Building Portfolios in the New Economy:
Strategic Asset Allocation

Brian D. Singer, CFA
Partner, Head of Dynamic Allocation Strategies Team

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Investment Analysis Framework

A framework refined through 30 years of experience
The Modern Era

Relative Growth of S&P 500 (inflation adjusted)

Past performance is not indicative of future results.

William Blair
Asset Class Fundamental Value & Price Discrepancies

Key output of investment process: Expected return (8-year horizon, annualized)

As of 4/30/2013

Source: William Blair, Investment Expectations

S&P, MSCI, Barclays Capital, Bank of America Merrill Lynch, JP Morgan, 6 month LIBOR

Expected return information is intended to illustrate potential expectations for various capital markets and should not be considered representation of past or expected future returns for any William Blair investment strategy or product. Expected returns are provided are for informational purposes only and not intended to be reflective of results a person should expect to achieve. Actual results will vary and may be higher or lower than the values indicated. Differences between expected and actual results may be exaggerated in volatile market environments. There is no guarantee that expected return indicated will equal the actual return for any capital market. The expected return of an asset reflects the average probability distribution of possible returns and is based on the convergence of price to value (over an 8-year period for equities and 5-year period for bonds) plus income accruing to an investor.
Disciplines to Frame Themes in a New World Order

- Geopolitical Analysis
- Macroeconomics
- Game Theory/Strategic Decision Theory

Macro Themes
## Game Theory in the New World Power Order

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**Pre-Cold War (1900 – ~1950)**
- Multi-player
- Players evolve
- Incomplete information
- Mistakes more probable, less costly
- Unstable

**Cold War (~1950 – 1980s)**
- Mutually Assured Destruction (MAD)
- Mistakes improbable, with huge cost
- Stable

**Post-Cold War (1990s – Present)**
- Multi-player
- Players evolve
- Incomplete information
- Mistakes more probable, less costly
- Unstable
U.S. Bargaining Powers

Primary Objective
- Find and unify House around a fiscal strategy that both tails can support

Secondary Objective
- Achieve spending cuts

2014 Midterm wins

Legacy

Party Polarization

R = 0.93

[Graph showing the distance between the parties in the House and Senate from 1879 to 2007, with a correlation coefficient of 0.93.]
112th (2011-2012) Congress

[Graph showing the distribution of Liberal-Conservative scores for the 112th Congress, with labels for House and Senate differences, and individual scores for Pelosi, Obama, Lieberman, Biden, Kemp, Portman, Rubio, McCain, and Ryan.]

Blue = House Democrats
Dark Blue = Senate Democrats

Red = House Republicans
Dark Red = Senate Republicans

Density

House Difference

Senate Difference

Left Tails

Right Tails

POLARIZED AMERICA / VOTEVIEW.COM
Integration and Connectedness
Trade and capital flows can alleviate global stress

**Distribution of Population in Developed and Developing Economies**

*More developed regions*

- **Consumers**
- **Savers**

*Less developed regions*

- **Consumers**
- **Savers**

**Trade Flow:** Purchases of goods & services send currency to emerging markets

**Capital Flow:** Asset purchases (capital investment) send currency back to developed markets

## Wealth Creation Enablers

<table>
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<tr>
<th>Enabler</th>
<th>Source</th>
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<tbody>
<tr>
<td>Rule of Law</td>
<td>Heritage Foundation, Cato Institute, Fraser Institute</td>
</tr>
<tr>
<td>Legal System</td>
<td>Cato Institute, Fraser Institute</td>
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<tr>
<td>Labor Flexibility</td>
<td>Heritage Foundation, Cato Institute, Fraser Institute</td>
</tr>
<tr>
<td>Entrepreneurship</td>
<td>Heritage Foundation, Cato Institute, Fraser Institute</td>
</tr>
<tr>
<td>Corruption</td>
<td>Transparency International, Heritage Foundation, Cato Institute, Fraser Institute</td>
</tr>
<tr>
<td>Trade Freedom</td>
<td>Cato Institute, Fraser Institute</td>
</tr>
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Investment Themes

• Fiscal Policy [profligate or uncertain (-)/prudent or stable (+)]
  The degree to which we believe the market will focus on short-term fiscal improvement or deterioration and/or on long-term fiscal solvency.

• Demographic Dependency [dependent (-)/independent (+)]
  The degree to which we believe the market will focus on dependency ratio-related demographic issues.

• Leverage [excessive or decreasing (-)/appropriate or increasing (+)]
  The degree to which we believe the market will focus on liability encumbrance.

• Financial System Liquidity [insufficient or uncertain (-)/sufficient or stable (+)]
  The degree to which we believe the market will focus on short-term systemic financial sector liquidity.

• Central Bank Policy [profligate or uncertain (-)/prudent or stable (+)]
  The degree to which we believe the market will focus on Fed, BOE, ECB or BOJ balance sheet size or composition.

• Regulatory Direction [restrictive or uncertain (-)/unrestrictive or stable (+)]
  The degree to which we believe the market will focus on the change in or uncertainty with the regulatory environment (whether property rights, political fiat, tax, labor flexibility, trade flexibility, etc.).
Multi-Asset Approaches

- **Investment Style**
  - Active
  - Passive

- **Allocation Style**
  - Asset Based
  - Risk Based

- **Global Tactical Asset Allocation**
- **Dynamic Risk Capital Allocation**
- **“Classic” Static Balanced**
- **Risk Parity or “Risk Balanced”**
Conclusions

Challenges of the future

- Geopolitics will involve many leadership “games” $\rightarrow$ mistakes likely
- Insolvency, bloated central banks, demographics & weak leaders $\rightarrow$ high & volatile inflation
- Constitutional, parliamentary & direct democracies will be tested $\rightarrow$ leadership rewarded

Fundamental analysis is necessary, but no longer sufficient for superior performance

Superiority requires other disciplines

Accept randomness & mistakes

*We invest in claims on economies, not countries. With free exchange, markets are hard to suppress.*