Newsletter

WINTER 2010

INSIDE

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Lessons learned, lessons forgotten

The next CFA Victoria Financial Markets Forecast Dinner will be here soon! Book early or miss the boat.

Photo courtesy of CFA Institute

(upper left): How can you make sense to your clients? Jean Brunel, editor of the Journal of Wealth Management, recently explained at a CFA Victoria luncheon that this is not so difficult if you ask the right questions. (bottom): How severe is the sovereign debt crisis? Speaking at the CFA Institute Annual Conference, author Niall Ferguson explained that our current situation is dire, but hardly unprecedented.

President's Letter

Andrew Shortreid, CFA

THE AUTUMN MONTHS HAVE BEEN BUSY ones for the new board of CFA Victoria, and the team is moving forward on many fronts. It's an exciting time of year for us, one in which we collectively lay out our goals and objectives, map out resource requirements, and put together our budgets and action plans. We're fortunate to possess an abundance of creativity and energy at the board level, and it always shines through during our annual society development exercise.

The board held this year's annual strategic planning session on October 6th, and we were pleased to welcome Chip Deale, Head of Society Relations at CFA Institute, as our facilitator for this session. As happy as we are with the Society's achievements to date, it's clear to each of us that we need to continually push the boundaries of our member and candidate services, and build stronger relationships within the broader community. Some great ideas came out of this planning session and we will be implementing many of them in the coming year.

In addition to our new and ongoing society-funded initiatives, we are also able to compete for an allocation of "special project" funding from CFA Institute. Recall that last year we applied for funding to implement an external financial review program and to do an overhaul of our financial accounting / reporting process. The review is presently ongoing, as our treasurer, Patrick Ngo, explains in his Report from the Chair on page 7 of this issue, and the reviewed financials will form part of our first ever annual report, to be delivered in early 2011.

With respect to this year's funding application, our package detailed a project that I can best sum up as a three-year public relations overhaul. Our plan is to work with a local consultancy to refine how we approach and communicate with local stakeholder groups, including employers, educators, and the investing public. If anyone is interested in being part of this project, or has relevant insights to share, please let us know at info@cfavictoria.com.

Great ideas came out of the planning session and we will be implementing many in the coming year

Turning to programming matters, we're happy to announce, in conjunction with the other Canadian Societies, the development of a National Webcast Program. A while back, the Canadian Societies as a group received a Collaboration Award at one of the global CFA Leadership Conferences. The prize money received as part of the award is being put towards the cost of delivering a series of webcast programs specifically tailored to Canadian Charterholders.

These webcasts will range from standard one-hour specialty events to broad multi-day asset management conferences, and will be available to CFA Victoria members at little or no cost. Most of the content will originate from the Toronto Society, who has promised us that they will try to avoid any start times at 8:30 AM EST!

Last, I want to ensure that everybody is aware of our upcoming 3rd Annual Financial Markets Forecast Dinner. This year's event will be held Thursday, January 20th, 2011 in the Pacific Ballroom of the Marriott Victoria Inner Harbour Hotel.

This year's forecasters will be Hank Cunningham, Fixed Income Strategist with Odlum Brown, Robert Spector, Chief Economist with McLean Budden, and Frank Mersch, Co-CIO of Front Street Capital. We urge you to book your seats without delay (see the notice in this issue for details) as the Dinner has been sold out each of the past two years. We're happy to announce that we've been able to keep our ticket and table prices unchanged from previous years. What's more, this year we will be welcoming Laughing Stock Vineyards (www.laughingstock.ca) as our wine sponsor, and they will be pouring their 2007 Portfolio!

That's my update for this edition of our Newsletter. Here's wishing each of you a safe and fulfilling holiday season, and the best of beginnings to 2011. Cheers! ■

Share your knowledge and insights with readers of the CFA Victoria Newsletter

Do you have a story idea or a topic that will interest and inform CFA Victoria members? Send an e-mail to let us know what you would like to see in the newsletter or if you want to write something yourself.

Potential topic areas include, but are not limited to:

- Industry developments
- Investment themes
- Profiles of notable members

If you have an idea for an article, please send it to:

Gord Walker, CFA
Gordon.Walker@RBC.com

History in the Making:

Lessons and Legacies of the Financial Crisis

WHAT'S FASCINATING IS THAT CRISES LIKE THIS ARE NOT NEW, BUT ARE AS old as the bond market, and the bond market is very old — sovereign debt markets are much older than equity markets, dating back to 12th and 13th century northern Italy when the Italians made the great discovery that it was easier to get people to lend money to the government than to actually pay taxes.

Thus providing a bit of historical perspective, best-selling author Niall Ferguson (*The Cash Nexus* and *The Ascent of Money*) sought to give his audience at this year's CFA Institute Annual Conference a deeper understanding of the global financial crisis through insights into the ongoing sovereign debt problem. At the time of Mr. Ferguson's presentation in May, Greece's sovereign debt crisis was at its peak. Now that attention has moved on to Ireland (with Portugal and Spain waiting in the wings), this is a good time to revisit his observations.

Mr. Ferguson began by commenting that we are experiencing a world turned upside down: it used to be emerging markets that had crises of public debt, now it is the big rich countries that have debt problems, with the average public debt to GDP ratio of the G-20 Advanced countries rising to above 100%. He noted that Ken Rogoff, who also spoke at the Conference, has said that a ratio of about 90% is the threshold above which developed economies are at risk of serious economic problems.

The reasons for this extraordinary public debt explosion are clear. First, there are the bailouts and extraordinary measures occasioned by the global financial crisis. Second, there has been a calamitous decline in government revenues due to the Great Recession. Mr. Ferguson pointed out, though, that most developed countries have a structural deficit that has been years in the making as western democracies have refused to raise as much in taxation as they spend on various public services and transfers. "For years, I've been arguing that this is the Achilles heel of the western economic model."

Mr. Ferguson emphasized that what we've seen happen to Greece is something that can happen to any economy that ends up with excessive public debt, and, again echoing Mr. Rogoff, he pointed out the non-linearity of this kind of progression. "When sentiment turns against you and your credibility is called into question, you very quickly find yourself in a tailspin, a kind of death spiral, because the rising cost of interest payments causes the debt to become uncontrollable."

Looking at some historical examples, Mr. Ferguson first compared British and French bond yields from 1752 to 1814, a period of great conflict between the two nations. Looking at the varying spread between the British and French borrowing costs, he pointed out the clear impact of negative political news, especially military news, on default-risk and inflation-risk premia, saying that "war and revolution are the traditional causes of public debt crises". (Incidentally, in Mr. Ferguson's view, Britain won the "great contest" partly because its wider and deeper bond market allowed it to finance a huge navy and global empire at significantly lower cost than the French could.)

For years, I've been arguing that this is the Achilles heel of the western economic model

The pattern repeats itself. As Mr. Ferguson put it, while discussing yield spreads over UK consols for 19 countries from 1870 to 1939, "Financial history in large measure is a succession of sovereign debt crises." Notably, the big blow-out countries in the 1870s included Greece, Mexico, Uruguay and Argentina, and Mr. Ferguson noted that unlike lightning, "Sovereign debt crises keep on striking the same places over and over again".

Mind you, not just the usual suspects are vulnerable to public debt crises. Mr Ferguson reminded his audience that over the years "nobody has an unblemished record, not even the UK."

Fast forwarding to the current crisis, Mr. Ferguson showed his audience debt-to-GDP projections to 2040 from the Bank of International Settlements for Portugal, Ireland, Greece and Spain (the PIGS). Even under the best scenario, the ratio does not fall below 100% for any of these countries. "All this is very shocking," he told his audience, "until you realize that the situation in the United Kingdom and the United States is, in fact, worse." The best case scenario sees the ratio rising to 300% for the UK by 2040 and to 200% for the US. Hence, Mr. Ferguson's next slide boldly proclaimed, "PIGS 'R' US". He went on to say, "We can't possibly point the finger of scorn at Greece or Portugal if our fiscal position is even less sustainable than theirs."

Mr. Ferguson provided further evidence that the UK and the US were "out-pigging the PIGS" in the form of what he called his Metrics of Doom. "The situation is extremely serious in both of the big English-speaking economies, and what is quite interesting is how few people want to confront that reality, particularly in the decision-making bodies that are responsible for fiscal policy."

What causes public debt crises? Mr. Ferguson listed three factors -- excessive debt, excessive interest payments, and excessive reliance on foreign capital -- noting that the last of these was the key one to watch when assessing sovereign credit risk. He added that this was something the US should worry about since "a large proportion of US treasuries have been bought by our principal strategic rival, the People's Republic of China."

Digging deeper, what really causes these crises? Again, Mr. Ferguson offered three causes: economic weakness exemplified by low productivity growth and low returns on private sector investment, political weakness where excessive expenditure and insufficient taxation are politically determined, and irrational exuberance because investors keep forgetting to learn from history. Regarding the second cause, Mr. Ferguson took the opportunity to paraphrase Milton Friedman's description of inflation by saying, "Crises in

Continued on page 6.

Psychological Influences on Investor Decisions

— *A Behavioral Finance Approach to Strategic Asset Allocation*

IN SEPTEMBER, CFA VICTORIA HAD the pleasure of hearing Jean Brunel, editor of the *Journal of Wealth Management* and a trustee of the Research Foundation of CFA Institute, discuss wealth management at a Society luncheon presentation.

Mr. Brunel began by telling his audience that an important milestone had been reached, meaning the recent publication in the *Journal of Quantitative Finance* of a paper by Harry Markowitz and Meir Statman (and two others); in this paper, they had integrated features of goal-based allocation and traditional mean-variance theory and showed a mathematical equivalence between the two approaches.[1] Mr. Brunel himself had earlier tried to write a paper showing that behavioral finance might not be theoretically optimal, but "it was close enough for government work", and he confessed to now feeling "a sense of well-being that comes out of people like that saying you've been on the right track." He expects to see a lot more people looking at the application of behavioral finance now that it has the imprimatur of one of the two fathers of modern portfolio theory.

A second thing that had happened since Mr. Brunel last spoke to CFA Victoria in 2006 was the global financial crisis. Among clients, he had noted that "those families that had taken the time to go through behavioral design in their strategic asset allocation lived through the upheaval of 2008 in a way that is inordinately better than for families that did not." He believes that behavioral finance is useful because it makes us, both clients and advisors, really connect to asset allocation.

One shortcoming of the investment advisory industry in Mr. Brunel's eyes is that practitioners fail to focus on how the individual client views the investment problem and they overwhelm clients with jargon. As he put it, "Most people in our industry when asked the time will tell their clients how to make a watch!" His solution: "Instead of "thinking of ourselves as financial engineers and all those things that make us look good, I have started to think of myself as an interpreter."

As an interpreter, he has two goals: interpret in capital market terms what clients are telling him, and interpret back to clients what is available to them through capital markets.

To achieve the first goal, he has had to change his approach. "I have stopped asking clients about their needs. I now ask them about their dreams and nightmares." Meeting a new client, he might now ask, "You have all of this money, what do you want this money to do for you?"

Regarding the second goal, Mr. Brunel noted that clients usually are not interested in capital market history or anything of that nature. Instead, their curiosity is more pragmatic: "they are interested, if they trust you, in knowing what is reasonable and what isn't."

The fundamental idea behind goal-based allocation is to look at what a client really wants, anticipating that each client usually wants more than one thing, and then providing a way to identify the nature or amount of money needed to meet each goal at a particular time.

Based on his experience, Mr. Brunel said that for many families the biggest nightmare is having to change their lifestyle. He added that one of his newest clients was slightly more specific, saying that he feared having to change his lifestyle "in a way that my neighbors will notice."

To illustrate, Mr. Brunel gave the example of a client whose goals included that "no descendant of my father will ever lack for a proper education." Another goal of the client was that "no descendant of my father will ever lack proper medical care", not a small matter, Mr. Brunel pointed out, if you live in Dubai or other parts of the world where proper medical care often involves hiring a private jet. As an "interpreter", he had to translate what those goals mean in dollar terms.

As this shows, in addition to uncovering a client's personal needs, an advisor often has to discover what the client wants for his or her children or grandchildren; that is, dynastic goals. Philanthropic goals can also be important, especially for clients in Anglo-Saxon countries Mr. Brunel noted.

Once this discovery process is complete, the next task is to construct sub-portfolios to meet each of the client's needs given the constraints related to each need. Depending on goal priority, more risk should be assigned to the lower priority goals to ensure the key personal goals are the ones least likely to be missed. Mr. Brunel noted that this was Statman's most important contribution to behavioral finance: not that we all have various goals, but that we need different risk profiles for these different goals.

To show how the starting point of behavioral finance differs from that of traditional finance, Mr. Brunel asked how many of the audience had ever bought insurance. And how many had ever bought a lottery ticket? Those who had done both, he said, were idiots from a traditional finance perspective (including himself among that group). He went on to explain, that in behavioral finance terms we are not really idiots. There is a part of us that says, "Hey, I've acquired all this and I'd hate to lose it" and another part that says, "If I could get more, I wouldn't mind it." In other words, we have two goals with different risk profiles.

Overall, though, the attributes that characterize humans do not make us well suited for dealing with capital markets. Mr. Brunel pointed out that behavioral finance has shown that we tend to adapt to minimize our downside and are lousy decision-makers. One thing we are very good at, however, is saying what we will do or want to do. This is the key to his process for serving clients.

That said, Mr. Brunel pointed out that behavioral finance does not take one to a different place with respect to asset allocation compared to traditional finance; it gets you to the same place by a different path. Notably, his approach generally leads to a 60:40 equity to fixed income allocation as is typical in the portfolios of institutional investors following conventional theory.

In the current market environment, a behavioral finance approach like Mr. Brunel's can be beneficial in three ways.

VICTORIA CFA SOCIETY

3rd Annual
Financial Markets Forecast Dinner
Thursday, January 20, 2011 | Victoria Marriott Inner Harbour

You are cordially invited...
The 3rd Annual Financial Markets Forecast Dinner, hosted by CFA Victoria.

Thursday, January 20, 2011
The Grand Ballroom
Victoria Marriott Inner Harbour
728 Humboldt St | (250) 480-3800

Cocktail Reception begins at 5:00pm

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First, such an approach makes it easier to deal with unusual conditions. Mr. Brunel said his approach makes it easier to associate parts of a portfolio with the goals the sub-portfolios are designed to meet. For example, his clients came through the recent crisis reasonably well because they knew ahead of time that a portion of their assets was aimed at the long term and would go up and down in value depending on market circumstances. He did not have to talk to his clients about relative returns, which is something he avoids because he has been told once too many times that "You don't eat relative returns."

Second, being able to vary the definition of each 'bucket' (sub-portfolio) provides flexibility in balancing client goals and fears and in modifying time horizons. To Mr. Brunel, capital markets are all about preserving wealth, while entrepreneurial ventures are about creating wealth. According to him, the attitude of many clients can be summed up by, "Since there's no chance I'm going to make another fortune in this lifetime, I'm going to take growth with a grain of salt."

Third, Mr. Brunel's approach helps clients relate to their portfolios and what they contain. For example, a client wondering why his or her portfolio contains commodities might be told by his advisor that they represent a non-correlated asset, but the client probably cares little about correlation. In Mr. Brunel's experience, that is simply how some clients think. His response to such a question, say for an American client concerned that economic growth in the United States would lag that of the rest of the world for a long period of time, would be to say that the expected global growth and demand would cause commodities to rise in value, and without talking about correlations, real returns, etc. he could convince the client that this was something he might need to have in his portfolio.

Summing up, Mr. Brunel put it succinctly: "It's all about making sense to our clients, and therefore having a better relationship with them, and allowing them to have a better relationship with their portfolio." ■

[1] Portfolio Optimization with Mental Accounts; Sanjiv Ranjan Das, Harry Markowitz, Jonathan Scheid, Meir Statman

History in the Making *(continued from page 3)*

public debt are always and everywhere a political phenomenon."

What comes next? Mr. Ferguson explained that in theory there are six ways out of a public debt crisis: a higher GDP growth rate, a lower interest rate on the public debt, a bailout from an external source, fiscal pain through increased taxes and/or a cut in public spending, increased recourse to seigniorage by the central bank (e.g., inflation), or default in its various forms. He immediately eliminated the first three since one consequence of a mountain of public debt is to lower the trend growth of GDP, especially as inflation premia in nominal bond yields rise in anticipation of future inflation which pushes real interest rates higher. Similarly, interest rates on public debt rise as investors grow nervous about the possibility of default, which can create a self-fulfilling prophecy especially if the term structure of the debt is short. A bailout is only an option for a small player: as Mr. Ferguson asked, "Who bails out the US?"

That leaves cutting and taxing, printing, or defaulting. The only nation that has been able to exclusively cut and tax its way out from under an excessive public debt that Mr. Ferguson knows of is the UK, which was able to reduce its debt-to-GDP ratio from 250% immediately after the Napoleonic wars to 70% in 1914 on the eve of the First World War. Of course, Britain during this period had the advantages of the industrial revolution, a global empire, and an undemocratic franchise that meant the propertied classes were over-represented in Parliament.

The more likely outcomes going forward are printing and defaulting. Nations with monetary sovereignty and own-currency debt usually resort to printing; otherwise, default becomes the likely outcome.

"One way to think of our present predicament," Mr. Ferguson said, "is that we have the public finances of a world war without the world war." Consequently, it is useful to consider how the US and the UK reduced their debt burdens following the Second World War. From 1946 to 1991, the total debt reduction (as a percentage of GDP) was 90% for the US and 212% for the UK. For the US, roughly half of the reduction was accounted for by inflation and half by growth. For the UK, inflation accounted for the entire reduction.

What does this imply for investors? Showing that real bond returns were negative through the 1940s, 50s, 60s, and 70s, Mr. Ferguson said that bondholders should beware. He also warned of increased currency volatility. "In a fiat money world, in which everybody has an incentive to reflate and depreciate, we are going to get a series of quite significant moves in developed markets exchange rates. It's possible that there just won't be a fiat money that deserves the name 'reserve currency' five years from now."

Is there a chance that the US or UK could match Britain's remarkable 19th century success at reducing its public debt burden without resorting to inflation or default? Not in the mind of Mr. Ferguson, who stated "I do not see any institutional possibility that the UK today or the US today can repeat that performance."

[A webcast of this presentation from the CFA Institute Annual Conference can be viewed at http://www.cfainstitute.org/learning/products/multimedia/Pages/30940.aspx] ■

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Treasurer

Patrick Ngo, CFA

CFA VICTORIA SOCIETY'S FINANCES REMAIN IN EXCELLENT SHAPE. WITH continued ongoing support from you, our members, as well as additional funding from CFA Institute, we have been able to deliver a wide range of programs, events and activities to our members and candidates while staying within our financial means, and we expect this to continue for the foreseeable future.

When I took over as treasurer in early 2009, the Society was in the midst of transitioning from a June fiscal year-end to a September fiscal year-end. Having the fiscal year-end set to September coincides with CFA Institute's fiscal year-end and helps to align our Society's financial planning and management with those of the Institute.

As the volume of our Society's transaction records keeps growing and record-keeping becomes increasingly complex, our historical Excel-based tracking practice is quickly proving inadequate. Last year, as noted in our Technology Chair's report in the previous Newsletter, we have started to use PayPal as an option in collecting revenue from our Program Events. This, in addition to an increasing demand for budgeting and planning, has prompted me to look at alternative options for our Society's financial record-keeping needs. Starting in fiscal year 2009/10, I have begun using GnuCash, a free, widely supported, open-source accounting software application. The transition to the accounting software took some time, but everything now seems to be in place and in good working order.

The next challenge to be addressed is automating the record keeping and coordination of transactions between PayPal and our accounting software. While there are bolt-on options available that provide this capability for GnuCash, I am strongly considering switching to a more mainstream integrated accounting product such as Quickbooks.

For fiscal year 2009/10, the Society has engaged Hayes Stewart Little & Company, Chartered Accountants to perform a Review Engagement for our Society. The accountants will review the Society's financial statements to determine whether our Society's financial statements are prepared in accordance to Canadian generally accepted accounting principles. This Review Engagement is currently in progress and I expect to be able to report the findings to our membership by the end of 2010.

CFA Victoria currently has an available cash balance of around $50,000. I am contemplating investment options for the Board to consider for this fiscal year. I will also be developing investment policies for our Society going forward. The goal is to have sufficient cash on hand available for Society use while investing the excess for future needs.

Finally, for fiscal year 2010/11, I will be working with the Board to develop a comprehensive budget for the Society's activities for the upcoming year. The intent of this activity is to better plan our year in a more financially responsible way. Many significant initiatives are being planned this year, including an increased focus on public awareness.

I welcome any suggestions from our membership on investment alternatives that are in the best interests of our Society. As well, if you have a strong desire to help improve our Society's financial practices in any way, I would enjoy hearing from you. ■

The intent of this activity is to better plan our year in a more financially responsible way

CFA Victoria Mission

CFA Victoria promotes the highest standards of integrity, professionalism and ethical behaviour within the investment industry, and encourages professional development through the CFA Program. We facilitate the open exchange of information and opinions between members of Victoria's investment community.

Member Report

Welcome New Members

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Vice President Treasury, Credit and Risk Management
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Lincoln Jiang
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Raymond James

Shane Leech-Porter, CFA
Research Analyst, Research and Risk Measurement
bcIMC

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It's important to keep your contact information up to date and let others know where they can reach you.

Please let us know if you're changing jobs or making any other move.

Send your information to Gordon.Walker@RBC.com with "Members on the Move" in the subject line.

A Call for Volunteers

CFA Victoria depends on volunteers to enable all of our activities and initiatives. You can help by applying your time and skills in any number of ways. It's a great way to meet others in the local financial community and show off your talent.

Interested? Of course you are!
Contact us at Info@CFAVictoria.com to find out how you can get involved.

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