Framework Investing

Managing a Hybrid Portfolio

Framework Member Conference Call

Oct 5, 2017

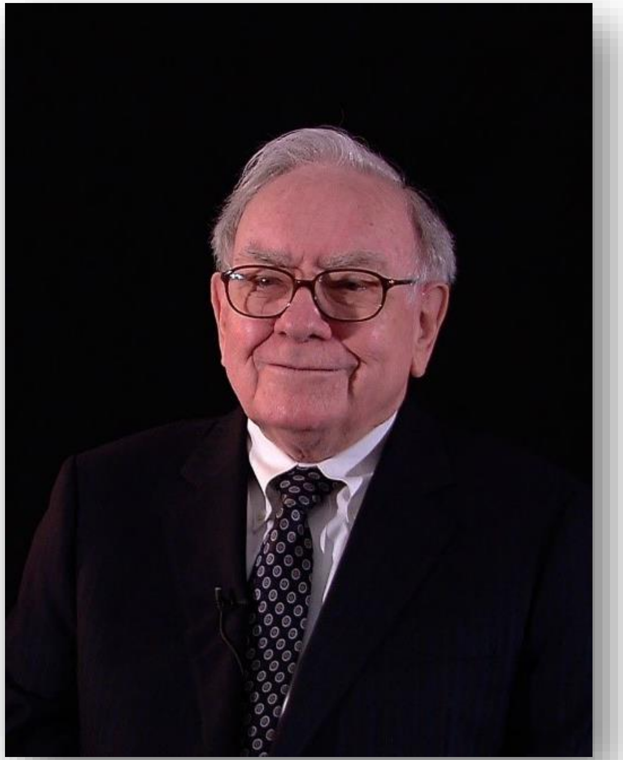
Agenda

- Portfolio Principles
- Leverage
- Bond Replacement
- Investment Layering
- Q&A

Portfolio Principles

Foundations

Building an "Efficient" Portfolio



- "Maximum returns for minimum effort"
- Academic Efficiency
- Buffett Efficiency

Academic Market Efficiency

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Efficient-market hypothesis

From Wikipedia, the free encyclopedia

The **efficient-market hypothesis** (**EMH**) is a theory in financial economics that states that an asset's prices fully reflect all available information. A direct implication is that it is impossible to "beat the market" consistently on a risk-adjusted basis since market prices should only react to new information or changes in discount rates (the latter may be predictable or unpredictable).

The EMH was developed by Professor Eugene Fama who argued that stocks always trade at their fair value, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices. As such, it should be impossible to outperform the overall market through expert stock selection or market timing, and that the only way an investor can possibly obtain higher returns is by chance or by purchasing riskier investments.[1] His 2012 study with Kenneth French confirmed this view, showing that the distribution of abnormal returns of US mutual funds is very similar to what would be expected if no fund managers had any skill—a necessary condition for the EMH to hold.[2]

There are three variants of the hypothesis: "weak", "semi-strong", and "strong" form. The weak form of the EMH claims that prices on traded assets (*e.g.*, stocks, bonds, or property) already reflect all past publicly available information. The semi-strong form of the EMH claims both that prices reflect all publicly available information and that prices instantly change to reflect new public information. The strong form of the EMH additionally claims that prices instantly reflect even hidden "insider" information.

Critics have blamed the belief in rational markets for much of the late-2000s financial crisis.[3][4][5] In response, proponents of the hypothesis have stated that market efficiency does not mean not having any uncertainty about the future, that market efficiency is a simplification of the world which may not always hold true, and that the market is practically efficient for investment purposes for most individuals.[6]

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Market Efficiency

“The Price is Right”

“There’s no free lunch”

Portfolio Implications of Market Efficiency

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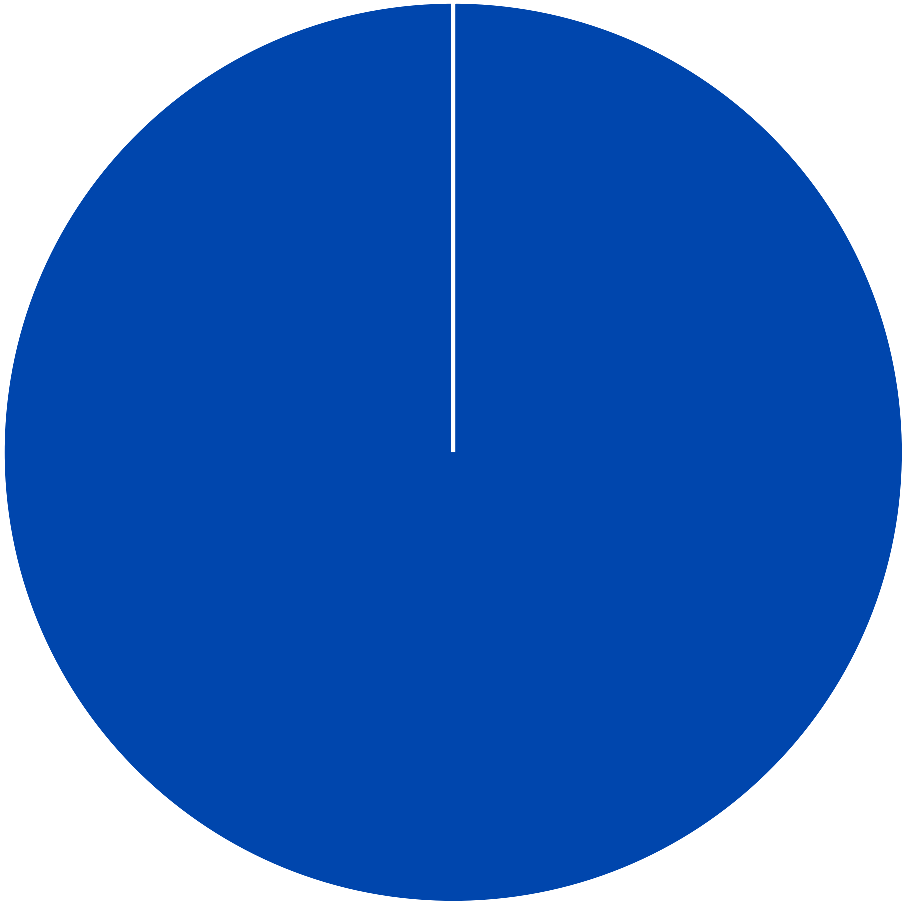
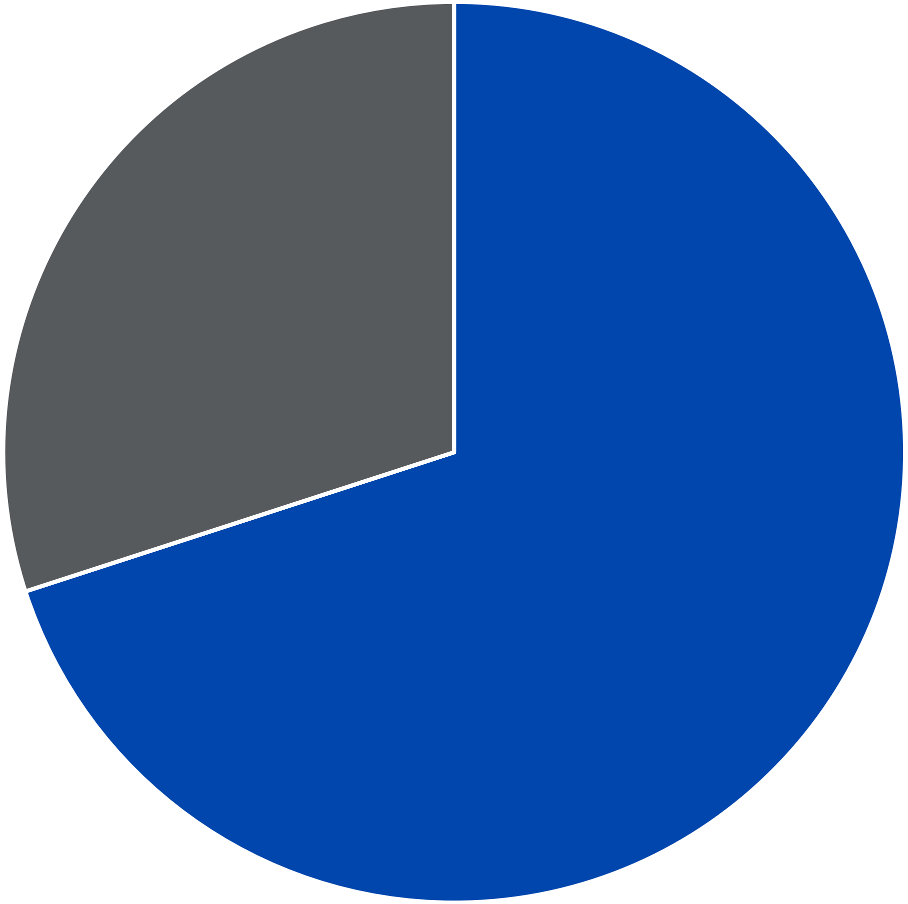
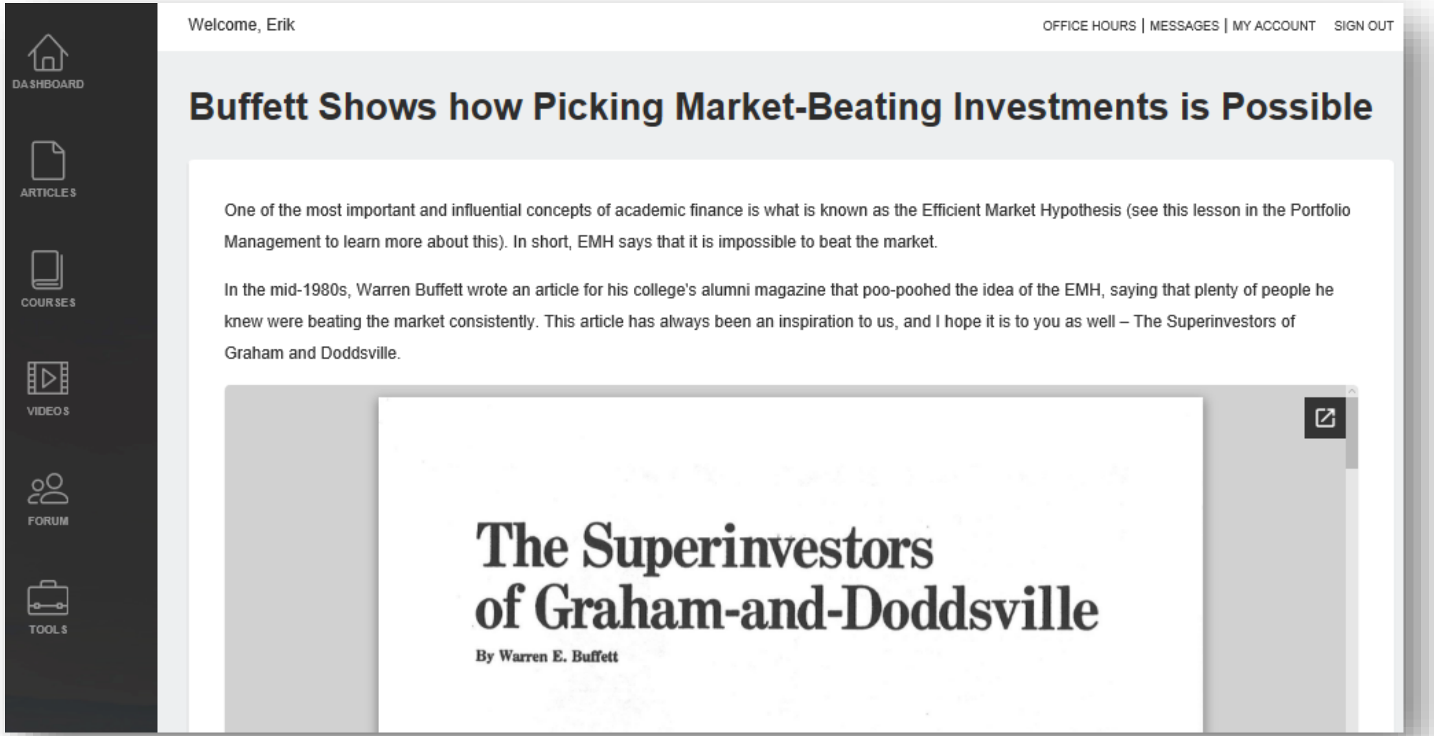


“Price is NOT right” “No free lunch”



Buffett's Idea of Efficiency

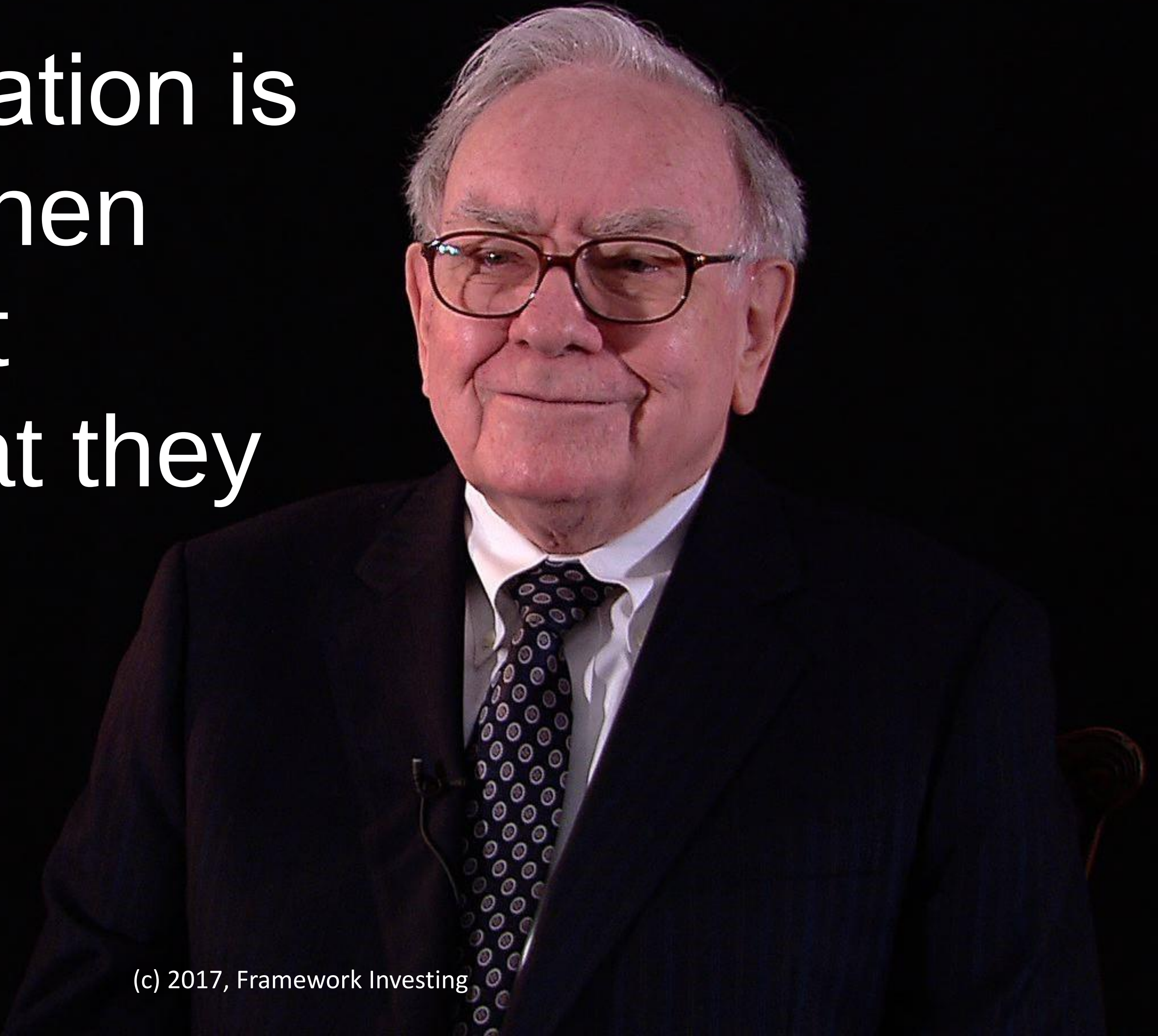


- "Sound Framework for Valuing Investments" LaunchPad

"Investors should remember that excitement and expenses are their enemies…"

“Never invest in a business you can’t understand.”

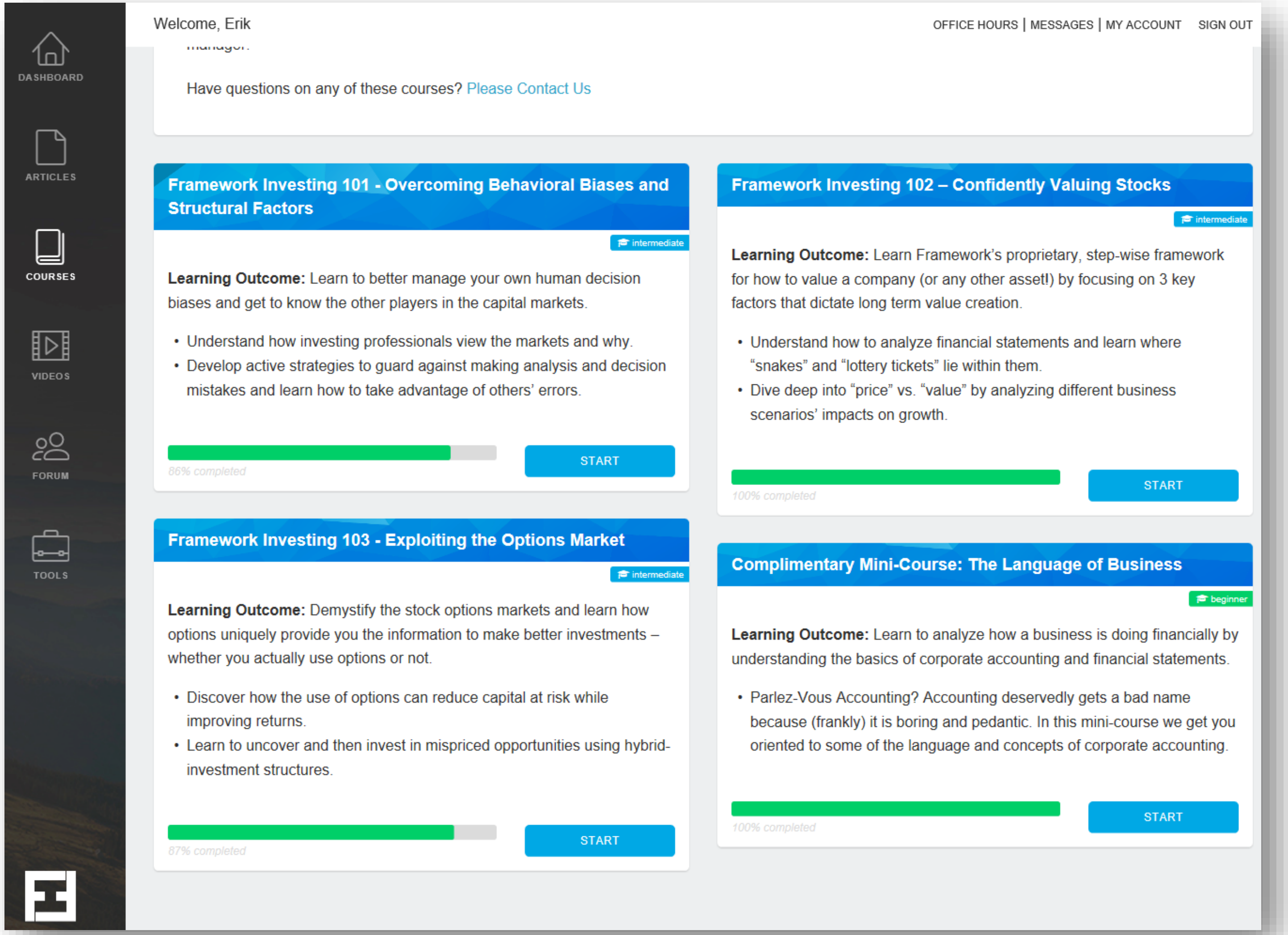
"Wide diversification is only required when investors do not understand what they are doing."



Leverage

The basics of an important but dangerous investment tool

103 Class on Structuring



Leverage Basics

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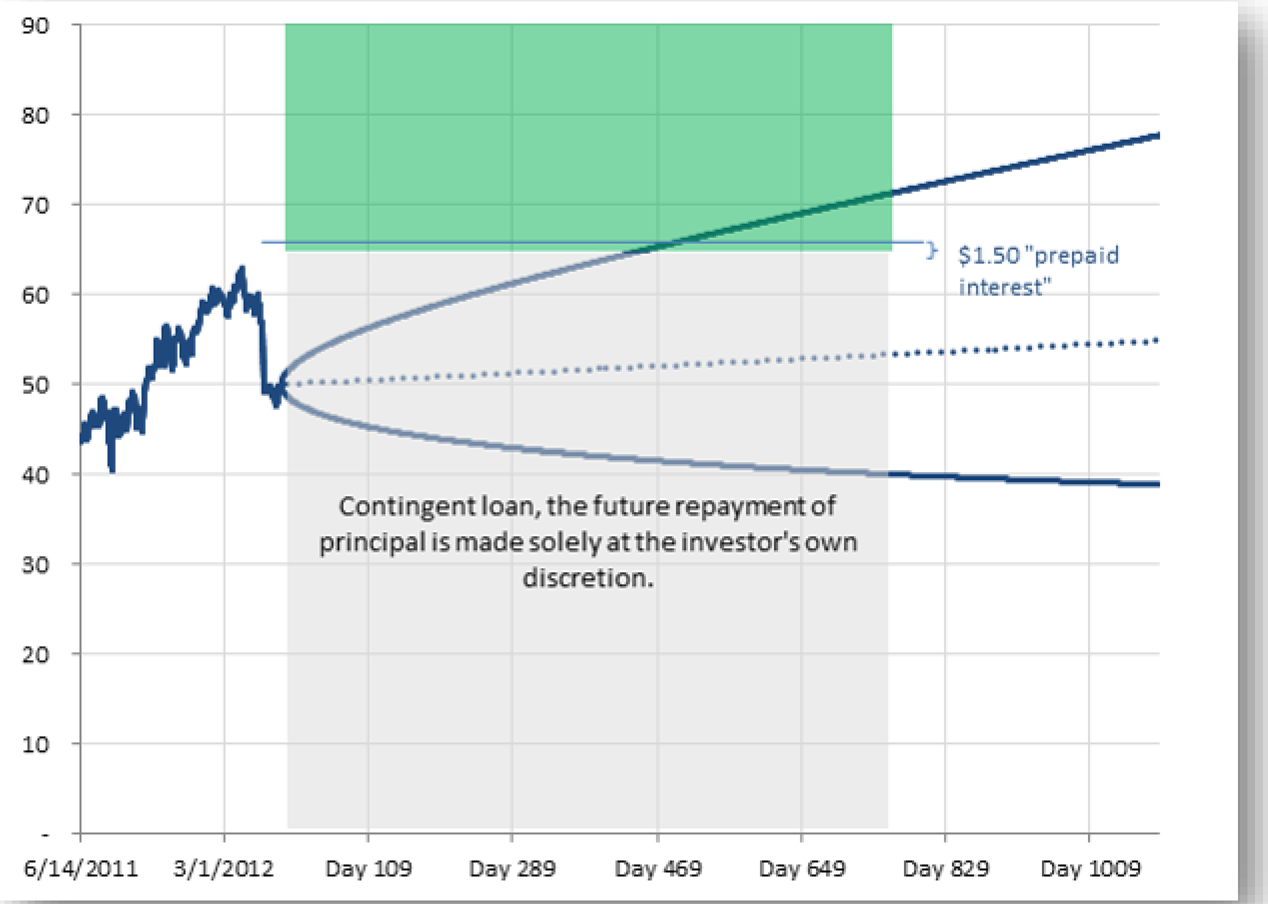
- Leverage always involves altering capital at risk to affect the percentage return of an investment
- Leverage always involves borrowing money – actually or virtually

Leverage Basics



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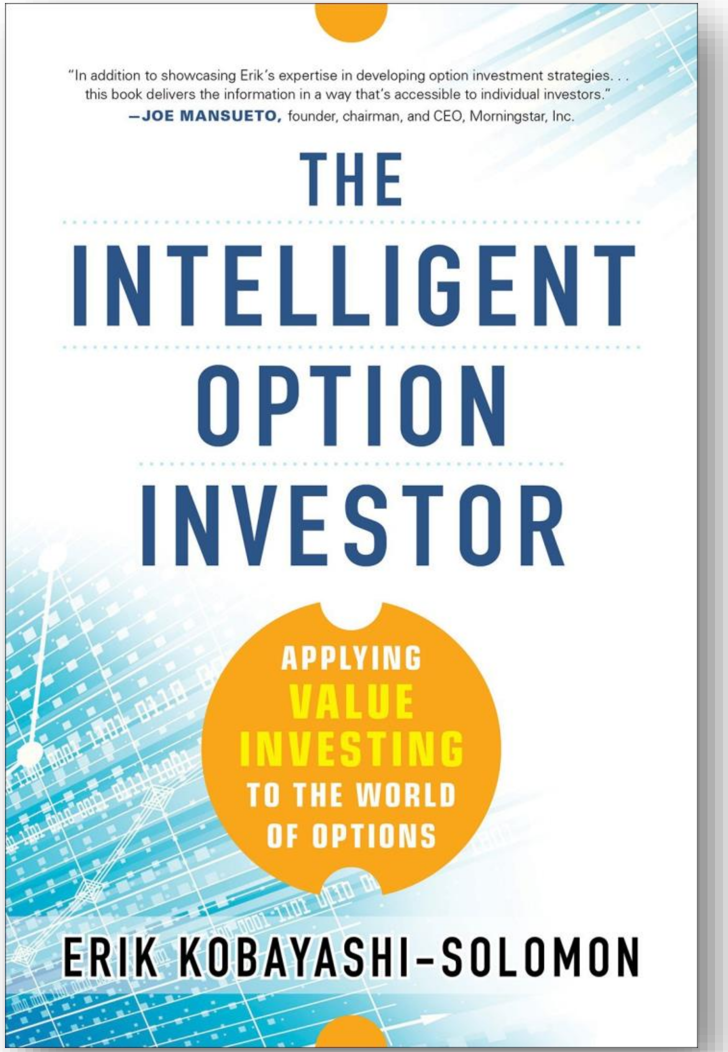

- Leverage always involves altering capital at risk to affect the percentage return of an investment
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- Options ≠ Leverage
- Leverage has a different effect on the upside and the downside: "IOI Leverage"

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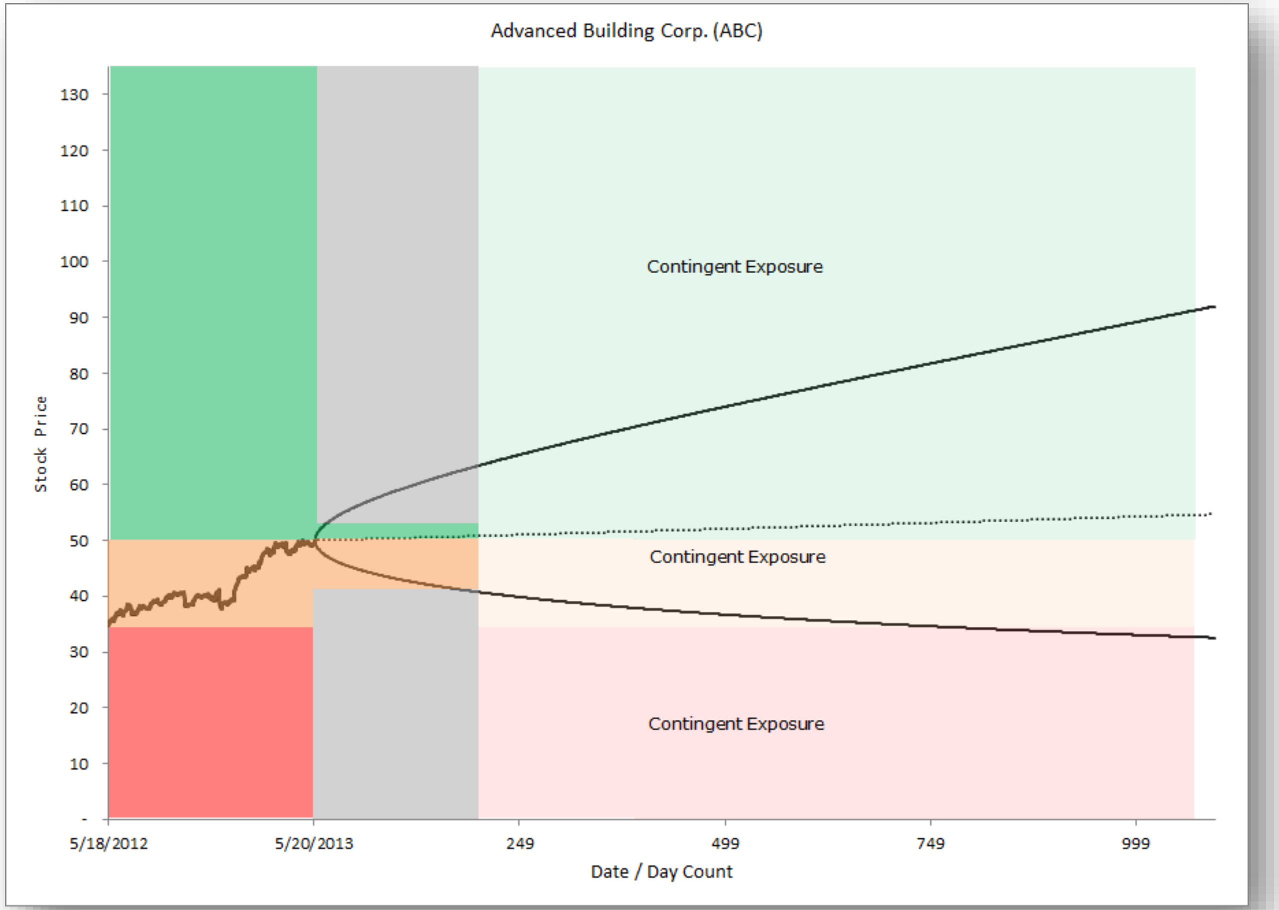

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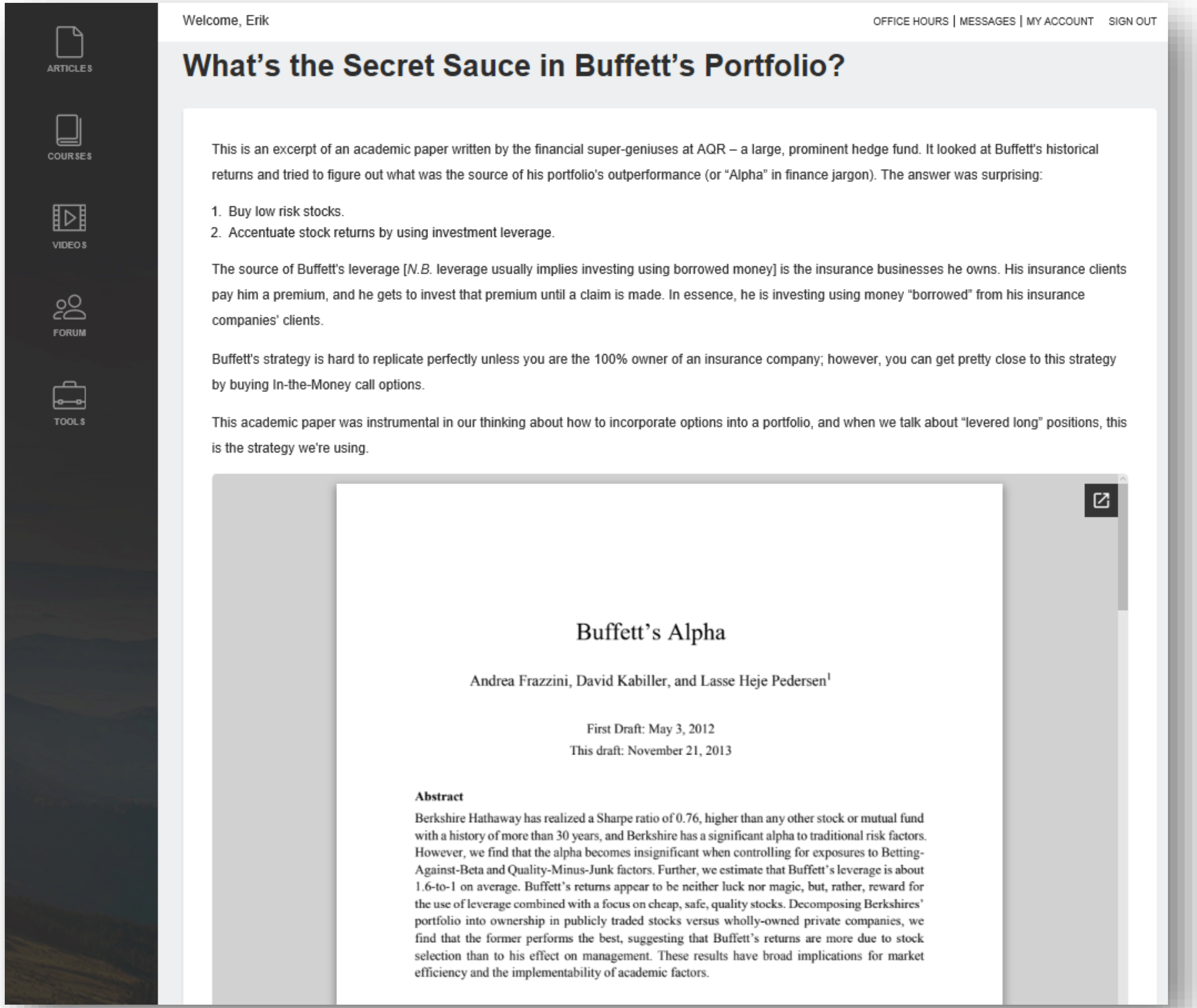
- Leverage always involves borrowing money – actually or virtually
- Options ≠ Leverage
- Leverage has a different effect on the upside and the downside: “IOI Leverage”
- Levered and unlevered positions can be “layered”

The Power of Leverage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What's the Secret Sauce in Buffett's Portfolio?

This is an excerpt of an academic paper written by the financial super-geniuses at AQR – a large, prominent hedge fund. It looked at Buffett's historical returns and tried to figure out what was the source of his portfolio's outperformance (or "Alpha" in finance jargon). The answer was surprising:

1. Buy low risk stocks.
2. Accentuate stock returns by using investment leverage.

The source of Buffett's leverage [*N.B.* leverage usually implies investing using borrowed money] is the insurance businesses he owns. His insurance clients pay him a premium, and he gets to invest that premium until a claim is made. In essence, he is investing using money "borrowed" from his insurance companies' clients.

Buffett's strategy is hard to replicate perfectly unless you are the 100% owner of an insurance company; however, you can get pretty close to this strategy by buying In-the-Money call options.

This academic paper was instrumental in our thinking about how to incorporate options into a portfolio, and when we talk about "levered long" positions, this is the strategy we're using.

Buffett's Alpha

Andrea Frazzini, David Kabiller, and Lasse Heje Pedersen[1]

First Draft: May 3, 2012
This draft: November 21, 2013

Abstract
Berkshire Hathaway has realized a Sharpe ratio of 0.76, higher than any other stock or mutual fund with a history of more than 30 years, and Berkshire has a significant alpha to traditional risk factors. However, we find that the alpha becomes insignificant when controlling for exposures to Betting-Against-Beta and Quality-Minus-Junk factors. Further, we estimate that Buffett's leverage is about 1.6-to-1 on average. Buffett's returns appear to be neither luck nor magic, but, rather, reward for the use of leverage combined with a focus on cheap, safe, quality stocks. Decomposing Berkshires' portfolio into ownership in publicly traded stocks versus wholly-owned private companies, we find that the former performs the best, suggesting that Buffett's returns are more due to stock selection than to his effect on management. These results have broad implications for market efficiency and the implementability of academic factors.

- "Sound Framework for Managing Portfolios" LaunchPad

Bond Replacements

Accepting downside exposure

Bond Replacements

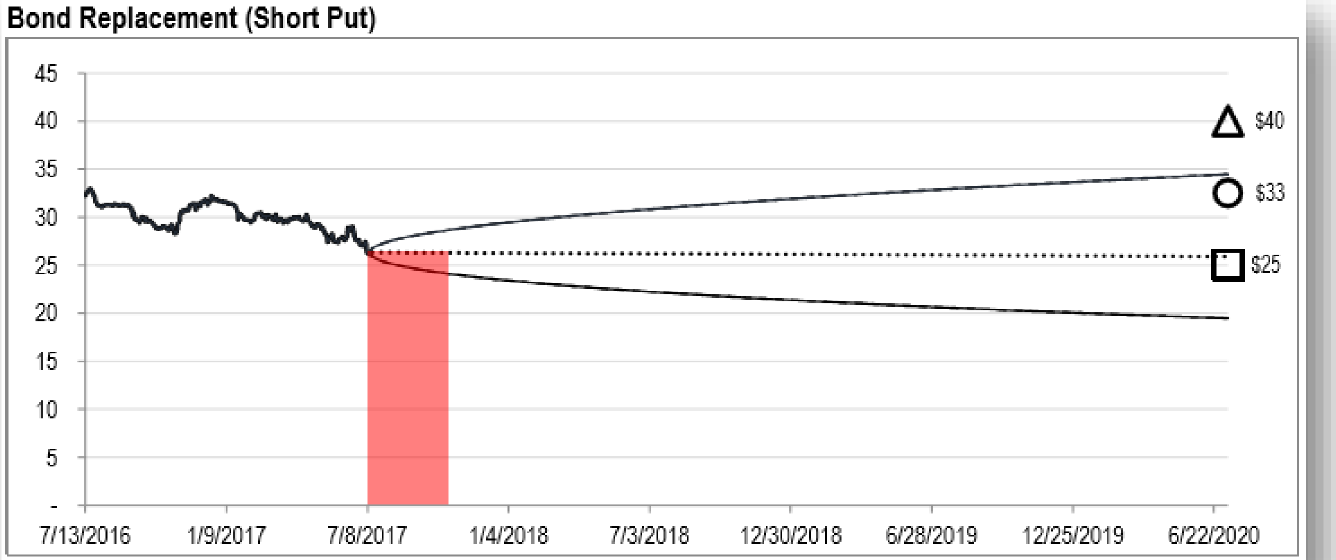
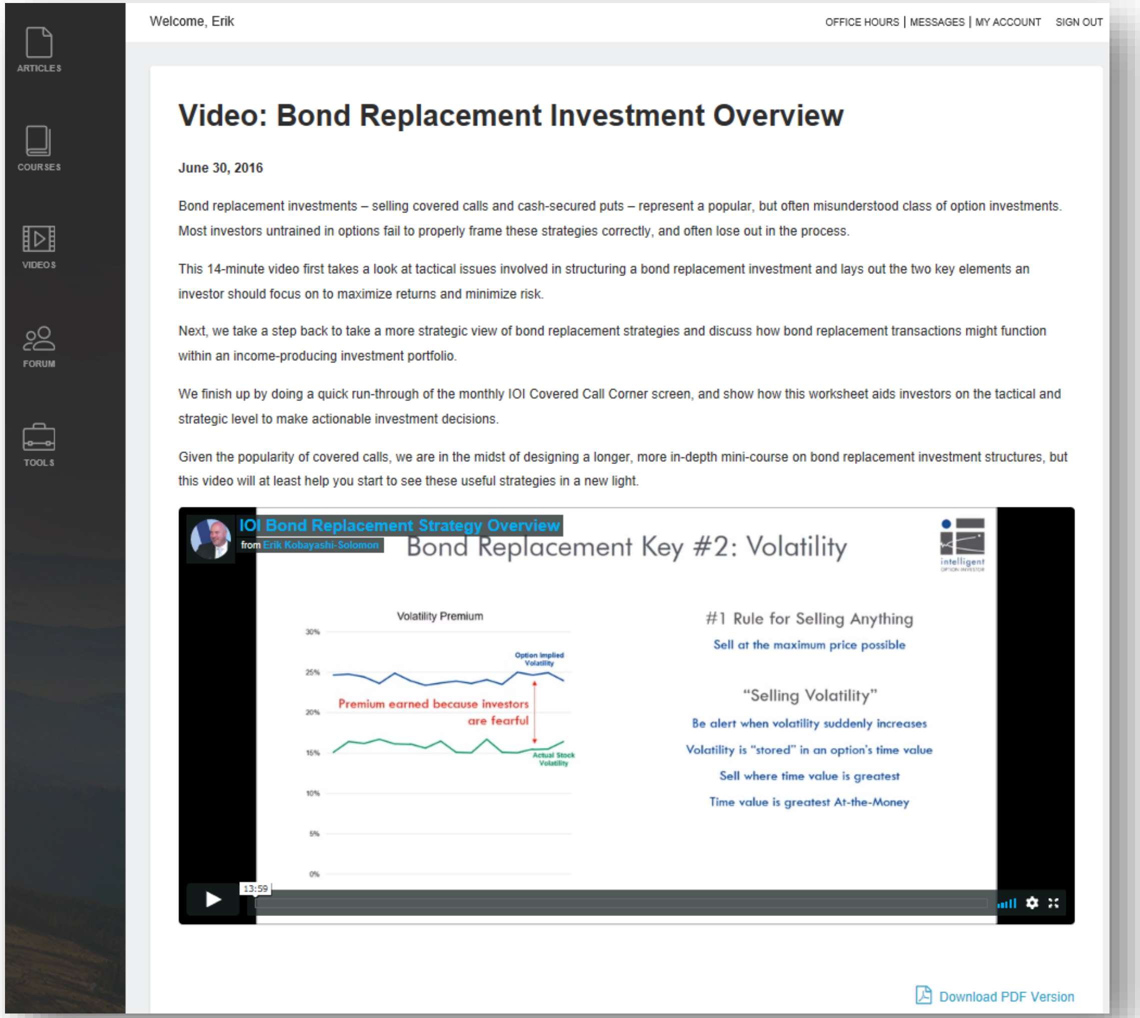


Figure 22. Source: YCharts, CBOE (pricing data), Framework Investing Analysis

- Covered Call / Short Put
- Usually executed as an unlevered strategy
- Income focused
- Best uses:
  - "Tentative" investments
  - Small position size / diversified "bond portfolio"

Bond Replacements



https://frameworkinvesting.com/video-bond-replacement-investment-overview/

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- Best uses:
  - "Tentative" investments
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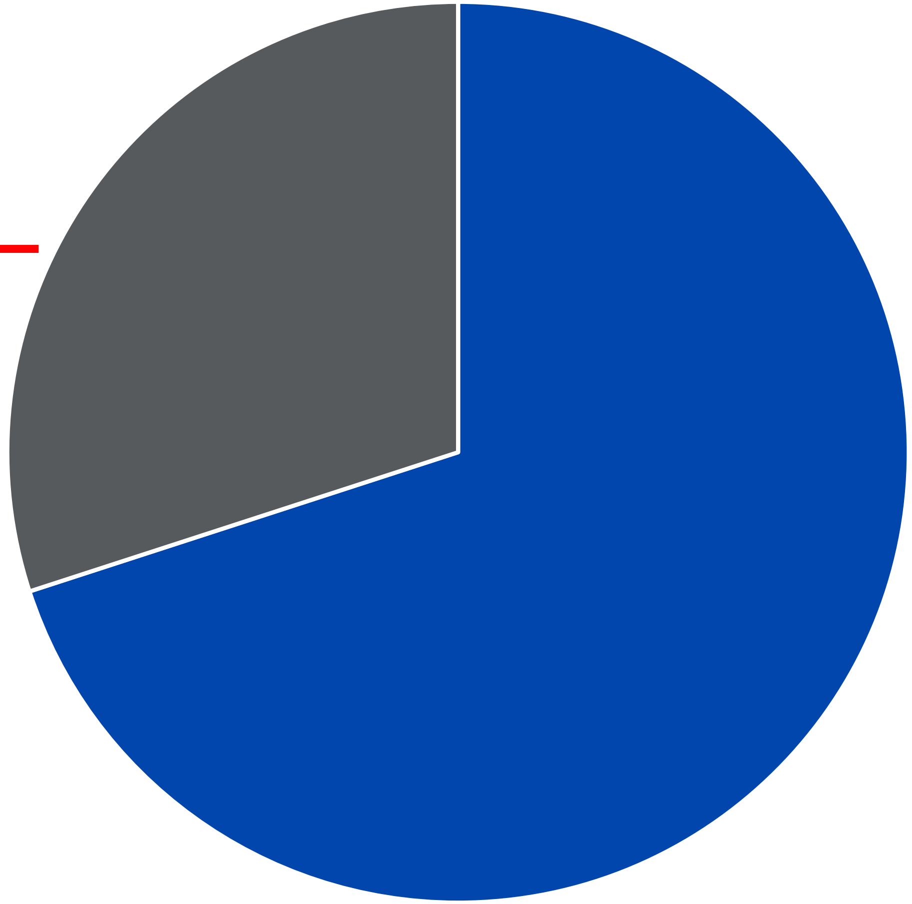
Layering

Options allow investor a wider range of choices – investing isn't binary

Our Efficient Portfolio

“Price is NOT right” “No free lunch”

A few slices –
let’s say five...



A Balanced Investing Meal

High valuation uncertainty

Operational + financial leverage

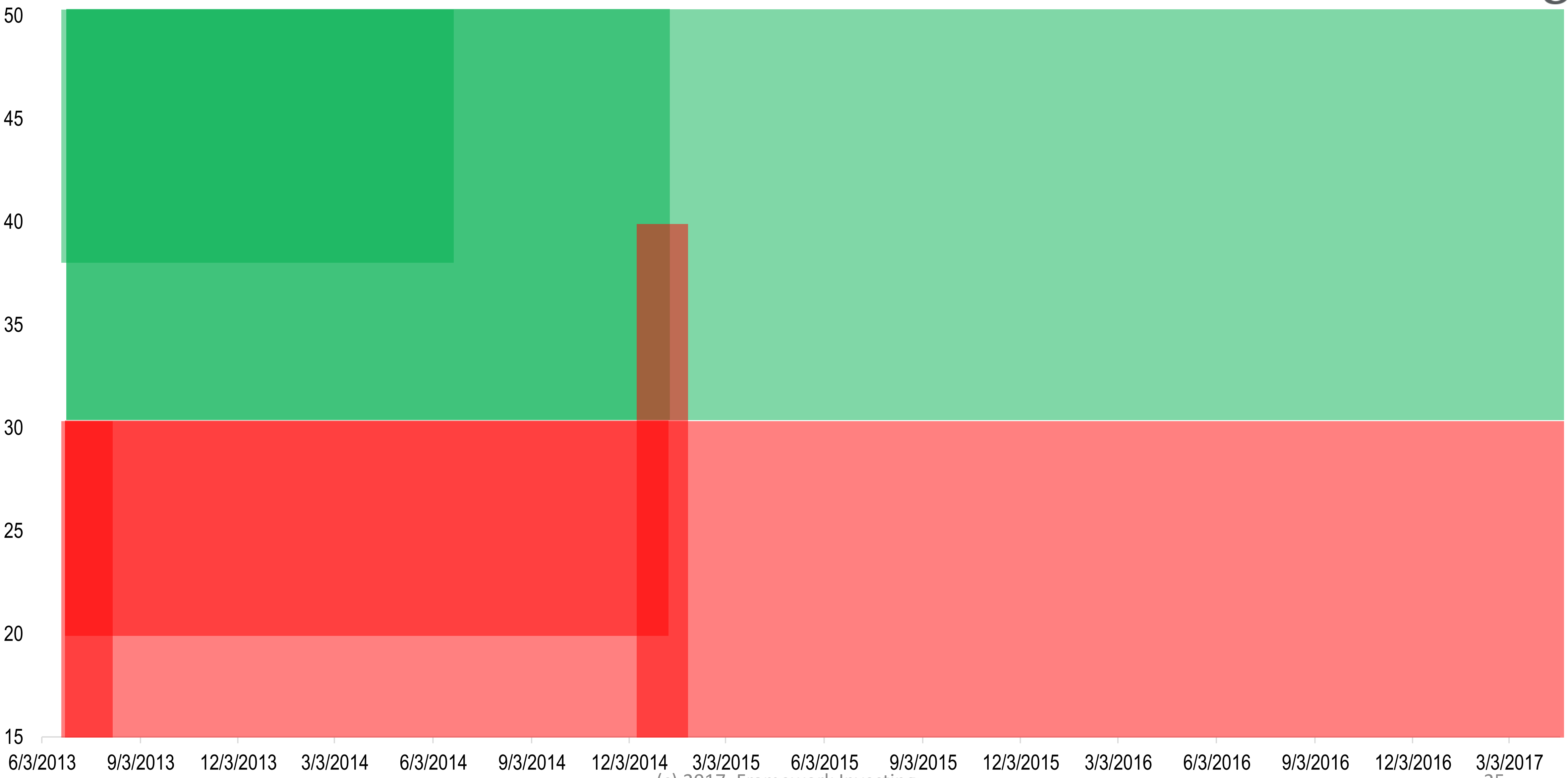
Close to fairly valued

Low valuation uncertainty

Extremely undervalued

Special Occasions

Theory into Action - Oracle



Thank You

Q&A Session