

CalPERS Presentation - 12th January 2001

The logo for Global Wealth Allocation (GWA) features the letters 'GWA' in a white, serif font, positioned within a dark blue circular arc that curves from the top left towards the center.

Global Wealth Allocation

Building Portfolios without Prices

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Thank you, Kate. Good morning, everyone.

A famous economist once said that there are only two problems in economics: wealth creation and the allocation of it. Similarly there are two major problems facing fund managers: what stocks to hold and what proportions in which to hold them, the allocation decision.

Once a manager decides what stocks to purchase, the allocation decision is typically made relative to the client's benchmark, usually a market capitalisation index which is dependent upon share prices.

As we know from the Nasdaq price behaviour over the past two years and ten years ago from the Japan bubble, prices can be volatile and can, therefore, mislead. Price volatility plays havoc with fund managers' allocation decisions.

We seek to avoid the volatility that price movements can impart to our portfolios by getting back to basics and focusing upon fundamentals. We focus on wealth creation.

Our investment philosophy is that we believe core active portfolios should be constructed independently of prices. By focusing on wealth creation and thereby avoiding price volatility we can deliver consistent, top quartile, risk-adjusted returns with low tracking error.

How do we do this? I know that the Dow Jones Index closed at 10,609 last night. But what is more interesting to us is the question, "How much wealth is the Dow Jones creating?" and, in particular, what is more relevant to us here today: how much wealth is the EAFE Index creating?

We know, for example, that the 1,032 companies in EAFE are generating \$750 billion of cash earnings every year – which is comparable to the S&P 500.

Now we are interested in the total wealth created by companies within an index because, although prices in the short term are volatile, in the long run share prices reflect the growth of wealth. In other words, the company's share price mirrors the wealth creation of the company.

We measure wealth in four separate ways. Our first two measures are net profit and cash earnings. These are either paid out to shareholders or retained by the company, providing us with the other two measurements – dividends and book value.

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For our international portfolios we translate these measures, which we make in local currency, into US dollars using an inflation adjusted exchange rate, Purchasing Power Parity, or PPP – not spot exchange rates. This provides a universal, real wealth comparison, in US dollars and adds stability to our weights.

How do we build international portfolios using our measures of wealth creation?

First, we believe that our portfolios should contain ALL companies that are in the relevant benchmark, in this case the 1,032 companies in EAFE.

Then taking cash earnings, for example, we rank the companies from the biggest cash generator to the smallest. Then we calculate each company's proportion of the \$750 billion of total cash earnings generated by EAFE. This is, in effect, a weighting or allocation scheme that can be viewed as an active strategy.

We do the same for each one of our four wealth creation factors: net profit, cash earnings, dividends and book value. These are then combined into one single EAFE portfolio. And this is our core competence – building portfolios without reference to prices by focusing purely on wealth creation.

With this systematic, bottom-up process it is a straightforward matter to establish country weights for our EAFE portfolio. Country wealth is simply the sum of listed companies' wealth - in this case each MSCI Country Index of companies. This approach avoids having to use macro-economic measures such as GDP which bear little relationship to the actual wealth creation of listed companies in most countries.

By focusing on pure wealth creation numbers we are able to obtain more stable weights which are not static, but dynamic.

Why do we want active country weights?

We believe that country selection is dominant in international performance and that it will continue to be so in the future. Country selection returns are also less volatile. Focusing on country wealth creation enables us to get the right balance between the risk and return in our EAFE portfolio which is in the lowest decile for tracking error within the InterSec universe.

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Another advantage of using active country weights is that this affords an efficient, low cost, top-down implementation strategy. We are able to implement our portfolios using either State Street or Barclays Country Index funds. Our live experience over the past 2 3/4 years has delivered better than 50% crossing, thereby lowering our transaction costs.

Following a highly disciplined re-balancing programme of 90-day cycles, allows us to exploit the price volatility in the market. At each re-balancing point, we accumulate markets whose falling prices have carried them below our allocation and we sell those markets whose rising prices have carried them above our wealth allocation.

Turn-over is in the lowest quartile which, when combined with the substantial crossing, produces transaction costs well below average – 15 basis points per annum.

Overall we expect to deliver 200 basis points per annum more than the Index with a low tracking error.

In summarising then and to conclude, we offer our clients the following features: the stable weights – because we focus on wealth creation, low tracking error – because we focus on country selection, low turn-over – because we have a disciplined re-balancing programme and, finally, high capacity – because we hold every company in the benchmark. It is with these features that we seek to achieve our aim of delivering consistent, top quartile, risk-adjusted performance with low tracking error to our clients.

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