ADVISOR PERSPECTIVES

Our Interview with Mohamed El-Erian

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Mohamed A. El-Erian is co-CEO and co-CIO of PIMCO, one of the largest investment management companies in the world. Previously, he was president and CEO of Harvard Management Company, where he oversaw the university's $35 billion endowment. He spent 15 years at the International Monetary Fund, working on policy, capital markets, and multilateral economic issues. His recent book, *When Markets Collide,* is available through the link above.

We interviewed Mr. El-Erian on July 16, 2008.

Your asset allocation targets an 8-10% steady state nominal annual return, with 8-12% volatility. This is in excess of the historical returns on US equity markets. What are the key factors that will allow investors to achieve these returns?

Let's start one step one higher. What will determine success for financial advisors in the coming years? I believe that, more than ever, it boils down to getting four key factors right: (1) Specifying and implementing an asset allocation that is consistent with the long-term evolution of risk and returns in the market. This is also a function of the specific objectives and risk tolerance of the individual investor. The best way to frame this question is to ask "If you had to make a decision and could not touch it for three years, what allocations would you choose?" (2) Which investment vehicles should be used? (3) How do advisors deal with the fact that individual decisions embedded in investment vehicles may not add up well, especially during a particularly fluid time such as this?, and (4) What else should advisors do about managing risk and, particularly, the "fat tails" on the left side of return distributions?

The primary thesis of my book is that the world is changing so rapidly that all four factors are at play. So, it matters a great deal how advisors allocate assets, deal with the passive versus active decision, and manage the tail risk.

The reason this matters is that, not only are markets going through a transformation, but the policy and market infrastructure to support these transformations are not equipped to deal with these changes. There will be market accidents and policy mistakes, and these will be much larger

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than what we seen in recent past. I wrote the book before the Bear Stearns saga. Things are playing out much more quickly than what I expected.

Your target asset allocation (based on 2007 data) advocates relatively low equity exposure (49%, based on the mid-point of your range) and bond exposure (14%), with relatively high allocations to real assets (27%) and "special opportunities" (8%). Can you describe the rationale behind these targets? Which asset classes do you expect to perform the best in the coming years, along with providing the best diversification benefits?

My key recommendation for the "typical US investor" is to lower the allocation to equities and, within that, the allocation to US markets. This reflects the fact that the growth dynamic and value proposition are going global. Indeed, even if you are wholly invested in the S&P 500, you are increasing your participation in non-US markets, because its constituents are much more globalized than in the past. But, things are happening so quickly it makes sense to have a greater direct exposure to markets on the international side.

I recommend a lower than traditional equity exposure because of new investment opportunities that don't fit readily and easily into traditional and historic approaches. For a long time, investors did not have to worry about inflation. It is clear today that we are in a world of higher inflationary pressures. As a result, advisors need to think about appropriate inflation protection for their portfolio. That is why there is a real assets category.

Opportunities are also arising in areas that are not well-defined in terms of traditional asset classes. For example, preferred securities in the capital structure do not fit easily into traditional asset classes (i.e., as debt or equity). But preferred securities are becoming increasingly important as investment vehicles. The same is true for climate and water related infrastructure.

Advisors must recognize that good investment opportunities are more global in nature, including in emerging and frontier markets and that many opportunities might be excluded by the traditional mind set. Inflation is going to be a bigger factor over the next three years.

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One of the themes in your book is that "the next few years will belong to those who prudently manage risk." You discuss a tendency of retail investor to outsource this function and to succumb to "agency problems." How can advisors best position portfolios for risk management and avoid these dangers?

There are two sets risk. First, those that - at least in principle - can be delegated to external managers, which often translates to an issue of how well you choose your investment vehicles. In the past, this has been less of an issue for many because buoyant global liquidity lifted all boats and forgave mistakes. With the erosion of global liquidity, it now matters a lot. Advisors need to look not only at the return potential for each manager and investment vehicle, but also at their history of risk mitigation.

Second, someone (either the advisor or through an asset allocation product) must look at the risk characteristics of the portfolio as a whole, and make sure they are consistent with rapidly changing correlations and herd behavior among certain managers. This can be done by advisors directly or through asset allocation products (e.g., target date funds) that do this explicitly.

Another principle you advocate is the separation of alpha and beta in portfolio construction (something we have written about in our publication). Why has this principle gained in importance and how can advisors best implement it?

The dispersion of returns among actively managed strategies has become very large. In the old days, the dispersion resembled a "fan chart." It started with relatively small dispersion in fixed income classes, to larger ones in public equities and very large ones in illiquid asset classes.

Today, we are seeing much more dispersion across all asset classes. The result is, unless you are absolutely confident of your active management choices, it is better to go passive.

The cause of this greater dispersion is that markets are more volatile. We came from a period (until the middle of 2007) that was very good to investors. Risk premia across all asset classes were compressing, delivering high returns and declining volatility. As long as investors were exposed and levered they did well. Now investors can get easily caught with the wrong position in a highly volatile environment. The hurdle for active management has gone up. You have to be sure you are actually getting something. You are paying higher fees and being exposed to more risk.

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You discuss the concept of "Armageddon protection" – insurance against particularly disastrous scenarios. How should advisors hedge against these scenarios?

I worry because the minute we talk about the higher probability of market accidents and policy mistakes, it increases the severity of these failures if they come together. At Harvard we introduced a "fat tail" protection strategy that has worked well during times of market dislocations.

I mentioned previously the four components of building a successful portfolio. The fourth component involves asking what a really bad state looks like, and if there is cheap insurance against it. For example, when you buy car insurance, it is to protect against low probability and high impact events. You do not buy insurance because you expect to crash your car; at least most people don't!. As long as risks can be partially insured cheaply, investors should be willing to forego some returns by paying out a premium. The mindset is very important. This type of tail insurance should run in parallel to the asset allocation process, and will be more important in the future. I expect to see new products in the financial marketplace specifically for this purpose.

Turning to current events, you say that "the present turmoil is neither the beginning nor the end of the transformation phase." Can you discuss the turmoil and transformation going on in the financial services sector and how you expect it will ultimately play out?

Part of the thesis of the book is that there was a lot of noise in the system. Instead of thinking this noise was a sign of something important, it was ignored. People did not read the signals and got caught off sides when the market turned. The general sense of complacency was greatly facilitated by the proliferation of structured finance.

This constituted a major innovation that, like others in history, was initially over-produced and over-consumed. Investors did not look at how these structured products would behave under a full range of scenarios. We now see the consequences – a lengthy process of de-leveraging and de-risking. We see it everywhere – in investment and commercial banks and mortgage agencies

The trouble is that it is very difficult to de-lever simultaneously across the whole industry. Firms must raise capital or sell assets. As they simultaneously raise capital, the cost of capital goes up. As they simultaneously sell assets, the prices of those assets go down. Unless

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banks get a new balance sheet (through a sovereign wealth fund, the US government, etc), this is a lengthy and disorderly process.

I don't believe it will end quickly. A number of steps have to take place. Any attempt to declare an early end to this crisis is premature. It will play out over a long time. Fasten your seat belt and don't put yourself in a position where you have to be a forced seller.

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