



The Perfect Storm

A storm is brewing for investors. It could turn out to be *the perfect storm*: a simultaneous collapse of stock, bond, and real estate prices with inflation reducing the purchasing power of ravaged investment portfolios. At the heart of the perfect storm is the prospect that foreigners will stop financing the profligacy of the US government and US consumers. The perfect storm is an increasingly likely consequence of large and growing current account and fiscal deficits.

If foreign central banks stop funding the \$2 billion a day current account deficit and seek to diversify their foreign reserve holdings, the result will be a rout of the dollar, higher inflation, higher interest rates, and a plunge in consumer spending. The US will go into recession and corporate profits and government tax revenues will fall. The stock, bond, and real estate markets will tumble. With large declines in asset prices, counterparty defaults in the huge and unregulated derivatives markets are likely to exacerbate downward pressure on asset prices. Foreign and domestic holders of US dollar denominated assets will continue to reduce their exposure until asset prices stabilize at bargain basement levels.

The risk of the perfect storm is accentuated by the current high valuations for stocks, bonds, and real estate. Falling interest rates, produced by years of Federal Reserve expansionary monetary policy, has resulted in extreme asset price inflation in stock and real estate prices. The wealth effect associated with asset price inflation has supported the growth in consumer debt creation and spending at non-sustainable levels. The reversal of loose monetary policy by the Federal Reserve along with a reluctance of foreigners to continue financing the twin deficits now sets the stage for serious deflation in asset prices.

The US has been able to work itself out of economic problems in the past with varying degrees of pain. This time it will not be easy to avoid a painful resolution to the twin deficit problem given over-extended entitlement programs, open-ended military commitments, an extreme wage gap with our emerging market trading partners, record consumer debt burden, large external holdings of our national debt, and already low federal tax rates.

With all the media attention given to the twin deficits, financial planners are well aware that the dollar, the economy, and the stock market are being threatened. Unfortunately many planners share the belief that the problems we face somehow will be worked out without much damage to long-term

investor interests. So far, planners appear not to have appropriately factored the perfect storm scenario into investment strategies and financial plans.

Redefining Investment Practices

The perfect storm calls attention to the need for financial planners to model long-term return expectations and to consider how alternative investment scenarios can affect investment returns and the realization of client financial goals. The requirement to model investment returns from a forward-looking fundamental perspective is a generally un-welcomed but essential foundation of financial planning. As anyone who has attempted to forecast returns using fundamental valuation techniques knows, these forecasts are very sensitive to inflation, real earnings growth, and end of period valuation assumptions. This fact is not a flaw in fundamental valuation techniques, but rather reflects the nature of the beast. While one cannot know the future, financial planners can do a better job of modeling investment risk and return, and integrating well structured investment strategies and financial plans than clients can do themselves. Financial planners can also do a better job of dynamically adjusting portfolio holdings toward investments and asset classes with fundamentally attractive return prospects, while reducing exposure to the ravages of potentially adverse economic scenarios.

Financial planners should consider more than one scenario when formulating investment strategy. While it is impossible to protect portfolio values and future consumption goals from all possible adverse economic scenarios, when the probability of one or more adverse scenarios becomes large enough, *scenario-based portfolio protection* should be utilized. Scenario-based portfolio protection can be thought of as a form of insurance, where the size of the premium is the return differential associated with a more favorable economic scenario(s). The appetite for insurance varies with the client and their circumstances. Some investors cannot afford or are unwilling to buy insurance, betting that a favorable economic scenario will play out. Often investors in more favorable financial circumstances are willing to reduce their expected investment return for downside risk protection. Scenario-based portfolio protection shares some things in common with *traditional prudent man*, *mean-variance*, and *capital asset pricing model* risk management. All four approaches promote the risk reduction benefit of diversification.

However, scenario-based portfolio protection differs in some important respects from these other forms of risk management. Traditional prudent man risk management is supported by the experiences, concerns and

practices of skilled professional investors. Compared with scenario-based portfolio protection, traditional prudent man risk management is less computationally demanding, less rigorous in working out the investment implications of identified risk factors and more concerned about working within generally accepted investment management conventions.

Unlike scenario-based portfolio protection, mean-variance risk management quantitatively defines the benefits of diversification based on single set of expected returns and covariances, usually dealing with a single period. Scenario-based portfolio protection is multi-period and does not require estimates of covariances. With scenario-based portfolio protection, covariances are implicit given the probabilities and returns attached to the scenarios. Unlike scenario-based portfolio protection, mean-variance investing in practice places a high reliance on historical returns and covariances.

Capital asset pricing model risk management distinguishes between systemic risk, the risk for which investors as a group are compensated, and specific risk, the risk for which investors as a group are not compensated. Unlike scenario-based portfolio protection, capital asset pricing model risk management assumes that markets are efficient enough not to look for inefficiencies. Capital asset pricing model risk management focuses on selecting the appropriate level of systemic risk given the client's tolerance to portfolio returns variability and diversifying away as much specific risk as is practical. Applications of capital asset pricing model rely heavily on econometric analysis of historical returns. There is little empirical support for the idea that historical returns provide an adequate basis for estimating the systemic risk premium, or portfolio beta or specific risk. Given the degree of "real world" market inefficiency, capital asset pricing model risk management does not work even in a pure forecast expectations case.

The reliance on historical mean returns, standard deviations, and correlations in formulating investment strategy, establishing risk and return expectations and projecting the likelihood of meeting financial planning goals is a big problem. The case for using historical returns can be challenged on both theoretical and empirical grounds. The theoretical basis for extrapolating returns is the belief in a stable return generating process, where the series of returns observed in real world is randomly generated from a fixed returns generator with embedded population mean returns, standard deviations, and correlations. Even the most cursory study of economics should lead one to reject this model of how returns are generated.

Empirically, return distributions do not conform to the type of distributions expected by the *random walk model*. Rather, empirical return distributions are generally characterized by fat tails and varying scale, implying the existence of market bubbles and a general instability in the return generating process. While the study of historical returns is enlightening in many respects, the failure to go beyond analyzing historical returns in formulating returns expectations is a big mistake.

In the wake of the peaking of the stock market bubble in 2000, there has been a growing disenchantment with extrapolating historical returns and employing a fixed asset allocation policy. Setting an asset allocation policy and staying the course regardless of what is happening in the world does not work well with clients when realized asset class risk premiums do not meet expectations. Financial planners seeking a better way need to overcome several decades of indoctrination in market timing dogma, where all forms of active asset allocation were shunned.

Investment decision making, now as always, is best characterized by uncertain prospects, no guarantees even in the long run, and the risk of being fired before being proven right. Putting the client first requires being proactive in seeking out investment opportunities, managing risk and cost, and quantitatively matching investment solutions to the long-term financial goals of the client as best one can. Managing investments from the perspective of the rear view mirror does not cut it.

Some Things to Consider

While there are some vocal notables climbing the twin deficit wall of worry, including Paul Volcker, Warren Buffett, and Peter Bernstein, there are a surprising number of pundits who hold that the problems they present to long term investors are either overblown or that those in power will do whatever is necessary to forestall a collapse of the dollar and US asset prices. Let's hope they are right. But in the event they are wrong, reducing exposure to the threat posed by the Perfect Storm seems advisable. Just thinking about the likelihood of the perfect storm, what it portends for investment returns, and what steps can be taken to protect clients' long-term financial interests should sharpen ones views on the state of investment management as practiced by financial planners and what if anything can be done about it.

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