

Event Title:

Steering Your Own Ship

Investment Opportunities and Pitfalls



Panelist: Andrew Rudd
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Four Seasons Hotel
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Event Overview

Andrew Rudd, chairman and CEO, Advisor Software, Inc. and former professor at Cornell University's Johnson School, provided the following remarks as part of a panel discussion, "Steering Your Own Ship: Investment Opportunities and Pitfalls" during the April 24, 2008 Parker Series event at the Four Seasons Hotel, San Francisco. Other panelists included Charles Lee, managing director, Barclays Global Investors and former director of the Parker Center for Investment Research and Sylvia Melikian, principal, portfolio management/operations, MacFarlane Partners. The event was moderated by Jeff Parker, managing director, Parker Family Limited Partnership.

The Parker Series is a set of networking events, sponsored by the Johnson School, that are designed to educate, stimulate, and broaden one's perspective on timely business issues.

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Mr. Rudd:

There is a huge difference between the ways institutional investors -- such as insurance companies, pension funds, and endowment funds -- and retail investors -- that is you and I with our own savings -- approach the management of assets. Those of us who have been involved professionally in advising or managing assets can't fail to be amazed by the chasm that separates the two groups.

Let me explain the difference. Institutions almost always employ a strategy or follow an investment policy (I use the terms strategy and policy interchangeably in this context). It is a top down process: first decide strategy then implement. Typically the strategy will be determined by some form of asset liability analysis, and be expressed as an asset allocation -- so much in domestic equities, fixed income, hedge funds, and so on -- with ranges around the target. This asset allocation will then be implemented by investing in securities, hiring managers, etc.

Retail investors typically don't have a strategy, they have products. This is a bottom up process: invest in products -- mutual funds, variable annuities, CDs, etc. -- and on many occasions they let the asset allocation fall where it may. Retail investors act like the consumers they are, being subject to an avalanche of marketing and branding. What is sad is that first, they pay for the advertising and brand development, and second, most of these products are largely interchangeable. One large capitalization, growth fund is much like all the other large capitalization growth funds!

Let's compare these approaches. For the institutional investor, the use of the target asset allocation has a large number of advantages:

1. it provides a discipline,
2. sets a basis for the control of risk, and
3. gives one a benchmark for assessing the benefit of any divergence from the asset allocation, etc.

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In short, it enables the manager to take the first step into scientific or analytical asset management.

Where does the asset allocation come from? As I said earlier, it usually arises from some form of asset liability study. For example, a pension fund will estimate the benefits that they are contractually required to pay to retirees and the benefits accruing to the current workforce, value them with the help of an actuary, then identify the best mix of asset classes that will produce sufficient wealth -- in other words, identify the portfolio that will best fund the liabilities. Similarly, a university endowment fund will compute the expenses that they will be required to support (typically measured in terms of a spending ratio) and likewise set their asset allocation to best meet the universities' liabilities. One phrase that is frequently used is Liability Driven Investing, indicating that the liabilities dictate the investment policy. You may have heard of the acronym LDI.

Now it so happens, that two university endowments, those of Harvard and Yale, have been popularized as doing extremely well -- in fact so well that as you know, among other outcomes, questions have been asked in Congress and their strategies have been scrutinized by the popular press. Their success has also led to a little known, but dangerous affliction in financial services -- I call it Endowment Envy. It turns out that it's not just Harvard and Yale; Cornell has also done pretty well -- for the last fiscal year, the Cornell endowment produced a rate of return well over 20%.

Ironically, while Universities have done well with their investments, and they employ a large number of business school faculty to spend time researching the institutional problem, almost no faculty have done research on the retail problem. To the extent that they have, it's been to document how badly retail investors do. And, as a group, retail investors do get remarkably poor results. It is as if they sell when they should buy, they trade when they shouldn't, they don't trade when they should, they don't diversify, and they chase fads, and so on.

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Why is this? There are several explanations. Behavioral traits, such as the ignorance of costs, lack of focus, and lack of knowledge are perhaps the main reasons. As a result, when they read these articles about University Endowments, envy takes over. How can I get results like Yale? Unfortunately, the answer is that in general they can't. The problem is that the circumstances that Yale faces are quite different to those that you and I face. They can achieve their results for a number of reasons, which don't apply to us:

1. Universities operate with an imposed discipline of governance, and oversight;
2. They operate at a different scale, which is important for access (information, products, talent, etc.), and in a competitive environment;
3. They can achieve greater diversification.

And now the really key reasons:

4. They have a continuing flow of gifts;
5. They don't pay taxes like you and I;
6. Endowments have a long-term horizon, and are typically regarded as existing in perpetuity;
7. Their goals are reasonably common and straightforward -- and totally unlike those of individuals.

So what should the retail investor do? First, to answer the question: What am I investing these assets for? What's their purpose? What do I hope to achieve with them? For most of us, the answer is twofold: first, to fund my financial commitments -- my mortgage, credit card loans, etc., and second, to fund my life goals, to pay for my aspirations, whatever they may be. These represent the liabilities which I hope to extinguish with my assets.

So I can think of a simple balance sheet -- I call it a household balance sheet. On the right I have the liabilities: these are all the claims that I am either legally or emotionally responsible for, appropriately capitalized. Financial liabilities, the cost

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of living (groceries, gas, etc.), my goals (sending Carl to Cornell, Steve to Sonoma State, funding long-term disability insurance, going on a "round-the-world" vacation, a second home, leaving the grandkids a bequest, and funding a professorship at the Johnson School, etc.). And on the left hand side, I have all my resources: certainly savings and investment accounts, IRAs, 401(k)s, but also social security, my capitalized wage income, life time bonuses, if any, inheritances, etc.

Just as a corporate balance sheet informs us of the state of a corporation, a household balance sheet tells us similar information on the state of a household. We need rules of course, like GAAP accounting, but it is conceptually no different. We get to see a household's net worth -- the excess of the present value of resources over the present value of claims. Can you really afford to build a factory? Can you really afford that vacation home? If I buy that BMW now, I won't be able to allocate those assets to my retirement fund. The balance sheet is the starting point for the sensible, scientific analysis of household financial decisions -- no different from what accountants have long been doing for corporations.

An aside for the engineers and quants among us: what we have done is to build into software the financial objects that represent all the items of interest. These include goals, financial liabilities, human capital, social security, and so on. We do this on an after-tax basis (both going-concern and termination, if necessary), paying particular attention to the capital markets' exposures to the objects. This permits us to simulate out for multiple generations if needed, enabling a judgment to be made as to whether the balance sheet can be financed into the future (so as to eliminate situations where a household is asset rich, but cash poor).

If a household has a viable balance sheet, the next important decision is how to invest its savings. Clearly the magnitude and characteristics of the claims will dictate how to invest the assets. The retail investment problem is none other than the direct application of LDI, Liability Driven Investing, in this case in the presence of taxes. And because of the diversity of goals among individuals (not to mention tax status), the importance of LDI is potentially greater than in the institutional

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arena. Unfortunately, even with this extreme individual diversity, I have yet to meet anyone while giving these talks that has liabilities like Harvard or Yale!

What have we discovered as we have gone through this R&D project? First, there are a great number of nuances, some of which are clearly important. It is a problem that can only be addressed effectively and efficiently with technology, and an advisor or investor willing to invest the time to understand the process.

Finally, two years of research, two years of development, and three patents later, we have a solution to address the individual's investment (and insurance...) problem. We are looking for a few good advisors to command it!