



Re-imagining the art of portfolio construction

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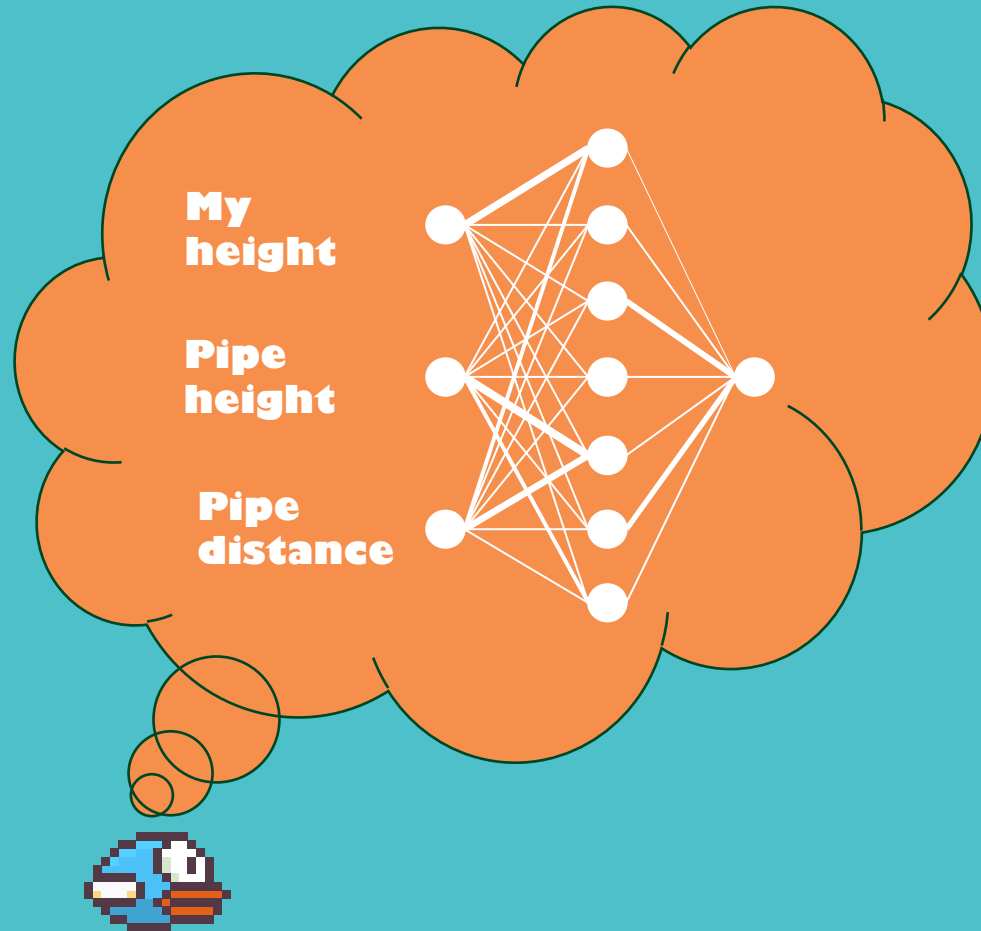
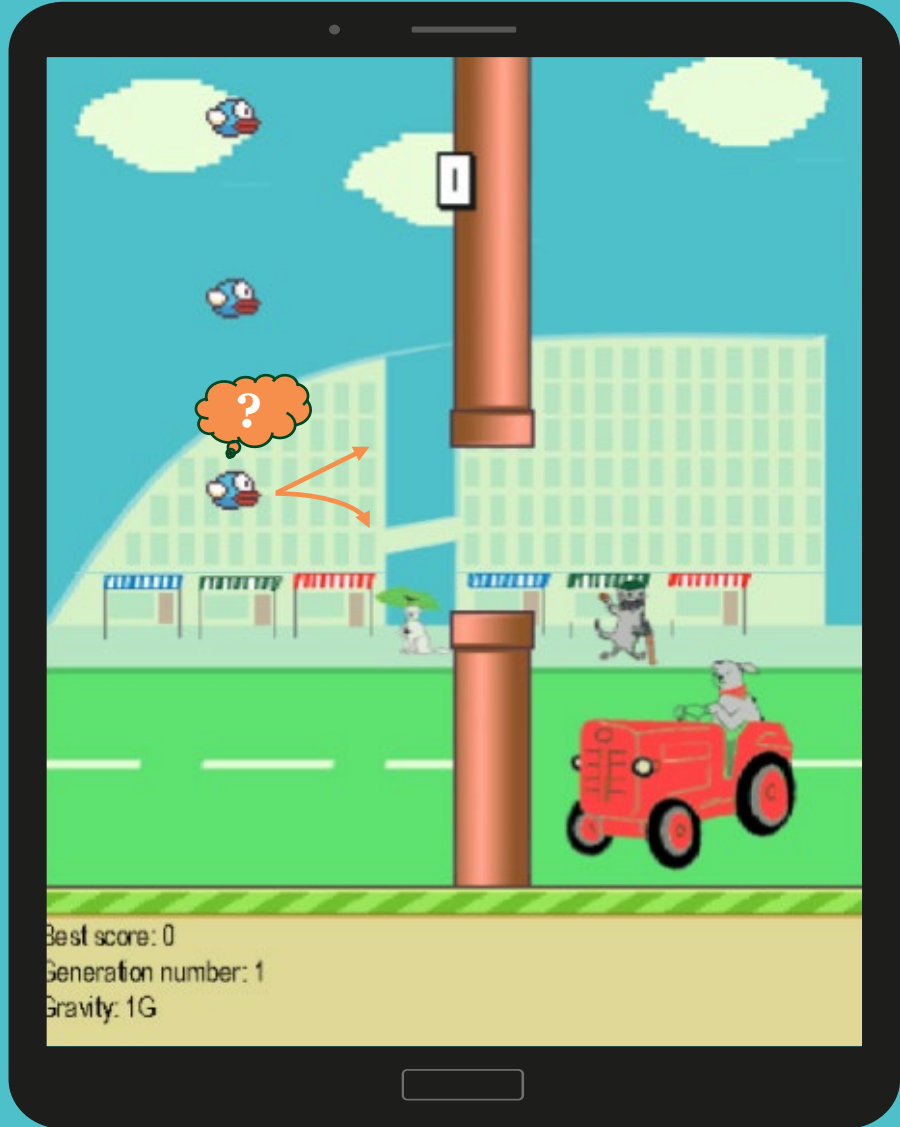
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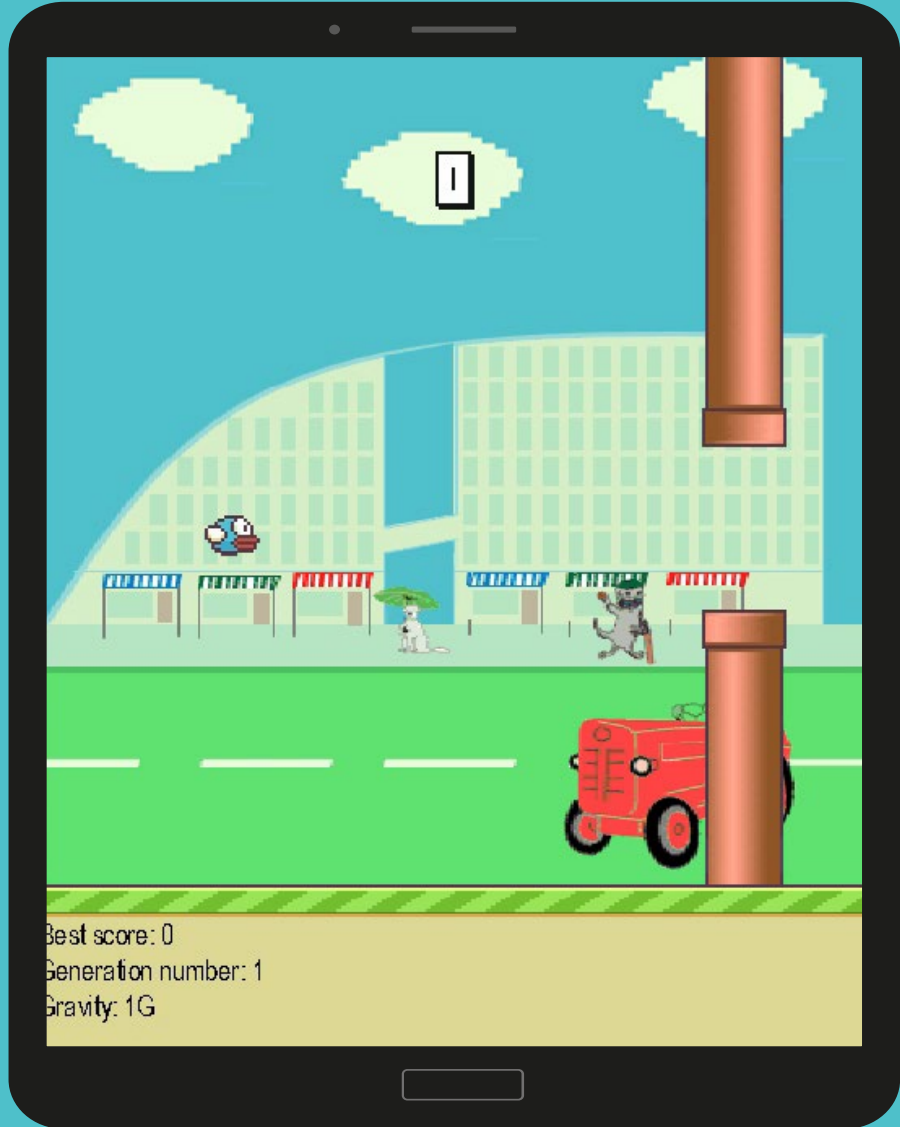
NOVEMBER 2021

Summary

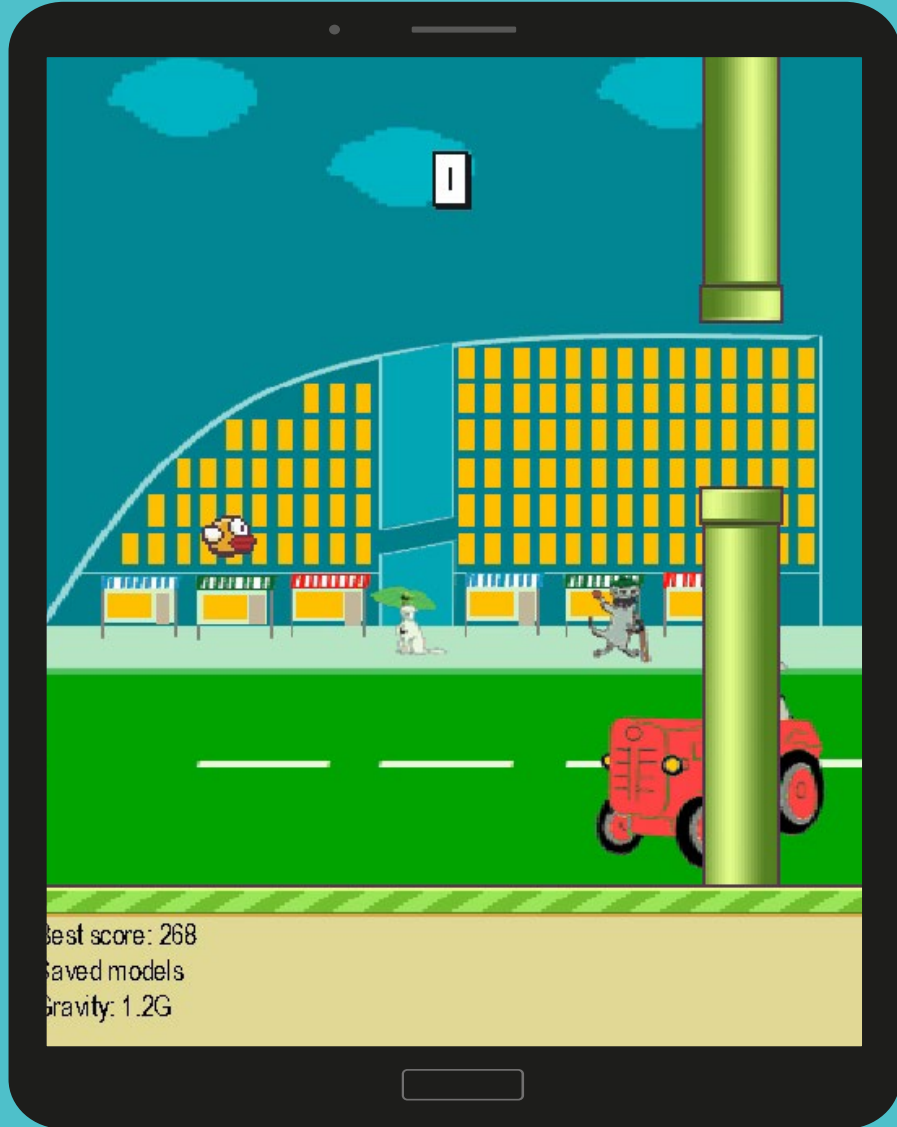
- Portfolio construction hasn't evolved
- Current methods are vulnerable to a sea change
- The likelihood of this is increasing
- Portfolio construction may need a re-think

Flappy bird primer





Stable environments =
hyper-optimised
agents...

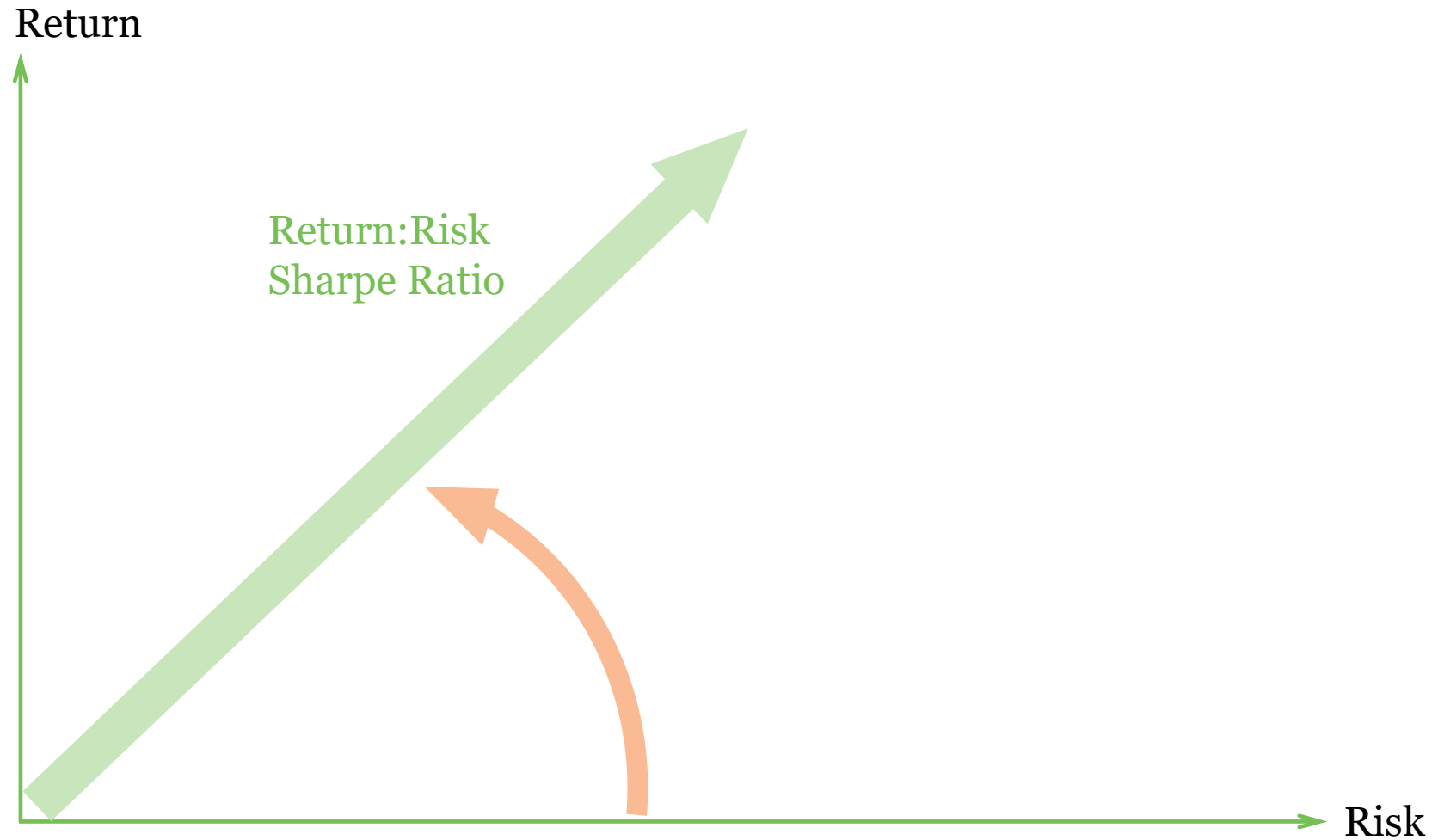


... vulnerable to small environmental change

What sort of market environment?



Markowitz in '52 – the fundamental trade-off

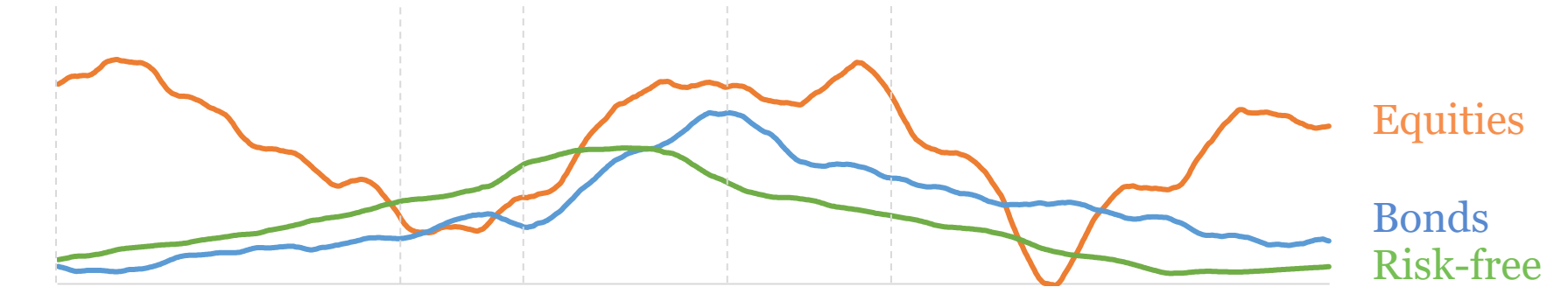


Allocating optimally

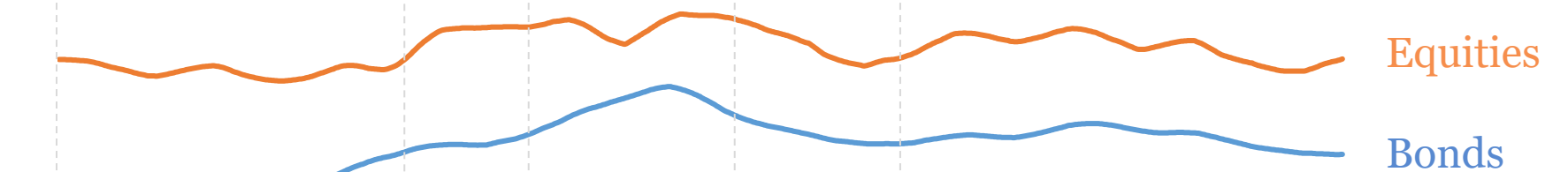


Stylised conditions 1952 to today

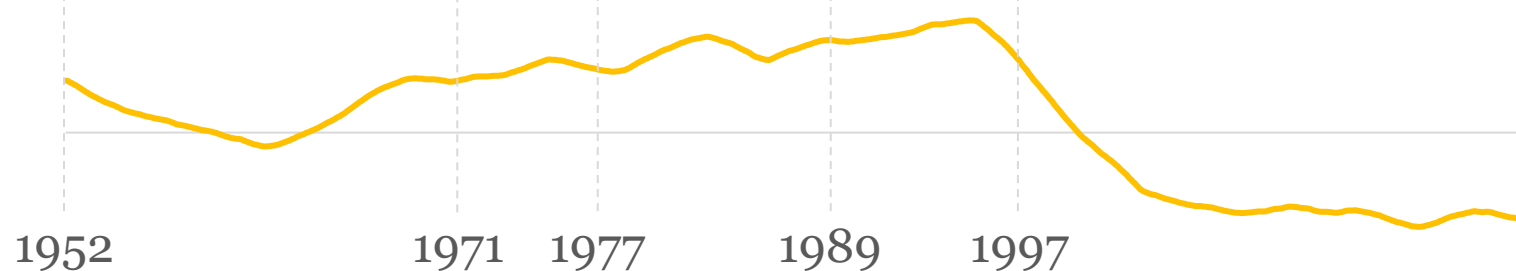
RETURNS



VOLATILITY



CORRELATION



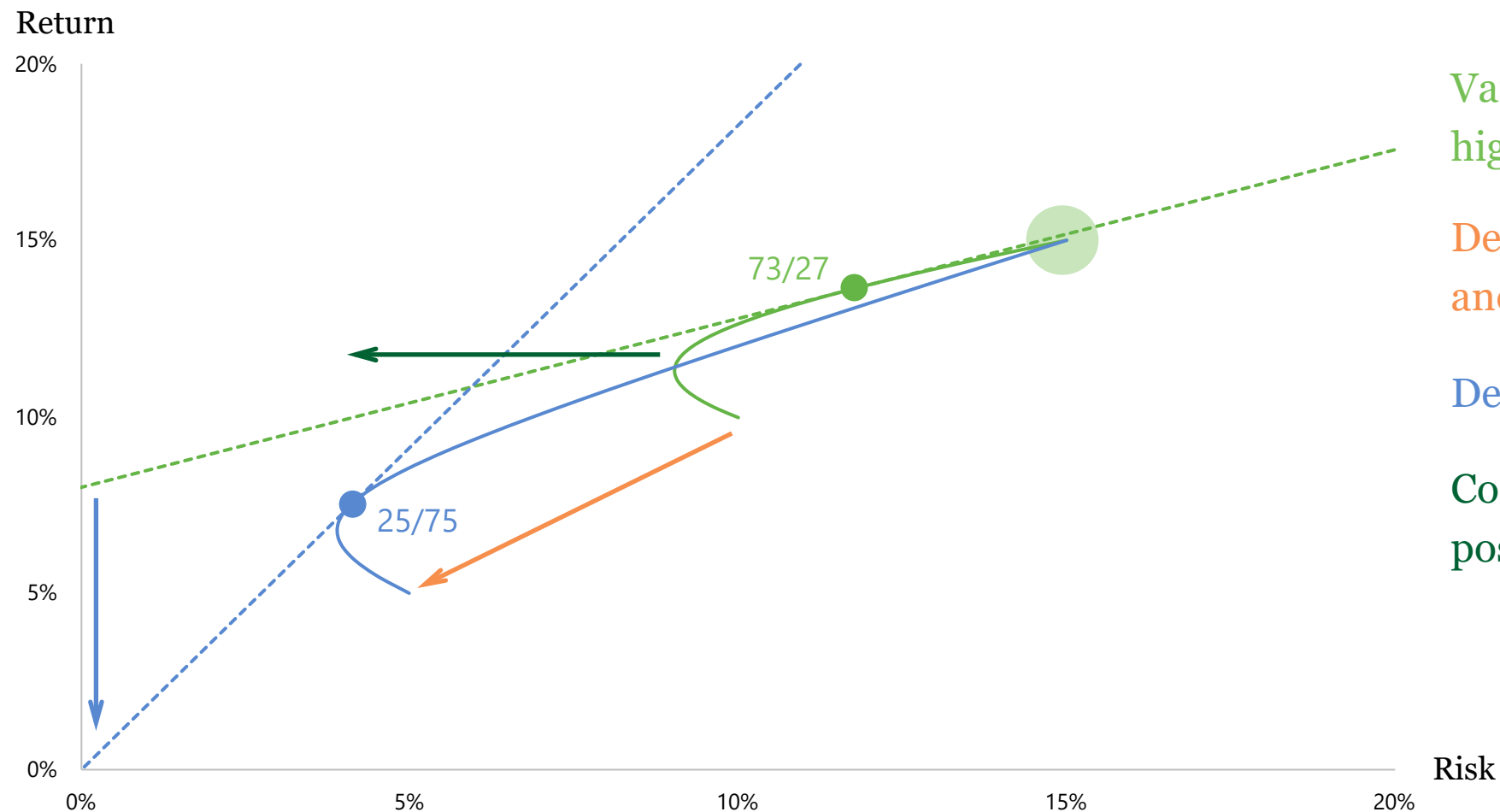
Source: GFD, Ruffer. Returns: S&P500 Total Return, GFD 10y US Treasury Total Return, GFD 2y US Treasury Yield. Volatility: S&P500 Total Return, GFD 10y US Treasury Total Return. Correlation: S&P500 Total Return and GFD 10y US Treasury Total Return

A Financial Renaissance

- Gold standard and Bretton Woods (1971)
- Federal Reserve Reform Act (1977)
- Apple II, TRS-80, Commodore PET (1977)
- China's Four Modernisations (1978)
- Commercial internet service providers (1989)
- Asia Crisis (1997)

Portfolio construction in its natural habitat

SHARPE RATIO INCREASES FROM 0.5 TO 1.8



Variable equity returns with high but steady volatility

Declining bond returns and volatility

Declining risk-free rate

Correlation flip from positive to negative

The Great Carcinisation



Portfolio
construction

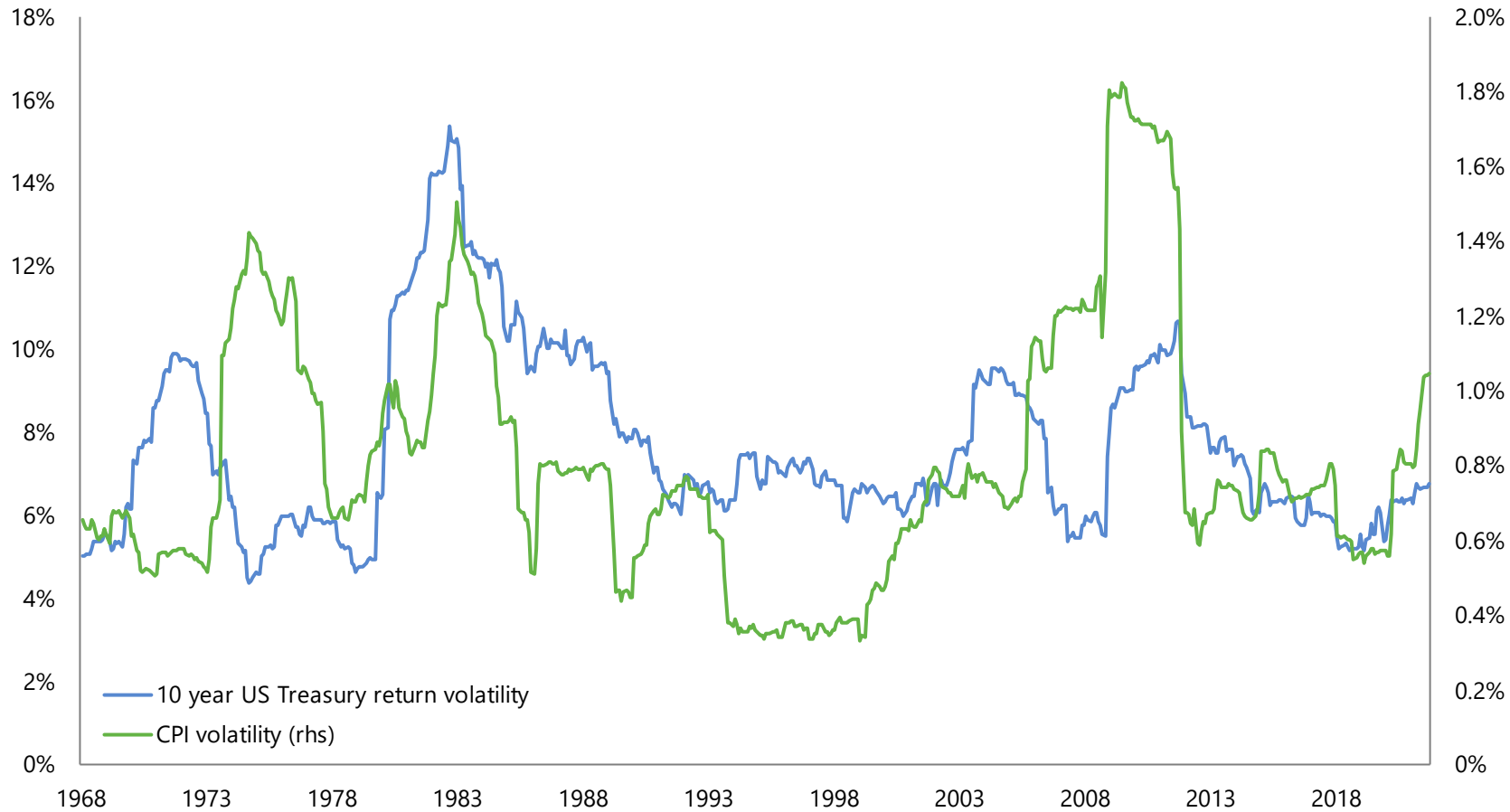
Risk metrics

Exposures

Risk premia

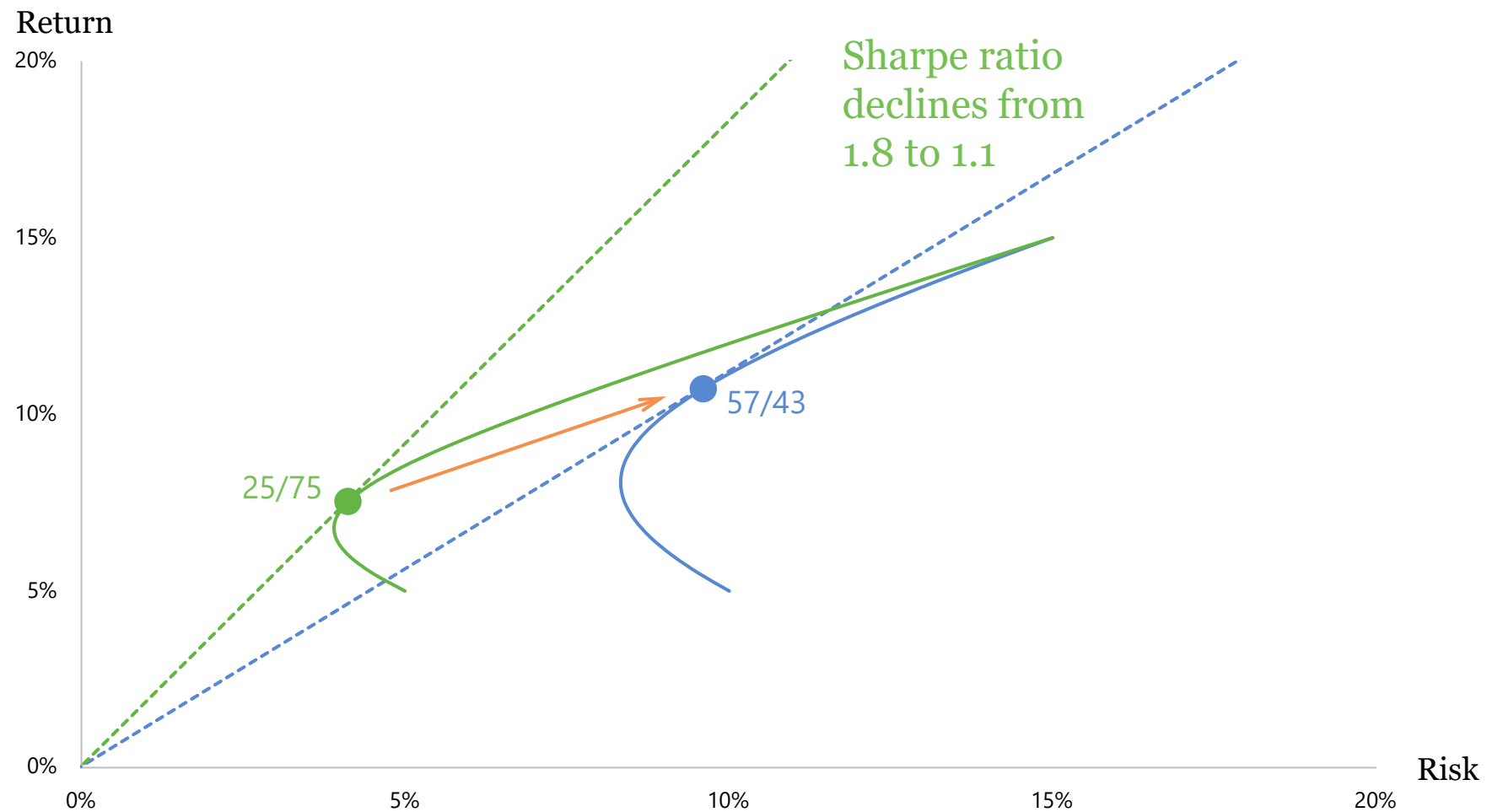
Why might the environment be changing?

INTEREST RATE VOLATILITY COULD BE DUE A RETURN



The framework starts to creak

A RISE IN BOND VOLATILITY LEADS TO WORSE OUTCOMES





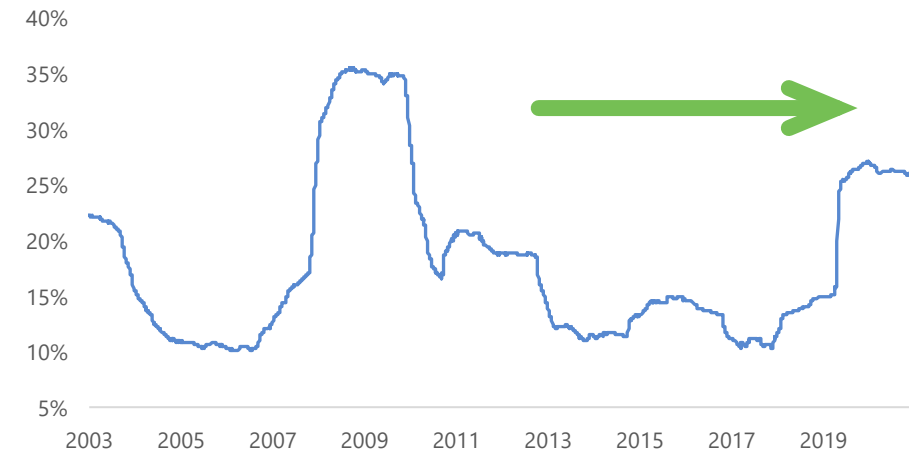
Rate volatility is just one product of the changing environment

Danger lurks beneath the surface of equities

RETURN



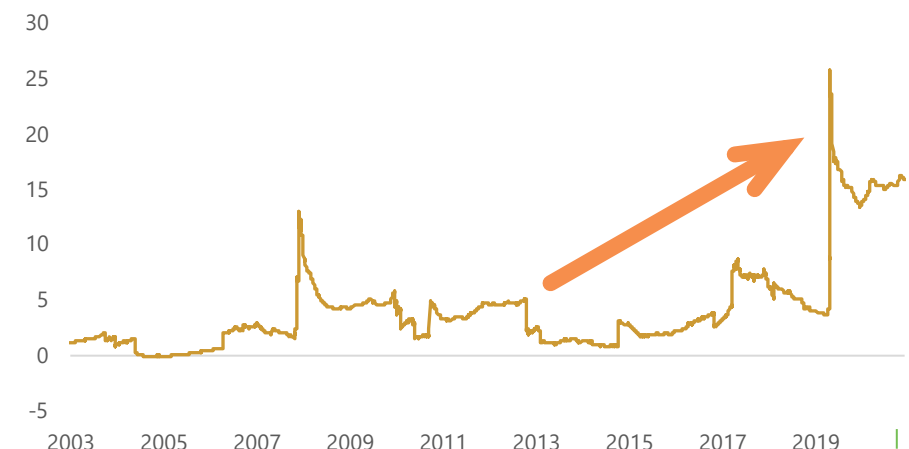
VOLATILITY



SKEWNESS

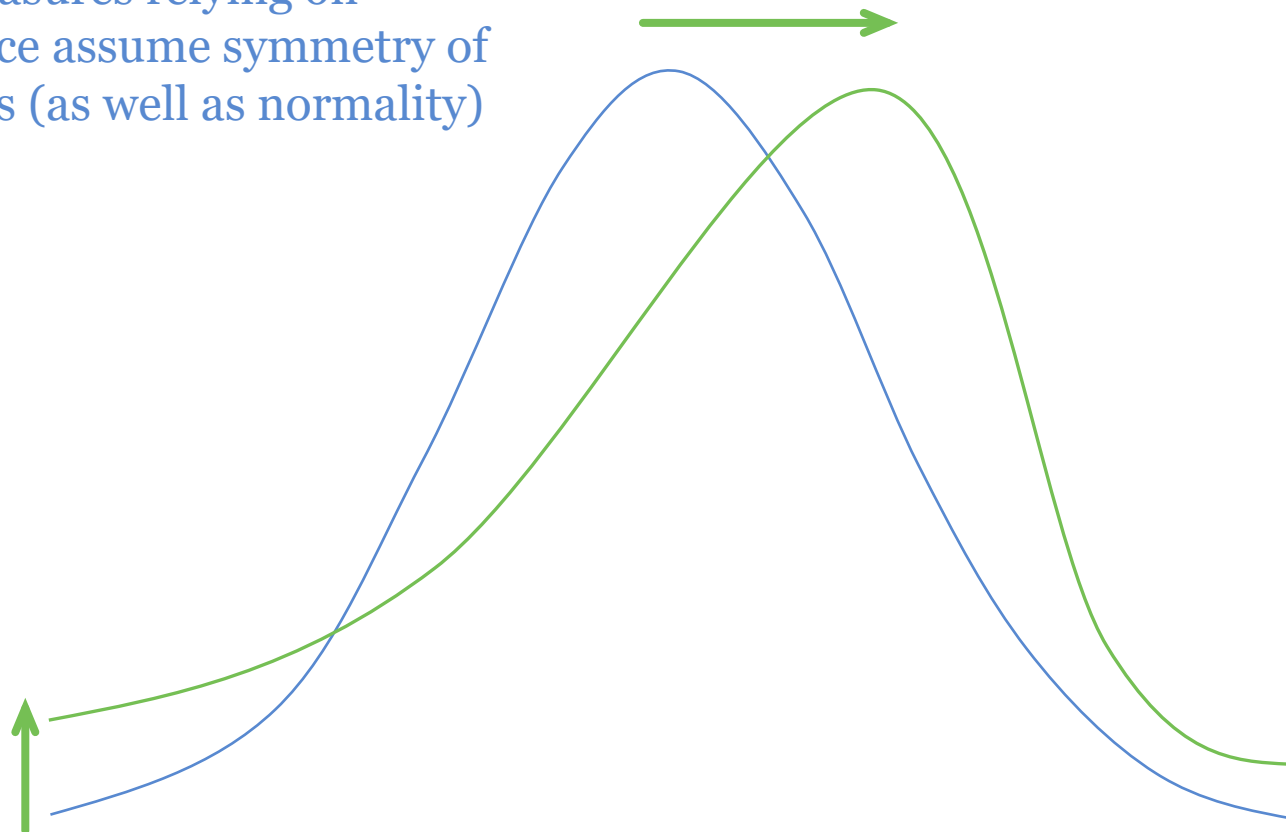


FAT-TAILEDNESS



The framework breaks

All measures relying on variance assume symmetry of returns (as well as normality)



The more symmetry is violated, the worse the allocation errors produced by the framework

Modernising Modern Portfolio Theory

- If we consider our wealth proportionally, rather than in absolute dollar amounts (defining a function $U(r)$)

$$E[U(r)] = U(0) + U'(0) \cdot \overset{\text{Return}}{\underset{\text{Max}}{E[r]}} + \frac{1}{2!} U''(0) \cdot \overset{\text{Volatility}}{\underset{\text{Min}}{E[r^2]}} + \frac{1}{3!} U'''(0) \cdot \overset{\text{Skewness}}{\underset{\text{Max}}{E[r^3]}} + \frac{1}{4!} U^{(4)}(0) \cdot \overset{\text{Kurtosis}}{\underset{\text{Min}}{E[r^4]}} + \dots$$

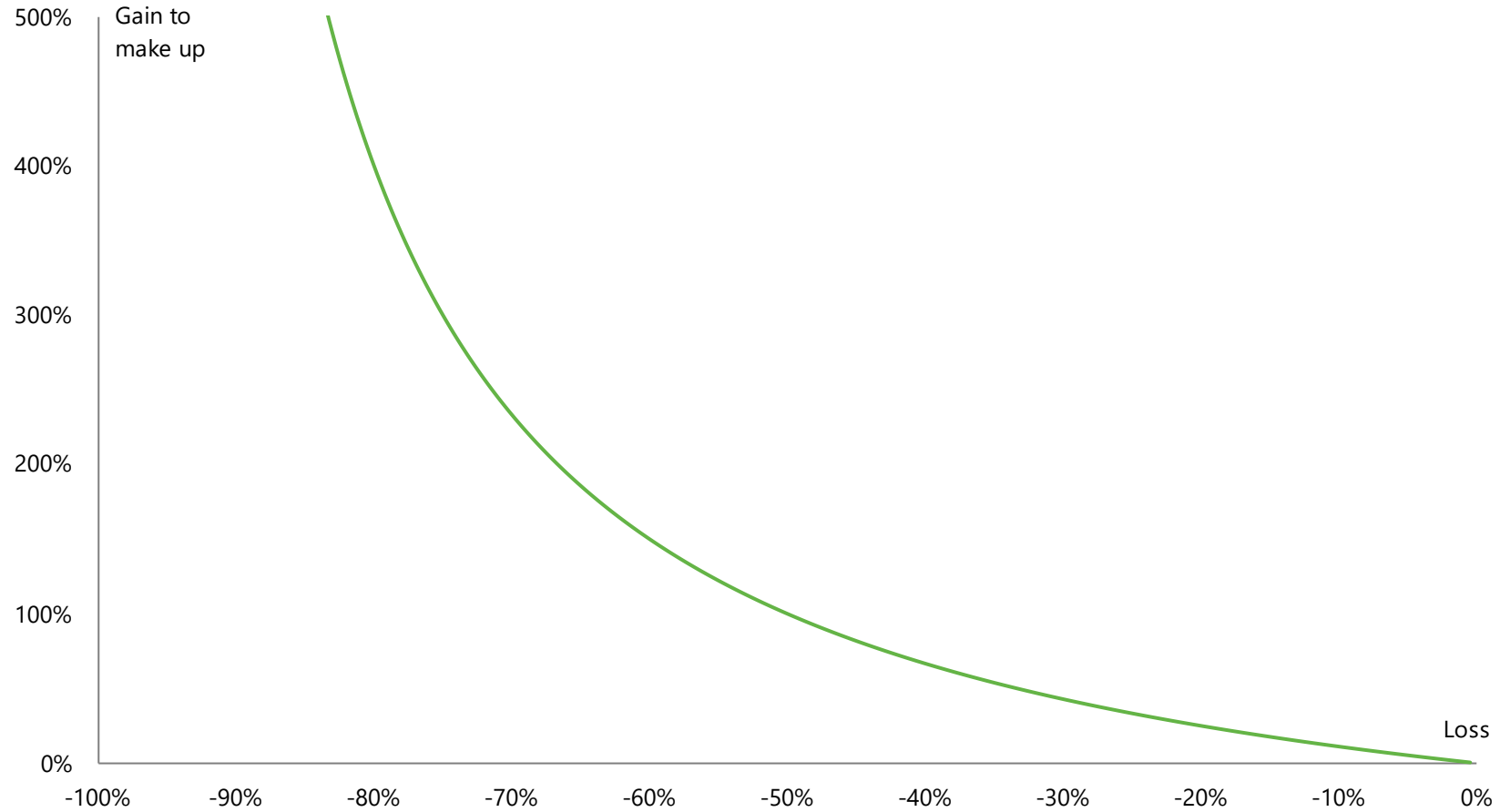
- Complicated

- Estimates of return and covariance still needed

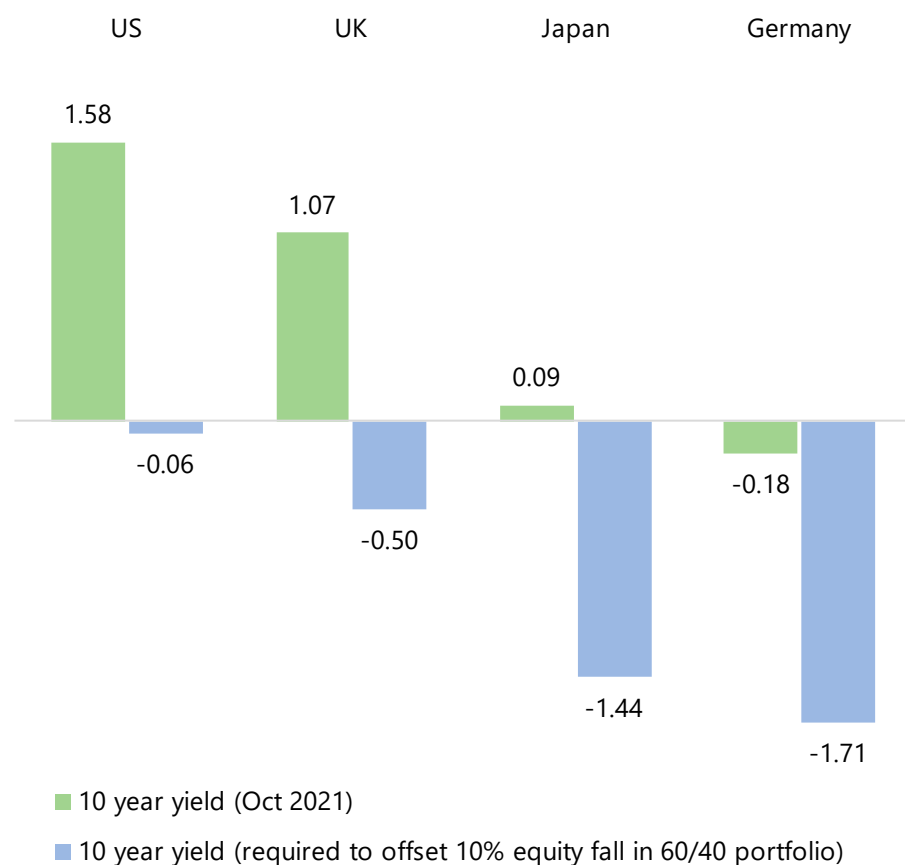
What to do?

- Avoid large losses
- Find convexity
- Make sure you pay for it

Preservation of capital before all else



No more free lunches



“It is pretty obvious that with interest rates near zero and being held stable by central banks, bonds can provide neither returns nor risk reduction.”

Bob Prince, Co-CIO
 Bridgewater Associates
 July 2020

Need convexity

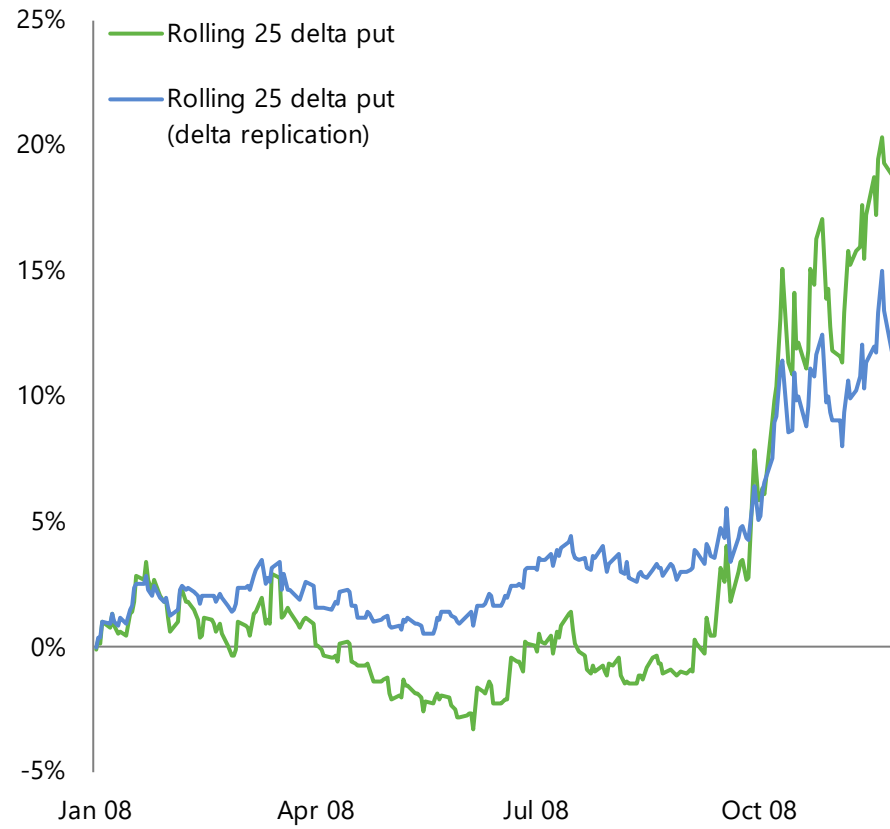
- Asset returns compensate for potential losses in bad times

$$\text{Risk premium}_t^i = -\text{Covariance}(\text{Asset excess return}_{t+1}^i, SDF_{t+1})$$

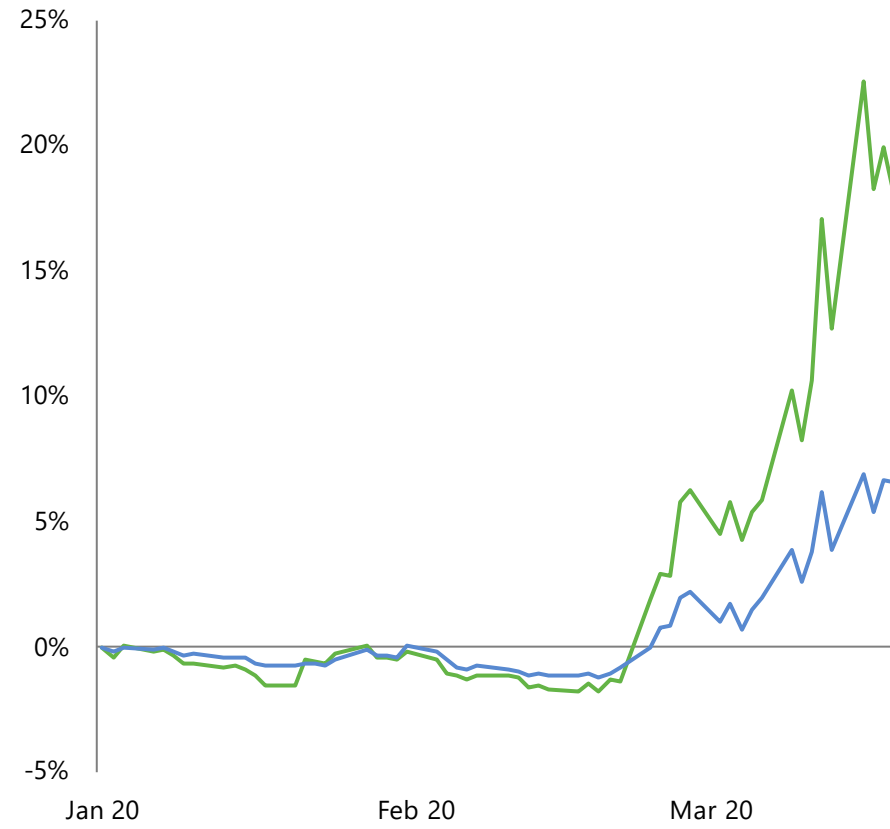
- Assets that benefit from bad times carry negative risk premium
- Convex payoffs come with a price

Got to pay to play

2008



2020



Protection framework

VALUE

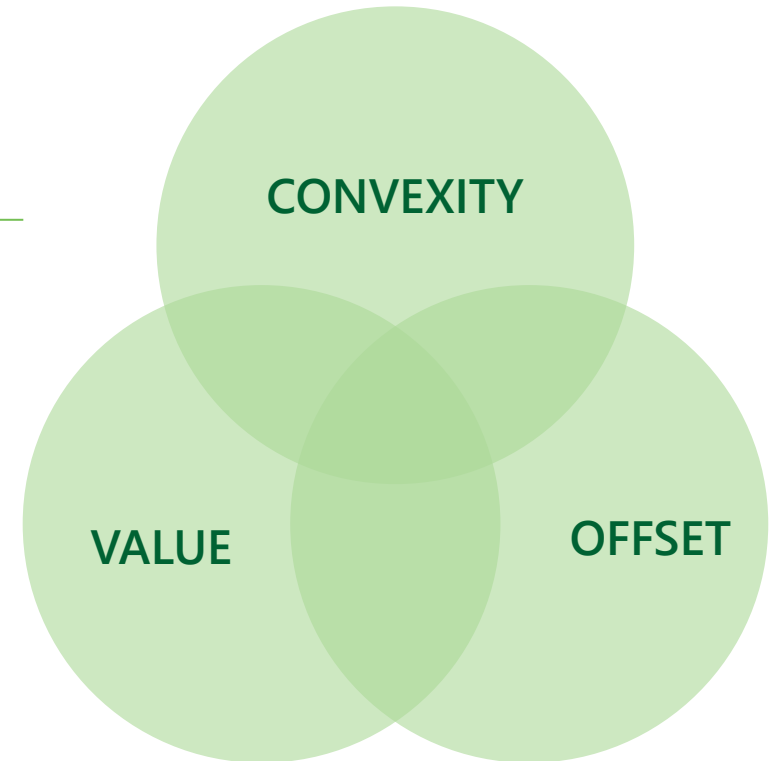
Look for protection we believe to be cheap
 For instance, where there is a structural supply

OFFSET

Identify protection which can provide a meaningful payoff in adverse conditions

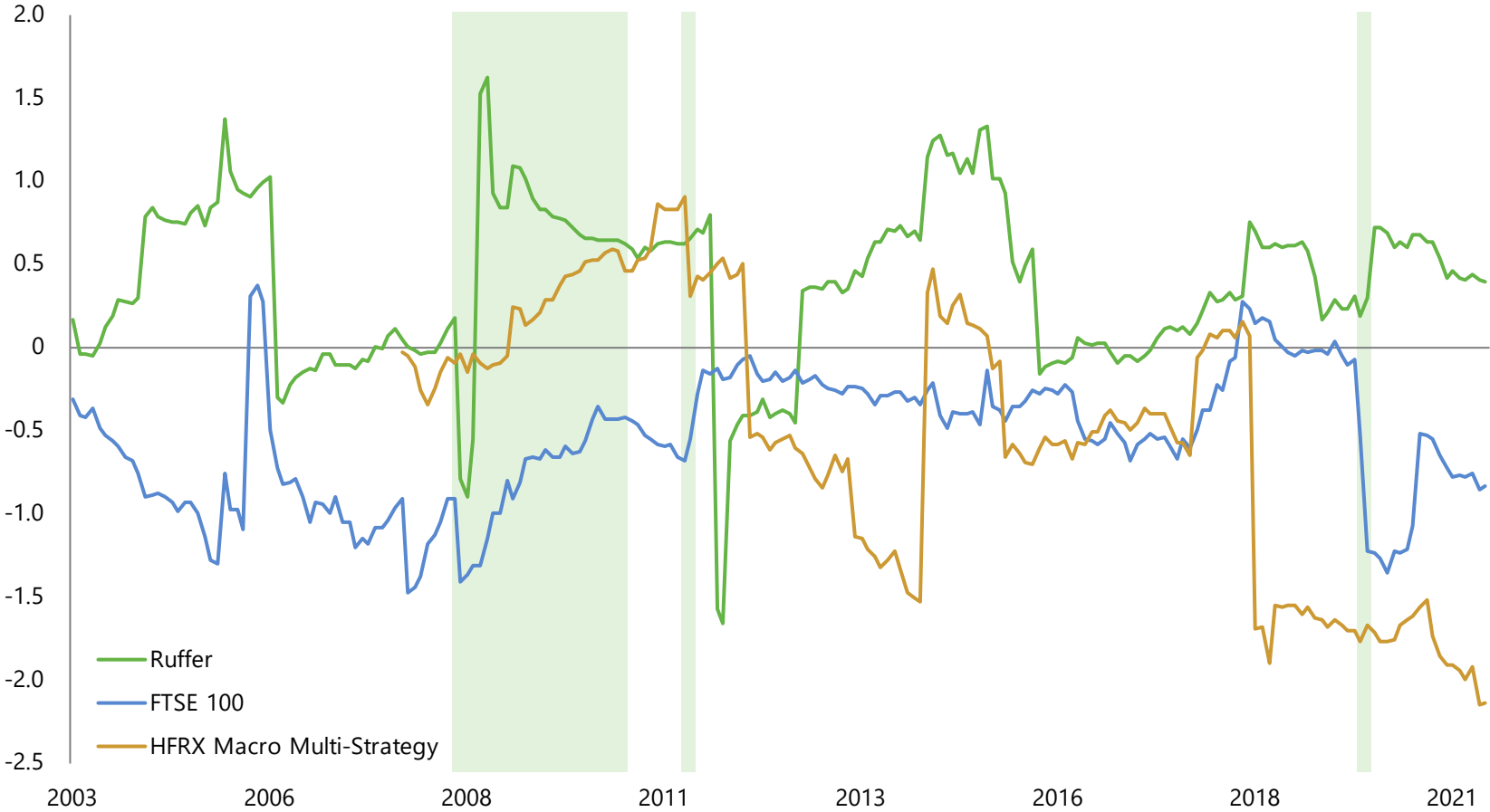
CONVEXITY

Target protection to match risks in the portfolio



The right sort of convexity

SKEWNESS OF RETURNS – RUFFER AND COMPARISONS



Source: Source: Bloomberg, Ruffer, data to 30 September 2021. Performance data is included in the appendix. Data is based on reinvested income. All references to Ruffer performance refer to the Ruffer Total Return Fund class 'O' shares



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[RUFFER.CO.UK](https://www.ruffer.co.uk)

Regulatory performance data

PERCENTAGE GROWTH

To 30 Sep %	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21
Ruffer	19.8	8.9	17.8	0.7	4.0	4.6	27.3	10.1	4.0	2.0	11.1	2.6	2.3	12.9	0.3	1.6	1.7	7.3	12.6
FTSE 100	9.9	11.7	19.8	8.8	8.5	-24.2	4.7	8.1	-7.6	12.0	12.5	2.5	-8.5	13.8	6.9	1.9	-1.4	-20.8	20.8
HFRX MMS				8.4	13.0	-0.4	16.8	5.1	-2.1	8.1	1.4	5.8	-1.4	-1.8	4.2	1.4	-1.5	4.4	9.5

Source: Ruffer, FTSE International, Bloomberg. Ruffer performance is shown after deduction of all fees and management charges, and on the basis of income being reinvested. Past performance is not a reliable indicator of future performance. The value of the shares and the income from them can go down as well as up and you may not get back the full amount originally invested. The value of overseas investments will be influenced by the rate of exchange. Calendar quarter data has been used up to the latest quarter end. Ruffer LLP is authorised and regulated by the Financial Conduct Authority. This document, and any statements accompanying it, are for information only and are not intended to be legally binding. Unless otherwise agreed in writing, our investment management agreement, in the form entered into, constitutes the entire agreement between Ruffer and its clients, and supersedes all previous assurances, warranties and representations, whether written or oral, relating to the services which Ruffer provides.

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