

# Investing In Turbulent Times

Too late for this  
cycle, the horse has  
left the barn

Truthier Title: Preparing for the next disaster.

For entertainment purposes only.

WHB, HII\*, NFCW\*\*, PA\*\*\*

April, 2009

\*Hobbyist Individual Investor

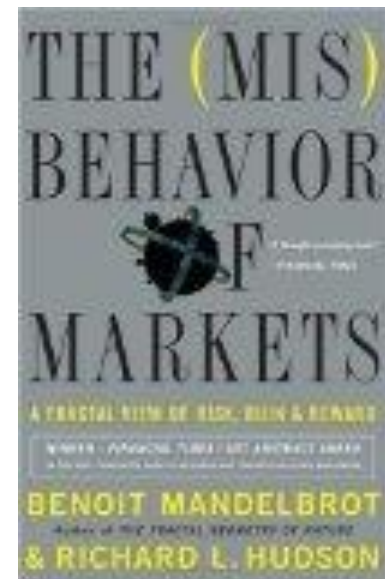
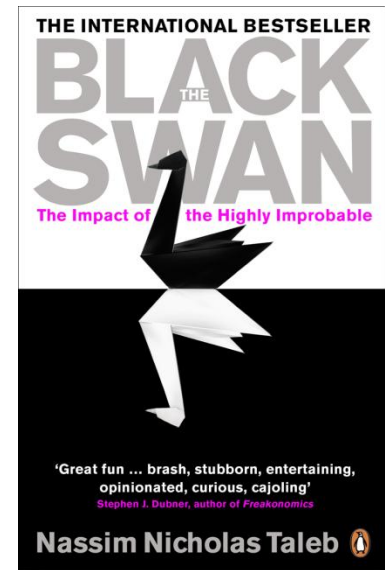
\*\*No Financial Credentials Whatsoever

\*\*\*Perspective Architect

# The Market

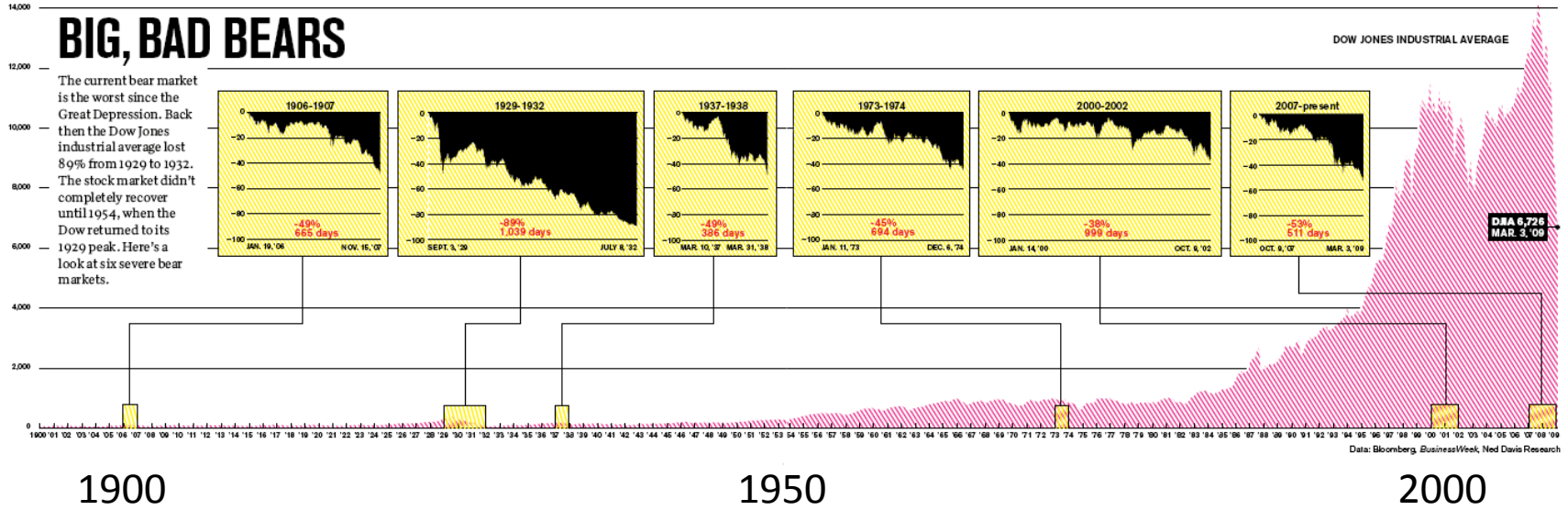
- “Finance is a scary, inherently unstable, essential activity.”  
(Economist Special Report on Finance, 2009)  
[http://www.economist.com/specialreports/displaystory.cfm?story\\_id=12957709](http://www.economist.com/specialreports/displaystory.cfm?story_id=12957709)
- Modern Portfolio Theory (MPT)
  - The basis for investment portfolio design.
  - Math based technique to find a sweet spot of return & volatility using a collection of uncorrelated investment vehicles (like stocks and bonds).
- Taleb, Mandelbrodt: financial market characterized by inherently unpredictable, highly consequential events, (that are explainable after the fact).
  - In an economic collapse, all assets are correlated

Turbulence:  
Not an Aberration  
The Norm



Disclosure: I didn't read The Black Swan. I listened to the lecture by Taleb on FORA.tv

# The Market: A Significant Disaster every Twenty Years or So (on Average)



Like the San Francisco earthquake, you know it will happen again.  
 You don't know when.  
 You don't know how big.

Source: [http://www.businessweek.com/magazine/content/09\\_11/b4123026586146.htm](http://www.businessweek.com/magazine/content/09_11/b4123026586146.htm)

Our objective: find a way to construct a portfolio which maximizes your chance to meet your financial goals, while being robust to Black Swan events.

DEPT. OF FINANCE

# BLOWING UP

*How Nassim Taleb turned the inevitability of disaster into an investment strategy.*

BY MALCOLM GLADWELL

Taleb: Learn to Love Turbulence

New Yorker, Apr 2002

Full Text: [http://www.gladwell.com/2002/2002\\_04\\_29\\_a\\_blowingup.htm](http://www.gladwell.com/2002/2002_04_29_a_blowingup.htm)

## “The Portfolio Balancing Act

In turbulent times—like these—the “rules” for asset allocation often go out the window”

“Put 85% to 95% of your money in an ultra-safe asset like U.S. Treasury bills or inflation-indexed bonds, and put the rest in speculative, leveraged bets. That's the sort of approach advocated by Boston University finance professor Zvi Bodie and by hedge fund manager Nassim Nicholas Taleb in his best seller *The Black Swan: The Impact of the Highly Improbable*. It minimizes damage from an ugly downturn while maintaining some upside.”

## “The Portfolio Balancing Act

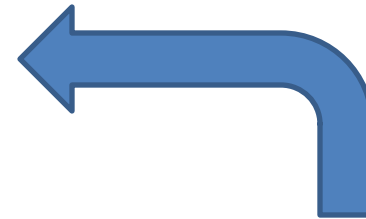
In turbulent times—like these—the “rules” for asset allocation often go out the window”

“Put 85% to 95% of your money in an ultra-safe asset like U.S. Treasury bills or inflation-indexed bonds, and put the rest in speculative, leveraged bets. That's the sort of approach advocated by Boston University finance professor Zvi Bodie and by hedge fund manager Nassim Nicholas Taleb\* in his best seller *The Black Swan: The Impact of the Highly Improbable*. It minimizes damage from an ugly downturn while maintaining some upside.”

\* To see a Taleb Lecture go to FORA.tv



Actually, you need to act ahead of the big events.



An interesting approach!

- ~~Speculate~~ (Invest) for upside
- Build a safe core.

# More Lessons for the Individual Investor

---

- Be skeptical of MPT based asset allocation.
- Understand Need vs Want
  - ✓ Do you need that new trinket?
  - ✓ Do you really need to live in NY?
- Do not exacerbate a black swan event.
  - ✓ Should you own XY stock if you rely on an XY pension?

Bad Stuff Happens!

Reference: <http://ultimibarbarorum.com/2007/07/07/buttonwood-flipped/>

# Portfolio Design for Non-Professionals: The Starting Point

---

What are your needs?

When will they happen?

How much have you saved?

What are your biggest financial risks?

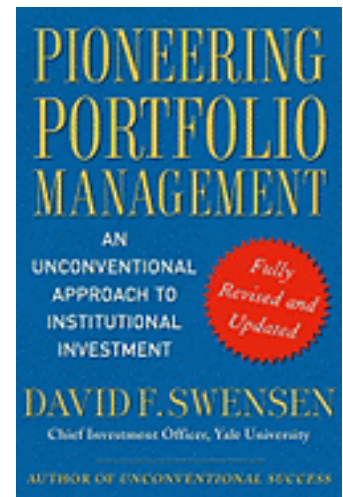
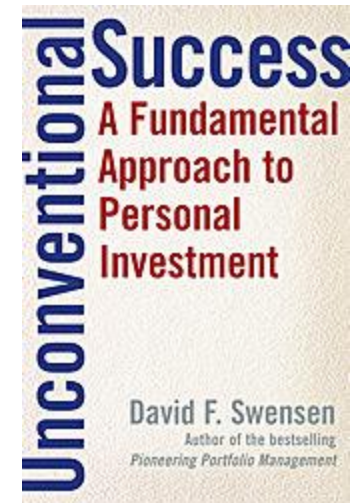
What financial products best mitigate those risks?

How do I minimize the impact of the inevitable catastrophe?

# Portfolio Design-Personal

- Starting design is from David Swensen (Yale), *Unconventional Success, A Fundamental Approach to Personal Investment*.
- Asset allocation has diversification characteristics of MPT, but is not derived from MPT.
- Connects each segment of the personal risk profile with responsive investment vehicles, weeds out asset classes based on misalignment of buyers and sellers interests, or lack of transparency.
- Example: to a class of investors, the biggest risk might be inflation.
  - ✓ Stocks have historically beat inflation over long term, but are volatile in short term.
  - ✓ TIPS\* can provide both inflation protection and Black Swan robustness (principle protected).

\* TIPS = Treasury Inflation Protected Securities



## An Investor's Guide to U.S. Treasury Inflation- Protected Securities

If you don't know about TIPS,  
you should.



Treasury Inflation-Protected Securities (TIPS) are direct obligations of the United States government. By protecting both principal and interest against inflation, TIPS pay a real rate of return above inflation.

THE WALL STREET JOURNAL Digital Network WSI.com MarketWatch BARRON'S All Things Digital SmartMoney More

Enter Symbol(s) or Keyword(s) SEARCH

MarketWatch Learn why it pays to be lazy... Welcome, please sign in. My Portfolio • Community • VSE • Alerts

Front Page Tools & Research Lazy Portfolios Sample Portfolios

Aronson FundAdvice Smart Money Coffeehouse Yale U No Brainer Margaritaville 2nd Grader

- There is a sample Swensen Portfolio\*
- Composed of 6 funds, mix of domestic and international stocks, bonds, real estate.
- One of a set of “Lazy Portfolios” tracked by MarketWatch
- All are based on index funds and have similar performance over 10 years.
- 5 year annualized return 3.81% Y/E 2008

Reference: “New Lazy Portfolios Online Updates are Here” by Paul B. Farrell.

\*The Swensen Portfolio: part of a process, not a destination.

# Pay attention to the details

---

Which is worse?  
A 25 % Black Swan Event.  
Losing 1%/yr via fees, trading costs or  
taxes for 25 years.

# Sounds like same old, same old.

---

- Mostly true.
- Base Strategy for coping with turbulence:
  - Use Low Cost Conventional Products.
  - Filter through personal risk/reward/need profile.
  - Stress Test by Black Swan analysis.
  - Build a protected core.
- Same old, same old with a twist: save more than you might have thought.

Objective: ~~Perfection~~, Least Bad Plan

# Sounds like same old, same old.

---

- Mostly true.
- Base Strategy for coping with turbulence:
  - Use Low Cost Conventional Products.
  - Filter through personal risk/reward/need profile.
  - Stress Test by Black Swan analysis.
  - Build a protected core. ←
- Same old, same old with a twist: save more than you might have thought.

Time to do this:  
During Bull Cycle Rebalance

Objective: ~~Perfection~~, Least Bad Plan

# The World of Investing

---

The barely knowable

Mired in complexity

Promoted by the involved

Corrupted by the greedy

Bought by the irrational