

# Qwest for Returns

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## The fall of “buy-and-hold” asset allocation

In the wake of the Great Bear Market in late 2008/early 2009, the Wall Street Journal published an article on July 10, 2009 entitled “Failure of a Fail-Safe Strategy Sends Investors Scrambling” that questioned the wisdom of buy-and-hold asset allocation (<http://online.wsj.com/article/SB124718008880220049.html>). The main complaint of the approach of buy-and-hold asset allocation was its inability to respond to changes in economic, investment and risk climates:

Asset allocation, a bedrock of investing for decades, appeared to fail miserably in 2008. The conviction shared by most investors -- that they should spread their money across myriad asset classes to minimize losses -- was shaken as nearly all markets tumbled in unison.

The Great Bear of late 2008/early 2009 devastated portfolios, and diversification was relatively ineffective. Virtually all asset classes moved down together, except for cash, default free Government of Canada bonds and U.S. Treasuries. As a result, some investors are now demanding tactical advice from their advisors.

This failure of traditional buy-and-hold asset allocation is a huge challenge for investment management professionals. Some high-net-worth investors are asking some very simple, but embarrassing, questions:

- If buy-and-hold is best, why shouldn't I just buy some ETFs from a discount broker?
- Since asset selection determines the overwhelming majority of returns, why does dynamic asset allocation get so little attention and fund selection get so much attention?

## The rise of dynamic asset allocation

What should wealth management professionals do? To get a peek of how the future may evolve, consider how institutions are behaving. The large pension and actuarial consultant William Mercer wrote that one of the top investment trends in 2010 will be Dynamic Asset Allocation: “Dynamic Asset Allocation (medium-term asset allocation tilts) will be de rigueur to capture market mispricing in the medium-term” (see <http://www.mercer.com/summary.htm?idContent=1368600>).

Moreover, they also believed that investors will pay a lot more attention to macro-economic risk: “Investors will critically examine their investment strategies in the context of evolving deflation/inflation risks”.

We believe that properly implemented dynamic asset allocation can perform like a balanced fund during normal times and also capitalize on investor uncertainty during periods of crisis or volatility.

The shift to dynamic asset allocation is an enormous challenge for current wealth management business models. The wide availability of ETFs and ETF solutions now make the issue impossible to ignore. Advisors that adapt will gain share, and advisors that don't adapt are at risk of seeing their piece of the pie shrink.

## Macro-economic change – creating wealth management challenges

The bear market put a premium on investment advisors who can adapt and customize asset allocation. Ideally, portfolio construction not only reflects client goals, but also the current market trend. This would help protect investors from threats that are specific to their investment horizon (e.g. retirement during a period of rising inflation). This requires tactical advice and ongoing portfolio customization.

The business model of most advisors serving retail and high-net-worth clients is asset gathering, which encourages recommendation of standard asset mixes, diversified by asset class, and outsourced to "best-of-breed" third-party managers. As a result, fee-based compensation encourages conformity and standardization of client portfolios as the key to scalability and high margins.

While this is a sound business strategy during most markets, its assumptions fall apart under stress. Clients found that their investment advisors were unprepared to adjust their asset allocation in a bear market. Consequently, most clients were offered some plain vanilla approaches to portfolio construction:

- Simplistic risk buckets (aggressive, conservative, etc.)
- A long-term approach to asset allocation
- A focus on adding value through manager selection
- Standardization of client portfolios

Simplistic risk buckets spit out a mix of stocks and bonds for "aggressive" investors, "conservative" investors, and everyone in between. This approach tends to put conservative investors into long-term government bonds. Unfortunately, a long-term bond allocation ignores inflation risk. On the other hand, standardized aggressive and medium risk portfolios ignore macro-economic risk, which has risen dramatically in the last while.

## Entering a new "old" era

The accompanying chart from Macquarie Equities Research shows the macro-economic challenge that investment advisors face today. The volatility in the OECD leading indicator has skyrocketed in the wake of the Great Recession. While this level of volatility is not unprecedented and was last seen in the 1970's, most investment managers working today haven't experienced it in their own working lives and may not be able to properly adjust to the current environment.

**Volatility in OECD leading indicator**




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*Picerno explained that in contrast to early interpretations of the Modern Portfolio Theory, subsequent research has shown that optimal asset allocation is not static. The risk-reward trade-off varies over course of the business cycle in a partially predictable and thus, in principle, exploitable way.*

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*The Inflation-Deflation Timer model in effect provided low-cost crisis insurance by performing positively during periods of dislocation and performing similarly to the benchmark during more normal periods.*

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## Dynamic asset allocation – wealth manager’s solution

Many asset management and wealth management professionals dismiss dynamic asset allocation as unworthy of serious research and attention. Even though the overwhelming majority of investment returns come from asset allocation, attempts to add value via dynamic asset allocation are dismissed as impossible in principle.

Contrary to popular belief, dynamic asset allocation can add value. Financial journalist, James Picerno, recently authored a book entitled *Dynamic Asset Allocation: Modern Portfolio Theory Updated for the Smart Investor*, where he explained that in contrast to early interpretations of the Modern Portfolio Theory (MPT), subsequent research has shown that optimal asset allocation is not static. The risk-reward trade-off varies over the course of the business cycle in a partially predictable and thus, in principle, exploitable way. Furthermore, he contends that investors should adjust their asset allocations over the course of their lives.

A paper presented at the UK’s Institute of Actuaries came to a similar conclusion ([http://www.actuaries.org.uk/\\_data/assets/pdf\\_file/0009/149445/sm20090427\\_summy.pdf](http://www.actuaries.org.uk/_data/assets/pdf_file/0009/149445/sm20090427_summy.pdf)) [emphasis added]:

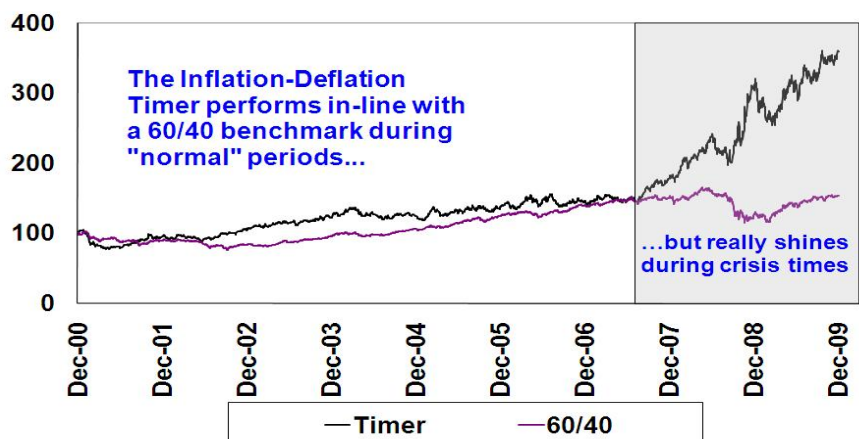
Investment strategy is often static, punctuated by infrequent reviews. ***For most long-term investors, this practice results in large risks being taken that could otherwise be managed with a more dynamic investment policy.*** The bulk of this paper is aimed at analysing and describing two multi-period investment strategy methodologies - in order to derive potential dynamic strategies. Along the way, ***we show how static investment strategies can fail to deliver an investor’s long-term objectives*** and describe the relationship of our work to other areas of the finance literature.

## Dynamic Asset Allocation example: Inflation-Deflation Timer model

Consider as a case study our Inflation-Deflation Timer model, which is fully described in our November 2009 *Qwest for Returns* newsletter, of how dynamic asset allocation can add value to different investors’ portfolios (see [http://www.qwestfunds.com/publications/newsletters\\_pdf/newsletter\\_november\\_2009.pdf](http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_november_2009.pdf)).

As shown in the table below, the Inflation-Deflation Timer model was able to effectively adjust to macro-economic risk during crisis periods and performed in-line with a 60% stock/40% bond benchmark during other times. This model in effect provided low-cost crisis insurance by performing positively during periods of dislocation and performing similarly to the benchmark during more normal periods.

### Cumulative Returns



## Case study - the conservative investor

For illustrative purposes, we will consider the case of a hypothetical investor we will call "Mr. Income". Mr. Income is an older investor who is either in retirement or nearing retirement with mainly income oriented needs. MPT and standard asset allocation techniques would put Mr. Income into a conservative risk bucket, with a very high weighting in fixed income assets.

The weakness of fixed income portfolios is the lack of protection from unexpected inflation. Given the current macro-economic environment of runaway government spending and easy monetary policies, that risk is considerable.

The chart below plots the risk, as measured by maximum loss and return (for the test period of December 2000 to December 2009), of different allocations to an all-bond portfolio and the Inflation-Deflation Timer model. The dot near the bottom of the chart labeled 100% DEX Bond Universe shows the risk and return characteristics of an all-bond fund over the test time period of December 2000 to December 2009. Each dot from that 100% DEX Bond Universe point represents progressively higher allocations to the Inflation-Deflation Timer model, until the allocation becomes 100% Inflation-Deflation Timer model and 0% DEX Bond Universe.

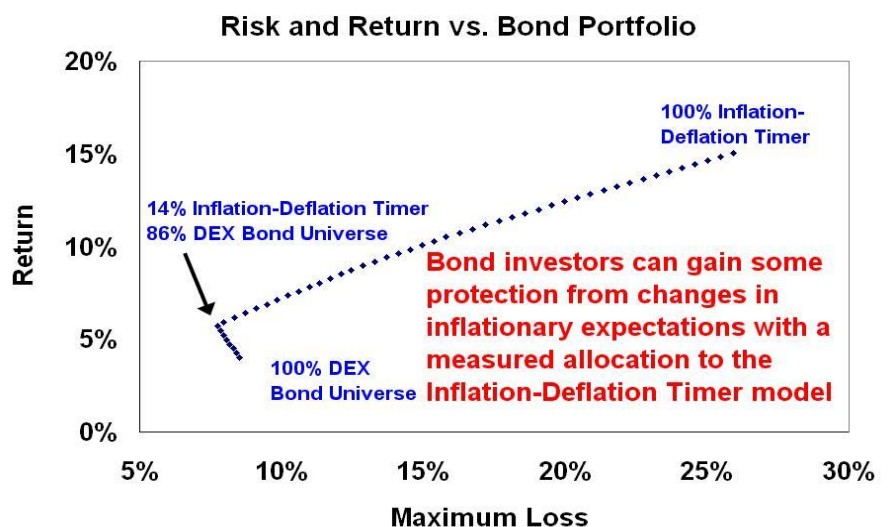
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*Bond investors can gain inflation protection with a measured allocation to the Inflation-Deflation Timer model.*

*The Inflation-Deflation Timer model can perform better than standard inflation hedge vehicles.*

*It is designed to be act like a call option on inflation, which limits the downside risk should deflationary forces become prominent.*

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As our Mr. Income initially allocates more to the Inflation-Deflation Timer model from the 100% bond fund, downside risk falls and returns rise. The minimum risk portfolio in this example turns out to be a 14% allocation to the Inflation-Deflation Timer model and 86% allocation to the bond fund. From that point onward, risk rises but so does return.

Mr. Income is gaining some inflation protection with a measured allocation to the Inflation-Deflation Timer model. What's more, we would expect that the Inflation-Deflation Timer model would perform better than standard inflation hedge vehicles, e.g. gold, commodities, TIPS, etc., because of its asymmetric return pattern to changes in inflationary expectations. The Inflation-Deflation Timer model is designed to act like a call option on inflation, which limits the downside risk should deflationary forces become dominant.

We would caution that the results of these scenarios are dependent on many variables, such as the choice of asset classes, the behavior of those asset classes as well as the specifics of the implementation of an Inflation-Deflation Timer model. Past performance is no guarantee of future returns.

## Case study - the aggressive investor

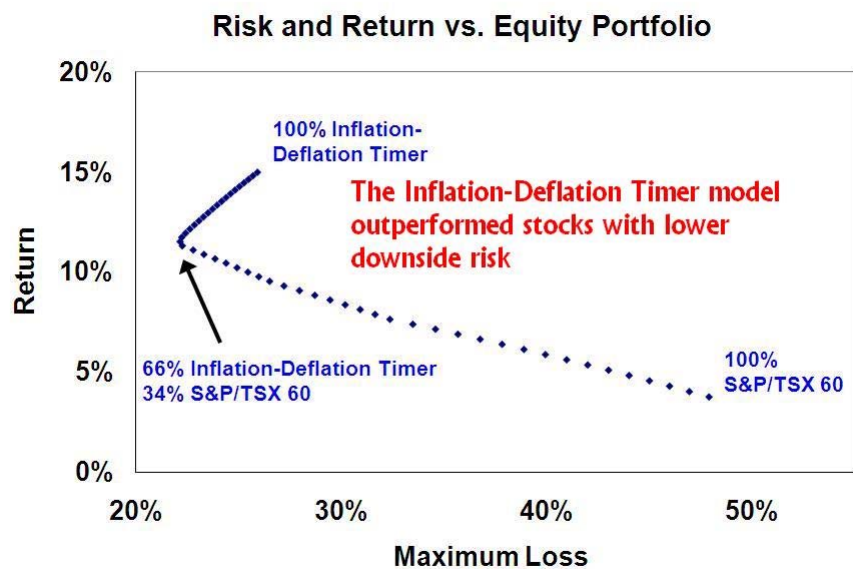
Suppose we have another hypothetical investor whom we will call “Mrs. Growth” who wants to give a portion of her wealth to her grandchildren, all of whom are young children with long investment time horizons. MPT analysis would put the grandchildren into aggressive risk buckets, with a high weighting in equities.

As the chart below shows, the Inflation-Deflation Timer model outperformed stocks with lower risk. Using the same analytical framework as before, we find the minimum risk portfolio to be a 66% allocation to the Inflation-Deflation Timer model and 34% allocation to equities, as defined by the S&P/TSX 60 Index. Mrs. Growth, who is more comfortable with risk, could allocate greater amounts to the Inflation-Deflation Timer model.

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*The minimum risk portfolio for an aggressive investor is a 66% allocation to the Inflation-Deflation Timer model and 34% allocation to equities, as defined by the S&P/TSX 60 Index. Investors who are more comfortable with risk can allocate greater amounts to the Inflation-Deflation Timer model.*

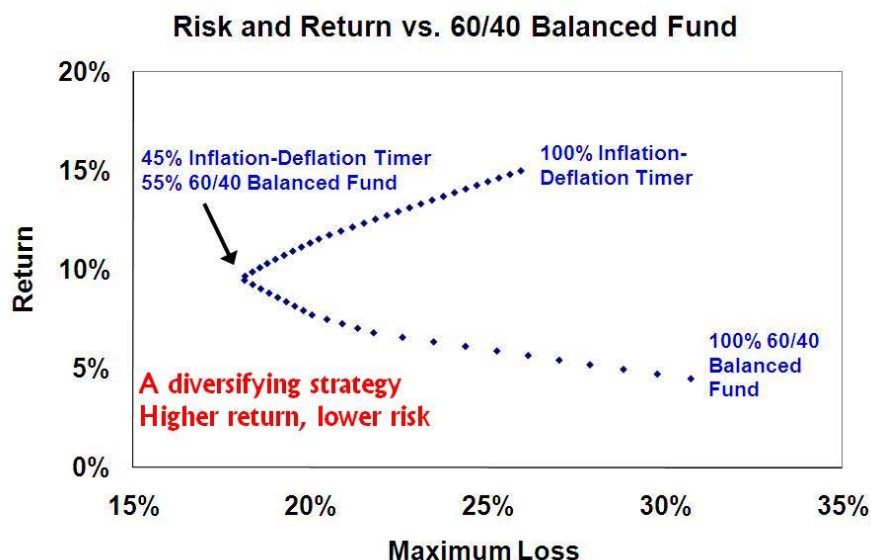
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## Case study - the moderate risk investor

Let's look at our third hypothetical investor who passes away and his portfolio is distributed to an heir. Let's call this investor "Mr. Heir" and assume he is in his 40s and in mid-career. Again, MPT and standard asset allocation techniques would put Mr. Heir into a moderate risk bucket, with a balanced fund as the most appropriate solution (60% stocks and 40% bonds).

As the chart below shows, the Inflation-Deflation Timer model added considerable value compared to a 60/40 balanced fund portfolio. The minimum risk portfolio is a 45% allocation to the Inflation-Deflation Timer model and 55% allocation to the 60/40 balanced fund portfolio.




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*Advisors who adopted such a solution would have had little trouble gathering assets at the end of 2008 instead of having difficult conversations with their clients.*

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## Bottom line

Here is the acid test. While the 60/40 fund was devastated in 2008, the Inflation-Deflation Timer model performed well during the Great Bear Market of late 2008/early 2009. Advisors and wealth managers who adopted such a solution would have had little trouble gathering assets at the end of 2008 and into 2009 instead of having difficult conversations with their clients.

## Evolution, not revolution

Today, current wealth management business models are threatened by a number of competitive forces. Investors can use low-cost ETF solutions to build do-it-yourself static buy-and-hold portfolios, which bypasses the investment advisor. Moreover, high-net-worth investors are demanding more of their advisors in the wake of the current climate of economic fragility.

Successful wealth management professionals can adapt to changing conditions by evolving their business model with the addition of dynamic asset allocation to their toolkit. We would characterize such a change as evolution and not revolution. The old framework of financial planning, financial advice and buy-and-hold are not totally dead.

The addition of a measured level of dynamic asset allocation to a portfolio can significantly add value to an investor's risk and return profile.

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*People are our strength.  
Creating value is our  
goal.*

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### **About the Author**

*Cam Hui has been involved in the equity markets since 1980, both on the buy side and the sell side. Most recently, Cam was a Relative Value and Technical Research Analyst with Merrill Lynch in New York. He is currently living in Vancouver, British Columbia with his family. He maintains his interests in the markets through his investment blog:*

*<http://humblestudentofthemarkets.blogspot.com>*

*Cam serves as a member of Qwest Investment Management Corp.'s Board of Advisors.*

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## **Qwest Investment Management Corp.**

Qwest Investment Management Corp. ("Qwest") is an investment management firm which specializes in identifying, structuring and managing investment products. Qwest is currently focused on investments in the natural resource sector.

Qwest's executive management team has over 100 years of combined experience in corporate and financial product structuring and investment management which provides the team with the skills required to evaluate and profitably manage the risk and rewards inherent in the capital market industry.

Qwest is the parent company of Qwest Investment Fund Management Ltd., a company which provides investment advisory, portfolio management services and fund management services, and Heritage Bancorp Ltd., a company which provides administrative services.

## **Interesting Facts About Qwest**

- Specialists in investing Canadian capital in the natural resource sector;
- Throughout their careers, members of the Qwest management team have completed hundreds of financings and have raised and/or invested billions of dollars of capital in the natural resource sector;
- Resource company flow-through specialists;
- Recognized for our experience in Canadian oil and gas sector;
- Top quartile oil and gas-weighted flow-through portfolio performance.

## **Calgary-Based Portfolio Management**

From our Calgary, Alberta office, Qwest's portfolio management team is strategically situated to conduct in-depth research and analysis of Canada's oil and gas companies. Our portfolio management team is led by Ms. Jennifer Stevenson who brings over 20 years of oil and gas industry experience and a strong track record in financing and investments in oil and gas companies.

The portfolio management team's additional strengths include:

- first-hand knowledge and insight into the oil and gas sector (i.e. situated in the heart of the Canada's oil patch)
- years of experience working with management teams to finance their oil and gas companies
- specialization in the research and analysis of Canadian mining companies
- considered to be leading experts in the oil and gas sector by Canada's most reputable media outlets

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