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On Watch

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Are Modern Portfolio Theory and Diversification Dead?

D. FORT FLOWERS, JR., CFA
President and CEO

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Reports of my death are greatly exaggerated — Mark Twain

In the 1980s, Modern Portfolio Theory (MPT) moved from the halls of academia to the mainstream. Bill Sharpe and Harry Markowitz shared the 1990 Nobel Prize in Economics for developing MPT. Managers of Ivy League endowments adopted it and achieved rock star status, at least in some circles. In 2000, Yale's Chief Investment Officer David Swenson wrote *Pioneering Portfolio Management* extolling the virtues of MPT and its application to investment portfolios. This best seller resides on many professional and amateur investors' bookshelves.

Many investors who believed they were following MPT did very well through most of the last two decades, but then Lehman went bankrupt, credit dried up, and many sustained unacceptable losses. Understandably, many who were hurt in this debacle started to question MPT's validity.

Story continued inside ...

Story continued from front ...

What does Modern Portfolio Theory Imply?

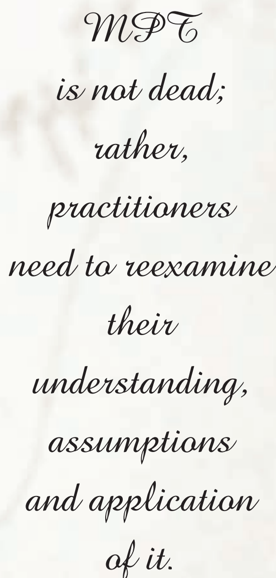
A rigorous discussion of MPT requires an in-depth understanding of statistics and more time than this article allows; however, some of its important implications include:

- Investors should seek to earn their desired return with the lowest level of risk possible.
- Each investment has its own risk and return characteristics.
- Prices of individual investments and asset class prices don't move in lockstep (they aren't perfectly correlated). Even though a diversified portfolio of investments will provide the weighted average return of the individual investments, **the risk of this diversified portfolio will be lower than the weighted average risk of the individual investments**. This is a very powerful concept and the fundamental reason for diversifying investment portfolios.
- Portfolios can therefore be invested in higher amounts in riskier assets (earning higher returns) and, if those assets' returns are not highly correlated, risk can be lowered – one of the investment world's few free lunches.

The events beginning in late 2008 seemed to many to turn MPT on its head because almost all investments dropped in value at the same time, so asset classes seemed to be much more correlated than investors had assumed. Many so-called advisors began taking advantage of the confusion by declaring Modern Portfolio Theory to be dead, diversification to have failed, and everyone needed to find a new paradigm, which they would happily provide.

So, is MPT Dead?

In a word – No! It continues to represent the only comprehensive and intellectually rigorous approach for the pricing of assets and construction of portfolios. Investors' recent disappointments are not because MPT is flawed, but because many investors and practitioners have misused MPT concepts and drawn false and dangerous conclusions. Examples include:



- **The flawed belief that prior years' returns, risks and correlations accurately predict the future** - While the past can be a good starting point, changes in conditions and biases in the data must be considered. The data used in statistical analysis must have a reasonable and fundamental basis grounded in expectations of the future, not just the past. Predicting that the future will look just like the recent past can be a very painful mistake – and it's one that many investors made.

- **Assuming that the risk of non-public investments (private equity and private real estate) is much lower than actual** - This error occurs because private investments' infrequent (e.g., quarterly or annual) valuations artificially smooth valuation fluctuations compared to the much more volatile daily prices of their publicly traded counterparts. This flawed assumption led many investors to underestimate the risk of non-public investments and thus have much higher than appropriate allocations to private equity and real estate.

- **Practitioners don't adjust their portfolio models for risks that are not well addressed in simple portfolio simulation software** - Hedge funds and private equity have significantly more risk than is captured in most asset allocation models. These risks are primarily due to illiquidity and the higher-than-expected probability of "black swan" type events (e.g. liquidity crisis, 9/11, etc.). Therefore, it is important to adjust these models by placing hard caps on the amount of exposure in these asset classes so that these risks do not unintentionally raise the overall risk of the portfolio. Investors who ignored this issue ended up with portfolios that were highly illiquid right when liquidity could have provided a great deal of protection.

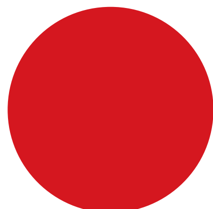
Many investors wrongly believe that Modern Portfolio Theory includes the Efficient Market Hypothesis (EMH). EMH in simple form says that all available knowledge is already reflected in the market prices for securities. Consequently, they argue that there is no advantage to actively managing portfolios. Many take EMH a step farther and believe in slavishly sticking with the asset allocations generated by the software used in applying MPT.

We do not believe that EMH is entirely correct (but that's a different article); therefore, we tactically allocate portfolios to enhance returns and control risk. We allocate more or less to asset classes within client-specified bands based upon our observations of valuation anomalies within and across asset classes. These tactical "calls" have enhanced returns and reduced risk over a long period of time with the most significant outperformance occurring when valuation anomalies have been most evident.

The past few years' events have highlighted errors in the application of modern portfolio theory and provided substantial opportunities for those who look beyond the efficient market hypothesis. MPT is not dead; rather, practitioners need to reexamine their understanding, assumptions and application of it.

Japan Trip Report

NOTES & QUOTES



I visited Tokyo in June to see the effects of the Great Eastern Japan Earthquake. While the focus was real estate, discussions with our private equity, hedge fund and other managers (quoted below) provided a broader context. Given my tactical favoring of Japan, and as my international deep-value micro-cap equity strategy opens to new investors, I wanted to assess first-hand Japan's prospects.

Insights gained

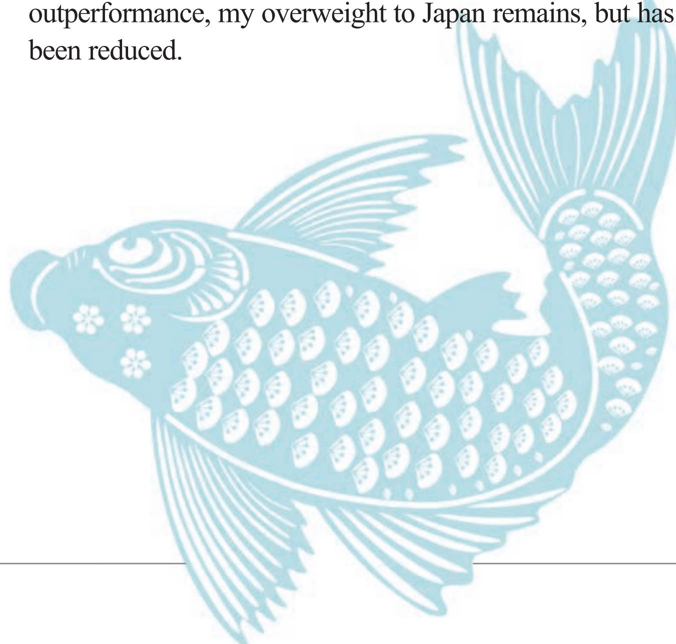
The healthy real estate market surprised me, as low interest rates and readily available bank loans have supported asset values despite still-bottoming rental rates. Offices built to higher earthquake standards have benefitted from a tenant flight to quality. Other high-end segments such as international hotels and ex-pat housing are weak, while at the micro-level, *"Soil liquefaction has forced penthouse dwellers near Tokyo Bay to use the bathroom at the elementary school down the block."*

Supply-chain disruptions have been resolved more quickly than expected, but consumer spending outside of household staples remains weak as daily news updates continue to reinforce weak consumer sentiment. Iconic flagship stores were pretty empty at lunchtime. This change may be secular: *"the luxury goods market will never fully recover."* Firms like Toyota have maintained uneconomic local plants for political reasons, but more production may move offshore as the summer of 2012 will see electricity rate increases of 20-30% unless shuttered nuclear plants are restarted. As a result of tragedy, there is now a consensus to double the consumption tax to 10%, a long-overdue boost to government revenue. Finally, the quality of perseverance under adversity evidenced itself: *"The Japanese people have achieved greatness despite, not because of, their political leaders;" "Except at very high levels, there is no scientific link between cancer and radiation."*

BRUCE L. SWANSON, PHD
Chief Investment Officer

Investment implications

Japan remains the cheapest large equity market with 25% of its stocks selling at less than a 10X price-to-earnings ratio and 66% at less than book value (versus 5% and 14% in the US). Its earnings per share growth this century is as high as Shanghai and two-to-three times the US and Europe. While 2011 growth may disappoint and progress in corporate governance has stalled with activist investors giving up, the combination of cheap valuations, abundant bank financing, unorthodox monetary policy and the fiscal stimulus of reconstruction is difficult to beat. Although Japanese treasury bonds are a poor investment, the additional consumption tax revenue may reduce "tail risk" Japanese solvency concerns. Nonetheless, asset classes must continually compete for allocations within our portfolio. The Nikkei 225 Index has returned 5% since our April *Sentinel Horizons* piece, versus a 15% decline for the S&P500 and a 19% decline in Western Europe. In consideration of this outperformance, my overweight to Japan remains, but has been reduced.



THE HOW AND WHY TO BE A GREAT BENEFICIARY

Although your trustee controls your trust, you have choices that can be either constructive or destructive to your interests as beneficiary.

Negative choices include:

Passivity – simply accepting the trustee's actions, which one day may cause discontent when the trustee takes investment or distribution actions with which you disagree

Aggression and antagonism – insisting that the trustee act as you deem appropriate and then getting angry when the trustee does not accede to your wishes

Both negative choices can cost you money, in terms of legal fees incurred by the trustee (and charged to your trust) and by you. They also can increase your blood pressure and cause lost sleep.

Or, you can use an approach that we routinely find to be in our beneficiaries' best interests…you can be a great beneficiary!

What is a Great Beneficiary?

A great beneficiary is:

Informed and knowledgeable – She reads and seeks help to understand the trust instrument and applicable law, both of which must be followed by the trustee in administering the trust. She takes the time to develop an understanding of basic investment principles, the account statements and the complex role of the trustee.

Communicative – He talks frequently with the trustee, listens carefully and asks for clarification when he doesn't understand.

Not antagonistic – She avoids making demands and instead says things like, "Please explain" and "Help me to understand."

Understanding of his own limitations – He knows he is not an investment or fiduciary professional. He doesn't just accept the trustee's actions at face value, but takes extra care to understand trustee actions that require specialized expertise. The beneficiary knows not only what he knows, but also what he does not know.

Realistic – Trustees must consider and balance the interests of all beneficiaries (current and future), all in the context of the terms of the trust and the size and nature of its assets. Given these constraints, it may not be realistic for the trust to support all of your needs or for the trustee to manage the trust in the way you prefer.

Good at managing his own financial affairs – The trustee often must consider the beneficiary's financial situation and behavior. A beneficiary who is a spendthrift who mismanages his own finances or fails to seek productive employment may have a great need for distributions, but the trustee may be less responsive to requests for them.

Responsive – Trust instruments often require the trustee to obtain financial or other information about the beneficiaries. Respond promptly (and honestly) to these information requests.

Not manipulative – Openness and candidness in your dealings with the trustee are better in the long run than attempting to trick the trustee or manipulate him to accomplish your hidden objectives.

Proactive – Takes the initiative in asking questions, seeking education, etc.

Of course, trustees should strive for greatness, too. But, to borrow the expression, think of your trust as a two-way street. If you act like a great beneficiary, your trustee is likely to rise to the occasion. And, you are likely to be a much happier beneficiary.

ROSS W. NAGER, CPA
Senior Managing Director and Principal

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms. **For further information**, please contact Anthony DeToto, Senior Vice President, at adetoto@sentineltrust.com or 713.559.9578.

Contributing to this issue:
Anthony J. DeToto
D. Fort Flowers, Jr., CFA
Ross W. Nager, CPA
Bruce L. Swanson, PhD

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
713.529.3729

www.sentineltrust.com

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