Volume 4, Issue 5 www. AlternativChronicle.com May 3, 2011

AlternativChronicle

Living In a World of Fairy Tales

by George M. Klar…..President, Alternativ Solution Inc.

Did you watch Prince William and Kate's wedding? A large slice of the planet certainly did, many waking up in the wee hours of the morning to see the pageantry. Why did we bother? Was it important? Did mass curiosity get a hold of us? Were we manipulated by the media? Whatever the reason, an event that had little or no bearing on our lives was able to command an extraordinarily large global following.

Don't get me wrong....I wish the newlyweds well and hope they have a happy marriage. You have to admit, their story is a wonderful fantasy come true. Maybe that's it....the fairy-tale ending! Is that what captivated us? We escaped reality and leapt into a world of make-believe.

Ironically, there are similarities to this fairy-tale in the investment world. Investors today aren't satisfied with making reasonable returns for risk-taking. Instead, they have embraced the idea that making high, even extraordinary, returns is achievable just by buying great assets and dumping lousy ones. In the process, we are unwittingly playing a global game of musical chairs using a broad array of securities. Not surprisingly, many believe we have evolved into global speculators extraordinaire.

Finance teaches us that the return on any asset class is linked to its risk. As risk rises, investors want to be compensated via higher returns or else they will seek opportunities elsewhere. Normally, investing works according to this guideline. However, risk is also based on perceptions, which can change suddenly and dramatically.

It's been said that self-delusion is part of human history. It might explain why we stumble from one crisis to another. Right now, the media and the public are fixated on investment questions such as "Are we in a bubble? Which asset classes are affected?" and "When will the bubble burst?" From my perspective, the more pertinent questions are "Why do bubbles form" and "Are they more likely to form in certain asset classes?"' (con't pg. 2)

Pension Returns After the Crash

By Special Guest Columnist…..Ross Ferguson

In recent years, the financial press has featured many articles concerning the funding status of pension funds, with most pointing out that many plans do not have sufficient assets to meet their anticipated liabilities. While this is cause for concern, there may be another issue which pension stakeholders should examine, namely the rate of return assumption that actuaries make about investments.

Admittedly, I have not scoured all the available material concerning this issue, but my understanding is that typical actuarial assumptions for plan returns are in the 7% to 8% range. I have not heard of any pension plans using 5% to 6% for example, but sponsors, actuaries and beneficiaries should consider revisiting their current assumptions.

The last few years have seen tremendous volatility in stock markets and huge swings in corporate bond spreads. Stock markets have recovered to almost pre-crash levels and corporate bond spreads are roughly where they were in the summer of 2007. That is a huge relief to market participants. The question is, based on our traditional equity, fixed income and real estate markets — the primary investment outlets for pension funds — what kind of returns should we expect in the future? Let's examine each major asset class. (con't pg. 2)

Inside this issue:

From the Mailroom

Our readers often send us emails. This one referred to the article in April's edition:

"Another good issue, especially your piece on sudden changes to perceived financial risk…. Your point on knowing (and sticking with) your time horizon is an extremely important one….as you pointed out, short term, knee-jerk reaction to events like those in Japan, may be reversed before there is a chance for even very capable short-term managers to re-establish positions."

AW, Toronto

Alzheimer's Update:

I've raised over $5,300, thanks to your generous support …..Thank-You!

Cheers, GMK

Experts believe that bubbles can form when certain conditions arise. The first condition is easy access to cheap capital. The second is a belief system that distorts reality and fosters a misjudgement of risk. The third condition is a growing population that warmly embraces this new reality. As the warped view spreads, people believe it's normal. The final condition is a misalignment of the governance and incentive systems. Instead of punishing or preventing undesirable social behaviour, that activity is actually rewarded.

Ben Graham believed investing was the act of purchasing financial instruments (or real property) that provided the expectation of favourable future returns and the return of principal. Speculation, by contrast, was the act of acquiring assets that had some probability for a return but principal repayment wasn't guaranteed. By implication, owning fixed income securities and holding them to maturity was "investing". Strictly speaking, buying real estate, equities, art, collectibles, commodities and many other risky assets is deemed speculation because you aren't sure of the outcome at the start of the transaction.

In a by-gone era, astute investors would carefully examine demographics, capital flows, political risk, foreign exchange, technological innovation, productivity, monetary and fiscal policy, and a host of unique firm-specific factors before making their investments. Once a security was bought, it would remain a holdings as long as the underlying economic thesis remained unchanged. This approach is used by Warren Buffett, who makes decisions with a long time frame.

Today, however, we live in an exceptionally competitive and fast-paced world that demands instantaneous results. Performance horizons have certainly shortened and are measured in weeks or months rather than years. Ben Graham's approach has been replaced by Modern Portfolio Theory, which relies on diversification to control and reduce risk.

Modern Portfolio Theory, at its core, assumes humans are capable of logical decisions and careful analysis. But what happens when everyone behaves emotionally or worse, embraces a totally flawed, illogical or deluded view? Then you cannot rely on diversification's power and it becomes, to some degree, ineffective.

If investors believe it is easy to make superior returns from assets, whether it's called gold, commodities, foreign exchange, Greek bonds, real estate, oil, China, microcap equities or whatever, then money flows rapidly into these areas distorting their true value. These distortions can inflate or depress prices. Either way investors react, sometimes on mass, which leads to herding and bubbles. This is exacerbated when speculation has run amok for long periods.

So where's the bubble today? Is it gold, commodities, real estate, bonds or foreign exchange?

In my view, the bubble is the widespread and growing illusion that we can all get rich by speculating, rather than engaging in productive activity. It's the delusion that says superior returns must be a function of intellect. Just ask the experts to give us their secrets to wealth creation. Investing is easy! Anyone can do it well.

It's just a fairy-tale, but one we so desperately want to believe. Now if only it were true! ◻

Pension Returns After the Crash (continued)

Money market assets earn around 1% in Canada (less in the U.S.). Okay, few plans have major allocations to short term investments, but whatever amount is parked there earns far below the average actuarial assumption. In the fixed income market, Government of Canada bonds are yielding less than 4% across the yield curve. Corporate spreads can add up to 250 bps in many instances, but less than 100 bps for medium term issues. Clearly, you don't hit the 7% average return on this asset class unless you assume some level of yearly capital appreciation.

Let's turn to equity markets. So much has been written about historical returns and volatility. Yet despite the long term evidence, the first decade of the millennium saw markets experience modest returns. Does this mean targeting 7% to 8% future returns is unrealistic? No, but in the aftermath of 2008 and 2009, some funds have already cut their equity allocation and a number of funds are planning to lower their exposure in this area.

So is real estate the savior asset class? Unfortunately, 'trophy' properties can no longer be bought at capitalization rates of 8% or higher. In fact, 7% or less may be more in line with current market conditions. So this means we cannot turn to real estate to solve the return shortfall problem.

Right now, all combinations of traditional assets seem incapable of achieving the actuarial assumptions that are needed for pension investors. So it's no surprise that alternative assets that promise higher returns have grown rapidly. But products such as high yield bonds, private equity and hedge funds are also associated with higher risk and lower liquidity. While in the long run, alternatives might solve the riddle of how to reach actuarial return assumptions, to do so their weights must be significant, and that's not the case right now.

Accordingly, long term institutional investors erring on the side of caution should have a good look at their current return assumptions and how they plan to meet them. Simply put, there is no free lunch in the capital markets. ◻