



Dear Fellow Investor,

Please be informed about our philosophy:

The theory and practice of our investment strategy in the context of the advisory process at

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Building investment strategies Managing risks around cycles and super cycles

Given the uncertainties associated with risk, building solid investment strategies is both a science and an art. As a global investor, we examine the theory and practice of investment strategy in the context of the advisory process.

We also highlight a selection of tactics that can be used to build portfolios designed to weather unforeseen events at all stages of the economic cycle. Whether markets are in a phase of overheating, slowdown, contraction or recovery, or whether a commodity super cycle is on the horizon, investors need to be aware that longer-term and structural changes in the economic environment may require large-scale readjustments to their portfolios across asset classes. Understanding the business cycle can help identify turning points in asset, sector and style performance.

Applying these strategies and tools can significantly help in building a resilient investment approach. Although challenging, it is important to bear in mind that much can be learned from a crisis and that innovation is often borne of difficult circumstances.



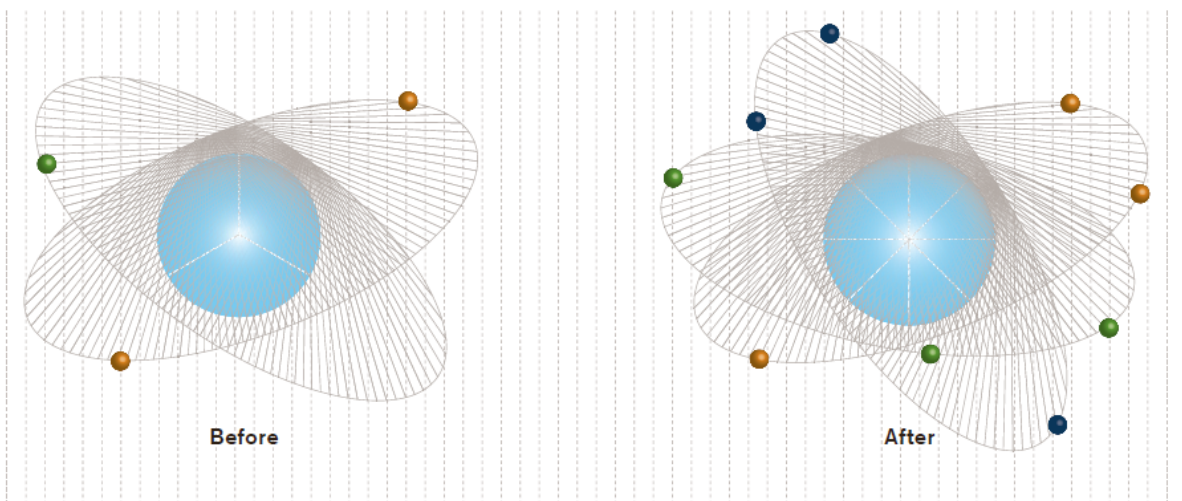
The advisory process analyzes clients' needs in terms of financial objectives and risk tolerance and derives a financial concept and a client profile which form the base for building robust investment strategies.





Building investment strategies

Building investment strategies is not just about designing strategies tailored to investors' return expectations, but also about concrete implementation in portfolio construction. The last step in implementation is performance monitoring and risk management, which should be understood as a continuous process.



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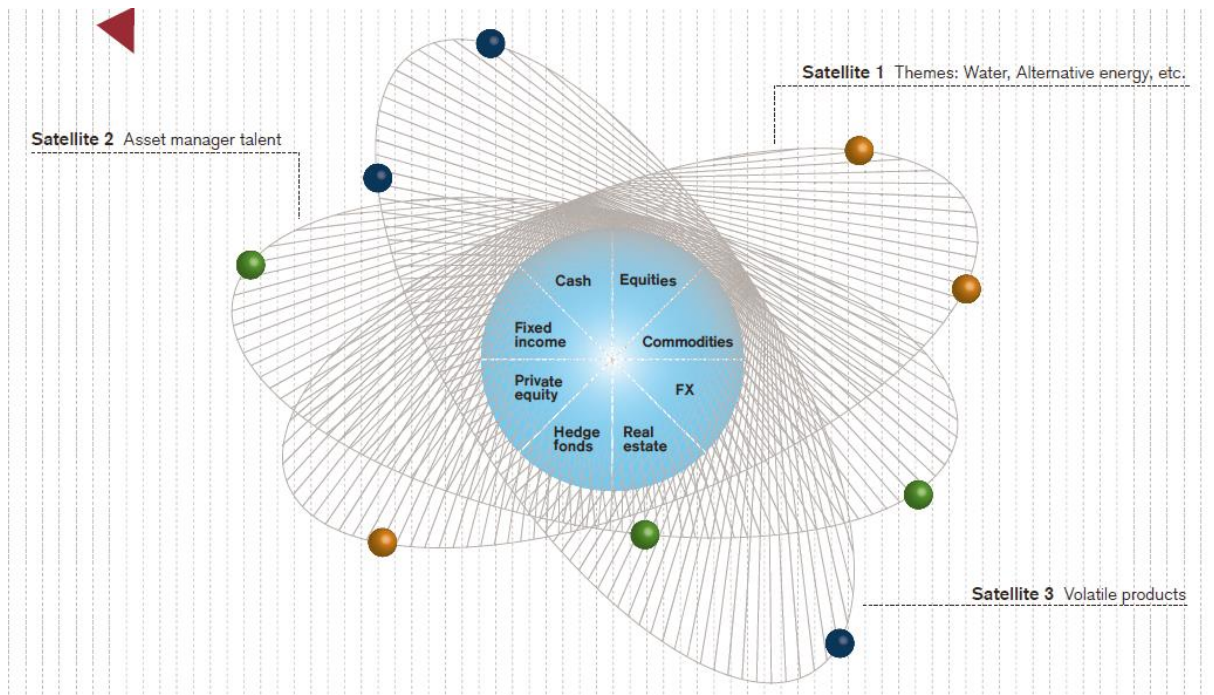
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Investment strategy

Building investment strategies involves constructing portfolios tailored to investors' needs, such as return expectations, risk tolerance over a certain time horizon, and individual constraints.

This may involve core and satellite holdings when appropriate.



Implementation 1

Specific investments that meet the strategy must be selected. Any investment strategy must be placed under risk analysis, which also involves stress tests under extreme scenarios.

Implementation 2

Implementation of the investment strategy involves selecting exact assets, timing decisions according to the implementation guidelines and varying those investments across the cycle. In a core/satellite context, this entails defining the primary and secondary investment goals, and selecting the asset classes that best fit them.





Combining art and science

In today's unprecedented market conditions, building a robust investment strategy is more important than ever. Initially, individual objectives and constraints need to be identified, which involve both scientific factors, such as fixed liabilities, and more artistic elements, such as attitude to risk.

After that comes the design and implementation of an investment program – the stages discussed here – and these again involve both scientific and artistic elements. We look at the general theory and practice of these investment processes.

It can be difficult enough to judge the merits of individual assets and investment products. When a number of instruments are combined together in a portfolio, the issues become even more complex, since movements in the returns on the different assets may either tend to offset one another or to move together. So investors should devise an overall investment strategy, which enables them to evaluate individual investment opportunities within the context of a portfolio and pursue their original investment goals without taking excessive or disproportionate risks.

Some studies have indicated that basic decisions on allocation to broad asset classes – bonds versus stocks, emerging versus developed markets and so forth – account for something like 90% of portfolio returns, but typically get the least attention from investors, who tend to spend a disproportionate amount of time considering individual assets, such as particular equities, or a particular fund. In this article, we hope to give a framework for setting that broad asset allocation. The core theory underlying the construction of many portfolios was first set out by Professor Harry Markowitz in the 1950s (see quick guide). At its simplest, it provides two key insights. Firstly, there is the idea of a trade-off between risk and expected return: if you want to have a higher expected return, then you usually have to expect higher risk. Secondly, it looks at portfolio diversification: if you select a mix of assets whose returns are not perfectly correlated, then the overall risk of the portfolio will be less than the weighted average risk of its components. These two insights are extremely powerful and we believe they should be considered by almost any investor when designing a basic investment strategy.

In particular, the theory implies that in most cases it is better to move from a portfolio concentrated in a very small number of assets to one with a more diversified selection.





In the half-century since Markowitz's theory was first proposed, numerous theoretical and practical limitations have emerged, with reasonably effective responses to some but not to others. For most private investors, possibly the most important issue is that the decline in well-being caused by large losses is much greater than the boost to well-being coming from large gains of the same size. This asymmetry is not readily captured in Markowitz's framework.

The problem is compounded by the fact that markets tend not to move in the relatively orderly way assumed by Markowitz's theory, instead having occasional catastrophic lurches that are difficult to capture in a smooth statistical distribution.

To address this, some approaches to portfolio design start with a Markowitz-based approach and then apply an extra stage in which a computer simulation is carried out to find out how the portfolio would perform in a number of extreme events. These may come from history (the Russian 1998 default or a re-run of the current credit crisis, perhaps) or from imagination (a war closes Gulf shipping lanes, for example). This analysis is a combination of scientific technique with the "artistic" judgment needed to imagine and then assign a probability to extreme events, especially "unknown unknowns" or "black swans" (as described in Nassim Nicholas Taleb's book, "The Black Swan"). Applying such "event analysis" should reduce the vulnerability of a portfolio at times when such extreme events occur, by lowering the scale of riskier assets held in a portfolio, but that will also tend to limit the expected returns.

All these various stages of portfolio analysis represent a labour intensive process for both professional advisers and investors, so it is likely to be appropriate only for larger portfolios. For smaller portfolios, it generally makes sense to choose an off-the-shelf portfolio instead. Many banks and financial intermediaries offer a range of portfolios, adapted to different risk profiles and to various choices of well-diversified base currency and geography.

Such portfolios are sometimes derived from a Markowitz approach, sometimes from a more artistic method. Whichever way they are derived, investors can adapt them to reflect their own preferences, by, for example, adding extra geographic diversification or altering the amount of alternative assets. Such alterations make the portfolio more customized, but also take it further into artistic territory and away from more scientific principles.





“Core-satellite” portfolios have become popular in recent years, perhaps because they have a strong intuitive appeal, since they, in some sense, open up the “black box” of portfolio construction and make its components more transparent. The core contains investments that are relatively low-risk, have medium expected return, and are well diversified. This is surrounded by “satellites” containing assets that have higher risk and higher expected return.

The assets within each satellite are deliberately not diversified, but instead highly focused on a single theme, such as “water shortages,” “Chinese consumer” or whatever.

A well-chosen core-satellite portfolio, if analysed as a whole, could in principle turn out to be close to optimal in the Markowitz sense. After all, the satellites have been deliberately chosen to reflect highly specific themes, and if those themes are genuinely diverse, then the returns on assets relevant to one theme should have a low correlation with the assets assigned to the other themes.

However, it is very important that such portfolios are analysed to make sure that the chosen themes are sufficiently diverse – this is not always the case when core-satellite strategies are implemented. It is also a good idea to apply the stress-testing described above. Provided these steps are taken, a well-diversified set of satellites may be able to offer a portfolio that is close to a Markowitz optimum, and yet has the added advantage of being more intuitively appealing, and perhaps easier to monitor and adjust than the Markowitz “black box.” So for example, if one of the themes ceases to be as attractive as it was before, due to a changed political or economic landscape, then it is relatively quick and easy to replace the appropriate satellite with a new one. That could not be done very easily if the core-satellite approach has not been applied.

Currency considerations are critical to most private investors. The processes described usually take account of these by choosing a substantial number of assets to deliver returns that are correlated with the investor’s home currency, while including some assets linked to other currencies for diversification. But, as mentioned above, an investor is likely to react asymmetrically to currency losses and gains, and a currency overlay approach can be considered to address this.





Implementing the plan

Once an investor has selected a desired plan portfolio, he or she faces two related issues in implementing it. Firstly, the existing portfolio is likely to differ from the planned one – should assets be rearranged to meet the plan immediately, or over a period of time? Secondly, even once the desired plan portfolio has been achieved, there may be market circumstances where it is sensible to deviate from it, for example, by reducing somewhat the proportion of equities if a long and deep recession is expected.

The speed of adjusting an existing portfolio depends on two key factors. The first is market conditions. Say the existing portfolio has far more bonds and fewer equities than the target one, but momentum in stock markets seems to be trending down, then it probably makes sense to consider delaying the switch.

The second is cost and practicality. Switching out of one set of highly liquid, large-cap equities into a different selection is likely to be relatively easy, but illiquidity may make it impractical to reduce exposure to a private equity fund. In such cases, it may make sense to adjust a more liquid part of the portfolio to compensate, for instance by reducing exposure to mid-cap equities to offset too large a weight in private equity.

Once a portfolio has been aligned with the target, investors have to decide on a strategy for adapting it to market conditions across the cycle. The simplest approach is static: do not alter the portfolio. This approach relies on the inherent diversification already built in to the portfolio to dampen down fluctuations.

This gives up the potential benefits of a more active approach, but also removes the risk of misjudging the timing of switching between assets, and cuts out the accompanying transactions costs. For an investor whose time horizon is genuinely 20 – 25 years, such a strategy would historically have delivered powerful returns (see chart, page 8). Alternative assets such as hedge funds aim to offer additional diversifiers to take this effect further. However, as the experience of 2008 shows, even when all these opportunities for diversification have been used, the static approach still requires investors to ride out very large variations in their portfolio valuations across cycles.

Sometimes it may be necessary to wait well over a decade for the very big losses of some years to be offset by gains in others. Few investors are able to do this.





Instead, most investors choose some way of trying to reduce the fluctuations inherent in even a very well-diversified static portfolio. There are broadly three approaches to managing this: (1) entrust the process to a discretionary manager; (2) apply an ad hoc approach when adjusting the portfolio across the cycle; (3) use a clear set of rules and tools to make these adjustments. The first of these will be attractive to many investors, but is beyond the scope of this article.

The second is another example of the application of “art” rather than science – the danger is that someone can do very well in one stage of a cycle, and very badly at another when conditions change. This brings us to the third approach, which is back in the realm of science. A well-constructed set of investment rules would give a warning as the downswing of an economic cycle intensified, signalling the need to switch towards low-risk assets such as government bonds. It would then provide further signals to trigger progressively greater risk-taking as the cycle bottomed and began to reaccelerate. Such a process cannot eliminate cycles in the value of a portfolio, but may be able to dampen them if the signals it gives allow an investor to be more accurate and timely in decision-making. The cycle clock described in this Global Investor is one example of a process that aims to do this.

“Artistic” elements do play a key role in certain parts of the investment process, especially near the beginning where an investor should try to define his or her approach to risk. But “art” can also become a cover for poor decisions at the height of a boom, when investors may buy assets in exotic unknown locations (“financial tourism”), or at the trough of a slump, when fear deters investors from buying bargains. Scientific, analytical tools should thus form the core of any investment process.

A quick guide to Markowitz’s portfolio theory and its limitations

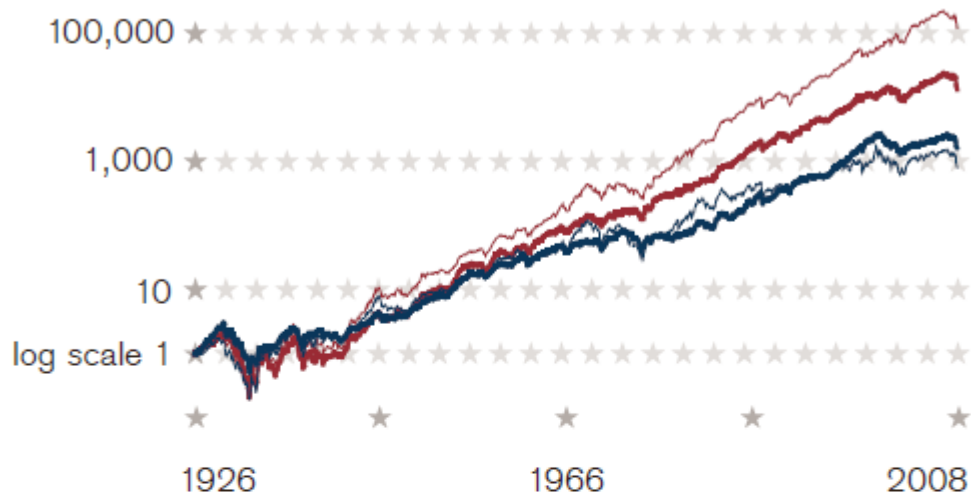
Assuming a diverse range of assets whose returns are not perfectly correlated, Markowitz showed how to choose a portfolio of minimum volatility at a given expected rate of return, or equally, how to get the highest expected return at a given level of risk. This box explains some of the major limitations of the theory, and how they can be addressed in practice:





1 The Markowitz approach needs knowledge of future expected relative returns for each asset and its future volatility and correlation with all other assets – but the future is unknown. In particular, at times of extreme stress, such as in 2008, assets that previously had low correlations can suddenly all start to move downwards together, so that an apparently optimal portfolio can turn out not to be especially well-diversified after all – in 2008, the only major asset class to maintain a low correlation with the others was government bonds. Practical solution: (a) Use historic data, but adjust for known changes; (b) also test the portfolio to see how it would have performed at times of extreme stress. —**2** Historic data are incomplete. They exist over long periods for some assets (e.g. US equities), but not others (e.g. forestry or Asian real estate). Practical solution: make assumptions to fill the gaps, e.g. that Asian real estate follows a similar path to the US property market at a similar stage of development. —**3** The theory assumes that investors want to obtain the highest expected return at a given level of risk, but in practice other considerations matter – liquidity is possibly the most important, with many investors valuing easy access to their assets, and thus being prepared to accept a somewhat lower return on an asset with greater liquidity. Also, the theory in its simplest form ignores transaction costs, which can turn a relatively simple problem into a highly complex one across multiple time periods. Practical solution: illiquid assets and those with high transaction costs can be “handicapped” by assuming higher volatility than has been observed in the past. —**4** The investor may have better information about some assets than others, or even better legally obtained information about some assets than the market does (e.g. through the kind of superior analysis that Warren Buffett apparently has been able to apply – see the article on page 31). Practical solution: hold more of such assets than the standard theory would suggest. —**5** The range of possible assets is so great that computing an optimal portfolio for all of them is impractical. Practical solution: a two-stage process is used. First, a decision is made at the level of broad asset classes (possibly very broad, e.g. “all fixed income,” or less broad, e.g. “short-dated eurozone investment grade bonds”). Second, a further decision is made within that class.





Size and style effects in the USA

Adjusting the allocation between safer and riskier assets across the economic cycle is one way to improve portfolio performance. For example, small-cap companies trading on low multiples have rewarded investors with higher returns in the long term, but can be vulnerable during economic downturns.

Small value (—) Big value (—)
Small growth (—) Big growth (—)





The eight styles Stocks within an investment style tend to perform as a group over several cycles. We define them as follows:

1 Value. A value style is a group of stocks which share low valuation and sound fundamentals. Value investors have an eye for long-term opportunities, since value takes time to materialize.

The example of Warren Buffett shows the full potential of this style. —**2 Growth.** A growth style focuses on companies that can grow sales, assets, earnings and generate above-market returns.

Growth investor Peter Lynch's approach focuses on buying stocks that investors are familiar with, which are unencumbered by short-term performance requirements. —**3 Contrarian.** Contrarian investors like Anthony Bolton follow a strategy of taking positions in undervalued quality stocks that show poor price performance. These investors go against the crowd in the expectation of high returns. —**4 Momentum.** Momentum investors seek to take advantage of market volatility by taking short- to medium-term positions in stocks that exhibit positive price performance. Chicago money manager Richard Driehaus holds that more money is made buying high and selling at even higher prices. —**5 Size.** A size-based style is determined by the market capitalization of its constituents. Historically, small caps tend to outperform large caps in bull markets, while large caps are less volatile. —**6 Cyclical.** Cyclical stocks are highly correlated with market conditions. Investors focus on cyclical companies, like carmakers and white goods firms, when economic confidence is high. —**7 Defensive.** Defensives are companies whose activity exhibits a low correlation to economic fluctuations. Defensive investors place a large proportion of their investable assets in bonds, cash equivalents, and stocks that are less volatile. —**8 Income generator.** An income generator style is also defensive, focusing on well-established companies that will return cash to shareholders given steady cash generation and limited investment opportunities.

