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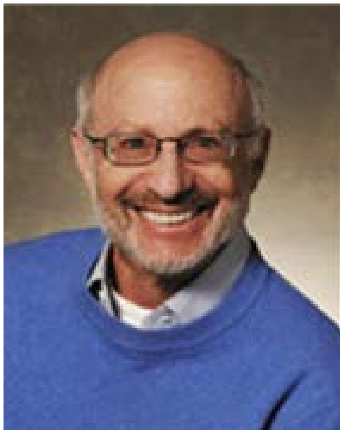
HERE'S THE THING!

Witness the investment world's "new normal" - product proliferation! Witness the innocent casualty – product integrity.

Investors are accosted by a Paradox of Choice. - Investment decisions are more complicated, and available information harder to grasp, than ever before. We consider whether "More Is Less".



Michael Edesess, PhD

GIMME MORE!

It all started earlier this year when I downloaded a BrightTalk webinar presentation[i] by Michael Edesess of Fair Advisors. Michael's exhortations that we should ignore most of the fresh thinking about portfolio theory to which we have been exposed over the past couple of decades is provocative to say the least. Michael believes in the "fundamentals" of investing – stocks, (not even bonds) and bills. His ideas remind me of the philosophical stance of some of my better football coaches, men who insisted that a good segment of every practice should be devoted to the fundamentals – to blocking and tackling. It all seemed quite boring at the time, 'til game day that is, when our laboriously honed blocking and tackling skills worked so effectively to frustrate the superior play-making skills of our competition.

As we do at Quaero, I shared the Edesess webinar with my colleagues, seeking their thoughts. The consensus was that the arguments made in the presentation lacked some rigor, but in fairness to Dr. Edesess, the opportunity allowed him only 45 minutes in which to address his base-case idea, his advocacy for long-term investing and his arguments against the use of bonds for risk reduction, mean variance optimization, rebalancing, tax harvesting, diversification, risk factor analysis and smart beta, performance evaluation, and behavioral finance. So for the sake of a good argument I will side with Dr. Edesess, and the fundamentals, in this debate. I'd like to begin with some discussion of the effects of the observed move away from the fundamentals.

PRODUCT PROLIFERATION

In an effort to solve investment problems encountered through the numerous market corrections that we have suffered over the past few decades, the best and brightest in our industry have responded with a proliferation of product ideas, moving us ever further away from the fundamentals. Following on the institutionalization of derivatives and then hedge funds we witnessed the introduction of "structured products", then "fundamental indexing", "smart beta" and "risk parity" strategies, all now available in a variety of vehicles, packaged and priced to please. The effects of these changes are twofold - *more product*, and *more complexity*. More product leaves investors to wrestle with the "Paradox of Choice"[ii] and more complexity, unfortunately, lends itself to more obscurity. The need therefore, to carefully discern the integrity of individual products and to intelligently determine the optimal allocation of such products is coincidentally more important and more difficult than it ever has been.

DISCERNING PRODUCT INTEGRITY

The only secure approach to investing in the "new normal" is to embrace our first dictum which is "if you don't understand it, don't buy it". Then dig in and do your best to test prospective providers for their ability to clear the product integrity hurdle. To do that, we embrace our second dictum which is "if you can't explain it simply, you don't understand it yourself (or you are trying to put one over on me)". There are, unavoidably, numerous hurdles to overcome in the race to discerning product integrity; one of the more prevalent obstacles to understanding is found in the mathematical models used to "prove" the effectiveness of a given strategy. It is important not to get bogged down in the math. On the intellectual integrity of mathematical applications to real world investment problems, I offer the ideas of three thoughtful people:

1. ***"Not everything that counts can be counted and not everything that can be counted counts."***
   - ***Sign hanging in Einstein's office at Princeton***

2. ***"Models should serve as an aid to understanding and not a replacement for it."***
   - ***From a paper entitled "Don't Marry a Model," by my erstwhile colleague Bob Collie at Russell Investments***

Jim C. Otar (1951 -)
CFP, CMT, BASc, MEng

And finally, allow me to introduce you to my friend, Jim Otar. Jim is a financial planner who works out of his home north of Toronto and travels extensively to present at workshops organized by major institutions for their own financial planners. He has written several books and over 100 articles on advanced retirement planning and market history; he builds retirement planning models with passion and has thus "played with the numbers" long enough to understand them well.

In his book Unveiling the Retirement Myth Jim challenges all models that rely on the "Gaussian mindset" (normal distribution) to address the challenges of retirement planning. He says:

3. ***"The greatest . . . impediment to the advancement of the mathematics of distribution is the fabrication of useless studies by researchers using Monte Carlo simulators. Their flawed research studies are applied to asset allocation, portfolio optimization, diversification, risk management and . . . actuarial calculations. I cringe every time I look at a publication that includes the words, 'using a Monte Carlo simulator . . . our conclusion is . . .'"***

Gaussian Mindset Baloney

OUR CLOSING ARGUMENT: Maybe we've all just gotten a little too sexy for our shoes. Maybe "More ***is*** Less". Maybe Michael Edesess has something in his insistence that we stick to the fundamentals.

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OUR HOPE:

My Australian colleague, Nick Birrell, drew my attention to an article by Robert Shiller, author of Irrational Exuberance, in Australian Financial Review Magazine. In the article, entitled "Why Warren Buffett can never be replaced by a computer" Shiller asks "Is the day approaching when, thanks to so many smart people and computers, financial markets really do become perfect, and we can just sit back, relax and assume all assets are priced correctly?" He goes on to explain, very elegantly, why this imagined state of "financial singularity" cannot exist and he concludes that "Human judgment, good and bad, will drive investment decisions and financial market outcomes for the rest of our lives and beyond." This is our hope.

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[i] Dr. Edesess' presentation is entitled "Why Everything You Thought You Knew about Investing Is Wrong" and you can access it by googling BrightTalk and signing up. The presentation is based on the book: "The 3 Simple Rules of Investing: Why Everything You've Heard About Investing Is Wrong – and What to Do Instead" By Michael Edesess, Kwok L. Tsui, Carol Fabbri, and George Peacock. It is a critique of the securities industry; a call for financial advisors to lead a restoration of professionalism and respectability (and downsize the industry).

[ii] The Paradox of Choice: More choice = more freedom and better pricing = greater complexity, obscurity and confusion.