

Asset allocation

By Michael Kemp

This is the revised text of a presentation that Michael Kemp gave to an Australian Investors Association one-day seminar on asset allocation in Sydney on 27 August 2010.

When allocating our capital to superannuation it is hoped that we are all thinking about undertaking the process of *investment* - as opposed to *speculation*.

When we see these two words we usually react by immediately putting them into different compartments. “No I’d never speculate. I’m an investor” but the reality is most people operate on rather shaky ground here as there is often a substantial cross over between the 2 activities. We think we are investing but in reality our behaviour can be close to that of speculation. And more often than not we aren’t even aware of it.

Benjamin Graham hinted at this in 1934 in describing a cynic’s distinction between the two. He said that “a cynic might describe an investment as a successful speculation and a speculation as an unsuccessful investment.” But Graham did go on to give his considered definition of investment. He saw it as an activity that embraced two concepts: That which provided *safety of principal* and a *satisfactory return*.

But safety of principal is easy to give lip service to, but difficult to achieve, and this is true of any asset class under consideration.

Shares

Consider Blue Chip Stocks. American financial journalist Oliver Gingold coined the phrase “Blue Chip” in the 1920’s in an analogy to the colour of high-priced casino chips. Whilst he was referring to high-priced stocks his original meaning has been altered a bit and today it refers to high quality stocks. But the ownership of blue chip stocks doesn’t guarantee **safety of principal** hence doesn’t define their purchase as the activity of an investor.

For example Telstra’s share price is currently only 30% of its all-time high of \$9.20. In recent times ANZ fell 62% within the space of 15 months and in 2008 Rio Tinto fell 81% in a 7 month period.

Here then comes the distinction: It’s not the securities that you purchase which defines whether you are an investor or a speculator. It’s the way that you interact with them. This is a connection that a lot of people fail to appreciate. Put quite simply you need to be confident that what you are buying is actually worth what you are paying for it at the time you buy it, because often it’s not. Your anchor should be *value*. Most people use **price** as their anchor.

When I started establishing my own view on value was when I started hoping for the share market to fall. We’ve all read the Buffett-isms like be fearful when others are greedy and be greedy when others are fearful - that we should buy profusely in bear markets. But the fact is that unless we have confidence in our own valuations then it’s all just words.

If you don't have a handle on value then either:

1. Entrust your capital to someone who has, or alternatively,
2. Diversify your capital allocation by asset class, company (for shares), and time. But if you do be content with market returns.

Diversifying "by company" acknowledges your incapacity to value shares. Diversifying "by time" acknowledges your incapacity to time the market.

"Diworsification" is a word that's thrown around a lot and it worries me. Whether people achieve returns which are superior to or inferior to market returns by either diversifying or concentrating their stock holdings needs to be linked to investment skill. Diversification would be "diworsification" for Warren Buffett. But it would be better for many other people. The majority either aren't interested in, or are incapable of, undertaking the capital allocation process. For these people diversification offers very real attractions.

Bonds

Another activity associated with investment is the purchase of bonds. Using Graham's definition again, can we guarantee security of principal with bond ownership? No – although holding Australian Government bonds has, at least to date, not resulted in capital loss by default.

Reinhart & Rogoff's book ("This Time is Different") tells us that worldwide there have been at least 68 cases of default on domestic debt and at least 250 cases of default on sovereign debt from 1800 to 2009. Fortunately, Australia is not on the list. But the risk to capital associated with bond ownership is not limited to outright default. More commonly it is associated with adverse interest rate movements. Bond values fall when interest rates rise. Thus when bonds aren't held to maturity a capital loss is realised (the longer the date to maturity the greater the loss).

For example: for a 1% rise in interest rates (on a 10 year bond with a 5% yield) there is a 7.4% fall in capital value. Because of this I find the idea of short term investments in long dated bonds to be a very risky activity.

Annual returns on long dated bonds are extremely variable and can periodically be negative. Your reaction to a graphical representation of annual bond returns is likely to be similar to that of a graph of annual stock market returns.

Long term bonds are far from capital-stable in the short term. It's why traders trade them. A particularly worrisome time to hold long term bonds is when interest rates are at historical lows such as now. The present yield on Australian 10 year bonds is below 5%. The yield on 30 year US Treasury bonds is 2.6%. In my mind this is placing too high an expectation on inflation remaining low for the next 30 years.

Property

We've had a strong residential property market in Australia for a number of years now. Is it going to continue or is it unsustainable?

A big problem in studying the performance of property as an asset class is the lack of homogeneity in what we are trying to measure. There is little uniformity with respect to location, function, size, valuation basis (building/land mix), age and condition of buildings and so the list goes on.

Whilst it is a study that relates to residential rather than commercial real estate Piet Eichholtz's price study of properties on Amsterdam's Herengracht - or Gentleman's Canal - provides a constant quality index virtually unheard of in any other real estate study. Eichholtz's study looked at price movements between 1628 and 1973 on the SAME houses. The "social status" associated with the district and the houses themselves had changed little in 345 years. Over 300 years of meticulously kept sale price records were available for Eichholtz to study. He found that the annual geometric inflation-adjusted capital gain was a mere 0.2%. But this should be what we expect because a greater rate would have meant that the properties would ultimately have become unaffordable – clearly something that can never happen in a functioning marketplace.

Eichholtz found that property prices were:

1. Volatile (capital growth in sub-periods was quite irregular).
2. Showed little REAL Capital Growth when viewed over the long term.

There's a reason why people today would not intuitively accept a real return of 0.2%.

We tend to extrapolate the present when forecasting. And at present the Australian experience is that the rate of capital gain on property is much higher.

Australian house prices over the last couple of decades have significantly outstripped inflation. Over the last 24 years the real capital return has been 3.6%. But this rate is unsustainable over the long term. By way of demonstration if we plugged 3.6% into the Herengracht example the Dutch today would be paying nearly 200,000 times the REAL (inflation adjusted) price for the same house than was necessary to purchase it in the 1620's! Relating this to actual figures it would mean that if a house on the Herengracht cost \$500,000 (in today's money) back in 1628 then today it would cost \$100 billion! This would mean that Bill Gates and Warren Buffett would have to pool their total wealth just to buy one house. OK for them, but I don't think Astrid and Melinda would be as happy sharing the bathroom.

There's another significant issue impacting property returns - It's the costs associated with acquiring a property – in the order of 5.5 to 6.0% of the property's price. A real capital gain of only 0.2% per annum would mean a period of 28 years of real capital gain just to recoup the acquisition costs and that's not even taking into account recouping any potential disposal costs. Eichholtz described, in his study, a 100-year period from 1855 to 1955 when the inflation adjusted value of Herengracht property actually fell by 30%. Don't get me wrong, people do make money on property but just like the stock market – long term inflation adjusted returns can be pedestrian. It's about timing and asset selection. The same principles apply for property as for buying shares.

Interaction not ownership

Now, returning to Graham's original description of investment as a process involving *safety of principal*. You can erode principal buying the bluest of blue chip assets. It bears repeating that the point many people fail to grasp is that it's not simply the assets that you buy that defines you as an investor - it's how you *interact* with those assets that defines you as an investor. Remember that every company that Warren Buffett's Berkshire Hathaway has owned now or in the past, has been, at one time or another, owned by others. Yet they have failed to achieve the returns that he has. What has distinguished Buffett as such a great investor has not been simply the stocks that he has owned but also *when* he has chosen to own them.

Graham's second criterion – a satisfactory return

Many of you would have read Jeremy Siegel's book which explored the geometric return on the US stock market over a 200 year period. Siegel stated that the return achieved from a hypothetical buy-and-hold investment would have been 7% real.

In order to consistently outperform the market averages you need to either exhibit luck or skill. But more people claim to achieve above market returns than actually do. Some claims are so ridiculous that you can actually refute them by applying simple mathematics. One tool that every investor should have is a good working knowledge of compounding.

I recently saw an organisation spruiking for clients claiming that their target return was 200% per annum. That's tripling your money every year. Such ridiculous claims need to be countered with ridiculous examples. By applying a 200% return to the hypothetical \$1 million which we are discussing today we could, in ten short years, amass \$60 billion so contesting for the title of the wealthiest person in the world. In 20 years we would have \$3,487 trillion which would pay off the current debt of the United States 236 times over. At this rate of return a mere \$10 would become \$35 billion within 20 years. So it seems that financial naivety is alive and well and there are still people willing to take advantage of it.

Ambiguity not probability

In the 23 years since I first became involved in the financial markets I have developed a healthy respect for what I don't know and never will know. Not from a lack of trying but because there is so much that is literally unknowable. And within this massive deficit of knowledge I still have to make decisions as to how to allocate my capital.

I just want to consider a case study which embraces this concept of uncertainty and how it can impact on market prices and decision making. It centres around a man called Archibald Hutcheson, a Member of The British House of Commons for 14 years from 1713 - 1727. Hutcheson was vocal in his admonition of the excessive market price of South Sea shares at the time of The South Sea Bubble (1720).

The South Sea Company had two income sources, one real and one anticipated. The real source was a reliable income stream from the British government for loans made to the government. The anticipated income stream never really eventuated. It related to the hope that the South Sea Company would earn income from trading with South America.

The annuity component could be valued, and Hutcheson did, using the concept of Discounted Cash Flow in order to calculate an **intrinsic value**.

On 11 June 1720 Hutcheson armed with his NPV (Net Present Value) calculations based on the Government annuity component delivered to the House of Commons his declaration that the “Intrinsick value” of South Sea stock was £200 per share. (“Intrinsick” is not a typographical error – it’s how “intrinsic” used to be spelled)

At the time Hutcheson delivered this information South Sea shares were trading in Exchange Alley for £740 and by August at £1,000. So the market put £200 of value on something that was near to certain and £800 of value on something that was totally intangible. Within weeks of Hutcheson’s cry for common sense the South Sea share price had fallen by 86% from its August high. The problem was that people had been operating in the part of the pricing spectrum that was **unknown** and might I add **unknowable**.

Yet people were shocked when the share price collapsed by 86% within a few short weeks. This is because their anchor was **price** not **value**. And we still do it. If you think this example is an historical irrelevance let me remind you of the Dot.com bubble - it was little different. So, as investors, you should work as close as you can to the **knowable** end of the spectrum in relation to income flows.

It’s often said that the stock market is like a casino. It’s not. In a casino you can work out prices because you know the odds of an event occurring. In the stock market you don’t. This whole issue was addressed by American economist, Frank Knight, in 1921. He reminded us that you can only apply probabilities when:

- (a) You know the population of all possible outcomes.
- (b) You know the chance of each event within that population actually occurring (eg. the roll of dice)

In financial markets you know neither (a) nor (b); ***we are making decisions in the face of ambiguity not probability.***

These are Knight’s words: “Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. A measurable uncertainty, or “risk” proper...is so far different from an unmeasurable one that it is not in effect an uncertainty at all”

What do financial commentators say when they are asked to comment in the face of ambiguity “I’ll wait until we are out of the present uncertainty?” The fact is that we are never out of the “present uncertainty”. Most commentators simply cannot bear to say: “I don’t know”

We know that John Maynard Keynes read Knight's book and shared his sentiments: This quote from Keynes: "The assumption of arithmetically equal probabilities based on a state of ignorance leads to absurdities." (*General Theory of Employment Interest and Money* p 152).

Shares don't usually have an annuity attached to them like the South Sea example. Warren Buffett knows this. So what does he do? He allocates his capital to companies with as predictable a cash flow as he can find.

I said earlier that if you don't have a handle on value then entrust your money to someone who has. The trouble is we usually find out who that is at the end of their career not at the start. For example Buffett's best returns were in his first 13 years. In his "Partnership" days (1956 - 1969) he achieved an annualised geometric rate of return of 30%. Over the last 13 years it's been 7.9% (nominal and that includes reinvestment of earnings).

To read more of Michael Kemp's work

Previous Articles

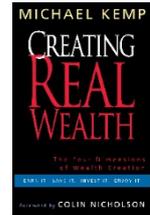
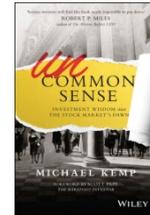
All Michael's previous articles for the website are now on the *Michael Kemp Articles* page on the Free Resources menu. They are now listed by title with a brief description of their contents.

Books

Michael has written two books, both of which are available for purchase from the **Buy Books** menu:

CREATING REAL WEALTH - The four dimensions of wealth creation

UNCOMMON SENSE - Demystify the complex world of investments and make your own investment calls



Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.