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On the Cover

Spiral Bowl 3
Heather root, with pewter inlay
and some parts patinated with pigment oil
2012
7.87 inches (20cm) × 7.87 inches (20cm)
Photo Credit: Cavin-Morris Gallery

Christophe Nancey *(French, born 1961) is a creative sculptor in the field of woodturning. His work shows an unsurpassed knowledge and understanding of the many processes that are now used in this creative medium which specializes in surface enhancement. He chooses from burrs and roots such as oak, ash, heather, elm, and maple. His work, inspired by organic forms, often incorporates the physical turning of wood that is wet or has been half-dried thus balancing the creation of textured effects within the cracks of their natural surfaces using a pewter inlay. He has exhibited primarily in galleries across France with representation in the US. This piece is available through Cavin-Morris Gallery in New York City. Visit www.cavinmorris.com to view more fine works.*

In this letter, I would like to revisit a topic we have covered several times in the past: the apparent dichotomy between reality and perceptions, or facts and opinions. I do not mean to focus on the causes of the phenomenon, if only because I am really not qualified to offer anything definitive. Rather, I want to focus on a couple of distortions against which one should develop defenses: wild volatility swings and changing investor behavior.

As the last several quarters demonstrated, but even more so as illustrated in the past few months, the oscillation of views between reality and perceptions has the potential to create substantial volatility swings in markets. Volatility is in part a function of the classic discounting process: it increases and decreases as market participants change their views of what to expect in the future. In a world where everyone is focused on more or less the same variables and the same sources of information and insight, the discounting process can be viewed as somewhat predictable if not always smooth.

While market adjustments are gradual most of the time, they have at times been quite drastic—and not always the result of a massive and unpredicted change in fundamentals. One of the most frequently quoted investment principles has argued over time that the best investment opportunities tend to be found when there is an extreme of valuation and a fundamental change. This argument usually accepted that one should wait to be rewarded, but presupposed that the wait would be measured in months or occasionally quarters, but certainly not in years or decades.

If we go back far enough in time, one major adjustment to the pound sterling exchange rate occurred as a result of a major change in fundamentals: the so-called "return of the sterling balances." (These were holdings of pound sterling by countries that were formerly members in the "sterling zone.") Others, just as extreme from a market standpoint, also occurred in part because of a fundamental change; the massive falls in Hong Kong stock prices in the fourth quarter of 1982 is a good example. Hong Kong, then a British colony, would revert to China in 1997. However, the dramatic decline in Japan from late December 1989 onward arguably involved no real fundamental change. Yet, in both these examples, market participants had allowed themselves to disregard fundamental developments and risks that were plain to see if one bothered to look for them. Whether in Hong Kong or in Japan, a US Dollar–based investor would have lost around 75% peak to trough, and, at least in the case of Japan, would still be in the red nearly 30 years later. Admittedly less dramatic events could be mentioned—the Southeast Asian currency debacle of 1997, the Russian ruble meltdown of 1998, the infamous "dot.com bubble" of 2000. They all share one or both of two common features: a state of suspended disbelief in fundamentals and the promise of a "new paradigm."

In short, it would be a major exaggeration to postulate that the current environment has no historical precedent. Compare and contrast these developments with the current world. A recent headline makes the point: "Bitcoin as a safe haven," implicitly alongside gold or the Swiss franc. One thus could argue that markets have not done their jobs. Typically, they should be forcing some discipline on government or corporate agents who move away from prudent management. Yet many of the current circumstances around the world are examples of serious geopolitical or economics issues—often structural in nature—being papered over for political purposes. A "new phenomenon" has been in part identified as playing an important role: "FOMO," the fear of missing out. This is the second issue that needs to be addressed.

Behavioral finance and its predecessor discipline, prospect theory, taught us about a number of biases that affect how individuals make decisions. They told us that traditional finance is normative, it tells us how things should work, while behavioral finance is descriptive, it tells us how things work in practice. Among the biases it identifies, one relates to regrets. It is said that individuals at times conduct themselves in a suboptimal manner, in order to avoid regrets. This clearly has an active element: to elect not to take a loss, for example, as a loss closes a mental account and thus gives rise to regrets. FOMO arguably also can be viewed as "insurance against regrets" as it involves buying something, possibly for just as unreasonable motives as those behind not taking a loss, for fear of regretting to have not bought it earlier, should it go up. Note that no account is taken of the potential for regrets related to the gamble not paying off—at least not explicitly.

Interestingly, FOMO may be compounding another bias that behavioral finance identified: momentum investing. It often is seen in part as a product of hindsight, overconfidence, illusion of control, and narrow framing biases, four other biases identified by behavioral finance. In short, FOMO could be a double bet on the view that recent market moves are a solid predictor of future moves. Add to this concerns over the role of status and competition, and the seeds are sown for some potentially difficult awakening at some later point in time. Going back to our earlier examples, one could argue (though this has yet to be conclusively demonstrated) that property and equity prices in Hong Kong in the early 80s or Japanese equity prices in the late 80s were both the results of a similarly flawed intellectual process.

The crucial element behind FOMO is that decisions are made on the basis of the hope of a gain and the fear of looking stupid for not running with the crowd, rather than on solid "fundamental" grounds tempered by some judgment about current valuation conditions. This is an important insight for at least two reasons:

(1) The disconnect between current prices and reasonable valuations can persist for an extended period of time. There is no compelling reason for individuals who have made a decision despite adverse fundamentals to change their mind, at least as long as markets continue to move in a given direction. Thus, one can expect distorted valuations to persist for an extended period of time; it is even paradoxically possible that the excessive valuation will be corrected over time as fundamentals gradually catch up with market prices. Yet, if the market move is based on hype and fueled by excess liquidity, the fundamental laws of economics and finance have not been repealed; the focus on them has just been temporarily suspended.

(2) One must therefore distinguish between a distortion that may simply be the discounting of developments that are unusually far into the future and one where the investment case does not make real sense, at least in the traditional sense of the preponderance of evidence. One can argue that the first term of this alternative is not really new, as many traditional investors in the 1960s and early 1970s used to view technology investments and their somewhat higher than "normal" P/Es as pie in the sky. The second term of the alternative, on the other hand, involves the creation of an investment thesis only remotely related to reality, at least in terms of a probability weighted outcome (akin to a lottery ticket). Remember the run on milk-related stocks in Japan in the 1980s on the grounds

they could benefit from the development of interferon which, at the time, was viewed as a potential cure-all for cancer.

This suggests that to avoid being caught in that "fake" new paradigm, investors need to work along two new lines of thought:

(1) They need to be aware that traditional tools, though not invalidated in the long term, can be suspended for at times quite a long period. This inevitably raises the specter of the classical behavioral trap of changing horses in the middle of the race. Thus, investors must be perfectly clear about their structural beliefs, and prepared to see these beliefs challenged for potentially long periods of time. This is all about maintaining intellectual honesty and rigor.
(2) They may need to arm themselves against these potential short-term tendencies through a greater use of portfolio hedges, potentially structured in option format. Few managers can honestly argue that they are totally immune from external pressures; it is always possible to construct narratives that justify behavior that conflicts with one's structural beliefs. At times this reaches the so-called "agency risk," first proposed by David Swensen, that arises when managers substitute their own appetite for risk for the client's actual risk tolerance. The inevitable risk that a prolonged period of underperformance will threaten the job of an investor can lead any professional manager to move in accord with short-term market developments, simply in order not to stand out in the crowd with poor relative performance (FOMO?). After all, he or she may no longer be around when finally proven right!

In short, the current environment is treacherous, with its instantaneous communications, massive amounts of accessible data that often cause primary research to give way to secondary or even tertiary research, and the corresponding lessened focus on hard facts when the data are "too hard" to sort through. And yet, this is not really a new scenario. We have seen analogous events in the past, though the areas of application, variables, tools, and errors may have been different. History shows that dislocations can persist but usually are eventually corrected. Though the sample of such disasters is relatively small, the longer a disruption persists and the more extreme it gets, the sharper and more painful the correction. The fact that this is not new news suggests that perhaps no dramatic investment process or policy changes are needed. At the same time, though, some modest accommodations, at the margin, may help individuals resist the siren's song and keep the focus on the real thing, even when it at times appear awfully hard to see.

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The Winter 2019 issue of *The Journal of Wealth Management* is quite broad, covering both hard and soft topics.

The first four articles deal with broad policy issues. The first, by Petra Ritzer-Angerer, focuses on the need for the fostering of trust that clients have in their advisors, transferring a model of trust intermediaries by Coleman to investment advisory services. The second, by Mathias Uhl and Philippe Rohner, observes that the wealth and investment management industries are undergoing significant structural changes based on technological advancements, updated client needs, and regulatory challenges. It highlights the advantages of accepting non-linearity in financial advisor's business models, client requirements, and investment strategies. The third, by Board of Ambassadors member William Reichenstein and William Meyer, explains how Medicare Part B and D premiums vary with a household's modified adjusted gross income; explains how certain life-changing events could affect Medicare premiums; illustrates that higher-income households may benefit by making Roth conversions through 2025; and explains the advantages for households with someone at least 70.5 of age of making charitable contributions through qualified charitable distributions from IRAs. Finally, the fourth, by Paul Hagelstein, Isabella Lackner, James Otto, Austin Perona, and Robert Piziak, considers historical real returns of portfolios consisting of equities and short-term bonds over 90 separate 30-year time periods, under three different rebalancing scenarios, providing investors in the accumulation phase and their advisors with useful historical data that may assist in asset allocation decisions.

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The second group comprises five articles that look at different aspects of investment decisions. The first, by Ronen Israel, Joseph Liberman, Nathan Sosner, and Lixin Wang, focuses on an important issue of tax efficiency in the management of equities, asking whether there is a tax benefit in avoiding high-dividend-paying stocks; it concludes that the tax benefit of lowering the dividend yield is not enough to compensate for the associated increase in capital gains taxes and decrease in expected pre-tax returns. The second, by Sam Pittman, Amneet Singh, and Sangeetha Srinivasan, looks at portfolio diversification. It notes that, following the global financial crisis, a portfolio concentrated in US large-cap equity and aggregate fixed income provided higher returns than diversified portfolios through 2019, and concludes that investors should continue to build diversified portfolios. In doing so they should consider that some asset classes more consistently improve risk-adjusted returns than others.

The third, by Wei Ge, notes that some investors have become wary of the high valuations of equities in the US market and started questioning whether the US stock market rally is running out of momentum. Though it is impossible to predict what might trigger the next financial crisis or when it may come, the article argues for utilizing the volatility risk premium (VRP) to mitigate the losses a portfolio may suffer from a potential future financial crisis.

The fourth article will be of special interest to readers dedicated to socially responsible investing. It is by Javier Rodríguez and Herminio Romero and assesses the true international diversification value of socially responsible globally invested exchange-traded funds (SRI ETFs), in comparison with their more traditional counterparts, and concludes that SRI ETFs' international diversification value is significantly higher than that of conventional ETFs that also invest globally. Finally, the fifth, by Aakruthi Alarnkar, examines the effect of key macroeconomic variables on sectorial indexes of the Bombay Stock Exchange.

The last three articles, as usual, do not form a real group, but each looks at interesting aspects of investment markets. The first, by Ravi Kashyap, is the first part of a two-part study. It offers a collection of various trading strategies and useful pieces of market information that might help to implement them, demonstrating that they can easily cater to the varying risk appetites, regional preferences, asset management styles, investment philosophies, liability constraints, investment horizons, notional trading size, trading frequency, and other preferences of different market participants. The second, by Manu Sharma, Puneet Gupta, and Rouhi Gopal, involves establishing a relationship between historical gold prices and the supply of gold, concluding that the correlation between the gold prices and its supply ranges from moderate to high. Our final article, by frequent contributor John Haslem, looks at revenue sharing for mutual fund brokers, and connecting that revenue sharing to future returns and inflows. It argues that the former is important while the latter is less so.

Jean L.P. Brunel
Editor