Kitchen Table Economics & Investing

Insights on the question I get asked at parties “How to retire at 50?” .

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Important Information

These are the views of Damian Lillicrap as an Author.

The views of the presenter are not necessarily the views of his employer.

This presentation is for general purposes only.

You should consider personal financial advice if you want your individual circumstances taken into account.

Past performance is not a reliable indicator of future performance..

My Story

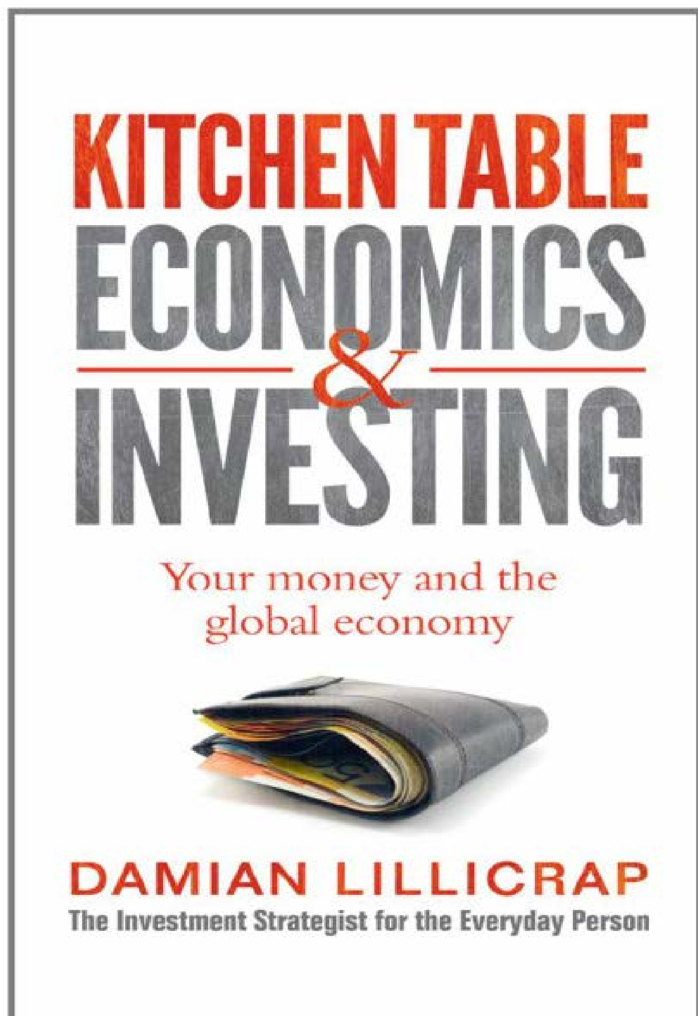
Chemical Engineer
Accountant CPA
MAICD – Company Directors Course

Currently:

Head of Investment Strategy – QSuper
with responsibility for Asset Allocation for $60 Billion invested Globally

Base Asset Allocation
Dynamic Asset Allocation – very much about managing risk

Author – Published Jan 2013 UQP



Easy reading but not dumbed down;

The more you know the more you'll find in it.

Explaining the current economic challenges around the world in everyday language.

A big focus on intergenerational inequity.

Today will cover: My answer to the party question "How to retire at 50?" considering three different styles of investing

Diverse asset class investors:

Beta Players

Diversified alpha investors:

Alpha Players

Highly concentrated swing for the fences investors:

Players' players

Also:

- *View of the world*
- *Insights into investment strategy*

Basic investing “Greeks” for beginners

Beta: Return from an index – or that you can get relatively mechanically from an asset class. Examples: ASX 200 for shares, Goldman Sachs Commodity index. Essentially mechanical – no skill.
Tip to remember = Beta is boring (or beautiful)

Alpha: The difference between a manager’s returns and the index they are trying to beat – represents their “skill” – a.k.a. “active” management.
Tip to remember = Alpha/active is aggressively trying to beat the index

S&P/ASX 200 **= a Beta**

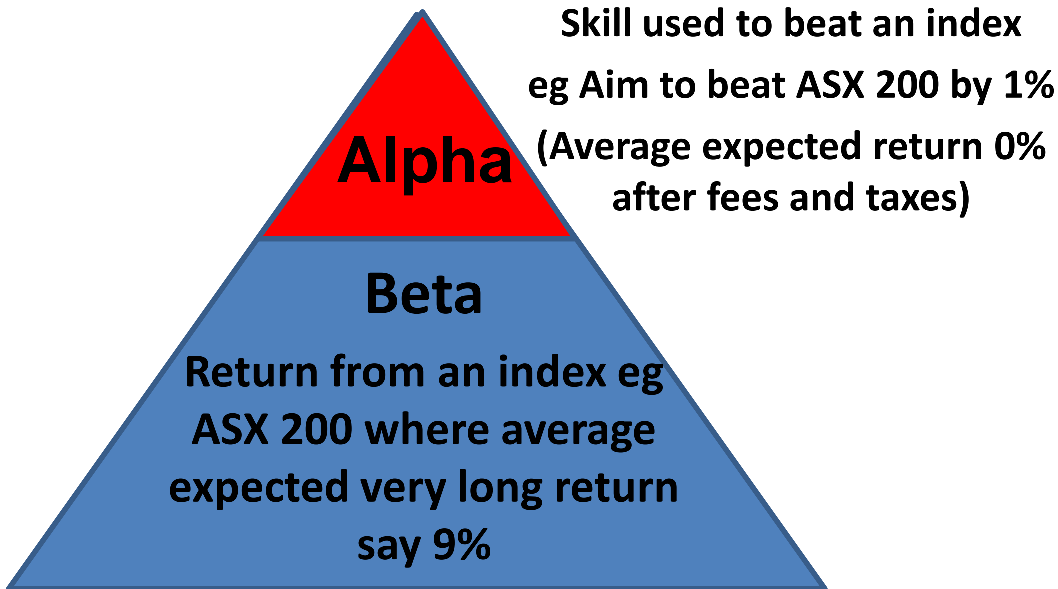
How much a manger is different to the index, ideally higher

= an Alpha

Alpha vs Beta

Impact on portfolio outcomes – Contribution to Risk

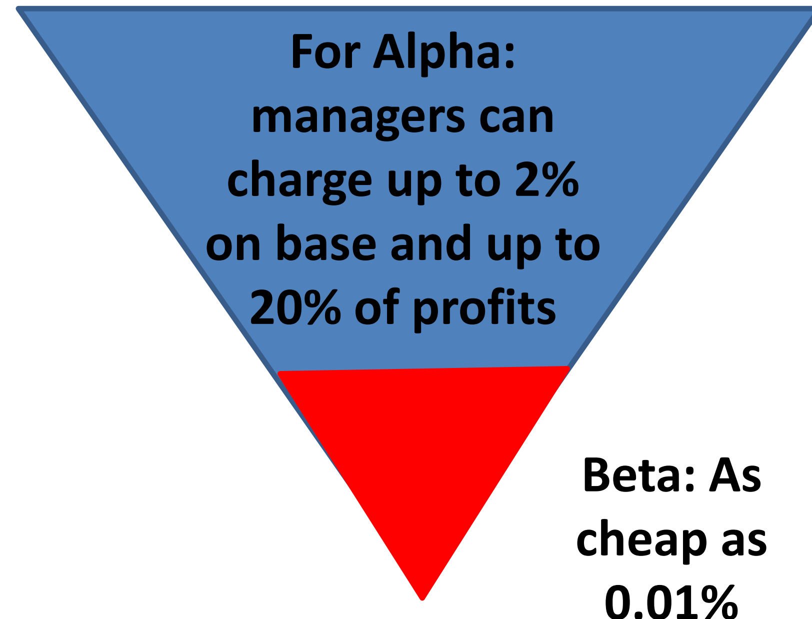
Cost per unit of risk



Skill used to beat an index

eg Aim to beat ASX 200 by 1%

(Average expected return 0% after fees and taxes)



Beta: As cheap as 0.01%

So Beta is most important to fund outcomes and cheapest!!

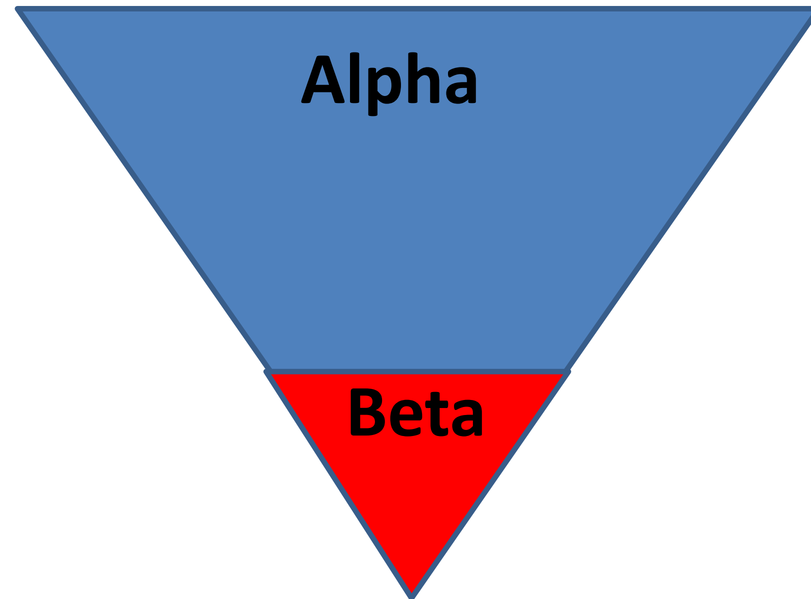
Obviously that's where all funds should focus, but do they??

Things are not what you'd think! A standard Aussie fund's approach follows: pretty much what we used to do.

Process

Time/Effort allocation

3. Rely on getting more alpha than other peers.



2. Set Strategic Asset Allocation (SAA) similar to peers – minimum risk position.

1. Set objective to beat peers.

My belief is that the better way is to tip this upside down – to focus on the Betas

Beta players: How does it work!

Imagine that you are at a casino.
You are playing a roulette table.

You might play Red or **Black**.
There are a **0 & 00**, so it’s not quite 50/50
actually 47% chance of either **Red** or **Black**
the house has only a **6%** chance of winning any spin.

Beta players: Risk premium

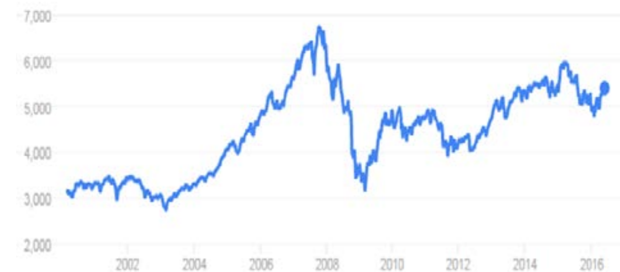
Investing in one asset class is not unlike owning one table in a casino.

A casino with just one table:

- Over the very long run should come out ahead – due to the slight advantage.
- But if they only had one table it would likely be a very rocky return.

If you only have one asset class e.g.

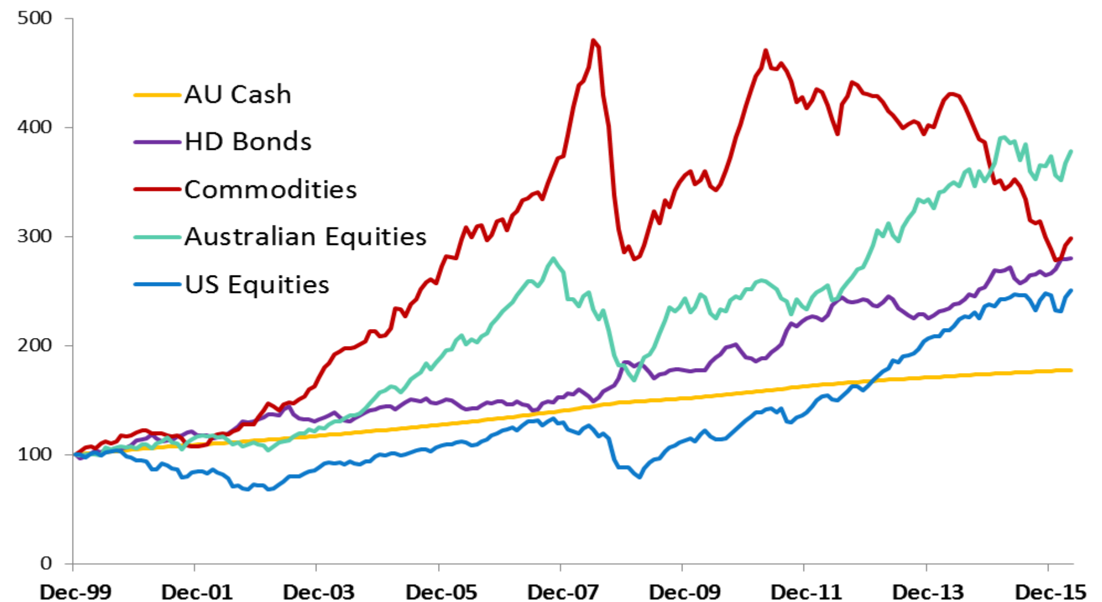
- Over the very long run you should come out ahead – because you should be paid a risk premium – a premium for taking risk.
- But, with just one asset class the returns can be rocky.



Beta players: Diversification

But a casino doesn't want a rocky ride so they diversify – have many tables.

Similarly when building portfolios you want to diversify with a range of different asset classes – betas!



Source: Bloomberg, QSuper calculations.

The second investment style:

Alpha players

Warning! generalisations follow, but generalisations supported by research[1].

You pay alpha managers money to invest to try to beat the market, but:

1. It is tough to beat the market, a lot of highly sophisticated players, with exceptionally smart people and amazing systems, all trying to beat each other.
2. Even if the skill to do this exists – it probably does – it is exceptionally difficult to identify these people from the exceptionally well credentialed, well presented people that want to sell you their services.

But surely you can look at their track records to see if they are good?

They almost always look good or you would never hear about them!

They are generally selling hope (as opposed to guaranteeing outcomes):

- That you don't need to save as much.
- However, you take the risk, they generally get paid either way – regardless if red (their bet) or black (not their bet) comes up.

Note 1. Journal of Finance in August 2008, The Selection and Termination of Investment Management Firms by Plan Sponsors

A case study – about identifying good active management

Imagine if you got a letter in the post Monday morning – fancy envelope addressed to you:

- Dear Damian, I'm a professional investor that would like to demonstrate my skill to you ...I predict that the market will go **up** over the next week!
  And it does (1 from 1)
- Then you get another letter the following week predicting **down** over the week!
  And it does (2 from 2)
- Then prediction of **down** over the week!
  And it does (3 from 3)
- Then, an invitation to invest, with prediction **up** over the week!
  And it does (4 from 4)
- Then, an invitation to invest, with prediction **up** over the week!
  And it does (5 from 5)
- Then invitation to invest flagging this is the last free tip. Prediction **down**!
  And it does (6 from 6)
- Then a final invitation to invest.

This is a true story!

One hell of a track record!!

What do you do???

Selling hope - case study

(example paraphrased from "Fooled by Randomness" Nassim Nicholas Taleb, Penguin Books Ltd, 2007)

This is a scam.

How does it work?

1. Send out 1,000 letters to people predicting the market will go up, and
   Send out 1,000 letters to people predicting the market will go **down**.

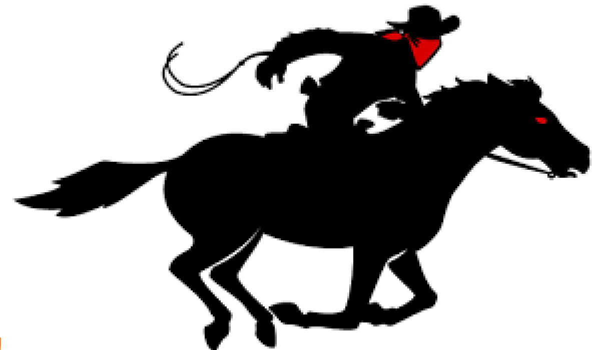
One prediction will be right, forget about the people that got the wrong prediction.

2. For the half of people that received the correct prediction:
   Write to half predicting the market will go up, and
   Write to half predicting the market will go **down**.

forget about the people that got the wrong prediction,
repeat step 2.

After a number of iterations invite them to invest.

Take the money and run!



Track records need to be taken with caution!!

Feedback from a respected alpha manager

They bet across a range of markets:
Equities, Bonds, Currencies, Commodities

They track what percentage of calls they get right.
Any guesses??

55% on average!
not a whole lot different to our red and black in the casino!!

Is the percentage better for high conviction calls??
No!

They have 400 investment professionals – the best that money can buy.
They have 2 million data series. US$120 billion under-management, and
They get 55% of investment calls right - that is sobering!!!!

They also employ diversification
- investing in around 50 positions at any time
– like the casinos many tables approach.

How has this fund gone??

Annual return over several decades ~11%.

Not bad!!

However :

- The founder has a net worth (est in 2015) of 15.5 billion.
- Starting wealth required if he had only invested in his own fund in 1999 would have been US$ 0.95 billion – so he would have had to have been a billionaire already to end up with the wealth he did.

Tip: to retire early don't invest in alpha managers, become one!!!

Past performance is not a reliable indicator of future performance.

The players' players!!!!

Swing for the fences!!!!!

Enough, I hear you say, of these many small exposures:

- to assets class – *beta players*
- or to small to positions – *alpha players*

Show you the money!!!!!!

You like big bets and you cannot lie!!

What do you need to know?

It's true it is possible to make a big bet, to nail it and to make a fortune.

- Most famous GFC example: John Paulson during the GFC:
    - Made 5 billion betting on CDOs – a lot of this was profits from betting other peoples money.
    - His big call since was gold – which has nearly halved in price.

Moral of the Paulson story:

- Better to be an alpha manager than to bet on one.
- Even he is batting 1 from 2 on his big calls (recall our very good hedge fund had a 55% track record - this is a tough game!!)

The players' players!!!!

Swing for the fences!!!!!

Let's say that you are onto a great idea – it's 50/50 after-all.

Even being right isn't everything:

- *LTCM*
- *Orange County*
- *Barings bank*

All went broke, on calls that turned out to eventually be correct.

John Maynard Keynes "Markets can remain irrational longer than you can remain solvent."

Even if you have a great idea, it is probably only good because it has gone a long way from fair value….
And that means it can probably go even further.

If you want to bet really big you want to make sure you can fund at least as much as you are hoping to win.

Don't bet what you can't afford to lose!

View of the world

Global themes

- Low cash rates
- High debt
- Lower trend GDP growth
- Low real wage growth
- Automation & AI taking jobs
- Populism/short termism

United States

- GDP solid
- Reform challenging
- Retreating from global leader role

Asia

- China growth model challenged
- Japan has debt and aging issues
- North Korea

Europe

- Structural issues with Euroland
- Open trade vs closed migration
- UK Brexit

Australia

- Economy narrowing
- 26 years since recession
- Housing
- Asia

Uncertainty is elevated

With regard to investing

– Growth seems to be continuing to recover (if slowly)
– Large imbalances and structural issues
– The authorities have shown the are keen to react to events
– Safety nets (monetary and fiscal policy) are pretty bare

The morale of the story - Stay diversified!

Summary: To retire at 50, or when you realistically can:

Diversification Mix of betas

Alpha typically better for managers

Markets can stay irrational

It is an uncertain world

Diversification is powerful

Options:

1. Focus on getting a good mix of betas.
2. Get a job where you invest other peoples' money and charge large fees – and if you blow up start another one.
3. Swot up, get a great investment idea, back it – but be sure you can afford to fund it – only bet what you can afford to lose.

Recall:

1. There is a lot of uncertainty.
2. Diversification is powerful – you can get people to do it well for you.

Discussion