

■ STRATEGIC ■ ECONOMIC ■ DECISIONS

– Philosophy of SED –

The logical basis of “Outperforming the Market”

*Where is the wisdom we have lost in knowledge? Where is the
knowledge we have lost in information?*

— T.S. Eliot

STRATEGIC ECONOMIC DECISIONS, INC.

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SED'S DISTINCTIVE RESEARCH PHILOSOPHY

—IMPARTING A NEW COMPETITIVE ADVANTAGE—

Via our **PROFILE** reports and lectures described below, we attempt to make our clients less wrong than the consensus—and for the right reasons. We undertake this challenge at two completely different levels of analysis:

Predicting the future—forecasting market returns in particular

Prescribing investment strategy—specifying what you should do with your money and why.

Before discussing the nature of our service, let's expand on the all-important philosophy lying at the core of our service.

Question 1: What exactly does it mean to be less wrong than the consensus in forecasting the future? How can this be achieved?

Answer: There are two theoretically legitimate ways in which to do so.

First, investors must confront the reality that the economic and financial environment is “non-stationary”, as statisticians put it. That is, structural changes occur, and these render yesterday's data much less useful in predicting the future than it would be in a stationary environment. Traditional extrapolatory forecasting methods must be replaced by more powerful modes of inference that address how and why the environment is changing, and what this means to markets. Since most investors do not use such methods and are thus late in apprehending structural changes, those that do utilize this approach gain a competitive advantage over the consensus.

Second, investors can outperform the consensus by avoiding those forecasting pitfalls that result from not understanding how the economy and the markets actually work. For example, we hear weekly from the best of sources that US interest rates will be driven way up if and when foreign investors become disenchanted with the US and pull out all of their money. In reality, foreign investors do not impact US interest rates, as historical data make all too clear. This is due to the reality that they *cannot* pull their money out because of the “No Net Selling” relationship of international accounting that was first stressed by James Tobin of Yale, one of the first Nobel laureates in economics. Investors who understand this do a much better job in forecasting both the dollar and interest rates, than those who do not. These investors commit fewer *errors of inference*.

What follows are some examples of how we at SED have helped clients **(i)** anticipate and exploit the phenomenon of structural change, and **(ii)** avoid a host of errors of inference.

SED's Record in Anticipating Major Structural Changes: Since its inception, we have been identifying and exploiting the existence of structural changes, which render most forecasting models unreliable. For example:

- We explained in the mid-1990s why productivity gains from the IT revolution were so late in coming—a paradox at that time—and we predicted that productivity growth was about to explode in an S-curve manner as it did, in fact, between 1997–2005, with significant implications for inflation, monetary policy, and GDP growth. This was a notable structural change missed by most observers, who mistakenly predicted that productivity growth would falter with the alleged “death” of the New Economy in 2001.
- We predicted in January 2004 that energy prices would rise sharply. The reason for our forecast lay in four predicated structural changes, all of which have occurred.
- We predicted that the US stock market would move sideways between 2002–2007, despite extraordinary earnings growth made possible by the productivity revolution. It has, for the very reason we set forth, a fundamental structural change in asset market preferences away from stocks and into bonds and real estate. This occurred, despite stunning earnings growth, with the valuation of equities falling rapidly and the valuation of bonds and real estate rising sharply.
- We predicted that the economic downturn in 2000–2002 would be much milder than others expected due to the 70% reduction in the riskiness of family income that has occurred since World War II. This reduction in risk was, in turn, due to eight structural changes in the US economy, which we first identified in 1987 and have revisited several times since through our publications on the differences between risk on Main Street and Wall Street.
- We predicted that inflation would not rise significantly during the economic recovery of the past three years, notwithstanding our bearishness about oil prices. This was because of three notable structural changes: the advent of outsourcing, the artificially low value of the Chinese currency depressing import prices, and the role of productivity gains in depressing unit labor costs. To date, our forecast has been proven right for the right reasons.

SED's Record in Identifying a Host of Errors of Inference: The second challenge in striving to be less wrong than the consensus is to avoid the numerous forecasting errors that arise from misunderstandings about how the economy and financial markets really work. For example, many people would be surprised to learn the following:

- Higher government deficits do *not* usually drive up either bond yields or inflation.
- Foreigners who hold nearly \$3 trillion of net US assets, and who become disenchanted with the US as a place to invest, *cannot* in fact pull out their money and drive up US interest rates (due to the accounting identity cited above).

- The extraordinary volatility of energy prices does not stem from hedge fund conspiracies or other forms of sorcery, but rather from the dual price-inelasticity of the demand *and* supply of oil and gas.
- Stock and bond market prices are not primarily driven by news about earnings, savings rates, and other *flow*-of-funds variables. Instead, they are driven by the shift in asset market preferences of those who own the entire stock of wealth—currently \$50 trillion. Yet shifts in the *stock* of wealth are rarely in the news, even though this is the news that matters most! This is one reason for the poor forecasting performance of investors who look to their Bloombergs for “news” to guide their strategic decisions. Such news is often mere white noise masking over what is really important.
- The great rise in household debt since World War II does not reflect a rise in “greed” on the part of pampered consumers who must have it all now. Instead, it results from the reality that it is rational for households to borrow more and for bankers to lend more, given the surprising reduction in the riskiness of family income cited above.
- The extraordinary volatility of currencies since the end of the Bretton Woods era has shocked everyone, as former Fed Chairman Paul Volcker has often attested. *Why* is it that currencies are both so volatile and so hard to forecast? The reason lies in the role of a very important new variable, discovered at Stanford University in the mid-1990s: the relative degree of “Pricing Model Uncertainty” in a given asset class. We were the first researchers to identify this variable and bring it to the attention of investors worldwide.
- The much celebrated and discussed Greenspan Conundrum in today’s yield curve is *not* a conundrum at all.

The Result: Clients Can Be Less Wrong than the Consensus for the Right Reasons

For the reasons identified above, SED’s Advisory Service has successfully helped many clients arrive at better-than-consensus forecasts of numerous crucial variables (productivity, the business cycle, the dollar, energy prices, and interest rates). Most importantly, these forecasts have been superior *for the right reasons*. The forecasting success that we have enjoyed stems from having both identified and exploited structural changes, and errors of inference as outlined above.

Question 2: How can individuals and institutions better allocate their funds in an environment that is ever-changing because of the role of structural changes?

Answer: While our Advisory Service does not seek to recommend specific individual stocks or sectors, we do focus on the logic of asset allocation where it concerns our clients. Considering that the investment management profession is currently witnessing a long-overdue meltdown of the received wisdom on this subject, our research is particularly important in today’s business environment. Specifically, traditional Modern Portfolio Theory, leading to a static and fixed policy portfolio implemented through indexing, can be

shown to be *invalid* in a real-world environment characterized by bull-bear market cycles and other messy aspects of reality—phenomena that are excluded in the classical paradigm. In today’s tough market environment, it is not surprising that the classical paradigm is being abandoned as panicky investors turn to hedge funds, commodities, and private equities.

But how *should* investors respond to today’s realities? Is there a new and better theory of portfolio management to guide them? Yes, there is: It has been developed at Stanford University and SED is currently playing a central role in developing and promulgating this theory, and in assisting clients to better allocate their assets.

The essential research results that have emerged from this program can be summarized most clearly by comparing the portfolio problem of investors to the challenge farmers face in determining the right mixes of crops.

The Farmer’s Problem: In Tahiti, the climate is stable with a mean temperature of 82 degrees and no change in season. In this environment, an optimal agricultural portfolio consists of 40% sugar cane, 35% pineapple, and 25% cattle. No crop rotation is required to maximize results. However, in Vermont, pronounced seasons exist, and it is necessary for farmers to rotate their crops to optimize results: 95% red cabbage in winter versus 90% corn in summer, for example.

The Investor’s Problem: Classical asset allocation theory works only in a financial environment without “seasons,” i.e., an environment without bull-bear market cycles or other forms of overshoot. However, research has proven that seasonality exists in financial markets everywhere, implying that investors, like farmers, must fundamentally rebalance their asset allocation periodically (via logic originally set forth by Paul Samuelson, in 1972). There exists no optimal fixed portfolio. Instead, there is a fixed *strategy*, specifying which portfolio a given investor with a given level of risk aversion should hold at each “state” (equivalent of season), and why.

This generalized portfolio theory implies that we must reconceptualize the *meaning* of active versus passive management. We must discard the traditional concept of “the market” as a benchmark, and replace it with a superior one. We must discard the concept of tactical versus strategic asset allocation, since it turns out that there is no difference between the two. Indeed, the concept of an optimal strategy fuses the two at the hip: if investors are strategically optimal, they will *automatically* be tactically optimal.

SED’s Role in Advancing the New Theory: The author is currently working with the staff of the CFA Institute to weave these new and more general aspects of asset allocation theory into the core curriculum of modern finance, while simultaneously assisting clients in solving their own asset allocation problems.