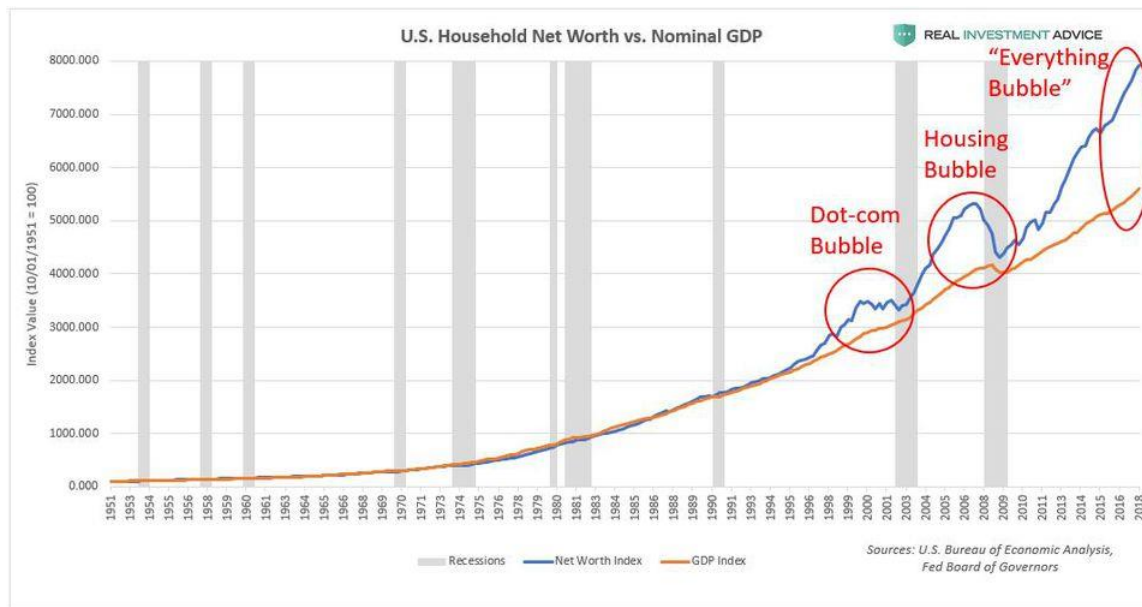


ABR Dynamic Funds' Portfolio Construction Series: Part 1

The Markowitz Contradiction

Here is a common message: “Core investments are overvalued. In the following graph, the orange line is all the wealth that has been created in the U.S. (nominal GDP), and the blue line is all the wealth Americans think they own (U.S. household net worth) – both normalized in 1951. How can our wealth grow faster than the total wealth that we create? We may be fooling ourselves. It may be a bubble.”



There’s nothing wrong or untrue about that message; stocks and bonds are indeed expensive by historical standards, but you’ve heard all of this before. This is, after all, “the most hated bull market in history.” However, no one seems to have anything useful to say next. *In fact, the main advice our industry seems to offer for dealing with this situation is: find a low-cost, passive ETF, and go all-in (to the bubble – that’s the part they don’t say).* It’s worked fine while the bubble was inflated, but we don’t think it’s the best strategy for the long-term.

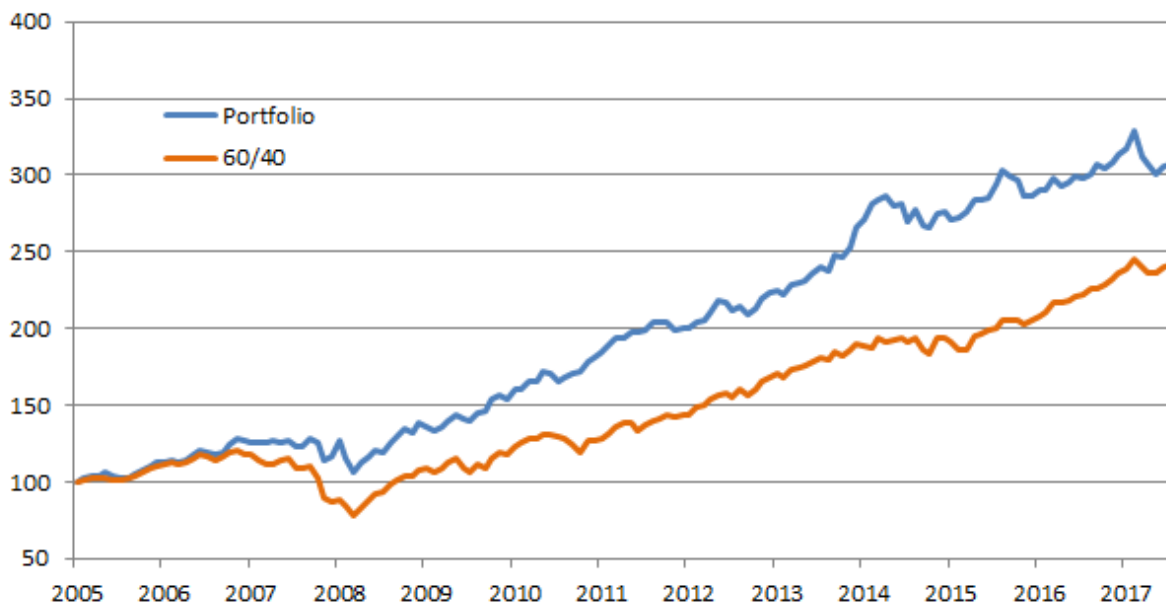
We’re going to begin a weekly series on the bad advice you’ll find in this industry, from bad strategies to red herrings in the media. Importantly, after surveying some of these things that waste investors’ time and money, we will pivot to what has worked better.

The series’ endpoint will be the creation of a portfolio which would have worked much better than 60/40, or some variant on simple stock and bond exposure. The stats and graph on the next page are taken from a white paper ABR has written on portfolio construction and show that portfolio compared to 60/40 over the past market cycle.

Table 5: Performance Metrics

	Portfolio	60/40
Return	9.40%	7.47%
Volatility	8.99%	8.99%
Sharpe Ratio	1.05	0.83
Max DD	17%	35%

Figure 8: \$ from Jan 2006 to Jun 2018



Source: ABR white paper on portfolio construction

On the following page, please find another excerpt from ABR’s white paper on portfolio construction, this time from the introduction. Like this series, the paper summarizes some interesting research. However, it is quicker and distills the more useful information for practitioners than would reading the numerous academic papers that form its foundation.

If you would like to discuss anything you read, please contact us at 212 918 4663 or info@abrfunds.com.

Next week’s preview: “If it ain’t dynamic, it might as well be SPY and TLT.”

Excerpt from the Introduction to ABR's white paper on portfolio construction

Diagnosing the problem

Proper portfolio construction is by far the biggest driver of good investment results, and it is sorely lacking in most portfolios. In fact, the problem is so bad, that a typical portfolio can be nearly recreated with just one single holding. Let's take a look.

According to the Campden Global Family Office Report, the average portfolio has the following allocations to each of eight categories. We have selected a representative for each of these categories and identified it in the third column. The exact choice isn't particularly important to the conclusion.

Table 1: Average Portfolio Allocations

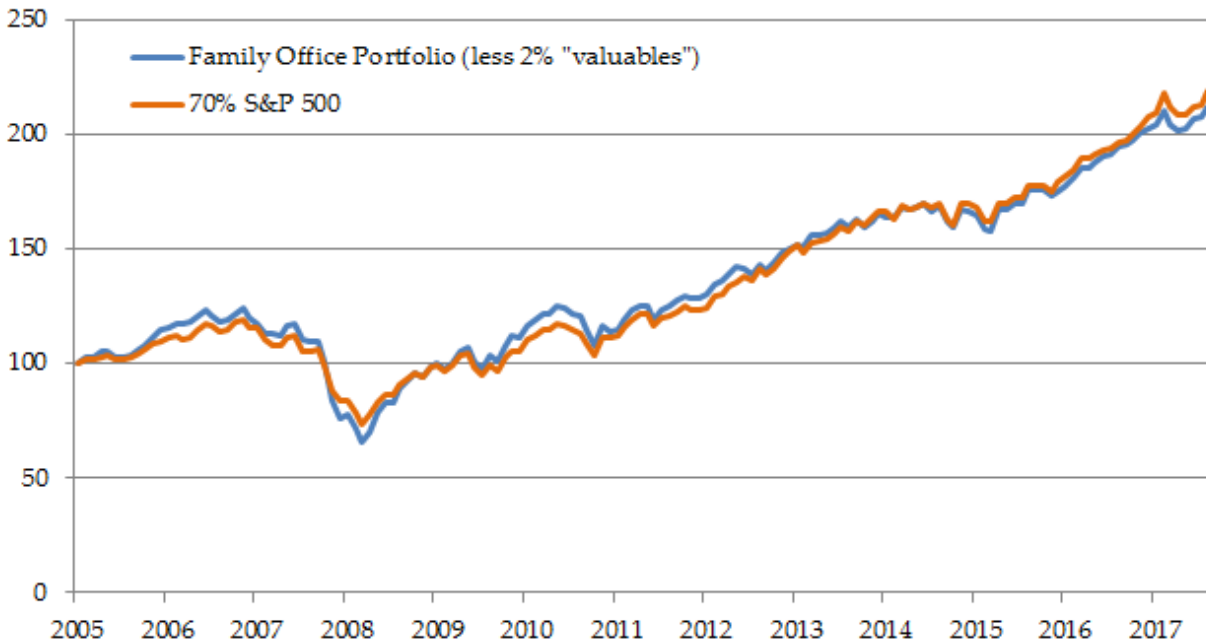
Allocation	Global Family Office Investment Category	Represented by
37%	Stocks and Bonds	22% S&P 500 + 15% COREPLUS Bonds
29%	Private Equity, Venture Capital, Real Estate	10% P.E. + 10% Tech + 10% R.E.
8%	Cash or Equivalent	8% Short-dated U.S. treasuries
8%	Hedge Funds	8% H.F. Index
7%	Private Equity Funds	7% P.E. Index
4%	Agriculture and Commodities	4% Commodity Index
4%	Exchange Traded Funds, Real Estate Investment Trusts	2% S&P 500 + 2% R.E.
2%	Valuables (Art, etc)	None

Numbers do not sum to 100% due to rounding

Remember, on the surface, this portfolio is even more diversified than 60/40. There are eight allocations, and "Stocks and Bonds" are only 37%. It must have provided a fairly smooth ride, right?

Nope. The results are remarkable (next page). The average global family office portfolio was just an expensive way to tie up too much capital and end up with diluted S&P 500 results. The following graph shows this portfolio vs. a recreation which uses nothing more than 70% exposure to the S&P 500 (with the other 30% of capital remaining totally idle – not even earning interest).

Figure 1: {} from Jan 2006 to Jun 2018



Prescribing a Remedy

Harry Markowitz won the 1990 Nobel Prize in Economics for Modern Portfolio Theory (MPT). The main consequence of MPT is that investing in a lot of stocks is better than investing in just a few of them. Their overall gains add up over the long-term, but their risks partially offset each other because some lose while others win in the short-term. Simply put, diversification is the only free lunch in investing.

Markowitz developed the portfolio construction tools for maximizing the only free lunch in investing. However, he acknowledged that he didn't use those tools for his own investments. When it came time for Markowitz himself to select his own investments, he simply tried to limit his future regret. Markowitz said, "I visualized my grief if the stock market went way up and I wasn't in it – or if it went down and I was completely in it. My intention was to minimize my future regret."

Coming from the man who wrote the book, so to speak, it was disappointing reasoning. However, it was understandable. Markowitz faced the same problem everyone faces. There is a limit to the diversification value of stocks. Diversification even into hundreds of them still produces results like the ones graphed above – it is the S&P 500 after all. No matter the number of stocks in the portfolio, crises still hit regularly, and much of the diversification value goes out the window as stocks tank together.

Nevertheless, the basic idea of MPT is still valuable if it is just used properly. It is very beneficial to apply the diversification principle to asset classes and strategies themselves, not just to assets within an asset class. After all, stocks that can be relied upon to win in a stock crisis are hard to find, almost by definition. However, there are other asset classes and strategies that have rather reliably won when stocks have lost. We'll see what they are and how to use them. Spoiler alert: don't count on most bonds.