

# SURE BETS... UNTIL THEY'RE NOT



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**VIGNETTES ON DIVERSIFICATION AND  
THE DISCOVERY OF NEW RISKS.**

**J**ohn Meriwether was in the news lately. Remember him? Perhaps not. His market-neutral hedge fund just lost 24%. Hmm, hedge funds. Ring a bell?

Ten years ago, the U.S. Federal Reserve was mopping up the mess created by Long-Term Capital Management—the Bear Stearns of its time. With similarly opaque counterparty arrangements, LTCM threatened to overturn confidence in the U.S. financial system. Oh, that John Meriwether: one of LTCM's founders. LTCM bet heavily on regression to the mean—with Russian bonds and hundreds of other assets—guided by a pair of Nobel-prize winners and some ace traders from Salomon Brothers.

With the assurance only a model could vouchsafe, LTCM took on leveraged positions and rolled them over time and again, until it couldn't.

Now doesn't that sound familiar? Non-bank ABCP and liquidity draining through the bottom of the well?

#### Ten Years On

From LTCM to Bear Stearns, it seems, liquidity risk is unchanged. It's just moved around a little, reappearing in unexpected places. But does that mean nothing has changed since 1998?

Yes, because as Wall Street doyen Peter Bernstein notes, the best lessons of

academic research are increasingly integrated into portfolio management.

No, because risk is not just a calculation of present values against standard deviations of returns.

Risk is the unexpected, the unpredicted, the unhedged (or unhedgeable) tail event that is only supposed to occur once in a lifetime. LTCM demonstrated that a decade ago. Non-bank asset-backed commercial paper demonstrated it again. Safe bets can run aground on the shoals of dried-up liquidity.

### So What's Diversification?

Consider the evolution of fiduciary requirements. For trustees, the provinces used to prescribe what were the safest of securities, the bluest of the blue chips. Widow-and-orphan stocks had a real backing: the reward, however minute, seemed to have little risk—given a strong dividend policy.

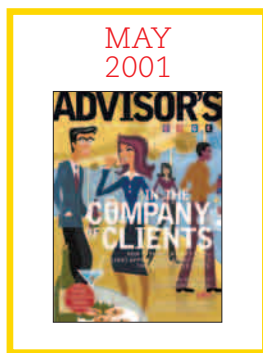
By contrast, stockbrokers had wider latitude, and Canada is a market with wide latitudes—between a disappearing number of blue-chip names and an ever-wider array of junior resource stocks: a boiling cauldron of risk for hot hands, and burnt fingers.

Some of those junior stocks blew up, real good. The junior resource space is littered with the debris of Bre-X and Cartaway Resources, among others. To be kind, on the blue-chip side Heartbreak Nortel couldn't get its income statements to sing in harmony with its earnings guidance either.

That's where mutual funds came in: a diversified portfolio that wouldn't be mortally wounded by the collapse of a single stock. And, in the '90s, some Canadian fund managers attained impressive returns, not so much by investing in

the broad market, but by playing to that Canadian taste for resource stocks. Until it all stopped, and with it, the rise of Altamira and Veronika's secret.

To be sure, many of today's mutual fund companies started with a single fund decades ago. These early funds were the original attempt at one-stop diversification, intuitive iterations essayed just as Harry Markowitz's mean-variance analysis was finding traction. For Markowitz, diversification meant combining relatively uncorrelated stocks to achieve an expected return greater than the volatile performance of the individual stocks. But mutual funds had a slow slog in acceptance, for two reasons: GICs were simple to buy and rates of return looked reasonable, while funds came with a punishing 9% haircut for the investor, at least in the 1980s. But the back-end sales charge and the rise of no-load funds changed the investment landscape for the average investor.



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There are two or three truisms in the fund industry. One is that investors chase returns. With great regularity, they buy last year's high-performing fund or asset class.

The second is that they prefer home markets. It may have been reasonable, for example, for U.S. investors to follow a slice-and-dice approach among domestic bonds and equities, with no more than 10% allocated to "suspect" foreign stocks when the U.S. represented more than 50% of the world's market capitalization.

But it turns out foreign investors are no less attached to their home markets. Of course, Canadians were long constrained by regulation to have a home bias. Even as the industry was arguing

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that the cap on foreign investment should be raised—it was 20% in the late 1990s—few were interested until U.S. technology stocks overheated. Indeed, if one looks at IFIC figures, foreign property averaged around 22%, and that includes RRSP accounts and investment accounts where investors were not constrained.

Which leads to the third truism: the holding period is increasingly shorter—investors stay the course for a year or two, not the 10 years required to see a strategy reap its harvest.

So dial back 10 years. Risk was often more present than reward. Emerging markets, out of favour since the 1994 peso crisis, were again looking attractive. But investors did not count on hot money, money that flowed all too easily away from the first hint of crisis. So emerging markets toppled in 1997 and 1998, taking with them LTCM as investors steered for harbour in U.S. Treasuries.

Ten years later, the shoe is on the other foot. It's the developed U.S. market that's enduring a liquidity crisis, while emerging market equities have posted three years at the top of the tables. Like liquidity, risk moves around a lot.

### Give us the Tools

But how easy was it for an investor or an advisor to analyze markets through the prism of diversification? The tools at hand were few. To be sure, there were daily performance tables in the papers, and there were Internet supplements, such as the Fund Library and GlobeFund. Morningstar **continued on page 23**

continued from page 21 had yet to arrive, although its elements were present in the form of BellCharts and PALtrak, while GlobeAdvisor had yet to be launched.

Investors and advisors were locked into a fund-by-fund analysis: who did what last year. Remember *Heavy Hitters* or *Smart Funds*? To be sure, funds supplied benchmarks, so there was some means by which to judge individual fund performance. Complementarity of fund holdings was harder to achieve. And crucial analytical parts were missing, such as the degree of fund overlap, and perhaps more important, correlation analysis.

Here's an example of a missing piece. There was a time when one fund company, thanks in part to acquisitions, had four different Canadian funds. And all four portfolios were essentially the same top-ten holdings.

As for diversification along the efficient frontier, there were many arguments for it, and a lot of risk/reward charts to illustrate it, but few tools to help effect it. But that was certainly a step better than the mutual fund marketing literature of a decade before, one priceless example of which: Buy Japan, Tokyo real estate is worth more than the whole of California.

That much has changed for the good: more real-time information is available than ever—and so newspapers have dropped their stock and mutual fund tables—while the investor can increasingly optimize a portfolio for a given level of risk, but of course, always through a rearview mirror.

### Plumbing the Market

While funds offered an opportunity for one-stop diversification, they were not necessarily placed to reap the best opportunities. To be sure, in the late 1990s it was hard not to make money, at least in

U.S. equities, no matter where one was invested: large-cap value or small-cap growth, reported one Morningstar analyst. Take yer pick.

Only with indexing did investors start to get a sense of what the market was, though indexing only gradually made its way to Canada. Indeed, many index funds are only a decade old. Investors were treated to the S&P 500, the TSX 60 or MSCI EAFE. But although such indexes represented more than 80% of the investable market, they did not represent all the investable opportunities.

Hence, the history of diversification is in some sense a process of discovering new markets—and new risks.

What would a properly diversified portfolio have looked like in the 1990s? Here's the Ontario Teachers' Pension plan as of December 2000: Commodities 3%, real-return bonds 15%, bonds 15%, cash 3%, real estate 9%, international equities 18%, U.S. equities 14%, and Canadian equities 25%.

Fast forward to 2007, and the OTPP portfolio looks a little different. Bonds are at 33%, Canadian equities at 7% and non-Canadian equities at 12.6%; the rest is distributed among alternative investments (8%), private equity (8.5%), real estate (20%), and timber and infrastructure (11%).

Now, this is an institutional portfolio. But that doesn't mean elements of it can't be duplicated. In fact, Yale Endowment fund manager David Swensen has written just such a book for investors. Where it differs from the conventional cash/bond/equity portfolio is in the addition of real estate. But there are real assets that could be included, whether as mutual funds, for example, or closed-end trusts devoted to infrastructure.

The OTPP portfolio also reflects something else: cyclical shifts in investment opportunities. Gold managers

were as lonely as Maytag repairmen for a long stretch of the '90s, basically after the collapse of Bre-X. The complaint was always the same: gold won't budge until the greenback swoons. Not till 2001 did managers hit the motherlode—well before the dollar started to waver. This provides a cautionary lesson for the investor: while markets can remain irratio-

## AS IF TEMPTING THE FATES, THE NON-DIVIDEND-PAYING TECH STOCKS COLLAPSED.

nal for long periods of time, they don't remain irrational—or illiquid—forever. And that's a dimension of risk appetite that has to be taken into account.

Another example. Oil barely moved in the 1990s. A decade ago, prices approached \$9 a barrel. Market watchers were wryly surprised whenever something significant happened in the real economy—among companies that made things people would buy, rather than selling advertisers net users' eyeballs glued to a computer screen. Then again, lipstick pigs appealed to the daytraders, and the IPO speculators, something Jeremy Siegel has highlighted as “growth trap” in his latest pulse-taking of *The Future for Investors*.

### Efficient Markets to Earth, Hello

There is a Nobel-winning theorem, awarded to Franco Modigliani and Merton Miller, which says investors should be indifferent to whether a company pays out dividends, retains earnings to reinvest, or finances its growth by taking on debt. A wash, in the absence of taxes.

It may well be investors are indifferent, but not if they live in a tax system where interest, dividends and capital gains are taxed dif- continued on page 25

continued from page 23 ferently. So that's another angle on diversification, made more fluid by then finance minister Paul Martin, cutting the capital gains inclusion rate twice in a year, back in 2000. With a drop from 75% to 66% and then to 50%, suddenly investing solely for capital gains looked doubly attractive.

Why doubly? Partly because many of the growth stocks of the 1990s paid few or no dividends. Earnings were reinvested, either to expand the business or to make acquisitions. A few old hands may remember that Nortel, before it was the stock-market darling of the late '90s, was beaten up in the mid-1990s for a few, ultimately non-accretive, acquisitions made at that time.

The second part is that the tax system seemed to reward non-dividend-paying companies. Prior to the mini-budget change, dividends and capital gains seemed equally favoured as against interest income; and for that reason, many pundits predicted the demise of the RRSP. Why pay tax on interest income once an RRSP is collapsed into a RRIF or annuity and then the cash withdrawn, they argued, when one could defer taxes indefinitely on capital gains accrued outside an RRSP?

As if tempting the fates, the non-dividend-paying tech stocks promptly collapsed. By 2002, evidence of a sustainable dividend payout was almost a bankable surety. Except when the dividend wasn't sustainable. It's a risky world out there.

### Back to the Future

Dividend stocks now have had a good run. So have more speculative stocks, particularly the resource stocks. Is that equilibrium?

Not necessarily, though in one sense equilibrium has been restored. Thank

the Halloween surprise for that. Flow-through entities such as income trusts are now treated more or less the same as dividend-paying stocks.

And so, one wrinkle gone. Surely another will arise. And new risks will emerge, piling up until the next liquidity freeze. <sup>AE</sup>

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