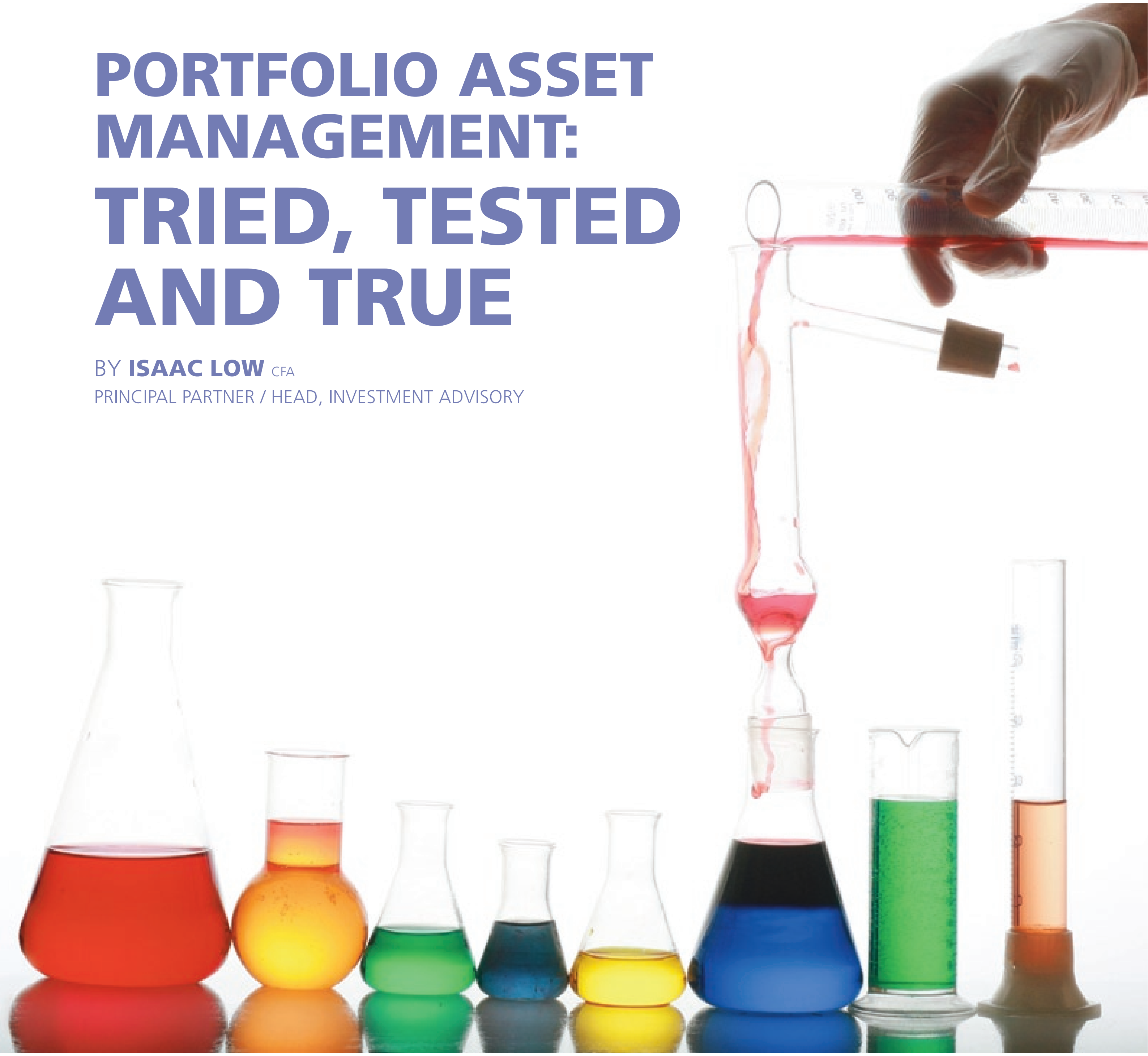
ISSUE NO. 3 • 2009 A QUARTERLY PUBLICATION
BONDS&ISSUES

FirstPrincipal financial

PORTFOLIO ASSET MANAGEMENT: TRIED, TESTED AND TRUE



BY **ISAAC LOW** CFA
PRINCIPAL PARTNER / HEAD, INVESTMENT ADVISORY

When we began planning our Investment Advisory Service in 2003, our goal was to offer a product that could cater to the man in the street, as well as for those who needed a bit more investment sophistication to cater to their specific circumstances. We also wanted something that could be applied consistently across good times and bad, and not fall victim to short-term fluctuations.

At that time, retail investors were able to achieve some degree of diversification through spreading their investments across several asset classes that were intuitively lowly or negatively correlated – stocks versus bonds, European equities versus Asian equities, etc. However, there was no way of telling if the allocations were efficient or counter-productive. Moreover, portfolios became over-weighted with risky assets as these grew in tandem with the markets. There was no systematic or regular method of risk mitigation. From a financial planning viewpoint, the client's investment objectives were also not necessarily aligned with their investment holdings.

ISSUE NO. 3 • 2009 A QUARTERLY PUBLICATION
BONDS&ISSUES

FirstPrincipal financial

OUR PROPRIETARY PROCESS

First Principal came up with Portfolio Asset Management or PAM – an investment strategy that employs efficient diversification across asset classes, coupled with regular rebalancing. Portfolios under PAM were designed with exposures to equities, bonds and sector funds. Further diversification was achieved via selection of fund managers with differing investment styles. PAM's allocation percentages were maintained via quarterly rebalancing. Reviews of the fund managers' performance were also carried out on a quarterly basis. Our clients could invest with amounts of $25,000 upwards.

From the onset, it was a challenge to market this "Long-Term, Broad Strokes" approach. Stock picking, short-term horizons and market timing have been entrenched in the mindset of investors. Much time and effort were expended on the part of our advisers, to educate and persuade their clients to adopt this investment approach. We are grateful for the success that we have garnered. We also thank our clients for giving us an opportunity to prove ourselves, and also to prove that PAM works.

When we launched our service in September 2003, the world was just coming out of the dot.com crash. Stock markets started their rise around the end of 2002 and investor sentiments were strong. This bull market would continue for a while, and by 2007 would have gone on for a good five years. There were some jittery periods during this bull run. But by and large, it was one big party for investors. Our clients too enjoyed the ride. Regular reviews and rebalancing meant that during this period, we were selling some equities as the markets were rising, and buying into bonds – something that was not a fashionable thing to do.

Driven by concerns for risk mitigation caused by rising markets, we undertook a review of our portfolios in early 2007. We were able to introduce additional asset classes that were more risky but were lowly or negatively correlated to existing asset classes. This allowed us to further improve our risk-reward matrix by increasing our exposure to bonds for the higher-risk portfolios. Hence from September 2007 onwards, our portfolios were modified to incorporate commodities and property exposure. This was in line with the global shift in asset allocation strategies toward more real and physical assets, in order to cushion the effects of over reliance on financial assets.

A PRESET FORMULA

The first two quarters of 2008 saw a lot of volatility. It required our clients to respond by selling some assets that had made profits and deploying these into assets that had fallen in value. Adhering to a system meant that regular reviews were carried out. Decisions were also made based on a preset formula, rather than having to improvise as we go.

Disaster struck in September 2008, a year after we introduced our new strategy. The collapse of Lehman Brothers in the US sent global markets into free-fall. Those were dark days as the world stared financial Armageddon in the face. Only investors holding cash were spared.

The only consolation was that our clients had periodically bought into bonds in the past four years, thus lessening their pain to some small degree.

The "black swan" events that hit the world in October 2008 also posed an interesting challenge and dilemma for First Principal. The VIX or "Fear Index" had literally hit the roof. How were we to respond in the midst of such extreme fear and pessimism? We made what we thought was a brave decision. We asked our clients to top-up their accounts!!

Let me quote from our letter to First Principal's clients in October 2008:

"The investment climate in the third quarter has been very volatile and all our equity funds have suffered sharp losses. Emerging Markets and Commodities, in particular, are facing their biggest challenges since 2001, and have fallen more than 30% and 40% respectively.

Our usual practice of rebalancing involves selling funds that have gone up (or fallen less) in value, and buying funds that have gone down. In the current environment, it would mean selling funds that have gone down in value by say 13%, in order to buy into Emerging Markets and Commodities. While it makes mathematical sense, selling some portion of a fund that has just fallen 13% in three months just does not sit well with intuition. If anything, it represents a buying opportunity.

The usual practice also means our clients will not be enjoying the full benefit of their original investment amount, which has fallen substantially in the last three months.

Another strategy in bearish markets requires an investor to average down, i.e., to buy more of the same investments at lower prices to achieve a lower average cost. This means it will take a shorter time to break-even.

Since our clients are investing over a five-year time horizon, we believe they are in a position to take full advantage of the market recovery when it happens.

Given the reasons outlined above, we are recommending using a Top-Up approach for rebalancing at this time.

The end result of this exercise is to bring your portfolio back to the optimum allocation, with avenues for more upside recovery.

We thank you for your support and confidence and look forward to better times ahead."

ISSUE NO. 3 • 2009 A QUARTERLY PUBLICATION
BONDS & ISSUES

FirstPrincipal financial

WHAT IS CERTAIN IS THAT INVESTORS SHOULD LOOK AT MORE DIVERSIFICATION, NOT LESS.

THE RIGHT CHEMISTRY

Not unexpectedly, not every client agreed with our top-up recommendation.

Some did but many were taken aback. It was hard enough for them to stay invested, while their portfolios fell in value with no end in sight. Needless to say, our advisers had a lot of explanation to do. In times like these where it was easier to hide and blame the markets, our resolves were strengthened as we went back to our clients to revisit the advisory process. An integral part of the process required our advisers to go through a risk-coaching questionnaire with their clients. The approach was both quantitative and qualitative, where among other things, certain aspects of investor behavioral idiosyncrasies were discussed. For example, one of the discussion topics mandated in the questionnaire was how clients would respond should their portfolios fall substantially. Typically clients would say that they would be unhappy but would hold on to their investments. Some clients responded by saying they would sell all their units. This afforded an opportunity for our representatives to further explore the reasons behind such a response, as well as clear up any unfounded fears or misconceptions. Unfortunately, despite our best efforts, there were clients who sold their investments when the markets tumbled.

In our risk-coaching discussions, there was a third group of clients who said that if the markets fell substantially, they would see it as a buying opportunity. These clients had their convictions tested as markets around the world went into free-fall in October 2008.

Based on our advice, there were some brave souls who bought in. Markets continued their corrections for a further two months, testing our resolve and convictions as well. Since then, thankfully, the markets have started to recover. *Table 1* is a summary of performance of some asset classes over the last four quarters, which our clients have exposure to.

TABLE 1

ASSET CLASS	% GROWTH			
	2Q 2009	1Q 2009	4Q 2008	3Q 2008
Global Bonds	-1.48	0.44	9.65	2.11
Global Equities	15.25	-6.92	-21.05	-10.71
Emerging Market Equities	28.38	6.60	-27.00	-23.03
Asian Equities	26.76	5.55	-22.35	-19.85
Global Properties Fund	32.00	-16.08	-29.55	-8.33
Global Commodities Fund	20.72	15.86	-30.50	-41.90
Dow Jones Industrial Average	5.69	-8.52	-18.49	0.60

Given that equities, property and commodities have fallen drastically in the third and fourth quarters of 2008, the top-up amounts were used to buy into these asset classes in order to bring the total portfolio back to its targeted allocation percentages. Apart from global properties and global equities that continued to fall in the first quarter of 2009, the other asset classes staged rigorous rebounds. In the second quarter, all sectors were in the positive, apart from global bonds, which fell only slightly.

ISSUE NO. 3 • 2009 A QUARTERLY PUBLICATION
BONDS & ISSUES

A BALANCED AND DIVERSIFIED INVESTMENT MIX

When almost everything went into a tailspin in the last quarter of 2008, there were renewed voices claiming that asset allocation does not work, and that it should be abandoned as an investment strategy. This stemmed primarily from a misunderstanding of the model, and is often due to a performance-driven emphasis.

First, it must be stated that asset allocation as a diversification strategy does not promise positive gains in all situations. Among other things, it is a risk mitigation strategy to contain losses in a downturn. In this respect, did asset allocation work? It most certainly did. Clients with portfolios consisting of significant allocation in global bonds would have withstood the market crash much better than those without.

Second, when the benefits of diversification are needed most, asset allocation was at its least effective. This is because in times of volatility, investors are driven by fear and panic selling, often aggravating what is already a tense market.

Yet, it is in times such as these that a cool head is needed. Investors needed a systematic, and hopefully, rational response when all around them was in chaos. This is where regular review and rebalancing becomes essential. Rebalancing gives a reasonable basis for decision-making. Indeed, it was the review and rebalancing process that forced us to take a hard look at the numbers, rather than react to market sentiments at the worst of times.

Third, it can also be seen that while increased correlation resulted in the slide in prices, affecting almost all asset classes, some negative correlation still existed between some asset classes, notably between bonds and equities. Strengthening correlations during times of volatility does not detract from the benefits of diversification. This is especially true when one takes a longer-term view, as opposed to month-by-month or even quarter-by-quarter. Investment planning as an integral part of financial planning looks at the "long- term and broad strokes" approach.

We continued to advise topping-up until February 2009, when we reverted back to our normal rebalancing.

This episode also brought home the importance of conducting a risk-coaching discussion with clients.

We see the wisdom of making it mandatory for our advisers to complete the questionnaire with their clients. We do not score the answers. Instead, advisers spend more time talking to clients about their objectives, risk tolerance, past behavioral tendencies and experiences, as well as their fears and aspirations. Clients would also have been exposed to worst-case and long recovery scenarios of a post-market crash. At the end of the session, clients should be left with no doubt that investments are risky, and that diversification and adopting a longer-term view are some of the ways to mitigate risk.

Looking ahead, there continues to be much uncertainty. Will it be an inflationary scenario or will we go through a lost decade of deflationary effects? There are equally strong proponents on both sides of the argument. What is certain is that investors should look at more diversification, not less.

FIRST PRINCIPAL FINANCIAL PTE LTD
24 Raffles Place #14-02 Clifford Centre Singapore 048621
Tel: 6220 5333 Fax: 6220 5377
Email: enquiry@firstprincipal.com
www.firstprincipal.com