

THE FAMILY WEALTH ALLIANCE | FALL FORUM 2009

Is It Different This Time?

GREYCOURT

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Greycourt White Paper No. 46

It's very difficult to think clearly during a crisis

- White Paper #46 tries to gain perspective by looking back at similar crises over the past century or so
- Barings Bank Crisis of the late 19th century (central bank policy)
- History of stock exchanges from the 16th century (policy errors)
- Collapse of brokers and savings banks in 20th century US (creative destruction)

Conclusions of the paper

- Free market principles will continue to dominate the commercial nations of the world
- In the short-to-intermediate term, it is the public conduct of central bankers matters
- Regulatory mistakes will be made, but they won't be huge or persistent

Conclusions of the paper

- The destruction of fragile business models is not all bad
- During periods of extreme market sentiment, it is very important to remember that *we can't know what we think we know*

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Things that Assuredly Will Be Different This Time

Coming soon to a world near you:

- A serious focus on executive compensation
- Not just in the financial sector
- Harkening back to Adam Smith: agency issues in the corporate form
- More broadly, a laser-like focus on risk at large financial firms
- Antagonism among the public and our future employees

Also coming soon to a world near you:

- A serious review of MPT and its real-world applications
- Buy-and-hold is dead
- Buy-on-the-dips now limited to day traders
- “Endowment model” is on life support
- Focus on liquidity
- Focus on tail risk

And, finally, coming soon to a world near you
and over-staying its welcome:

- The United States Government

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Modern Portfolio Theory: Après le Deluge

Complaints About MPT

- “Diversification never works when you need it.”
- But diversification isn’t even an MPT idea
- MPT has attempted to quantify the value of diversification
- MVO is just a more efficient form of diversification

Complaints About MPT

- “You never told me my portfolio could lose so much.”
- This isn’t a problem with MPT, but a problem with how advisors used MVO to design portfolios and to model outcomes
- The assumption that outcomes are evenly distributed
- The assumption that there are quantitative answers to risk assessment

Complaints About MPT

- “MPT encouraged excessive risk-taking.”
- But (again) this isn’t a problem with MPT, but a problem with how poorly banks and traders understood their own models
- And also how senior executives at global financial firms completely misunderstood the risks their institutions were taking
- Are global financial firms governable at all?

Deconstructing MPT

- Like it or not, the entire financial world runs on MPT
- Options pricing model
- Derivatives
- Trading algorithms
- Portfolio design
- Risk premia
- Etc., etc.

Deconstructing MPT

- Weaknesses in MPT are almost always weaknesses in the application of fundamentally useful theories
- Too many people forgot this simple fact: it's a theory, folks

Deconstructing MPT

- We need better tools for modeling for tail risk
- We need alternative approaches to portfolio design
- We need better tools for identifying market and economic bubbles
- MPT's time horizon is different from investors' time horizons
- By the way, where was MPT's Evil Twin, Behavioral Finance?

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Sustainability

Is Your Model Sustainable?

- Except perhaps for the technology industry, the financial industry is the most innovative sector
- Firms in our business must reinvent themselves @ every 5 years
- Even “57% of [SFOs] expect to change ‘substantially’ over the next decade.” Source: The Alliance

Is Your Model Sustainable?

- But corporate cultures are notoriously difficult to change
- Business models may be impossible to change
- Many MFOs and consultants won't survive the retirement of their senior people
- Attracting and keeping talent will be a huge issue, especially for SFOs and low-margin platforms
- Grow-or-die is here

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Trust

Trust is broken

- “I’m better off assuming that all these [advisors] are out for themselves.”
- “I don’t know if I can trust their advice when they were so wrong last year.”
- “Prove to me you’re not Madoff.”

- Source: Barron’s, IPI

Trust is broken

- The trust issue cuts across all platforms: SFOs, MFOs, open architecture, closed architecture, buy side, sell side
- Trust in a particular firm
- Trust in a particular model
- Trust in the advisory industry generally
- Outcomes matter

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Accountability

Investors are demanding accountability

- “Hey, we’re just consultants!”
- The Prudent Investor Rule
- Best practices in the wealth advisory business

Investors are demanding accountability

- What does accountability mean?
- Accountability for process
- Accountability for outcomes
- Impact on products and services

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