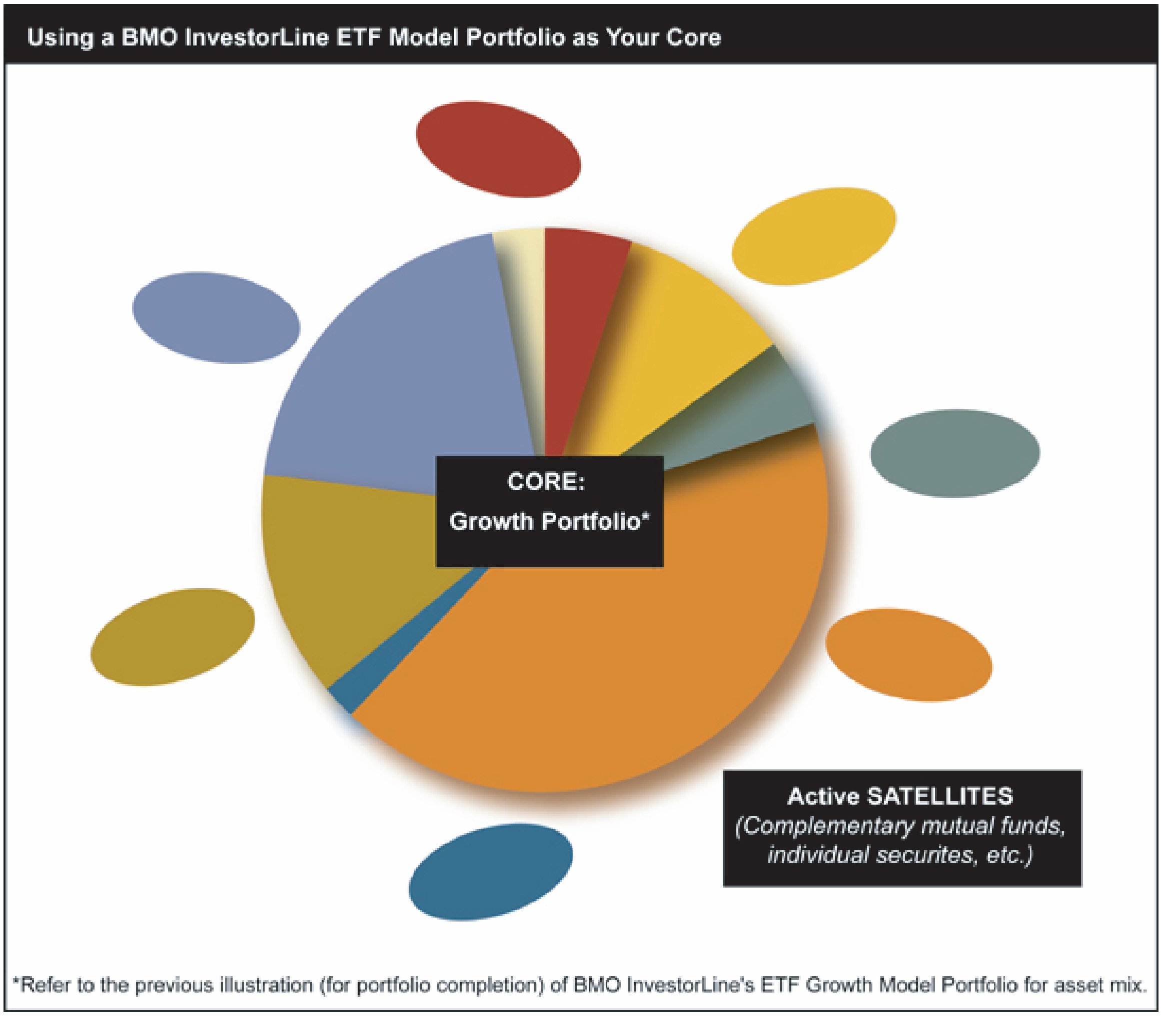
Until fairly recently, when we talked about asset allocation, we usually were referring to a pie chart with various slices; one for each asset class and representing the percentage of investable assets the client was to invest in each. The latest incarnation for asset allocation is the Core–Satellite approach, which simply refers to having a main investment manager (Core manager) and satellite managers surrounding that manager, filling in the other asset classes like alternative investments, commodities, real estate, private equity, international, etc.

> *What are alternative investments?* Alternative investments, also known as hedge funds, are simply investment vehicles that do not fit into the traditional stock, bond, cash, real estate, categories. Alternatives would include things like long-short equity, managed futures, private equity, private real estate, arbitration funds, quantitative funds, etc. The term hedge fund is also used interchangeably with alternative investments, but not all alternative investments are hedge funds. A true hedge fund is a fund that uses both long and short positions in the same fund, thereby hedging downside risk to some extent. These funds may also use leverage (borrowing to add more positions to portfolios) to enhance returns. Alternative investments can have risk parameters all over the scale, from very low to extremely high. (More on this later.)

Basic Asset Allocation



Core – Satellite Asset Allocation (borrowed from BMO InvestorLine)



As the thinking behind the asset allocation process has evolved, and as alternative investments have become more and more accepted, the complexity of the asset allocation process has increased exponentially. Today, many asset allocation models recommend that as much as forty percent of total investable assets be allocated to alternative investment vehicles. Top university endowment funds like Harvard and Yale have long been the benchmark by which 'proper' asset allocation models are judged. These large endowments, in the multiple billions of dollars, have very large allocations to alternatives. Their early acceptance of alternative investments gave credibility to the hedge fund industry early-on, and contributed in a major way to the growth and expansion of the industry, both in assets under management and breadth of product offering.

But is this an appropriate asset allocation for an individual investor, and if it's not, what is? There are several problems associated with the Core–Satellite approach to asset allocation, when a significant percentage of total assets are allocated to alternative investments. First, only the wealthiest individuals will have the resources available to invest in multiple alternative investment vehicles, since many have high minimum investment requirements. Many of these investments are highly risky, or at least have very different risk characteristics as compared to traditional stock and bond investments. Diversification, meaning spreading one's money among several vehicles, may be the only workable approach when dealing with these highly complex investments. If the investor doesn't have enough liquid capital to follow a core-satellite asset allocation with such a large weighting in alternatives, the whole process breaks-down.

Second, endowments, foundations, and large institutional investors have completely different characteristics than individuals. For one thing, they don't have the same tax issues. For another, they don't have the same current income and liquidity needs. And for yet another, they don't die (unless they are mismanaged). Endowments can afford to take very long-term bets and to invest in illiquid investment vehicles. The largest can also afford to invest in many different vehicles, even if the minimum required investment is quite large. Most individual investors do not have these same freedoms.

Active versus Passive

> An active manager makes specific decisions on individual securities to try and outperform a benchmark index, and charges a higher fee relative to a passive strategy; one in which the benchmark index is replicated so that the investment performance for that asset class will mimic the index and the fees are typically much lower. For example, for the strategies I offer I use a sector rotational strategy in which I overweight or underweight the various sectors of the economy based on my personal analysis of the economy and financial markets, while a passive strategy would be to buy an S&P 500 index fund that holds the exact same securities as held in the index in the same weightings.

Another related issue that has come to the forefront is the active versus passive argument. One of the key assumptions of MPT that has already been discussed a bit is the notion that markets are efficient. If this is true, actively managed investment approaches should not be able to consistently outperform the market indices. In fact, most investment managers, up to 80% of the total, fail to even match the performance of the major market indices, even before they deduct their fees. This fact has given weight to the efficient market argument of MPT. However, there is a different and much more logical explanation for this underperformance, which has nothing to do with market efficiency.

Almost without exception, the mainstream investment managers—those that any bank or brokerage firm—would recommend in an asset allocation proposal for an individual investor's portfolio, are long-only, style box managers. For example, if an asset allocation, either traditional or core-satellite, calls for a manager in large-cap growth, that manager will be a long-only (no short positions) manager, who will be hired specifically to stay within his style box (large-cap growth). To remain in this portfolio, the manager must stay fully invested at all times in large-cap growth stocks. Otherwise, the manager will be violating the very reason he or she was hired, and will be throwing the entire asset allocation out of balance. For instance, if the large-cap growth manager decided that large-cap value made more sense and moved some of the money he or she manages into large-cap value, he or she would likely be fired and replaced for what is known as style drift—moving outside of the stated objective of large-cap growth.

Because of the asset allocation process, and because of the measurement of performance and risk and the packaging of investment products already discussed, these managers are stuck in a very constrained environment where they are forced to invest under a set of strict guidelines, resulting in the consistent underperformance already mentioned. The problem is that, over time, markets change from growth to value, from large to mid to small cap, and from domestic to international and back again. Even the very best managers in their stated objective (example: large-cap domestic growth) are destined to underperform when the market changes to conditions where perhaps small-cap international stocks do best and large-cap domestic growth is out of favor.

It is a vicious cycle. Investing is so complicated that it requires firms to specialize in certain asset classes (large-cap growth for example), and once they commit to this style, they are not able to adapt to the changing investment landscape, even if they could change without getting fired, which they can't. The entire industry has been structured around this style box, asset allocation format, and again, this is the most logical explanation for the consistent underperformance of a large percentage of managers.

What has developed is that financial consultants have taken this underperformance of active managers to mean that markets are, in fact, efficient, and therefore have decided that passive strategies make more sense. In fact, given the consistent underperformance of active managers, they are correct to think this, given the current asset allocation landscape.

My belief is that the reason active managers underperform has nothing to do with market efficiencies, but rather is a direct result of the massive constraints they are placed under, to fit their strategies into style boxes, stay fully invested at all times, and to invest long-only, all of which is a direct outgrowth of the measurement and packaging focus of the industry.

Conclusions

So, you have read-through a lot of rather arcane and boring information about where we are right now in the investment management industry. Why should you care in the least? In the following paragraphs I will offer my conclusions on where the industry is headed and how you can use this information to help you make better investment decisions, not just about individual investments, but about your overall asset allocation, and about the professionals you hire to assist you with the process.

First, I would like to given a brief overview of where I see things going in the industry. I view the investment management industry a little like healthcare in the 1800s when blood letting was the norm. We are still in the very early stages of development of the basic theories behind proper investment strategies, and we are a long way from really understanding how to do it right. More specifically, I see the end to MPT as more and more professionals realize that the assumptions upon which MPT was founded are unrealistic in real world application.

When I was at UCSD, I attended a luncheon at which Harry Markowitz spoke. He told the story of how he was wandering around the library looking for a topic for his doctoral thesis when he came across the ideas that developed into MPT. He went on to describe how he formulated all of the assumptions to make the data fit his conclusions so that the paper would make sense and more importantly, so he would receive his PhD.

William Sharpe took MPT one step further, simplified it, and came up with the efficient frontier, which is, in very simplistic terms, all combinations of riskless and risky assets, presented in a graphical format, and which is the foundation of asset allocation programs used throughout the industry today. Sharpe also received a Nobel Prize for his work. Again, the efficient frontier depends on assumptions that make it less than ideal to say the least, but again, humans like things that can be measured and fit neatly into shinny little boxes with pretty bows.

The key to the evolution of the asset allocation process is alternative investments. As alternative investments gain more acceptance, and as the core-satellite structure of the asset allocation process becomes the norm, the belief in efficient markets and passive investment strategies will diminish. I am not saying that passive strategies on their own merits are bad. On the contrary, they have a place in the industry as a tool to be used in certain portfolios for certain investors under certain circumstances. But, I do not believe that passive investment vehicles will remain as the core component of a significant number of portfolios.

Where I see the industry moving, through the asset allocation process, is to a core-satellite approach with the core component consisting of an 'alternative investment' strategy. The term 'alternative investment' or 'hedge fund' will fade away, and the alternative will become mainstream. Much like the alternative music scene in Seattle initially was considered alternative, but as it gained popularity, became mainstream, and just as MPT after Markowitz and Sharpe laid the foundation for current asset allocation structures became the norm.

I have written extensively about the problems with alternatives, so let me give you a few quick bullet points on the pitfalls of alternative investments:

- Lack of liquidity – typically, investors are only allowed to withdraw money from the fund at specified times, and under certain conditions. Additionally, as we have seen recently, the fund can deny withdrawal requests at their discretion. Denials of withdrawal requests usually occur when the fund is having serious performance problems, which is exactly when you would want to get out.
- Lack of transparency – most alternative investment vehicles do not offer any information as to the positions they hold, the amount of leverage they use, or virtually anything else they are doing. This lack of transparency makes it extremely difficult to know if the fund is doing what they were hired to do. Amaranth is a prime example of this problem leading to its worst possible conclusion as this fund, which was sold as a conservative fund, allowed a 26 year-old trader to amass gigantic positions in natural gas futures, which resulted in a $5 billion loss in one week, and the collapse of the fund, wiping-out investors.
- High fees – Alternatives typically charge a 1% to 3% flat fee plus 20% of profits. This fee structure makes them very expensive when compared to traditional investment vehicles. (For a more thorough discussion of the pitfalls of alternative investments, specifically the problems associated with their fee structure, please visit the MPAM website at www.mpam.bz and then mouse-over the Investment Strategies button and navigate to The MPAM Long-Short Equities Strategy page.) While the high fees attract great talent, they also drive sometimes unwanted behavior, which can result in catastrophic losses.
- High minimum investment – I already wrote about this issue, which can leave many individual investors out of the game, since they are unable to afford to hire the required number of different managers to make their asset allocations work.

These problems are only a few of the main issues, but there are more. The point is that alternatives have some pitfalls, which to date have slowed their adoption and have prevented the asset allocation process from evolving to its eventual, proper format, in my opinion. Here is what is good about alternative investments, and why I believe they will eventually be the core component of asset allocations:

- Flexibility – Managers of alternative investment funds can do virtually anything. This is both a negative and a positive, but the positive aspect of it is that they can go long or short, they can shift among all different market caps if they are a stock fund, they can use leverage, and they can buy virtually anything (commodities, real estate, etc.).
- Brains – Alternative investments are typically run by the smartest people in the business, because running an alternative investment fund is, by far, the most lucrative job in the business.
- Returns – if you look at the returns of alternative investments and compare them to those of the tradition managers, you can clearly see that alternative investments can and do significantly and consistently outperform the broader market indices. This supports my conclusion that MPT is just plain wrong. Just to prove my point, if you think about long-only managers consistently underperforming their benchmark, you have to look at the other side of their trades and say that if they consistently underperform, all someone would have to do to consistently outperform would be to take short positions in everything they are long. The fact that they consistently underperform just proves the point that it is possible to consistently outperform, if the manager is not constrained to invest long-only.

So, what I see developing is the continuation of the adoption of the core-satellite asset allocation model, but with an alternative investment strategy ***as*** the core investment vehicle. The most common of these is the long-short equities strategy, which I believe strongly will be the norm of the future. I have seen this coming for a long time, and this is why I established The MPAM Long-Short Equities Strategy back in 2006.

The MPAM Long-Short Equities Strategy

When I established this strategy, I looked at the pitfalls of the alternative investments industry and tried to address as many as I could, while still offering the benefits inherent in an alternative strategy. Here are the characteristics of The MPAM Long-Short Strategy:

- Full liquidity – I use a separate account structure rather than a fund, so each client who invests in this strategy has their own account, which they can add to or withdraw from at any time.
- Full transparency – because each client has their own separate account, they can see exactly what I am doing for them on any day.
- Reasonable fees – my fee structure starts at a 1.5% flat fee with no performance-based fee. There is no other alternative strategy that I am aware of with a fee structure this low.

- Complete flexibility – within this strategy, I have the flexibility to move among all cap sizes, between value and growth, international and domestic, and long and short. I can also overweight and underweight the various economic sectors, and select the individual securities I feel represent the best opportunities to make my clients profits.

Finally, with regard to the issues of measurement of performance and risk and packaging, whenever there is a trend within the financial markets, opportunities develop to take advantage of that trend. Sometimes, the opportunity is actually going contrary to the trend. An example of that is the alternative investment industry itself. The whole reason these investment vehicles came about was because of the constraints placed on traditional managers, which offered managers outside the norm to capitalize on aspects of the markets, like short opportunities, that traditional managers were unable to trade.

So how does the individual investor deal with measurement and packaging?

In my opinion, investors need to consider all characteristics of the financial advisor; not just performance. Performance and risk are always going to be important, but the reality is, most alternative investment managers do not have a long-term track record, including myself, that an investor can use. What is most important is to find someone with a well-defined strategy that makes sense to the investor, that is understandable, and that coupled with the advisor / manager's experience, education, credentials, personal approach, etc, fits with what the investor's expectations demand.

I feel that my booklet, 'Ten Questions Your Financial Advisor Hopes You Never Ask' is a great place to start. Although performance is critical in achieving the investor's true, long-term investment goals, client service, communication, and having a comprehensive financial and estate plan are equally important. When an investor chooses to chase performance, they are setting themselves up for disappointment, and probably for underperformance (remember, past performance is no guarantee of future results).

If your current investment portfolio was developed using a traditional asset allocation model, which in turn was almost certainly developed using MPT and the efficient frontier, I would recommend asking your advisor some pointed questions. You need to understand exactly what the assumptions are underlying the decisions within the asset allocation, which are used to determine how your assets are allocated. First of all, if the advisor looks at you like you are from Mars, chances are they have no idea how the software they are using to create your asset allocation works, and if they don't understand the inputs, it is unlikely that they are really adding any value, and maybe you should consider a different advisor. If your advisor does not have the ability to show you a core-satellite asset allocation alternative, look elsewhere. Making changes to portfolios is certainly a pain, and I acknowledge that. But, the only person you are hurting by ignoring the issue is yourself. It's a little like being on a diet and cheating. The only person you're cheating is yourself.

If I can be of any assistance to you, or if there are points I have made in this paper that don't make sense, please contact me and I will do my best to clarify them. As I mentioned up front, I have tried to keep the math to a minimum, and to provide a simplified overview of a very complicated issue; proper asset allocation. Many of the topics touched upon here could be the subject of an entire paper, or book for that matter, but I have tried to limit discussions of ancillary issues.

Thank you for reading, and I hope this information has been thought-provoking and useful. Good luck with your search for the most beneficial asset allocation and the best financial advisor for your needs!

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