The ReSolve Master Class – Episode Three

Mike	**00:00:00**	Welcome back to ReSolve's Master Class where last episode we talked about Philip Tetlock and the trials and tribulations if you will, of prediction and what it takes to be a Superforecaster, and recognizing how hard it is to actually make predictions, what might we do in preparation today? Let's take preparation to the next level before we start predicting.
Adam:	**00:00:26**	It's really tough to predict the future and we have to start from somewhere. Where do we start as an investor that has liquid assets, and they want to maximize the chances of surviving in the next 100 years?
Mike:	**00:00:34**	And then really, that actually presents another issue we'll get to, which is the hurdle to actually make concentrated bets. Once you're very well prepared and your portfolio is robust in many different economic regimes, it gets a little bit harder to actually impart predictions that might meet that.
Adam:	**00:00:52**	Such a tease getting so far ahead, let's go all the way back to where many portfolios that we observe currently attack the problem. You've got a sort of ubiquitous 60/40 portfolio and when you drill in, you see that the vast majority of that portfolio is in a combination of whatever, funds, ETFs, managed accounts, individual securities. But all of those end up being focused in basically one area, which is, for the most part, your own domestic economy, your own domestic stocks, your own domestic bonds. So as a first step, let's think more globally, we have a practice in Canada, we look at Canadian clients as they come to meet with us, and 85 to 90% of their portfolio is allocated to Canadian stocks or bonds when you look through all of the underlying products. Yet, the Canadian economy only represents 2% of global GDP. Canadian stock and bond markets only represent two to three, maybe 4%, of total global market cap. So, you've got this profound mismatch and when you look at some of the major institutions in Canada, call it the major pension funds, the Canada Pension Plan, or Teachers, etc, then you see that over the last decade or so these big institutions have moved to take a global view. Their allocation to Canadian assets is much more in line with what you'd expect as a representation of the total global market landscape. That's a really good place to start.
Rodrigo:	**00:02:27**	It is a good place to start because you have this belief that you're well diversified because you have a lot of line items, a lot of funds, you have a lot of ETFs. There's also the interesting issue of this new trend that low fee ETFs is the way of passive investing. But what we actually find is a bunch of low fee ETFs that are very concentrated in Canadian bonds and equities. When you think about it, what

you're actually doing is maybe whether you know it or not making a big bet, and making a big directional prediction on your Canadian economy. So again, this is again following from the previous episode, that is you make an active bet without knowing it.

Mike: **00:03:08** Yeah, and it's not just Canada, American investors have the same proclivity to overweight their American stocks, Australian investors, UK investors all tend to overweight what they know and like best, and why not? You drive by it every day on your way home, you see the cell phone provider in your area, you see the grocery store provider in your area, and I always find it very informative Rodrigo. I think of your past and you grew up in Peru, and you're driving by a different cell phone provider and a different grocery store. It's not Rogers and Loblaw's or the Canadian equivalent, or the US equivalent, rather Verizon and big box store Walmart. But it's something different. Yet, this is where we end up with this home country bias. And I think when you think of the word globally, often people think stocks and bonds globally. But let's think of globally from further diversification of various asset classes and asset class types, of commodities or real estate, and the implications for the simple ubiquitous 60/40 stock and bond portfolio in your home country. That's a very significant slant to growth in that home country, abundant liquidity, benign inflation, these being the conditions for which those portfolios are destined to do best in.

Rodrigo: **00:04:31** And it's so interesting to see how the world seems to be concentrated in that one risk. Especially now with yields as low as they are, people are reaching for more returns. We can take more risk in order to get that that return. But we can go back some years to try to figure out from the wisest people in our history as to what a reasonable thing to do with your wealth would be. And if we go all the way back, you can find in the Talmud that there is a more thoughtful approach to creating a well-diversified portfolio that can withstand all types of shocks. And that was, correct me if I'm wrong, but it's a third real estate, a third in your business and a third in liquid assets.

Adam: **00:05:12** Yeah, that's right. Exactly. The key word for today, the thing that we want you to take away is the concept of diversity. The Talmud defines diversity as having a third of your assets in a company, gold and real estate. Of course, in the modern era, we start with this idea of the permanent portfolio, which was first proposed by Harry brown in the late 80s. Obviously, Harry had his good portion of his investing career through the 60s in the 70s. So, he was able to observe a real genuine diversity of economic climates. And in the 80s, he wrote a book on this idea of the Permanent Portfolio, which dovetails very nicely with the prescriptions of the Talmud. The Permanent Portfolio was essentially a quarter of your assets in stocks, a quarter in bonds, a quarter in gold and a quarter in cash. And that was fundamentally designed to protect against the major ravagers of your wealth over the long term, which are, let's name them: high and low regimes of growth, and high and low regimes of inflation.

If you move one step along in the evolution of this concept, Ray Dalio proposed this idea of the All Weather Portfolio later on in the 90s, where he more explicitly defined four quadrants of economic regimes, where you're dividing economic regimes into periods of positive and negative inflation shocks, positive and negative growth shocks, you've got four different quadrants. On the upper left, you've got a period of higher than expected inflation, lower than expected growth. Think of, for example, the 1970s, what did really well? Commodities and gold. Both compounded in the low teens, in terms of commodities, the high teens per year in terms of gold. Whereas go to quadrant two, upper right, you've got a period of high inflation and high growth. Think of the period from 2000 to 2008 where you've got the emerging economies are rocking, a major surge in global real estate, also a surge in commodities. Moving down one quadrant, now you've got lower than expected inflation, higher than expected growth. Now, we're talking about a period like the 1990s, where you've got this major boom in developed market equities, a major compression in credit spreads and so you really want to be in tech stocks, develop market equities. Those are what's going to serve you well.

Then the real crusher is that fourth quadrant, where you've got a deflationary growth shock, so extremely low inflation, a major crash and global growth. Think of the Great Depression, the 2008 global financial crisis, the tech wreck in 2002-2003, 1991 in the US, the major real estate markets crashed. They've got a period where things like global bonds, sometimes gold and cash.

Rodrigo: **00:08:26** We don't have to go that far. The 2020 Corona scare, right? You had the only two asset classes during that period being those ones that respond well to negative deflationary shocks and low growth, gold and treasuries. I think when you understand these different asset classes from that framework, you now have the tools necessary to start minimizing the chances that you're going to be specifically wrong, and you're going to try to maximize your chances, you're going to be broadly correct. If you think about Dalio, you mentioned Dalio last. This man made his career on trying to find and produce alpha, from an institutional perspective. But when it came down to his long term money, his trust money, he knows how difficult it is to predict. And therefore he chose to put all of his trust money into a framework like this one, where he didn't need anybody at the helm making all these specific decisions day in day out and it is just a framework that is based on how human beings interact with each other, how money flows and the non-correlated nature of these asset classes.

Mike: **00:09:34** Yeah. The structural nature of the asset classes with the corresponding dynamics of growth and inflation. So, when you think about Ray Dalios conundrum, which was I don't know who's going to be able to make the predictions that I've been able to make for my family, over the next 100 years. Recall our hurricane story. Recall these long lived assets. What I mean by that is assets that are going to live longer than their managers, which is pervasive across all of the universes that we're talking about of fiduciaries, whether they're on pension boards, or you're an ultra-high net worth individual who knows that those assets are going to exist long after you're gone. How might you consider allocating them over 20, 30, 50, 100 years, knowing as Adam, you went through the different quadrants that we go through? If we know the money is going to be here for 100 years, we're virtually guaranteed that we're going to have one of these periods come and ravage the wealth.

Adam: **00:10:38** You're almost guaranteed to experience all four of these different regimes. And so your portfolio needs to be resilient to whatever the future might hold, going back to the fact that we can't predict and therefore we want to maximize preparedness. Now, let's concentrate the arc, or let's distill the arc of what we've discussed today. We've gone from what we observe day to day for a very large proportion of even ultra-high net worth individuals living in a country. They typically still tend to focus their wealth in domestic stocks and bonds. And now we're talking about a portfolio that includes assets that are going to thrive in periods of extremely high inflation and struggling growth. So commodities and gold, you want to hold assets all around the world. You want to own domestic debt and equity, but also the equity of other developed markets in Europe and in the Pacific region, etc. And you want to own emerging markets which are designed to thrive during periods of often higher inflation or higher global growth. Often there's a concentration of commodity developers there, so you get some of that. You want to own real estate, so global real estate, not just be concentrated in the real estate of your own city or town or province or country.

We've gone from this concentrated portfolio to really expanding this concept of diversity. And now being resilient, to having the opportunity to be resilient and prepared for whatever economic regimes the future might throw at us.

Rodrigo: **00:12:17** I know that the intuition here is to say, no, hold on a second, if there's going to be an inflationary regime, I'll just do more of the gold and the TIPS, and I'll transition into it. But I think it's key when we talk about this target chart and these different regimes, that these are changes in expectations. These are shocks, whether they're inflation shocks, or gross shocks that happen nearly instantaneously. So if you're not prepared, if preparation isn't there already, it's going to be too late when it happens. 2020 Corona, if you were trying to ease into it, it was too late already. If you had risk parity in your portfolio, you did a much better job at trying to manage that situation because it was about preparation. You already had it there. It was there for you when that shock happened. When we talk about these regimes, what they actually are is that there are a series of ongoing shocks that is

		difficult to predict upfront. And the shock part is the key. It's not trends, these are just phase shifts almost most of the time.
Mike:	**00:13:16**	Preparedness. An ounce of prevention is worth a pound of cure. This is why prediction has such a high hurdle.
Adam:	**00:13:24**	Yeah, I think that clues up our discussion of diversity. Just to set the stage for the next conversation, we very deliberately didn't use the word diversification because diversification is a combination of both diversity and balance. So, in the next discussion, we're going to focus on diversification and therefore we're going to introduce how to create an appropriate level of balance in the portfolio. So all of these diverse markets can express their unique personalities.
Rodrigo:	**00:13:54**	Excellent.
Mike:	**00:13:54**	Cue the music