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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

MY CLASS SCHEDULE:

Foreign Language, Economics, and Choosing a Concentration

Labor Day has passed and students are back in class. With the start of the school year, Eye on the Market ("EotM") was inspired to take some courses in Greek as a foreign language, economic theory in practice, and portfolio management theory. EotM is excited to hit the books, and strategically avoid any 7AM classes.

IT'S ALL GREEK TO ME

While it's important to understand the theory behind current investment strategies, the details are sometimes lost on those not active in the financial industry. Many asset-pricing and security-selection theories use Greek symbols to convey statistical concepts such as regression formulas, correlation calculations, and probability. EotM believes that practitioners need to understand these principals. Conversely, most investors would rather ensure that their financial goals will be met – not take a course in foreign language.

Table 1 references some of the more common Greek symbols used in financial theory and the terms they represent. From an investment perspective, alpha is the difference between a benchmark return and the actual return for a security or portfolio, also referred to as excess return. Beta measures the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Ultimately, both variables are derived from a statistical model known as a regression analysis that examines the intercept and slope of a line.

Table 1

Greek Letter	Statistical Reference	Financial Reference
Alpha (α)	Intercept	Excess Return
Beta (β)	Slope	Systematic Risk
Delta (Δ)	Change	Change in Price
Sigma (σ)	Standard Deviation	Volatility
Mu (μ)	Mean	Average

While all of this makes sense to academics, investment professionals, and statisticians, the average investor may struggle to interpret these figures and results. To illustrate, below is one of the foundational concepts used in Modern Portfolio Theory ("MPT") to calculate the expected return on an investment...with a slight adjustment to the formula.

$$\text{Expected Return on Investment}_x = E(R_x) = \alpha_x + \beta_x E(R_m) \neq \textbf{Client Comprehension}$$

Individual investors are not alone in finding navigating financial information confusing. Warren Buffett, viewed by many as one of the most highly-skilled and successful investors of our time, wrote in his preface for the Securities and Exchange Commission's handbook titled *A Plain English Handbook*:

> *"Perhaps the common problem, however, is that a well-intentioned and informed writer simply fails to get the message across to an intelligent, interested reader. In that case, stilted jargon and complex constructions are usually the villains."*

ECONOMIC THEORY IN PRACTICE

EotM recently attended a meeting with Rick Rieder, Chief Investment Officer of Global Fixed Income at BlackRock, Inc. Rieder shared his views on the global economic landscape and what opportunities and challenges investors will likely face over the coming months and years. Below is a brief overview of his comments:

- Since the global financial crisis, central banks have pulled many of the levers they have at their disposal. To that end, Rieder is of the opinion that monetary policy may now have less impact on interest rates relative to a few years ago. Fiscal policy that focuses on infrastructure spending, changes to taxation, and incentives for research and development would be beneficial to improve growth prospects.
- Changing demographics will create challenges for both investors and policy makers. For example, student loan debt of younger individuals constrains their ability to enter the housing market, which may be contributing to muted growth. Conversely, countries such as Japan and parts of Western Europe have aging populations that are placing strains on governments. All of this will need to be addressed in some form to help ensure future economic growth.
- Rieder believes that many fixed-income asset classes are mispriced and will remain so going forward. Issuers of debt securities are employing more leverage and there are fewer covenants in more recently-issued securities. Covenants typically place restrictions on the borrower, so that the lender has more assurance the debt will be repaid.
- He believes that the U.S. consumer is in a good position, unemployment is low, and there is evidence of new job growth. As such, there are opportunities within fixed-income asset classes such as mortgage-related securities. Additionally, he noted that many emerging-market countries look attractive. Brazil, which has taken steps to bring down inflation and move from negative growth to either less negative or positive growth is one such example. The country has also taken steps to stabilize its political landscape.

PORTFOLIO MANAGEMENT THEORY

A recent EotM attempted to show both sides of the active versus passive argument. A complementary article in the July/August 2016 *Financial Analyst Journal* titled The Effect of Management Design on the Portfolio Concentration and Performance of Mutual Funds, further demonstrates how certain traits can have a positive impact on a fund's performance.

> *"... researchers found that portfolios that were concentrated, not only at the sector-level but also at the industry-level, generated better performance."*

A study was conducted to develop empirical evidence supporting several key findings. First and foremost, the researchers found that portfolios that were concentrated, not only at the sector-level but also at the industry-level, generated better performance. The authors also found that strategies with a single manager have higher levels of concentration, thus better performance, but also higher expenses. In addition to discussing how concentration can aid performance, the article noted that, when single-manager strategies became multiple-manager strategies, the level of concentration declined, as did the levels of abnormal performance.

So, does this mean that investors should only invest in single-manager, highly-concentrated portfolios? It depends on the investor's goals, objectives, and risk tolerance. All of the above may hold over long periods of time, but if the investor does not have the luxury of time, this strategy may not be suitable.

Mutual Fund Research & Marketing has several portfolios on the Highly Recommended Funds List that are concentrated and have either a sole manager or a management team with one individual dedicated to security selection. While these strategies have been successful over the long run, there have been periods of underperformance along the way.

SIDE NOTE

EotM is saddened by the loss of Gene Wilder, who passed away on August 29, 2016, at the age of 83. While he had many memorable roles, one of his more widely-known roles was that of the eccentric candy factory owner, Willy Wonka, in the 1971 film *Willy Wonka & the Chocolate Factory*. Just as students learn academics from their teachers and professors, Wilder was a brilliant educator on the art of making people laugh.