Report Back on the 67th CFA Institutional Annual Conference

BACKGROUND

The CFA Annual Conference was held between 4th and 7th May in Seattle, USA. Over 1800 delegates attended the Conference, making it the best attended CFA Annual Conference to date.

The organisation, as always, was excellent as, in general, was the quality of the speakers. The use of parallel sessions enabled over 60 papers and topics to be presented over the 3½ days of the Conference.

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Copies of all papers are available on the CFA Conference website: www.annual.cfainstitute.org

OVERALL THEMES

Given the number of papers presented and the number of speakers, it is difficult to isolate key areas of concern and interest. However, in my own view, these following areas of broad interest were extensively covered at the Conference.

1) Behavioural Finance

The issue of "emotion" influencing financial decisions was discussed in a number of papers.

Carl Richards in the opening Keynote Address to the Conference presented a paper on "The Behavior Gap". Using a populist approach, which apparently makes a big impact on TV and other client facing workshops, he uses simple graphs and pictures to identify where the emotions of the investor or the professional advisor or asset manager can interfere with making sound financial decisions. Mr Richard believes that the behavioural gap measures the difference between the average returns of the market and the returns attained by the individual investor or manager, which is debatable, but certainly worth considering.

Part of Mr Richard's presentation focused on how to identify and to recognize when common mistakes are being made and what measures to take to eliminate the emotional impact on decision making.

Another well attended paper on this subject was presented was by ***Nicholas Barberis, Yale School of Management, - "Behavioural Finance"***.

Mr Barberis' thesis was that until the 1990s, financial research was divided by the single framework of rational agents and expectations. Since the mid-1990s, the behavioral finance framework now suggests that many financial phenomenon are the result of "less than fully rational behavior". As such, psychology has become far more important in academic research on the financial markets.

Mr Barberis identifies three broad ideas currently dominant in behavioral finance.

- ***Representativesness***

  Does a relatively small sample enable investors to extrapolate past returns or past behavior of the market and use this to forecast the future? For instance PE Ratios in the US stockmarkets have fluctuated significantly in past decades as have interest rates, so the current level of these ratios does not forecast the future behavior of the market or the future earnings in the market.

- ***Overconfidence***

  Surveys show that over 80% of investors and investment professionals believe themselves to be above the median, particularly in the accuracy of their beliefs. Of course, mathematically, this cannot be correct as less than 50% of market participants can better the average returns of the market (less than 70% after all costs are taken into account). Overconfidence can also lead to excessive trading, which seldom adds value commensurate with risks and costs over time, or can result in excessive leveraging.

- ***Prospect Theory***

  Risk should be evaluated on the consideration of different possible future outcomes, with the investor deciding how good or bad each outcome will perform and make the investor feel. The probability of an outcome should determine the decision that a rational decision maker will take.

  Studies indicate that investors in stockmarkets that evaluate risk according to prospect theory do better than the more usual expected utility framework method.

2) Retirement Planning

A general theme of a number of speakers was how to handle **post-retirement** funding requirements. Dr Wade Pfau, for instance, in a very well attended seminar, focused on how to make decisions on spending drawdown of assets on retirement. Of course, a key concern in this debate is the **"longevity risk"**. Longevity risk is far greater than investment risk, since the variability of longevity seems to be far greater than the variability of investment returns. This leads to the growing acceptance amongst researchers in this field, according to Dr Pfau, that maximizing wealth to last during retirement can require the management of portfolios **as aggressively as possible**, subject to risk tolerance, to enable retirement capital to meet longevity requirements. Historically, a 50%-75% allocation to equities maximises the probability of success in making retirement funds last. The more cautious approach to managing funds after retirement, appears to be losing ground, given the challenges of facing 30 years in retirement.

This figure of an average 30 years spent in retirement by Americans is now core to the longevity retirement fund dilemma. About one-third of professionally qualified Americans are now employed beyond the age of 70, so clearly their retirement capital is insufficient to fund a comfortable retirement.

The 4% drawdown model smoothed out over the life of the retirement plan was also under attack. The consumption patterns of retirees need to be more closely studied – do they have a similar pattern of consumption over their retirement or does spending vary, particularly with age? In which case, smoothed drawdowns are not the answer.

A strategy discussed in some detail by Dr Pfau and in some other papers presented at the Conference, was to **split** investments in retirement. A portion of the retirement funds pool can be placed in high yielding assets (bonds) and fully drawn down over the first 10 years of retirement. This will provide income to the retiree over that period. The balance of the portfolio can then be invested relatively aggressively, without concern about short-term volatility, to give the retiree an enhanced pool of assets to draw down later on retirement.

Dr William F Sharpe, the 1990 Nobel Laureate, in a wide ranging Q&A session on the investment markets, stated that all of his time was now being spent on the problems of retirement security, retirement income strategies and the need for Government sponsored social security problems. He believed this was the biggest challenge facing Governments and the investment industry in the future.

3) Indexation

A strong theme amongst papers presented, particularly in the parallel seminars, was the growing use of indexation investment methods. For instance, in the exhibition hall, some 30% of exhibitors were index providers of one form or another. This was very different from say 10 years ago.

The indexation focus had three core themes

- ***Benchmark Indices***

  All the major index providers, Russell, S&P, FTSE, MSCI, Dow Jones, etc., had stands at the CFA Conference Exhibition Hall, and most presented papers during the parallel sessions. Of course, the indices provided by these companies are used by ETPs and index tracking mutual funds, etc., to provide products. However, there was an increasing move for the index providers and index calculators to provide "bespoke" indices for institutional investors, pension funds, etc. This enabled the Trustees, or investment committees, of such institutions to establish a proprietary benchmark that matched their risk profiles, members' expectations and performance requirements. Such indices were typically provided at low cost (5bps per year or less). The investor then had to find assets to give exposure to the asset classes covered by the proprietary benchmark indices. Increasingly this multi-asset portfolio was being provided by index tracking ETFs and other tracker products as they could exactly match the composite indices used by the benchmark institutions.

- ***Smart Beta***

  Whilst Smart Beta is still fully transparent and rules based and is used to provide an index, it differs from tracking index tracking products in that the index is not weighted by market capitalization. Smart Beta focuses on specific systemic risk factors, behavioral anomalies or structural inefficiencies that may exist in markets. So they are not used to produce the broad average market returns offered by market capitalization indices.

  No less than eight papers were presented by ETF companies, focusing entirely on, at least partly on Smart Beta, rather than traditional index tracking. To the extent that such beta products can enhance returns, as they specifically target above market average returns or reduce overall portfolio risk they offer investors something different, both transparently and cheaply.

  Dr William F Sharpe, in his session, was somewhat dismissive of Smart Beta, saying that it was only likely to be short-lived.

- ***Blending***

  The topic of blending both active and passive investment management techniques was not the subject of any particular paper, but came up as part of presentations or in discussions with market participants. It would appear that more research and academic work needs to be done on optimal blending strategies. Blending, however, now appears to be the norm in the USA. Arguably, no long-term investor, with fiduciary risks, relies purely on active investment strategies any more.

4) Risk Measurement and Risk Capital Allocation

A number of papers focused on this theme, few adding any new perspectives. However, there does appear to be a growing trend towards a Strategic Asset Allocation Model, whereby overall portfolio volatility is reduced by sticking to a risk adjusted asset allocation process. This approach is often favoured to the tactical asset allocation strategy where emotions, market movements, forecasted changes, etc., play a greater role and lead to greater portfolio churn and trading action.

After index tracking products, companies offering some form of risk management and asset allocation strategy or systems, were the next most prominent exhibitors at the CFA Conference.

5) Hedge Funds

The hedge fund industry was generally under attack at the Conference. In a paper presented at a plenary session **Simon Lack**, author of the best-selling book "The Fallacy of Hedge Funds", highlighted this attack. Starting with the statement that *"if all the funds that had been invested in hedge funds, in past years, had been put into Treasury Bills, the results would have been just as good."*

Apart from enhancing the merits of Treasury Bills as risk free investments, the thrust of Mr Lack's presentation was to calculate the overall performance of the hedge fund industry. Over the period 1998-2013, his statistics indicated that the hedge fund industry had produced a total profit to investors of US30 billion. However, over that same period, the fees, performance charges and other costs of the hedge fund industry had amounted to US$596 billion. The hedge fund industry only makes money for the issuers of hedge funds and not for investors.

The book, plus other recent publicity about hedge managers indulging in insider trading and the constant failure/closure of hedge funds, might be signaling the failure of this industry, at least in its current format.

6) Emerging Markets

Another broad theme of attention at the CFA Conference was general interest in the emerging markets. With Alpha performance from traditional investment classes hard to achieve other than through "alternative investment" assets, the merits of investment in emerging markets was covered in numerous papers and by a number of exhibitors.

Much of the Tuesday morning (6th May), was devoted to emerging markets. **Arjun Divecha**, Head of Emerging Markets at GME, pointed out that the MSCI Emerging Market index was trading at a PE of less than 12, meaning that value could be found in these markets. However, he cautioned against necessarily looking only at low PE stocks in this area, as the flight to quality had meant that higher PE stocks had performed far better than others over the period 2009-2013.

He did, however, single out Russia and its oil and gas shares, which were trading at PEs of 2 to4 times earnings as offering particular value.

Divecha as a stock-picker notably favoured individual shares in picking emerging market exposure, but did concede that the bulk of investment by US and other developed market investors, was through the use of index trackers or structured products when looking for emerging market exposure.

In another plenary session paper, **Clint Laurent**, CEO of Global Demographics Ltd.'s "Tomorrow's World: What Today's Global Demographic Trends mean for Asia and the Global Economy", focused particular attention on Working Age Empty Nesters (WAENs) in his analysis. These people tend to be the highest spenders and significantly influence global consumption patterns. North America, Western Europe and affluent Asia WAENs account for 65% of all consumer spending in this world.

Over the next 10 years, i.e. by 2024, he expected that nearly half of the affluent markets would consists of people over the age of 40, i.e. with the highest consumer expenditure, In China, growth in WAENs and over 40s would mean some 40 billion people becoming middle class income earners over the next 10 years. This is more than for the rest of the world combined.

As economic growth in China became more driven by private consumption expenditure rather than fixed investment expenditure, the economic growth rate in China would probably fall as investment spending has double the multiplier effect on GDP growth than consumption expenditure but this would not matter, the consumer demand for goods and services in China would drive up markets. .

Unfortunately, South Africa was rather left-out of the emerging market interest. Clearly a low economic growth emerging market has little to commend itself to many global investors.

7) Systemic Risk

Given the unclear outlook in the world economies and markets, some attention was given during the Conference to the macro-economic picture and to the risks to the markets.

Sheila Bair, as a Senior member of the US Presidential team that tackled the 2008 financial crises, presented a paper *"Safeguarding the System: Promoting Stability and Minimising Systemic Risks"* in one of the plenary sessions.

Her theme was that rebuilding the balance sheets of banks and other major financial companies had been the key objectives of the world's major central banks and regulatory authorities. This had been done successfully and Bair was relatively confident that the future risks to the financial systems due to the instability of the banking system had been reduced. She did, however, believe that the "too big to fail" idea had to be revisited. Monetary authorities might have gone too far in guaranteeing the solvency of banks, thereby reducing the risk for the bank's management, thereby encouraging risk taking.

The audience, in questions, directed some criticism to this aspect as well as to the very slow and only partial implementation of the "Volker Rule", which sought to separate the administrations of the banks between traditional banking business and risk taking institutions. Bair did indicate her support for the risk taking banks, particularly with regard to derivative trading, credit swaps, etc. being housed separately from traditional banking activities, will completely separate shareholders and management. Bair expressed two areas that still concerned her with regard to future systemic risk:

- The full impact of the withdrawal of quantitative easing (QE); and
- Derivative trading – the lack of supervision or understanding of the risks often concealed in large derivative transactions.

On balance, comparatively little concern was expressed about market valuations and potential instability in the financial system. The 2007-2009 financial collapse was now largely regarded as an historical event, with future systemic risks likely to come from different sources to those of the past. What these were likely to be, there was little indication.