Volume 3, Issue 10 www. AlternativChronicle.com Oct 4, 2010

AlternativChronicle

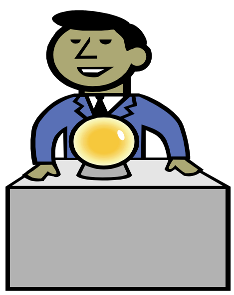
Using the Past to Predict the Future

Special Guest Columnist…..Paul Owens, former CEO, CAAT Pension Plan

How often have you heard the phrase "past performance is not an indicator of future results" when looking at historical returns? I'll bet it's often. Yet despite this, we continue to use historic data, and often the most recent year's results, to influence our asset mix allocations. Why is this?

In the absence of other information, there is an implicit assumption that last year's investment winner will continue to be tomorrow's winner. The underlying concept, called "performance persistence", is logically flawed and can lead to real problems.

We examined December 31st annual Canadian dollar total returns for 12 asset classes for ten years starting in 2000. It showed that Emerging Markets equity went from the highest return asset class to the lowest return and back to the highest in 2007, 2008 and 2009 respectively. Similarly, the S&P/TSX went from 3rd best to 11th and jumped back to 2nd best over the same period. In other words, asset class returns aren't consistent from year to year. So using yesterday's winners to predict future winners doesn't guarantee good performance or lower volatility.



To smooth out short term gyrations caused by looking at just the most recent year's results, performance is often examined over a longer time frame, say three years. Sounds like a good idea. However, this leads to another mathematical problem known as "end-date sensitivity". The condition arises when the performance of an asset class varies significantly depending on which end-date is selected. Let's examine this further.

Looking at 2008 and 2009 year ends, the DEX Universe bond index significantly outperformed the S&P/TSX Composite equity (con't pg. 2)

Inside this issue:

The Best Advice for Investors?

By George M. Klar — President, Alternativ Solution Inc.

If you're like me, throughout your career, you've probably spend a part of your day reading technical or industry related materials. In my case, it was finance and a large chunk of it dealt with investing, risk and portfolio management. Since forming a consulting company 3 years ago and joining the faculty at the Schulich School of Business, that hasn't changed.

Each semester, I teach a course on Investments. Students form teams to compete against each other over 10 weeks using stock trading software and starting capital of $1 million. They often ask me which strategy will work best and I tell them I don't know. "How can that be?" they ask, "You teach this stuff and have decades of experience in investment management". My silence has a reason; it prevents students from blindly adopting my views and allows them to focus exclusively on the portfolio management experience.

Similarly, in the investment world, both institutional and individual investors want to know what strategy will work best. They seek advice from investment banks, economists, analysts, major publications and the internet. There is an overwhelming amount of analysis available and a lot of it is very informative. But it's easy to get inundated and sorting the good from the bad can be quite challenging. Occasionally, the material can be downright scary (con't pg. 2)

Worth Quoting:

Doomsayers take note……
here is food for thought!

* * *

"The next decade will be as good for investors as the 1990s, said Ken Fisher, the billionaire chief executive officer of Fisher Investments Inc., dismissing notions that developed economies face below-average growth.

Fisher said the concept of a "new normal" is "idiotic," pitting him against money managers including Mohamed El-Erian, the CEO of Pacific Investment Management Co., which coined the term to describe a world of high unemployment, more regulation, and the shrinking importance of the U.S. in the global economy." [Full Story]

....Cheers, GMK

index in each of the two 3-year periods. Logically, sponsors who feel the best performing asset class will continue to deliver strong performance might thereby increase their Canadian bond allocation and decrease Canadian equities. However, sponsors who feel today's big winners are tomorrow's losers (and vice versa), something known as "reversion to the mean", would adopt an overweight position in Canadian stocks and underweight Canadian bonds under this scenario.

But had sponsors used five year averages as of 2008 and 2009 instead of three, they would have had conflicting results. In 2008, the five year Canadian bond returns beat Canadian stocks, but just a mere 12 months later, the results were reversed. So what happens if we look at returns over a longer period, say 10 or 25 years?

Again, using year-end 2008 and 2009 data, we find that the 10-year returns for the DEX Universe bond index outperformed the S&P/TSX Composite stock index. The same was true for the 25 year period ending 2008. However, 12 months later in 2009, the results were reversed; Canadian stocks beat Canadian bonds, albeit by a narrow margin of just 10 basis points.

These results clearly demonstrate that identifying tomorrow's winners based on yesterday's winners will always be a function of the end-date used and the number of years considered.

Conclusions:

What, if anything, can we draw from all this?

To start, using past returns to predict future performance is fraught with difficulties. Even smoothing the data by using multi-year returns and applying it to asset allocation can produce painful surprises. So any analysis using past performance becomes dependent on the choice of end-date and the averaging method applied. Those who understand the math know this can produce numbers that may justify whatever asset allocation they believe to be appropriate.

In making decisions about long-term asset mix policy, we suggest that sponsors shouldn't concentrate on short term historical returns. Long term returns are probably more appropriate since they capture several different economic cycles. Even these can be difficult to interpret since the performance is still a function of the end-date.

Let's acknowledge that asset mix decisions will always be somewhat subjective and a function of the sponsor's investment beliefs. Those beliefs might include some strongly held views about important matters such as performance persistence or reversion to the mean.

Either way, forecasting future performance and asset mix allocation based on past performance has some major limitations. ◻

Paul Owens is on several pension advisory boards and can be reached at … powens2@cogeco.ca

The Best Advice for Investors? (continued)

and financially dangerous. For example, in mid-Spring, a report crossed my desk that emphatically stated an equity market correction was overdue. The report started off by giving reasons why the equity market recovery to that point had been so robust. It then examined market valuations and said the market P/E ratio was simply too high. That's right, the analysis hinged on a single metric known as the P/E multiple. Finance students learn that this metric requires great care in its interpretation. The author predicted a realistic correction of 10 to 20%. Well, guess what? It did not happen.

Later in summer, as North American stock exchanges dipped briefly, I received an interesting article. The gist of it was that since markets had reached new lows, the markets **must** go lower. The article reviewed the recent dip, which it called a "plunge", and claimed it was a clear sign of a pending market collapse. The analyst said this new market phase could last up to two years and take valuations below 2008 levels. Guess what? It hasn't happened either (thankfully!).

Aside from being wrong, what other traits do these analyses share in common? To start, both apply a non-sequitur approach (that's Latin for "it does not follow") to arrive at conclusions. Next, they employ fear-mongering to get your attention and third, they dwell on recent economic events that's easily remembered to gain some credibility with the reader. However, they employ inconsistent or overly-simplistic decision rules to form their final recommendations.

Okay, so what's the best advice for investors? To start, no one knows what the future holds, not even highly paid professionals. If they did, they'd be multi-billionaires sipping champagne on yachts off the coast of some exotic locale. Instead, most spend their lives pumping out reports to those who'll read them. Occasionally, the advice fails the acid test of being rigorous enough. So great care is needed. Most importantly, ignore anyone who uses fear to influence you. We live in turbulent times and over the short term, markets can move for hundreds of reasons. They oscillate from being somewhat logical (adhering to our known models) to being illogical (influenced by wide-ranging human emotion). And that's what makes investing so damn challenging! In the investment world, when taking advice, it's wise to be cautious. ◻