

NORTHFIELD ASIA RESEARCH SEMINAR

Wednesday, 31st October 2018

Quay Restaurant

Circular Quay, Sydney

8:30 Continental Buffet Breakfast

9:00 Welcome and Introductions

9:15 Northfield Today

Dan diBartolomeo – Founder and President

Over the past 30 years Northfield have built a reputation as a market leader in risk management and portfolio construction. However, during that time the range of services Northfield provides has grown to encompass offerings for virtually the entire asset management industry. Listen to Northfield's founder and president Dan diBartolomeo explain how that process has happened, and where we are today.

- *Portfolio managers can identify, measure and control risk for both absolute and relative return strategies. Our models cover all traded securities and illiquid assets globally.*
- *Plan sponsors and asset owners of all types can monitor total portfolio risk and conduct "what if" scenario analysis by hosting our enterprise wide risk system or receive risk reporting only via our hosted consulting service or from one of our preferred partners.*
- *Private wealth advisors and managers may use our asset allocation/location and tax optimization analytical tools at the enterprise level or single portfolio level to trade off risk, return and taxes for their taxable clients.*
- *Bank and Insurance company portfolio managers may use our enterprise wide risk management system to monitor and control risk across all asset classes globally including illiquid alternative assets.*

9:45 Why Getting Risk Right is Wrong

Many investment professionals who use risk models make a common mistake. They assume that a risk model is working well if the amount of volatility realized by a particular asset or portfolio is consistent with what the model had predicted. They believe that volatility forecasts should be an unbiased estimator of subsequent realized volatility. In this presentation we will provide five different rationales as to why seemingly unbiased estimates of volatility are undesirable both statistically and economically. The implications of these arguments are that professional investors routinely take too much risk, back-tests and simulations fail to capture the true risk of strategies, and that evaluation of investment performance is biased toward perceiving luck as skill -- leading to upward biased performance related compensation.

10:30 Parameterization of the Tax/Risk Tradeoff for Taxable Portfolios

In the more than twenty years that Northfield has offered tax sensitive optimization techniques, many of our clients have struggled to define economically rational tradeoffs between investment related taxes and portfolio risk. While reductions in taxes can be easily demonstrated when investors make smaller tax payments than they otherwise would have done, the benefit to investors from reducing portfolio risk accrue slowly over time and are perceived to be beneficial only under volatile market conditions. In this presentation, we will provide the explicit framework that provides the most transparent method for sensibly making decisions for tax/risk tradeoffs. While the basic structure of the problem has been in place since the introduction of our tax optimization methods in 1996 we will explore many nuances to the appropriate parameterization of the problem. Among these nuances are the explicitly multi-period nature of the problem, correctly defining portfolio turnover for active management, and the inclusion investor-centric issues.

11:15 BREAK

11:30 The Fundamental Myths of Fundamental Models

Many investment organizations have come to the belief that "fundamental" (endogenous) models of equity returns and risk are somehow more useful than other models for a variety of reasons. While some of these reasons are correct there are important aspects of fundamental models that are widely misunderstood. In particular, the assertion that fundamental models are inherently more accurate than other risk model structures is entirely false. The purpose of this presentation is to make clarify the nuances as to what is and is not real about fundamental models in comparison to other model frameworks of return and risk. For purposes of definition we will consider a "fundamental" model as one where the factor exposures at the security level are observable at a moment in time. The

analytical structure of the model then involves statistical estimation of factor returns for each time period, and the estimation of the covariance matrix of these factor returns. By way of example, we might think of the capitalization of a company, or the price/earnings ratio of the stock, or the membership of the firm in an industry group as “fundamental characteristics” which we can observe at the security level. There is no need for statistical estimation of the information describing individual stocks or companies. Often, the “fundamental” aspect of such models arising from the use of data elements from the firm’s financial statements (i.e. book/price ratio) which is in some measure parallel to the way that fundamental investors might view a particular stock. It should be noted that our purpose is not to criticize fundamental models per se, but to illustrate the true benefits and disadvantages of this type of model.

12:15 LUNCH

13:30 Crowded Trades and The Liquidity Risk Time Bomb

During the financial crisis years of 2007-2009, much of the declines and volatility experienced by global markets purportedly had to do with liquidity related concepts. These effects ranged from the “hedge fund meltdown” of August 2007 to the destabilization of money markets triggered by the failure of Lehman Brothers. The near-failure of numerous other financial institutions contributed further to the misery, to which central banks responded with unprecedented injections of massive liquidity into financial markets. Since then, the equities world has been subjected to lots of discussions on “crowding” of strategies and factors. Interest rates have gone to zero or even negative in many countries. The rapid growth of ETFs makes the current problem worse, as ETFs are traded with high liquidity but without regard to the fact that many of the underlying securities may not be equally liquid. Regulators such as the US SEC and the various aspects of MIFID II in Europe have begun to require that asset managers of open-end funds and ETFs carry out analyses of their liquidity risk. In addition, regulators desire trading practices that do not unfairly shift the cost burden of large liquidations to remaining investors from those investors withdrawing. In this presentation, we will describe various approaches different participants in the asset management industry are taking to analyze liquidity risk. Unfortunately, we find that in all but a few cases the analytical approaches being undertaken are unsound. These flawed analyses give the impression that market liquidity to transact securities is far greater than actually it is. We will conclude with an optimization based approach for managing liquidation costs in crisis conditions.

14:15 Sector Taxonomy and Sustainable Long Term Investing

In this presentation we will examine the attributes that allow companies to survive in the long run. Through the lens of the nearly thirty year history of the Northfield risk models we can examine the set of companies, both in the US and globally, that have survived a quarter century or more. In the first part of the analysis, we contrast the characteristics of the portfolio of survivors as compared to the portfolio of non-survivors at various time points over the past three decades. In the second part of the analysis, we compare the set of actual survivors with the set of expected survivors as predicted the sustainability model of diBartolomeo (Journal of Investing, 2010). The second part of the analysis will be to review the market-relative performance of the portfolios of both the predicted and realized sets of “sustainable” firms so as to consider the investment viability of strategies based on sustainability. In the final part of the presentation, we will provide a comparison of GICS the sector scheme (presumed indifferent to sustainability) and SASB sector scheme in which sustainability is the key driver.

15:00 Closing Remarks

A wrap-up discussion with final questions and answers on any of the sessions.