

Temporary market inefficiencies – The case for a (r)evolution in Indexing Methods

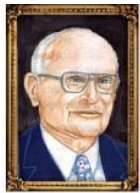
Global Investment Conference 2010
Mount Tremblant

Contents

- ▶ 1. The Index creation conundrum
- 2. The portfolio construction conundrum

How it all began

1950s: Theoretical framework of market capitalization-weighted indexing



Harry Markowitz

- 1952: Modern Portfolio Theory – Harry Markowitz
- 1970: Efficient Market Hypothesis – Eugene Fama



Eugene Fama

- "Nobody can consistently beat the market"
→ no active investment decisions

- Beginning of the 70s: First index product for commercial use
- 90s: Market capitalization-weighted indexing gains widespread recognition among investors during the bull market

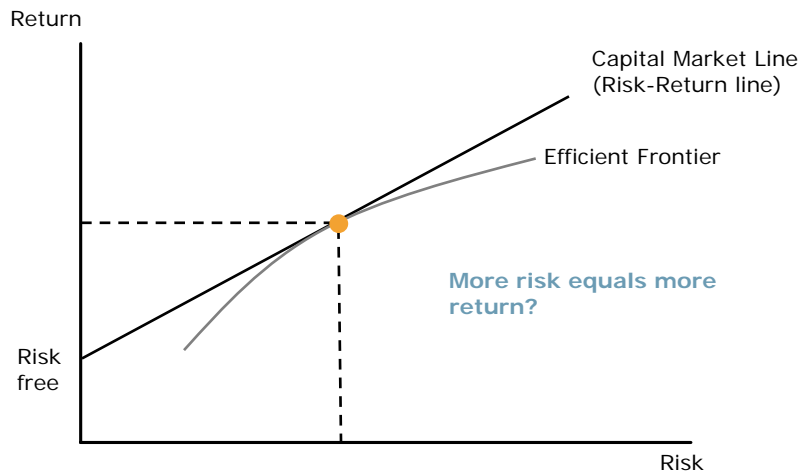
3

Assumptions of the Efficient Market Theory

	Actual parameter predicted by the EMT
Equity risk premium	Low (0.6%)
Market volatility	Low (4%)
Price pattern	Random walk
P/E ratio swings	13.8 – 14.0

4

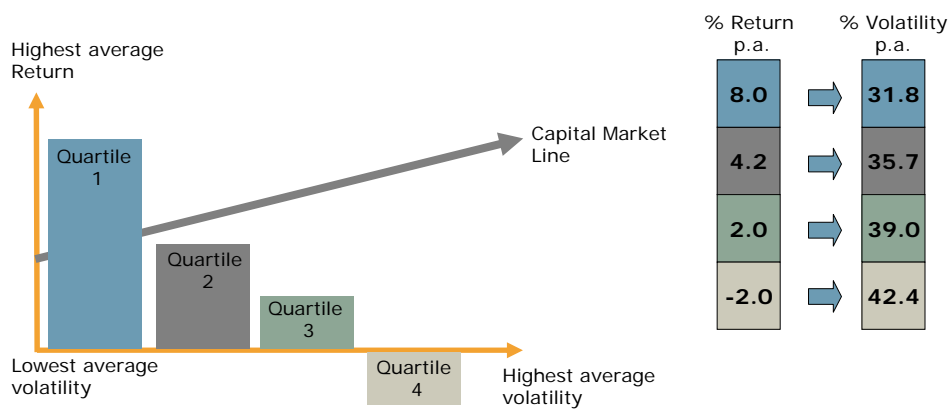
Is EMT and CAPM prescriptive?



5

EMT predictions are increasingly falsified

Highest average return quartile exhibits lowest average volatility



Source: Bloomberg, Data from 31.12.1984 – 26.02.2010, averages calculated across 5 year moving windows for return and volatility.

6

EMH does not reflect reality!

	Efficient Market Hypothesis Theory	Reality
Equity risk premium	Low (0.6%)	High (6%)
Market volatility	Low (4%)	High (18%)
Price pattern	Random walk	Bull and bear markets
P/E ratio swings	13.8 – 14.0	5.5 – 30.0

Source: Kurz and Beltratti (1997), www.sedinc.com (Strategic Economic Decisions Feb. 2002 Report)

7

New theory from Stanford University generalises EMT

CHICAGO GSB

Efficient market theory

Action-rationality

Investors maximize expected risk-adjusted returns

Belief-rationality

All agents have the same fixed beliefs that are true, i.e. the same return forecast with perfect conditional foresight

STANFORD GRADUATE SCHOOL OF BUSINESS

Theory of rational beliefs

Investors maximize expected risk-adjusted returns

Agents have diverse and time-varying beliefs reflecting different degrees of optimism and pessimism about future returns

Difference

Investors **never** make forecasting mistakes*

Investors **can** make forecasting mistakes*

*Based on the current available information
Source: Kurz and Beltratti (1997), www.sedinc.com (Strategic Economic Decisions Feb. 2002 Report)

8

Reality requires a critical re-think of static investing



Efficient market theory



Theory of rational beliefs

Forecasting model	Perfect conditional foresight (stationarity)	Unforeseen structural changes (non-stationarity)
Risk/Volatility	Exogenous (news about fundamentals)	Endogenous (correlated mistakes by investors)
Price pattern	Random walk	Bull and bear markets

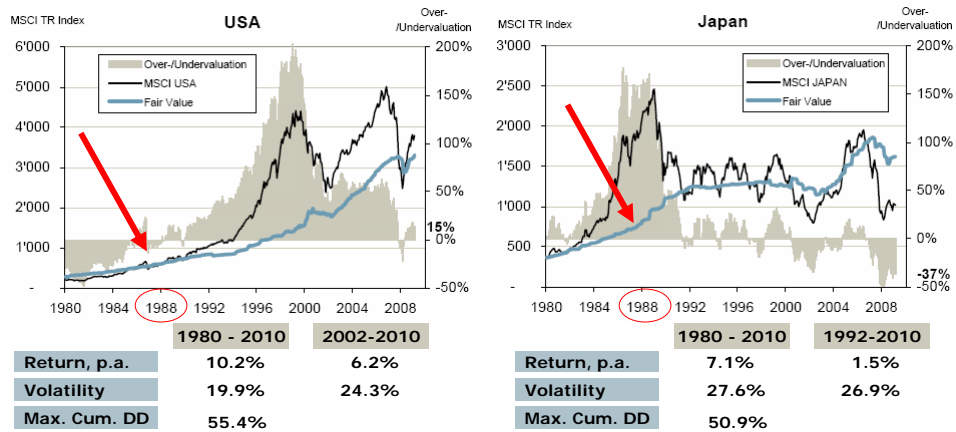
Conclusion MSCI Capital-weighted Indexing

MSCI Dynamic-weighted Indexing

Source: www.sedinc.com (Strategic Economic Decisions Feb. 2002 Report), Wegelin & Co.

9

Existence of bubbles and distinct bull and bear markets cycles

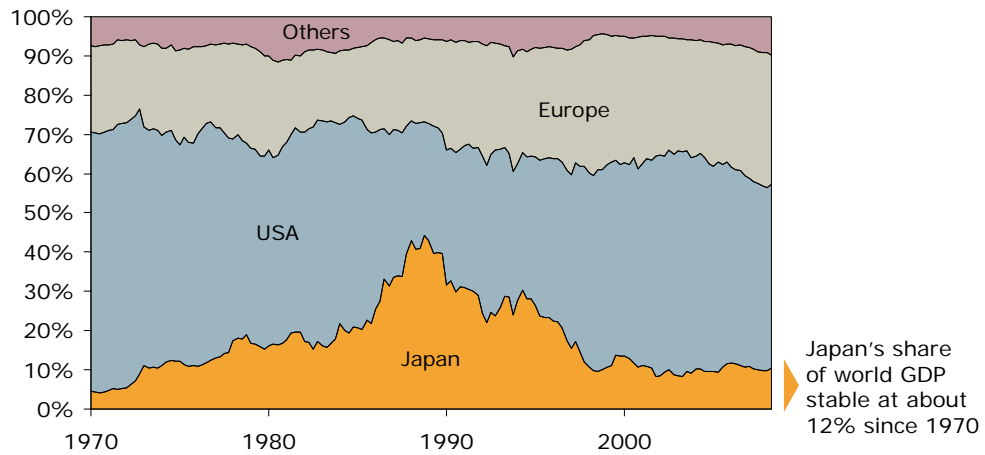


'History doesn't repeat but it does rhyme', Mark Twain

MSCI Total Return Index / Price to Book Ratio = Book Value Index, Book Value Index * normalized Return of Equity (12.5%) = norm. Earnings norm. Earnings * norm. Price to Earnings Ratio (15) = Fair Value Index

10

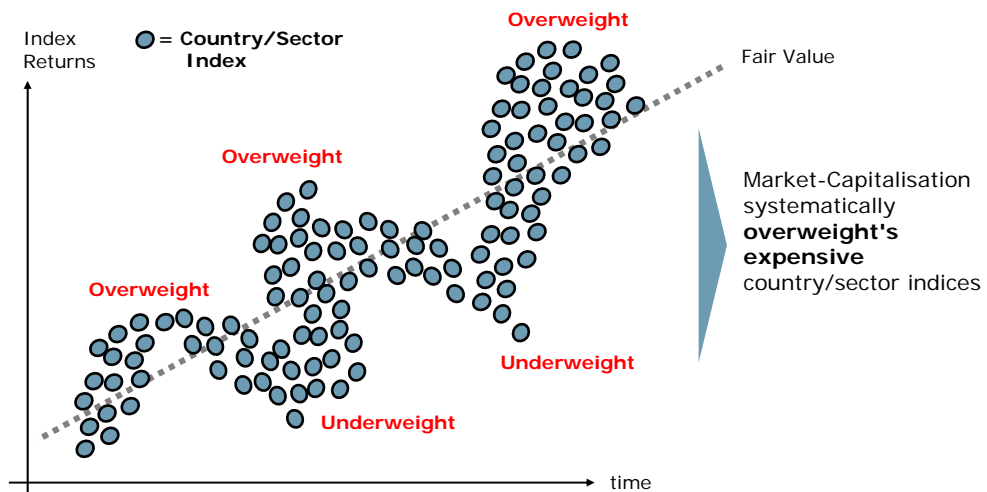
Capital weighted indexing is pro-cyclical and therefore inherently sub-optimal



Source: MSCI, Wegelin Asset Management analysis

11

Can investors improve on static buy-and-hold?



Source: www.sedinc.com (Strategic Economic Decisions Report Sept. 2004)

12

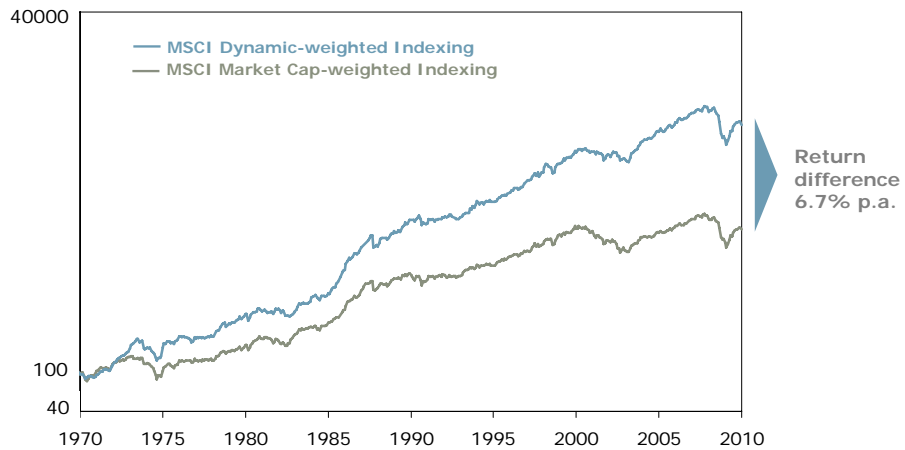
Dynamic weighted indexing – ranking according to attractiveness

	Countries	Sectors
Attractive	Norway Italy Netherlands United Kingdom Germany	Energy Financials Telecomm. Services Consumer Staples
Medium	Singapore Hong Kong Spain ... Australia Austria Japan	Information Technology Utilities Health Care Materials
Un-attractive	Sweden Canada USA Switzerland	Industrials Consumer Discretionary

Dynamic weighting systematically overweight's attractive country/sector indices based upon **valuation and quality**

13

MSCI Dynamic Indexing provides superior long-term returns



* Based on total return indices in USD for the time period 1975-2010 (net of trading costs)

14

Comparison of the different indexing methods*

	MSCI Cap-weighted	MSCI Dynamic-weighted
Return, p.a.	8.6%	15.3%
Risk (std. dev)	15.1%	17.1%
Information Ratio	NA	0.8

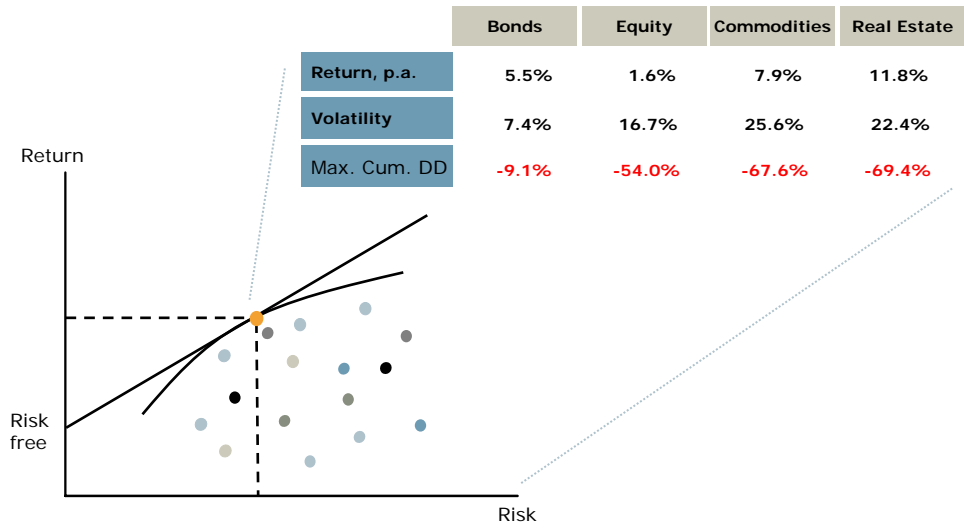
* Based on total return indices in USD for the time period 1975-2010 (net of trading costs)

15

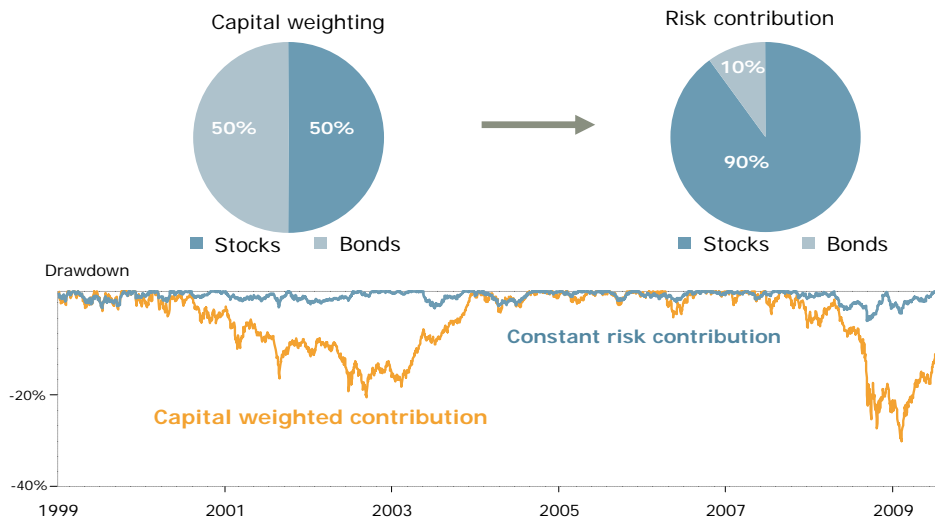
Contents

1. The Index creation conundrum
- ▶ 2. The portfolio construction conundrum

Does adopting a dynamic approach at the portfolio level also yield to superior results?



Traditional 50/50 portfolio = 90% equities risk



50% stocks: MSCI World Index (NDDUWI), 50% bonds: Citi Global Government Bond Index, in USD

Have we correctly balanced our asset classes ?

Bonds / Cash



Volatility ~ 0-10%
Max. Cum. Draw down ~ 10%

Equities / Commodities



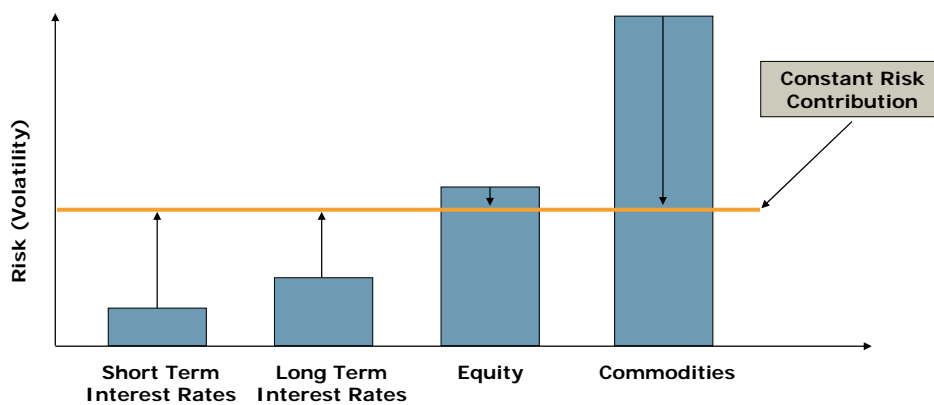
Volatility ~ 5-25%
Max. Cum. Draw down ~ 60%

Bonds: Citi World Bond Index; Equities: MSCI World Index; Commodities: GSCI Commodities Index (Jan 1999 – Dec 2010), in USD

19

Risk weighted instead of capital weighted (Risk Parity)

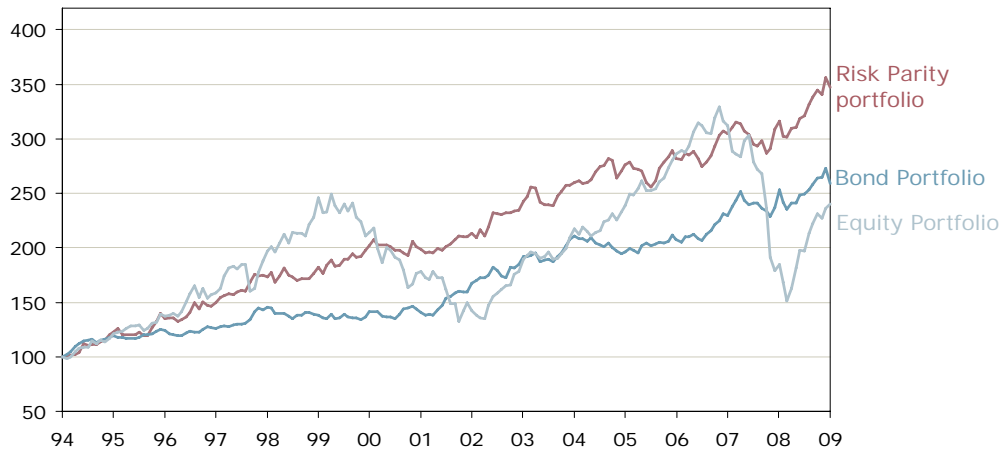
- Choice of asset classes and instruments
- Defined volatility target
- Equal risk weighted allocation



20

Risk parity allocation leads to lower draw downs

Indexed, in USD



Risk Parity Portfolio - Wegelin Global Diversification Strategy; Global Equity: MSCI World; Global Bonds: Citi World Bond Index
Source: Bloomberg, Wegelin & Co. Analysis

21

Inferior ideas die hard



John Maynard Keynes

The difficulty lies, not in the new ideas, but in escaping from the old ones.



Max Planck

Science advances one funeral at a time.

22

Disclaimer

This document contains confidential information and is not intended for public distribution. It has been prepared for informational purposes only and is neither an offer to sell nor a solicitation of an offer to buy securities or funds, and should not be construed or considered as an issue prospectus within the meaning of applicable legislation. The information contained in this document can be changed any time and without prior notice. Wegelin (LUX) Fund SICAV, Wegelin Asset Management Guernsey, and Wegelin & Co. Private Bankers make no statements about future performance of any fund or fund manager. Potential Investors should be aware that investments in private investment funds involve a high degree of risk. Potential investors should carry out any due diligence they require - this may involve seeking financial advice. Recipients must assess the suitability of any particular investment opportunity themselves and reach their own independent decision as to whether to make an investment. Wegelin & Co. Private Bankers assumes no responsibility (neither explicit nor implicit) for the accuracy, completeness and relevancy of the information provided.

Contact details:

Wegelin (LUX) Funds Sicav
31, Z.A Bourmicht 8070 Bertrange
Luxembourg
Phone: +35 2 26 30 22 54
info@wegelifunds.com
www.wegelifunds.com

Contact details:

Robert Huber
Wegelin & Co.
Fraumünsterstrasse 27
8022 Zurich
Switzerland
Phone: +41 44 218 13 68
robert.huber@wegelin.ch
www.wegelin.com