

ERM Symposium



Do Risk Professionals Have What it Takes to
Manage Assets?

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Disclaimer

- This talk does not necessarily represent the views of my employer, the sponsoring organizations or anyone else besides me ☺
 - Don't consider this investment advice
 - Do your own research
 - Win or lose – use your own skills
 - I'm not responsible if you win
 - I'm not to blame if you lose
 - Investment decisions should be based on a thorough analysis of your own individual circumstances

Should Risk Managers Manage Personal Assets?

- Do we have the right skill set?
- Do we have the right temperament?

Risk Manager Skill set

- Yes – comfortable with
 - Cost benefit analysis
 - Distribution of results/Stochastic analysis
 - Probability/Statistics
 - Low frequency, high impact events
- Temperament - Maybe
 - Control of emotions
 - Common sense
 - Patience
 - Confidence

Talking Points

- Efficient Market Theory
- Marketplace
- Contrarian investing
- Meeting goals
- Why should I buy?
- Many ways to invest

Efficient Market Theory

- Is it the truth?
 - If yes, then you can ignore your portfolio
 - Stick with index funds
 - If no, then you miss market imbalances
 - Learn to recognize them
 - Individual stock selection

EMT

- Works most of the time
- Mr. Market knocks every day for every stock
 - Pay attention and strike when you have the house advantage
 - Not the same as being a day trader
 - Maintain some cash unless you don't think the market can go any lower
 - Wait for a fat pitch and go big
 - Exploit

Volatility

- If EMT is not 100% true
 - Then volatility is your friend
- Standard deviation is interesting but esoteric
 - Works better with portfolios
- Who doesn't like volatility when prices are increasing?

Stochastic analysis

- Monte Carlo
 - Favorite of financial advisors
 - Useful to a point
 - Only one scenario actually happens
- Deterministic scenarios
 - More useful
 - Solve for scenario
 - When am I going to run out of money?

Advantage to personal actuary

- Buy SPIA before retirement to lock in returns
- Buy longevity insurance
- Sleep at night insurance
- Inflation risk
 - Don't ignore it
- Small losses are okay if winners are big

Beta – Useful?

- Mildly useful for portfolios
- Not for one company
 - Washington Post story

Marketplace

- Market of stocks, not a stock market
 - Search out inefficiencies and take advantage of them
 - Investing in an index guarantees average results

Behavioral Finance

- Investors are not always rational
- Traders take shortcuts
 - Stick with fundamental analysis
- Traders worry about short-term performance more than long-term goals
 - Patience is the key

Where to Invest/Live

- In USA, anywhere but NYC
 - Easier to avoid noise
 - Firehouse effect
 - Group mentality
- New York for investing is like the beltway for politics

Time Horizon

- Short
 - Noise
 - Reflects variability
- Long
 - Signal
 - Reflects true return

Market Timing

- Good idea or bad?
 - Bad idea if you are not good at it
 - Good idea if you can recognize the time to get fully invested
 - Hard to be consistently accurate
- Look for contrarian triggers
 - e.g., CIGNA VA hedge, WGO
- Saving allows you to market time by putting new money into undervalued assets
- You must be invested in order to earn market returns
 - 2003 provided a 28% return
 - Needed to be invested at the beginning of the Iraq war

Dollar Cost Averaging

- Is it always the best option?
 - Yes if the market doesn't rise over time
 - No if the market is rising
 - Investment at beginning of year provides an extra half year of growth for new deposits
 - Assumes you have the money at the beginning of the year
 - DRIPs - Dividend Reinvestment Plans
 - Great in concept but watch out for expenses

Mutual Funds vs. ETFs

- | | |
|---|--------------------------|
| • Managed | • Easier to manage taxes |
| • Better known <ul style="list-style-type: none">• Comfort? | • Lower expenses |
| • More common | |

Contrarian Investing

- Sometimes called value investing
 - Why isn't all investing "value" investing?
- This time it's different
 - No, it isn't

Contrarian Investing

- Use quantitative filter to identify prospects
 - Then look deeper
 - Some stocks are cheap because they should be cheap
 - Identifying the ones that are temporarily depressed is the art (and it's hard!)

Circle of Competence

- Know your knitting
 - Don't invest in something you don't understand

Margin of Safety

- Don't let discount rates fall below 10%
- Buy growth at a value price
 - e.g., 20% growth at P/E of 10
- Does the story make sense
- No debt is better than high debt
- High growth is better than no growth
- Small losses are okay if winners are big

Intrinsic value

- Value the whole company and divide by the number of shares
 - Use discounted operating cash flows
 - Subtract debt
 - Subtract value of defined benefit plan
- “Borrow” publicly available analysts estimates
 - Tend to be slightly low
 - Company corrects them if they are too high
 - Available for free on Yahoo and other sources
 - Make sure the estimates make sense
 - It's your money

Meeting Goals

- Saving
 - Most important
 - Live within your means
 - Set intermediate goals
 - Forces you to save more when the market is tanking
 - Have a base saving rate and compare to prior periods
 - Save at least part of your merit raise and bonus
- Investing
 - Expenses and turnover are keys

Goals

- Risk tolerance
- Personal objectives
 - Comfortable retirement
 - College for kids
 - New home
- Drives return requirements
- Comparison to benchmarks helps analyze success

Goals

- Learn what works for you
 - Budget/not
 - Forced savings?
 - Mutual funds/individual stocks
- Avoid buying on margin

Net Worth

- What is it?
- Sell all positions today and pay taxes?
 - What about qualified accounts that won't pay tax for years?
- Value if death today?
 - Include estate taxes?
- Impact on asset allocation

3 Legged Stool

- Social Security
- DB/DC plan
- NQ personal investments

Rules of Thumb

- Savings
 - Invest in 401(k) up to match
 - Fund your Roth IRA (if eligible)
 - Self directed NQ account
 - If you have a high marginal tax rate
 - Max out your 401(k)

Investment Plan – CFA Institute

- Objectives
 - Risk
 - Return
- Constraints
 - Time horizon
 - Liquidity
 - Taxes
 - Laws and regulations
 - Unique needs and circumstances

Balance

- Guidelines
 - Not a formal driver
- Industry
- Domestic/International
- Bond/Equity
- Cash

Asset Allocation

- Don't split out value and growth
- Split by asset class
 - International
 - Large Cap
 - Small Cap
 - Bonds
 - Cash
 - Alternative classes
 - TIPs, REITs, hedge funds, currency

401(k) Choices

- Self directed option
 - Good or bad?
 - What is an employer's fiduciary duty?

Asset Allocation

- Q or NQ – self direct or funds - Where to put
 - Bonds
 - Dividend paying stocks
 - Non dividend paying stocks
 - Alternative assets
- Include all your assets
- Should it vary between accumulation and retirement phases?
- Is this different outside US?

Asset Allocation Options

- 401(k) – without self directed option
 - use mutual funds for asset classes you aren't good at (e.g., international, small cap)
- Other Qualified
 - IRA
 - Roth IRA
- Trading portfolio should be Q
 - Tax deferral
 - Hard if no self directed option
 - Use portion to see if you are good at it

Bond alternatives

- Social Security
- Defined Benefit plan
- Why isn't this a bigger deal in the financial press?

Accumulation phase

- Run deterministic scenarios
 - 5% return
 - 10% return
 - Don't forget taxes/expenses/turnover
- Use stochastic tools available on internet
 - Many are available for free
- Would you be proud of your retirement?

Post Retirement

- How much income do you need?
- Common guideline 70-90% of pre-retirement earnings
 - Ignores pre-retirement saving
 - e.g., if you save 30% of earnings
- Assumes constant tax rate
- Lower expenses
 - No mortgage, no work expenses, lower family expenses, lower tax bracket (maybe)
- Higher expenses
 - Medical, leisure/travel

Why Should I Buy?

- Evaluate the underlying business
 - Don't buy companies you don't understand
 - Include your own experiences as a consumer
 - Is there a moat that will last?
- Evaluate management
 - Does management serve the shareholder?
 - "You should invest in a business that even a fool can run, because someday a fool will."
 - Warren E. Buffett

Art or Science?

- Art
 - Company management
 - Size of moat
- Science
 - Quantitative filters

Latticework

- Models from multiple disciplines
 - Santa Fe Institute
 - Business
 - Physics
 - Biology
 - Mathematics
 - Psychology
 - Social Sciences
 - Philosophy
 - Literature

PEG ratio adjustment

- Combine growth rate and dividend
 - Added this after the tax law change to level playing field between capital gains/dividends
 - Still prefer capital gains
 - Easier to manage tax bill
 - Most retained earnings are not allocated efficiently
 - Avoid conglomerates who grow just to grow

Price/Earnings Ratio

- Focus on forward P/E ratio
- Historical trend can be useful
- Create a chart that ties combined growth/dividend rate to intrinsic value Price/Earnings ratio
 - All numbers are readily available
 - Discount using a long term rate (I floor it at 10%)

Taxes are important

- Dividends or capital gains – do I care?
- Qualified money taxed at ordinary rates
 - During accumulation include tax inefficient assets
 - Bonds
 - REITs
 - During distribution
 - Keep up with the rule changes
 - May be advantages to emptying some Q accounts

Taxes

- Try to anticipate future tax changes
- Harvest losses – manage the timing

Expenses

- Most outperformance by mutual funds is wiped out by expenses to the fund and taxes to the individual due to turnover
- Domestic indices are often 20 bps or lower
- International and small cap will be higher
 - Aim for 100 bps or lower for active manager
- Look at results after expenses
 - Self directed plan can be well under 10 bps (I was under 2 bps in 2004)

Many ways to invest

- Other methods of investing may be just as good or better than the one I use
- Find one you are comfortable with
- Adjust and learn over time

Traits of successful investors

- Willing to invest time
 - Research
 - Education
 - Read, read and read some more!
- Treat investing as a hobby
 - It's fun!
- Admit your mistakes
 - Learn from them

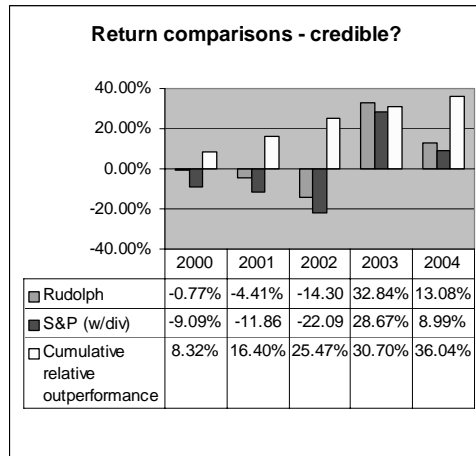
Tortoise and the Hare

- Slow and steady saving and investment returns provide a comfortable retirement
- Patience on the trigger
 - Assume you can only make 20 trades in your lifetime

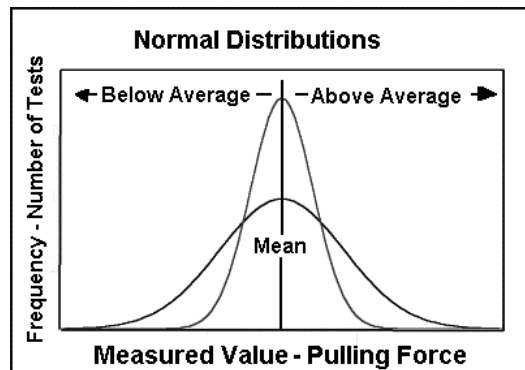
Humble Pie

- Every time you buy, someone else is selling
- Compare returns to benchmark
 - Provides confidence in down market

36% over S&P 500



Focus Investing – EZ stats



Focus Investing

- Smaller sample size
- More likely to be outlier (win/lose)
- Diversification is overrated
- Know nothing investor should stick to indices
- The hard part
 - How do I pick stocks likely to be above average performers
 - Which companies have a long term competitive advantage (moat)
 - Big bets on high probability events

Filter

- Calculate intrinsic value based on PEGD
 - e.g., growth rate 15% intrinsic P/E 18
 - e.g., growth rate 10% intrinsic P/E 15
- Use 5-year forward growth ratios
- Also use Benjamin Graham's value formula to sort opportunities
 - More weight given to growth

Purchase Principles

- Compare intrinsic value per share to current price
- Company's industry doesn't matter
- If lower by a lot then buy
 - I use 60% (but sometimes override)
- Rely on mean reversion
 - Undervalued stock price will correct itself
- Genius not required, but patience and conviction/confidence are

Passed Filter March 2004

		12-Mar-04	9-Apr-05	Story
KB Home	KBH	77.73	118.75	previously held
Leapfrog	LF	20.02	11.32	management
Movie Gallery	MOVI	20.00	28.47	bought, watch the moat
Sunoco	SUN	60.18	104.88	bought other energy stocks instead
Cemex	CX	28.50	37.06	dividend, long term purchase
AgCo	AG	18.96	17.78	weather/politics
S&P 500		1120.57	1181.20	

Sell decision

- Compare intrinsic value per share to current price
- Monitor value to price
- Set sell target
 - Review periodically
 - Earnings will increase at growth rate over time
 - some use 90%

Flexibility

- Roll with the punches
- Don't be a one trick pony that only knows how to do one thing
 - Times change
 - Good opportunities don't last forever
 - Revert to fundamental analysis
 - Based on discounted cash flows

Good Books

- The Warren Buffett Portfolio and Latticework: The New Investing
 - Robert G. Hagstrom
- The New Finance: The Case Against Efficient Markets
 - Robert A. Haugen
- Investment Policy: How to Win the Loser's Game
 - Charles D. Ellis
- Outstanding Investors Digest
- Anything by Bill Nygren, Longleaf, Charlie Munger, Warren Buffett, Phil Fisher