KEEL POINT

INVESTMENT BULLETIN

Volume III, No. 6
June 2014

8065 Leesburg Pike, Ste. 300
Vienna, VA 22182
www.keelpoint.com

Tales from the Road

Summer has arrived in Washington, DC with its famous humidity in tow. Unfortunately, the dog days of summer are not conducive to writing the monthly *Bulletin*. We were lucky to escape to a handful of talks and conferences so far this summer, and are yielding these two pages to the very smart individuals and groups we heard from (note all remarks are paraphrased). While the topics are not completely related, we will conclude with four common lessons.

Predictions

Stephen Dubner, co-author of the *Freakonomics* series of books, gave a dinner talk about predictions as part of a conference. As a society we are insatiable consumers of predictions on economic growth, weather, sports outcomes, political races, etc. Some people are paid lots of money based on their abilities to predict, but Dubner's conclusion is that, on average, the experts are no better than that one famous monkey who happens to own a dartboard.

Dubner illustrated this human shortcoming with a public policy dilemma. As the nineteenth century turned into the twentieth, New York City had a major congestion problem on its hands. The city of over one million had 200,000 horses clogging the streets. Congestion caused all the problems you might expect and one more – how to deal with the horse manure. Committees were convened to address the issue, but beyond the impractical idea of depopulating New York City and instructions to build more walk-up brownstones to stay above the street-level mess, there were no suggested solutions. Prognosticators declaring the end of densely populated cities like New York on account of horse congestion were of course quickly proved wrong by the mass-produced automobiles rolling off the lines in Detroit.

Dubner's ruling in favor of dart-throwing monkeys is an awkward one to hoist on a group whose job it is to guide clients towards their financial goals. By its very nature investing requires prediction, even if the prediction is as simple as stocks will continue to increase in value. Dubner's prepared remarks didn't address this inconvenience head on, but based on some of his answers to audience questions, we believe his advice would be to work on improving the data used to formulate predictions (political surveys for instance have become quite accurate) and to stick to your area of expertise (no matter your IQ, the further you are from your bailiwick the more likely you are to find a quiver of darts in your hand). We'll offer some of our thoughts on this in the concluding section.

Are Markets Efficient?

AQR, a mutual fund and hedge fund group with which we invest on behalf of our clients, put on a wide-ranging conference in Chicago. Topics included high-frequency trading's impact on investors (they think investors benefit due to lower trading costs and spreads) and a discussion of the efficiency of the market (they think it is and it isn't). We'll elaborate on the latter discussion.

Cliff Asness, a co-founder of the firm, presented his thoughts on the debate between those espousing the efficient market hypothesis (led by Nobel winner Eugene Fama) and those who believe behavioral biases run roughshod through the hypothesis (led by Nobel winner Robert Shiller). For those unfamiliar, the EMH states that all available information about a security is reflected in its price at any given time. The corollary is that it is no use trying to beat the market since you cannot possibly have an information advantage.

Asness came down in the middle of the debate, but a little closer to the EMH group. He believes that investors should approach the market as if it were efficient. Only after developing robust analysis showing that a segment of the market is inefficient and satisfying himself that there is an intuitive reason for why the inefficiency should persist would he countenance an approach other than indexing (buying a cheap ETF holding all market securities for example).

Despite this high bar, Asness and AQR believe that there are a number of strategies that do pass the historical and intuition tests. The first of four discussed in detail is the tendency for cheaper stocks, as measured by their ratio of market to accounting value, to outperform. While this has been known since the early '90s, value outperformance still persists most probably because the stocks have fallen out of favor or their more expensive counterparts suffer from the human tendency to extrapolate recent success into the future. AQR research shows that the value phenomenon holds for sovereign bonds, currencies, and commodities as well.

The second factor is momentum, or the tendency of stocks that have performed better (or worse), relative to their peers, to continue to do so. This tendency can likely be explained by a herding phenomenon – investors crowd into winners and out of losers. AQR finds that a momentum strategy has been successful across a wide range of asset classes and is improved further by combining it with the value strategy.

Assets with higher yields tend to perform better than those with lower yields. Otherwise known as carry, this is the third factor. Take

currencies for example. Theory states that the extra yield you earn on a higher yielding currency should be given back in the form of a lower real price at the time of sale. AQR's research, however, shows that this is not usually the case. This may be a result of central bank intervention or persistently low rates of savings in high yielding countries – yields stay high out of necessity to attract foreign capital.

Lastly, AQR believes lower beta or defensive stocks can outperform, on a *risk-adjusted basis*, their higher beta peers. Beta relates the risk of a security to the overall market and theory suggests it should be linearly related to realized returns. AQR posits that equity investors are most interested in maximizing their return per dollar invested and therefore choose higher beta stocks over defensive stocks. The result is that a defensive portfolio may earn more return per units of risk.

China

Matthews, another mutual fund company with which we invest on behalf of clients, hosted a lunch with Andy Rothman, their China expert. He is optimistic about the future of China for reasons that will resonate with capitalists – the tremendous growth of *private* enterprise. This is traced back to 1989, the year of the Tiananmen Square tragedy, but also the first year the Chinese government told college grads that they were on their own for finding work. Gone were the days of automatic matriculation into government jobs. The Chinese government simultaneously gave away the state-owned housing units occupied by factory workers. Aided by property rights and entrepreneurship-by-necessity, the economy began to grow.

If much about China is opaque, one analysis is very clear – the government is heavily incentivized to keep the economy growing fast enough so as not to foment unrest. Double digit growth rates are a thing of the past, but Rothman believes the country can continue growing in the 5-6% range this decade. And all of this growth is coming from the private sector. Recently announced reforms, especially the end of the *hukou* system whereby those born in cities have greater access to public services than those in the country, point to continued success of the private sector.

What about a credit bubble? Parallels have been drawn between China of today and the US of 2005-07. Both episodes have been marked by rapid growth in home prices and credit. Rothman's view is that China's situation is different. Outside of the four largest cities property prices are less inflated. Further, there are strict requirements on down payments; owners have more skin in the game. Lastly, he believes the government has the ability and will feel compelled to bailout a property bust should one occur.

Our View

Dubner is right about predictions; you can probably think of many examples of seemingly intractable problems that found unconventional solutions. US energy dependence (reversed thanks to the shale revolution) and the demise of the European Monetary Union (averted thanks to the ECB's promise to do "whatever it takes" to save it) come to mind. We do see a few ways to mitigate the unreliability of predictions, however.

First, diversify. If you don't know which company will invent tomorrow's solution, spread your capital amongst many of them. China has already taken over the US by some measures and will likely leap ahead in terms of overall economic clout soon. But Japan was supposed to do the same two decades ago. Spread your capital globally.

Second, stay long human ingenuity (a phrase we're borrowing from Dylan Grice formerly of Societe Generale). As a society, we're pretty good at solving problems, but solutions don't always come from the most likely places. We approach traditional equity markets with these first two lessons in mind. Low-cost ETFs covering much of the developed world are a way to get long a diversified basket of human ingenuity without paying for spurious predictive power.

Third, markets aren't completely efficient, so the pursuit of returns due to manager skill, or "alpha", is a worthwhile activity. AQR has robust data showing at least four areas that exhibit persistent inefficiencies. We think there are others as well. For example, our experiences with credit managers that have exploited mispricings surrounding corporate bankruptcies and regulatory change in the financial markets tell us there are inefficiencies out there.

Lastly, broad stock market indices are not always the best way to get diversified exposure. Take the indices for the Chinese equity market for instance. The booming growth in private enterprise that Rothman highlighted is not well represented in index-tracking ETFs. You actually end up with a lot more exposure to the large, frequently-traded state owned enterprises but little to the rapidly growing truly private sectors. □

This material is distributed for informational purposes only. The investment ideas and expressions of opinion may contain certain forward looking statements and should not be viewed as recommendations, personal investment advice or considered an offer to buy or sell specific securities. Data and statistics contained in this report are obtained from what we believe to be reliable sources including AQR, Stephen Dubner, Matthews, and Societe Generale but their accuracy, completeness or reliability cannot be guaranteed. An index is an unmanaged weighted basket of securities generally representative of a certain market or asset class. An investment cannot be made directly in an index. Our statements and opinions are subject to change without notice and should be considered only as part of a diversified portfolio. No conclusion should be drawn from any chart, graph or table that such illustration can, in and of itself, predict future outcomes. You may request a free copy of Keel Point's Form ADV Part 2, which describes, among other items, risk factors, strategies, affiliations, services offered and fees charged.

Past performance is not an indication of future returns.

Keel Point Advisors LLC is an independently owned registered investment advisor. Securities offered through WFG Investments Inc, Member FINRA and SIPC.