Are Investments in the International Market Pure Speculation

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Mark Twain’s view

“October is one of the peculiarly dangerous months to speculate in stocks... The others are July, January, September, April, November, May, March, June, December, August and February.”
Discipline is Paramount

“The investor’s chief problem – and even his worst enemy – is likely to be himself.”

Benjamin Graham
The danger of letting emotion drive investment decisions
Investors vs Speculators

“The psychology of the speculator mitigates strongly against his success. For by relation of cause and effect he is most optimistic when prices are highest and most despondent when they are at the bottom.”

Benjamin Graham
Security Analysis 1934 p12
Fads of the past ten years on the ASX...

Mortgage Trusts / Enhanced Cash

Tech Boom

Capital Protected Funds

Geared Products

Property Trusts

Private Equity

Hedge Funds / CDO’s

Hybrid Securities / Enhanced Cash Funds

Capital Protected Equity Funds

Mortgage Trusts / Enhanced Cash
Understanding the source of returns

You buy three things with every investment

1. An Income Stream
2. Expected Growth of the Income Stream
3. An Optimism/ Pessimism Multiple
US Stock Returns by the Decade

US Stock Returns by the Decade (%/year)

Investment Return: Dividends and Earnings Growth

Speculative Return: Impact of P/E Change

Market Return (S&P 500)
Periodic Returns

S&P 500

<table>
<thead>
<tr>
<th>Decade</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900s</td>
<td>9.1%</td>
</tr>
<tr>
<td>1910s</td>
<td>3.9%</td>
</tr>
<tr>
<td>1920s</td>
<td>16.1%</td>
</tr>
<tr>
<td>1930s</td>
<td>-0.8%</td>
</tr>
<tr>
<td>1940s</td>
<td>8.9%</td>
</tr>
<tr>
<td>1950s</td>
<td>20.1%</td>
</tr>
<tr>
<td>1960s</td>
<td>8.1%</td>
</tr>
<tr>
<td>1970s</td>
<td>6.1%</td>
</tr>
<tr>
<td>1980s</td>
<td>17.3%</td>
</tr>
<tr>
<td>1990s</td>
<td>17.8%</td>
</tr>
<tr>
<td>2000-2008</td>
<td>-0.6%</td>
</tr>
<tr>
<td>Average</td>
<td>9.5%</td>
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</tbody>
</table>
Extreme Events

- Investors do not have symmetric expectations of risk and return. Happy to take the extreme upside, but not the extreme downside.
- Extreme events distort the very long term picture of what works and what doesn’t.
- Need to separate out investors’ short term needs from the long term possibilities.
Market Timing Is Risky

S&P 500 Index
January 1988-December 2004

- Periods of strong and poor performance are unpredictable.
- Timing markets exposes you to the risk of missing the best periods.
- The risk is not worth taking: Capital market rates of return are strong and more consistent over time.
Asset Allocation explains return

DEFINITIONS

*Asset Class Selection*

How assets are allocated in a portfolio.

*Market Timing*

Shifting portfolio assets in and out of the market or between asset classes.

*Security Selection*

Finding ‘underpriced’ companies or industries.

- The vast majority of a portfolio’s return is determined by asset allocation selection.
- Only a small portion is determined by market timing and security selection.

Dispersion of returns from selecting fund managers

Distribution of Multifactor t (alpha)
1,302 Managers
1962 - 1995

Manager added value is similar to randomness minus expenses.

The distribution is “fat-tailed”: Active management adds extra uncertainty.

Managers with strong outperformance do not repeat; managers with strong underperformance do.

• “The idea that any single individual without extra information or extra market power can beat the market is extraordinarily unlikely.

• Yet the market is full of people who think they can do it and full of other people who believe them.

• Why do people believe they can do the impossible?

• And why do other people believe them?”

• Daniel H Kahneman
  • 2003 Nobel Laureate in Economics
Assembling a Core Strategic Portfolio of Equities

Core Strategic Equity Portfolio
40 / 20 / 40

Size

Small
- Small Companies – 20%

Large
- Large Companies – 40%

Price

Value
- Value Companies – 40%

‘The Market’
(All Shares)

(All Shares)

Growth
(Low ‘Book-to-Market Ratio’)

Value
(High ‘Book-to-Market Ratio’)
Size and Value Effects Are Strong Around the World

Refer to Appendix for Reference to these charts and statistics.
Know what we can control?

- Strategy
- Advice
- Services

- Markets
- Laws
- Inflation

- Investor goals & objectives
- Investor discipline

No influence or control

Influence

Control
Historical Range of Equity Market Returns

January 1980 – June 2008

Rolling Time Period
- Monthly observations
  Australian S&P/ASX 200 Accumulation Index
- Annualised results
  MSCI World Index in $A (Unhedged)

Source: Dimensional
Time Provides Certainty
• “Share markets are a vehicle for transferring wealth from the impatient to the patient”

• - Warren Buffett
Is it different this time?

All Ordinaries Index 1900 - 2008

Positive years: 87 (91%)
Negative years: 21 (19%)
Is it different this time?

S & P Index 1825 - 2008

Positive years: 129 (79%)

Negative years: 55 (30%)

Data Source: Value Square Asset Management, Yale University
All Ordinaries Index 1900 - 2008

Positive years: 88 (81%)
Negative years: 21 (19%)

Major economic downturns and the years following:
1987 Crash
1929 Great Depression
1918 World War I
1914 Earl 1980's Recession
1970's Recessions
1965 1950's Recessions
1957 1940's Recessions
1947 1930's Recessions
1933 1920's Recessions
1931 1910's Recessions
1929 1900's Recessions

Data Source: JP Morgans
<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage Total Return</th>
</tr>
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<tbody>
<tr>
<td>1973</td>
<td>-40 to -30</td>
</tr>
<tr>
<td>1974</td>
<td>-30 to -20</td>
</tr>
<tr>
<td>1975</td>
<td>0 to 10</td>
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<tr>
<td>1987</td>
<td>10 to 20</td>
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<td>1992</td>
<td>20 to 30</td>
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<tr>
<td>1997</td>
<td>30 to 40</td>
</tr>
<tr>
<td>2002</td>
<td>40 to 50</td>
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<tr>
<td>2005</td>
<td>50 to 60</td>
</tr>
<tr>
<td>2008</td>
<td>60 to 70</td>
</tr>
</tbody>
</table>

Data Source: JP Morgans
All Ordinaries Index 1900 - 2008

Data Source: JP Morgans
All Ordinaries Index 1900 - 2008

Data Source: JP Morgans
Stick to the strategy
Australian All Ordinaries Bull & Bear Markets

Average Bull Market Duration: 41.1 mths
Average Bear Market Duration: 14.8 mths
Average Annual Bull Market Return: 27.4%
Average Annual Bear Market Loss: -29.8%

Source: St. George Investment Solutions & Bloomberg
Principles & Beliefs

• Markets Work

• Prices for financial assets find equilibrium quickly and it is difficult to consistently predict and profit from any perceived inefficiencies in these prices.

• The capital market rate of return is available to every investor at a reasonable price and the rate of return generated over the long term has proved to be attractive.
Principles & Beliefs

• Risk and Return are Related

• The higher the risk, the higher the potential return. It is possible to outperform markets, but only by accepting increased risk.

• However, not all risks are worth taking. Certain risk factors can be controlled to minimise risk and aid long-term return. Remaining invested is a key risk management tool.
Principles & Beliefs

• **Diversification is Essential**

• Concentrated, non-systematic risk is unrewarded in investment portfolios over time. Diversification is the antidote to many avoidable risks.

• Therefore, investment portfolios should be comprehensively diversified across and within asset classes and sub-asset classes.
Principles & Beliefs

• Portfolio Structure (Asset Allocation) Explains Performance

• The dominant contributor to portfolio performance is the relative exposure of capital to the various asset classes and sub-asset classes.

• Use of strategic asset allocation, together with careful rebalancing, is likely to be more rewarding than speculative strategies such as market timing or tactical asset allocation.
Principles & Beliefs

• Costs and Taxes Matter

• Investment portfolios should be constructed and maintained with costs and taxes in mind.

• Costs and taxes may be implicit or explicit in an investment portfolio.
Principles & Beliefs

• Capital Markets Work and Are Efficient
  – for investment purposes, assets are fairly priced

• Risk & Return Are Related
  – priced risk factors determine expected return

• Diversification Is Essential
  – Diversification is the antidote to uncertainty. Concentrated investments add risk with no additional expected return

• Structure Explains Performance
  – Asset Allocation principally determines results in a broadly diversified portfolio
What have we learnt so far?

The bad news:
• If there are investment Superheros out there, we can’t find them with any degree of consistency or certainty
• Successful stock picking is extremely difficult and increases risk
• We can’t predict the future – it is a series of unforeseen events

The good news:
• You don’t need to know the future to be a successful investor
• The market return in each Asset Class is there for the taking
• Asset Allocation determines results

The Question:
How can we best access the market returns that YOU ARE ENTITLED TO?
In Summary

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

Preface by Warren Buffett in the “Intelligent Investor”, by Benjamin Graham