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Global Wealth Allocation

Building Portfolios without Prices

[david.morris@globalwealthallocation.com](mailto:david.morris@globalwealthallocation.com)

Thank you Mr Morrell. Good afternoon, gentlemen and ladies.

Charles Darwin taught us that all forms of life evolve continuously. They do this by means of a process he called 'natural selection'. In his words, "natural selection scrutinises daily, hourly, minute by minute, all that is good and all that is bad. That which is good is selected and retained. That which is bad is rejected or thrown away. It is by this process of natural selection that each life form perfects itself". Darwin teaches that evolution is a path to perfection for all forms of life. This also holds true for ideas. They too evolve continuously to higher orders in order to become of perfection.

Today I want to speak to you about an idea. It is a solution to a problem in global equity marketing that we at John Morrell & Associates present as another step in the perfecting of ideas about investing in equities.

Please turn to page 1. Here we see the 2 most commonly used performance targets that investment managers try to beat. The red line is Japan's Topix index, which consists of 1,300 companies, over the past 28 years. The blue line shows Morgan Stanley's World Equity index, including Japan. By the first quarter of 1998 these 2 indices were about the same at an increase of 10 times over the 28 1/4 year period.

These standard performance targets are the ones that most equity managers follow closely. They are driven by prices and in the case of international equity, currencies as well. Because managers follow these indices very closely certain problems arise and this is what I want to talk about today.

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Let's begin with the problems facing global investors who follow the world index. Turn to page 2, please. This chart does not show performance data, but rather the proportions of different markets comprising the global index of MSCI. It illustrates the problem that we are trying to solve. It can be seen that at December 1988, 10 years ago, the Pacific and Asia region including Japan, which is the red dotted line, represented 45% of the world's stock-market compared to just 30% for North America, which is primarily the United States. According to these stock-market valuations, the Japanese market which makes up the bulk of the Pacific region, was significantly larger than the US stock-market.

Most investors at the time knew this was a nonsense. At that time the Dow Nikkei index had reached 38,000 and price to earnings multiples had increased to well over 100 and the Yen/\$ exchange rate had doubled for the second time in 8 years. By December 1997 the relative shares of global equity had dramatically reversed. Currently North America is 50% of the world's stock-market and Pacific is less than 15%. To John Morrell & Associates this too is a nonsense. How can it be that within less than 10 years these proportions of global equity can vary to such a great extent? Has the relative wealth creation of these 2 great regions changed so dramatically? Indeed not.

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Because these graphs are based on prices of shares comprising the indices, these proportions are driven by expectation and currency, not by true worth. Any investors that followed the MSCI world index would have been buying more and more of Pacific's region in December 1988 and less and less of North America. And currently they are buying more and more North America and selling Pacific. We all believe that the US market is over-valued, but cannot define precisely to what extent. And surely after their significant collapse, Pacific markets are close to being under-valued. It is obvious that investors will be buying more of those countries where markets are rising and selling out of those countries where prices are falling. And this is the problem. Investors that follow these indices too closely will have a bias to buying high and selling low. That is the exact opposite of successful investing. So what is the solution to this problem?

The solution can be found in a new investment process that does not track these price indices, but rather tracks the underlying wealth of the underlying securities in these price indices. Turn to page 3. Here we see the price index for one country, the USA, measured in dollars along with some measures of country wealth. It is true, I am sure you would all agree, that in the long run the rate of growth in prices cannot outstrip the rate of growth of the wealth in the underlying securities. However, in the short term prices can grow at rates significantly different from the rate of growth in the underlying wealth. That is because in the short term expectations drive prices. Although a price index represents a consensus view at a single point in time, because it is driven by expectations it can change from minute to minute. And it does so. It is this shift in prices if followed too closely by investors that leads them to buy high and sell low.

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In order to avoid this we at John Morrell & Associates have decided to ignore price and turn to the measurements of the wealth in the underlying securities. The blue line on page 3 shows US GDP growth for the past 20-odd years. Some people have used this as a measure of wealth, but we reject this on the grounds that investors cannot buy nor sell units of GDP. They can only buy and sell shares of companies. More specifically they buy and sell shares primarily in the companies comprising the price indices they are given for performance targets. This defines the investible universe, i.e. the companies in which they primarily invest. We at John Morrell & Associates have adopted, as our investible universe for the purpose of measuring wealth, the MSCI global index which comprises 2,500 companies spanning 50 countries including Emerging Markets.

How do we measure wealth? We measure wealth the same way accountants do. The fundamental measurement of wealth creation in any corporation is profit. This can be defined as net profit after tax, which is the red line for all companies in the US MSCI index, or as cash-flow which is the green line. Given that the MSCI index for the US comprises 484 companies, we have a good approximate indication of country wealth. The graph shows the rate of growth of that wealth.

Now we all know that profit can only be retained in the corporation to finance future growth or distributed to shareholders in the form of dividends. The turquoise line on our chart illustrates the growth of US dividends and the magenta line the growth of US book value.

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To summarise if we reject prices and at John Morrell & Associates we do so, and if we reject GDP then the measures of wealth we are left with are the accounting measures for the companies in the investible universe. It is the wealth creation measured using company fundamentals, that John Morrell & Associates focus on in their new investment process.

Because we measure wealth in each country in local currency this presents problems for global investors. How do we convert our local currency measurements of company fundamentals into Yen for the Japanese investors? We convert our wealth measures not at the spot rates of exchange, but rather at purchasing power parity rates of exchange or what is known as PPP. Turn to page 4, please. Here we show the PPP exchange rate for the Yen against the dollar as the red line and compare it to the spot currency rate which is the blue line for the past 25 years. We have decided to use PPP because in our view it measures the long-term equilibrium exchange rate for any currency. You may recall that PPP is simply the ratio of inflation between any two countries. In the long run the spot currency rate will revert to its relative inflation exchange rate or its PPP. We use this exchange rate because in our attempt to avoid following the traditional price indices we are seeking to determine the long-term equilibrium proportions for each country in a global equity portfolio. Use of purchasing power parity which is a long-term equilibrium exchange rate is consistent with this objective.

Combining our measures of wealth for each country in local currency with our purchasing power parity exchange rates yields the regional proportions for a world equity portfolio shown on page 5. What strikes most viewers immediately is the relative stability of our weighting system. Because of this stability we have called this portfolio our 'neutral portfolio' which has been developed with what we now call the Morrell Method.

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These neutral weights can be compared to the market capitalisation proportions, according to the MSCI price indices, which is shown on page 6. It can be seen that in December 1988 the Morrell Method produced neutral weights suggesting that the price index proportions for North America were undervaluing that market. Although our neutral weights fell, they declined much more slowly than the market capitalisation proportions.

The comparison shows that currently the US market is overvalued relative to the Morrell neutral. Both the European and Emerging Markets are undervalued relative to the Morrell neutral and if you turn to page 7 we see that the Pacific proportions are the same in both systems, or fairly valued.

To implement the Morrell Method, the portfolio is rebalanced to the neutral weights each month. Currently we are selling North American shares as they continue to rise and rebalancing back to the lower neutral weighting. On the other hand, we are accumulating European and Emerging Markets shares as we rebalance to the higher neutral weighting.

Our back-testing of this methodology shows an extra return of 100 basis points per annum from December 1973. Although the standard deviation is 80 basis points per annum higher, the risk adjusted return calculation of the neutral performance is much better. In the last 6 ¼ years the returns to our system have been 170 basis points better than the market. Isolating the Emerging Market reveals that the Morrell Method delivers an extra 350 basis points of return.

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Applying the Morrell Method to a single country like Japan has produced much the same result. On page 9 we see the standard performance benchmark most managers follow in Japan which is the Topix index from December 1992. On page 11 it can be seen that the finance sector, much like a region in the global equity portfolio, has declined from 30% of the Topix market to 21% in six years. This is compared to our neutral weights on page 12, which has declined from 24% to 21% over the same period.

Looking at all of the sectors in the Topix index on page 13, it can be seen that while underweight the finance sector for most of the period, the Morrell neutral was overweighting consumer goods, energy and capital equipment. This variation of overweight and underweight positions means that the system is continuously investing in undervalued markets and dis-investing in overvalued markets.

The returns for the Japan neutral, as we call it, for the past 6 ¼ years amount to 190 basis points per annum ahead of Topix, before transaction costs. The volatility is 60 basis points lower. Going back to February 1980, based on our work using the less comprehensive 309 company index for Japan by MSCI, the performance for that 18 year period averaged 230 basis points above the market index. Volatility was 80 basis points lower.

So it can be seen that we have solved the problem that traps many investors who follow market capitalisation indices; namely, buying high and selling low. By continuously rebalancing our portfolios back to long-term equilibrium proportions which we call neutral, based upon the Morrell Method, we are continuously selling out of overvalued markets and buying into undervalued markets. In effect, we buy low and sell high

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This unique process which has evolved from the ideas currently in existence in the market place represents another step forward in perfecting investment strategies for Japanese investors by AIG-Morrell.

This investment process, founded on the Morrell Method, has been made available exclusively to Japanese investors through AIMIC. AIMIC has the exclusive right to market this investment process to institutions and retail investors here in Japan and in the rest of Asia.

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