

FRAMEWORK

Invest

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

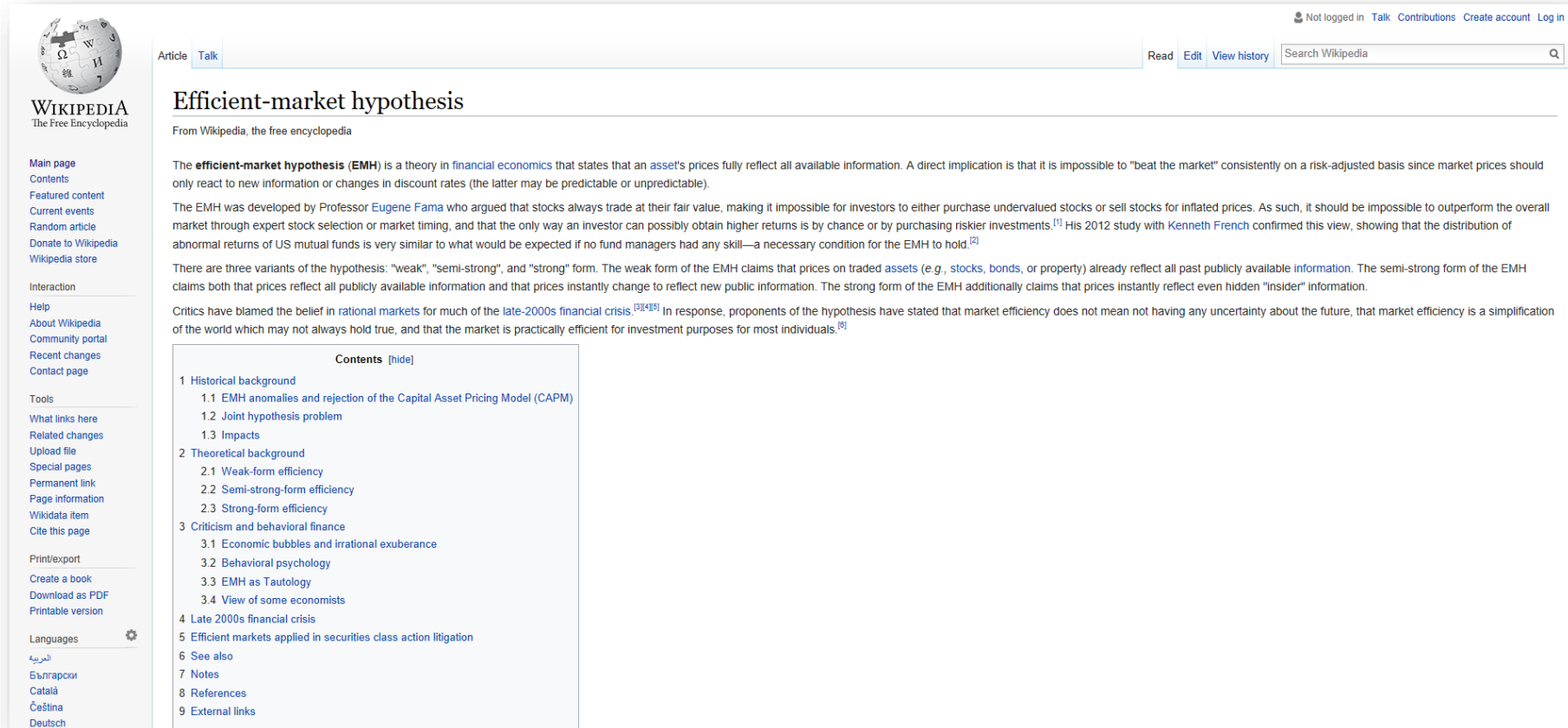
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Building an “Efficient” Portfolio



- “Maximum returns for minimum effort”
- Academic Efficiency
- Buffett Efficiency

Academic Market Efficiency



The screenshot shows a Wikipedia article titled "Efficient-market hypothesis". The page includes a navigation bar at the top with "Article" and "Talk" tabs, and a search bar. The main content area contains the following text:

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]

Contents (hide)

- 1 Historical background
 - 1.1 EMH anomalies and rejection of the Capital Asset Pricing Model (CAPM)
 - 1.2 Joint hypothesis problem
 - 1.3 Impacts
- 2 Theoretical background
 - 2.1 Weak-form efficiency
 - 2.2 Semi-strong-form efficiency
 - 2.3 Strong-form efficiency
- 3 Criticism and behavioral finance
 - 3.1 Economic bubbles and irrational exuberance
 - 3.2 Behavioral psychology
 - 3.3 EMH as Tautology
 - 3.4 View of some economists
- 4 Late 2000s financial crisis
- 5 Efficient markets applied in securities class action litigation
- 6 See also
- 7 Notes
- 8 References
- 9 External links



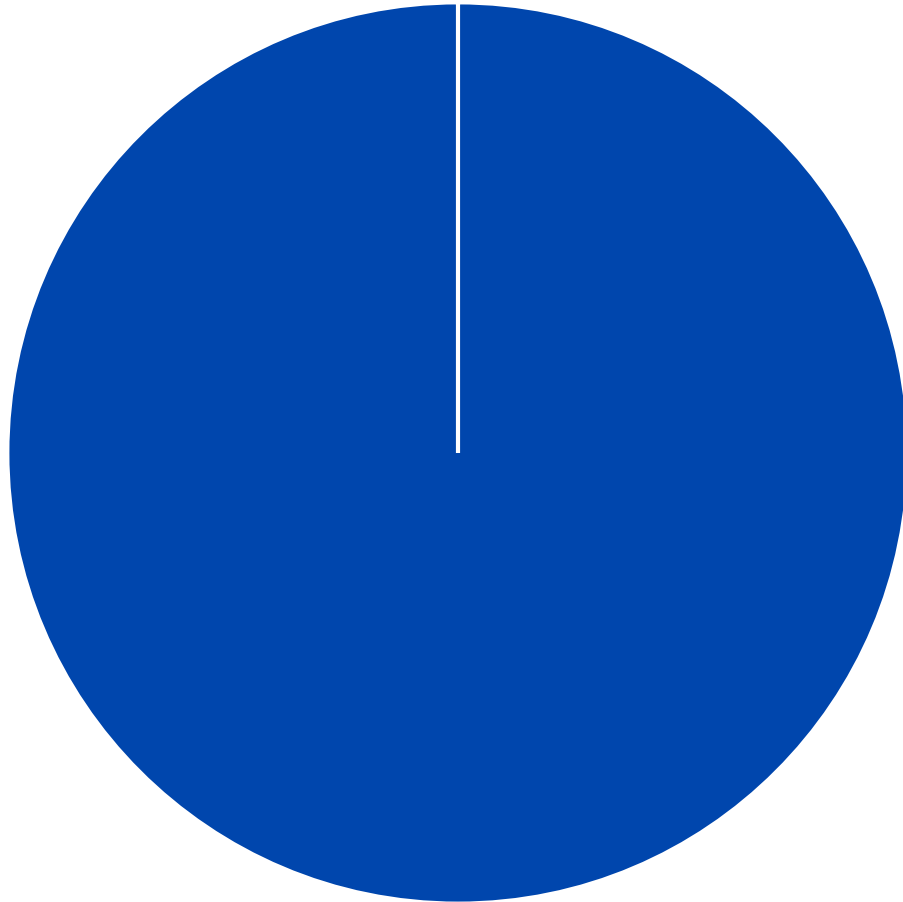
Market Efficiency

“The Price is Right”

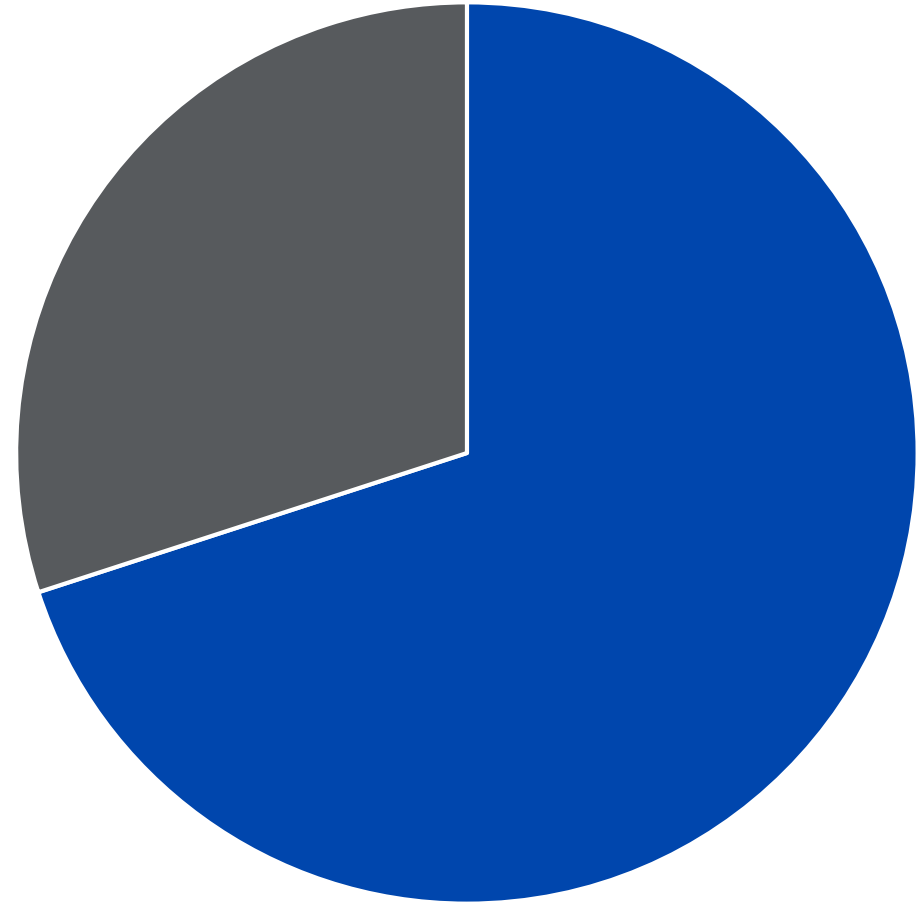
“There’s no free lunch”

Portfolio Implications of Market Efficiency

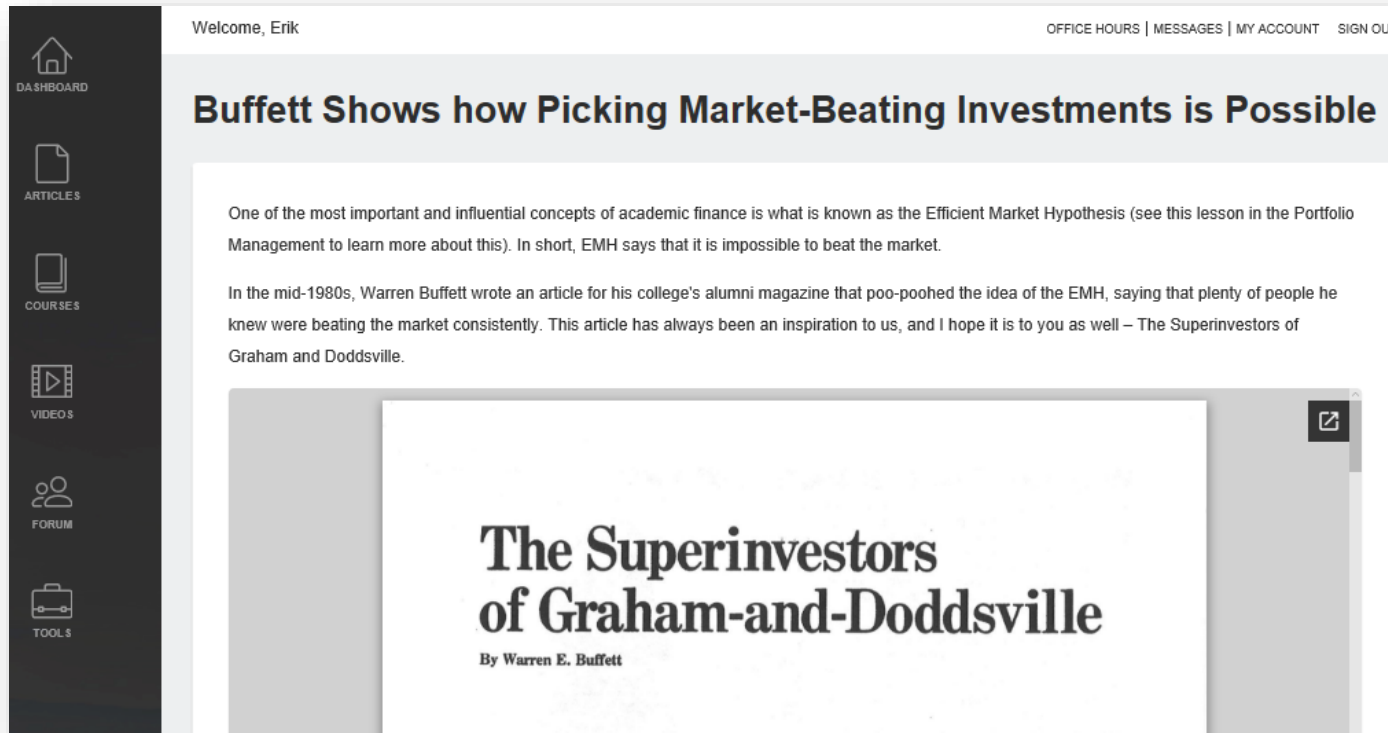
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“Price is NOT right” “No free lunch”



Buffett's Idea of Efficiency



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Buffett Shows how Picking Market-Beating Investments is Possible

One of the most important and influential concepts of academic finance is what is known as the Efficient Market Hypothesis (see this lesson in the Portfolio Management to learn more about this). In short, EMH says that it is impossible to beat the market.

In the mid-1980s, Warren Buffett wrote an article for his college's alumni magazine that poo-pooed the idea of the EMH, saying that plenty of people he knew were beating the market consistently. This article has always been an inspiration to us, and I hope it is to you as well – The Superinvestors of Graham and Doddsville.

The Superinvestors of Graham-and-Doddsville

By Warren E. Buffett

- “Sound Framework for Valuing Investments” LaunchPad

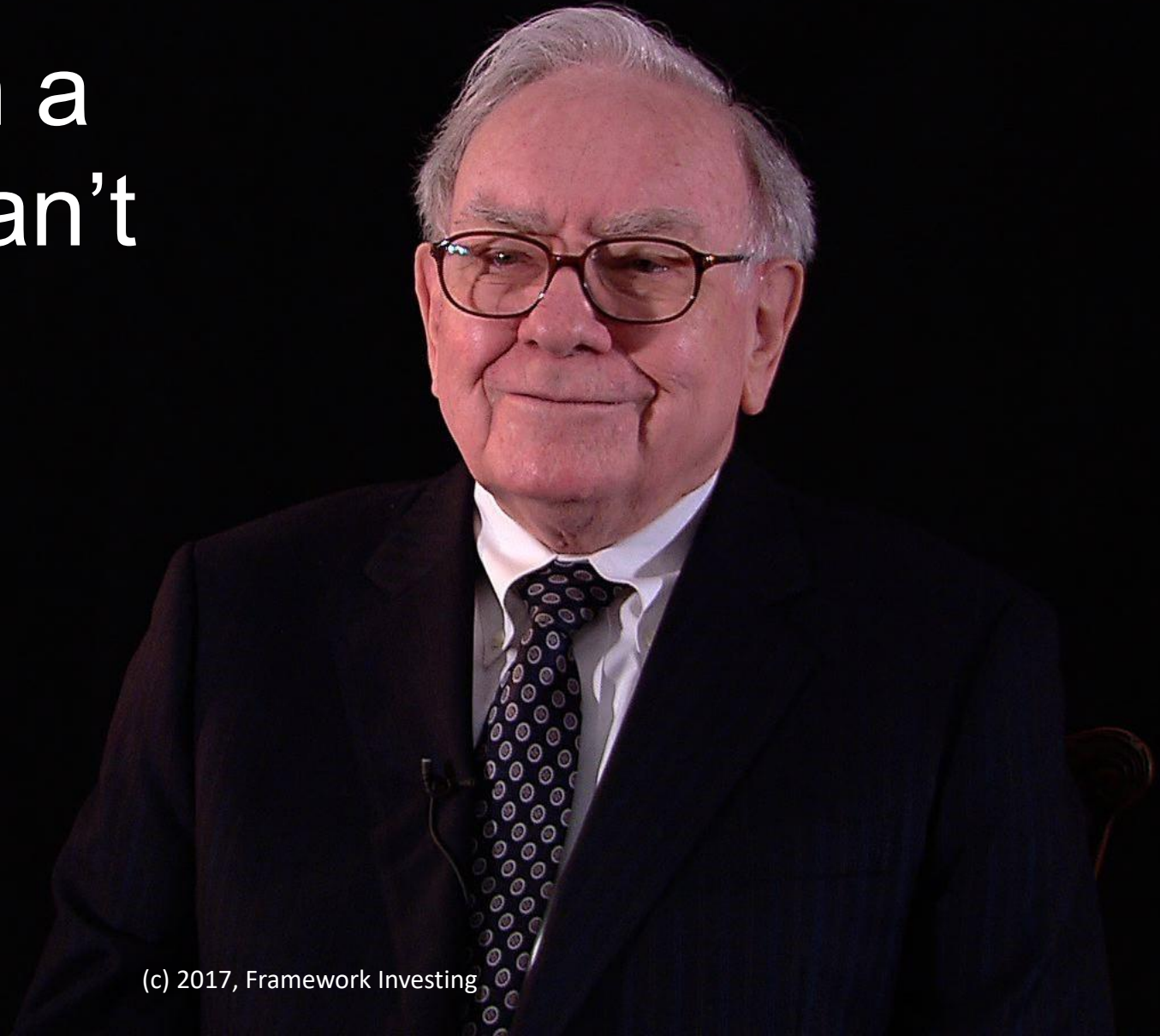


"Investors should remember that excitement and expenses are their enemies..."



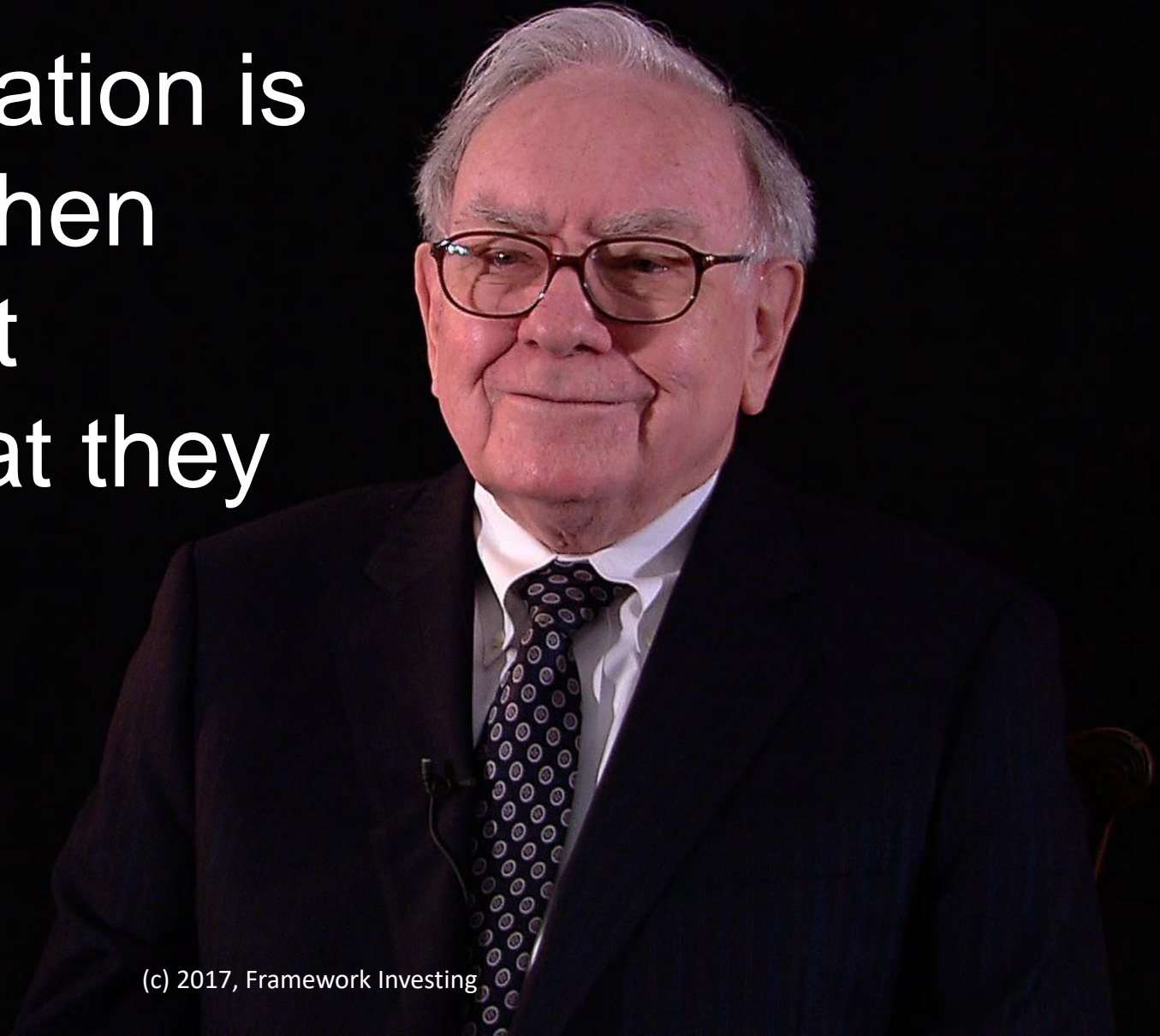


“Never invest in a business you can’t understand.”





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

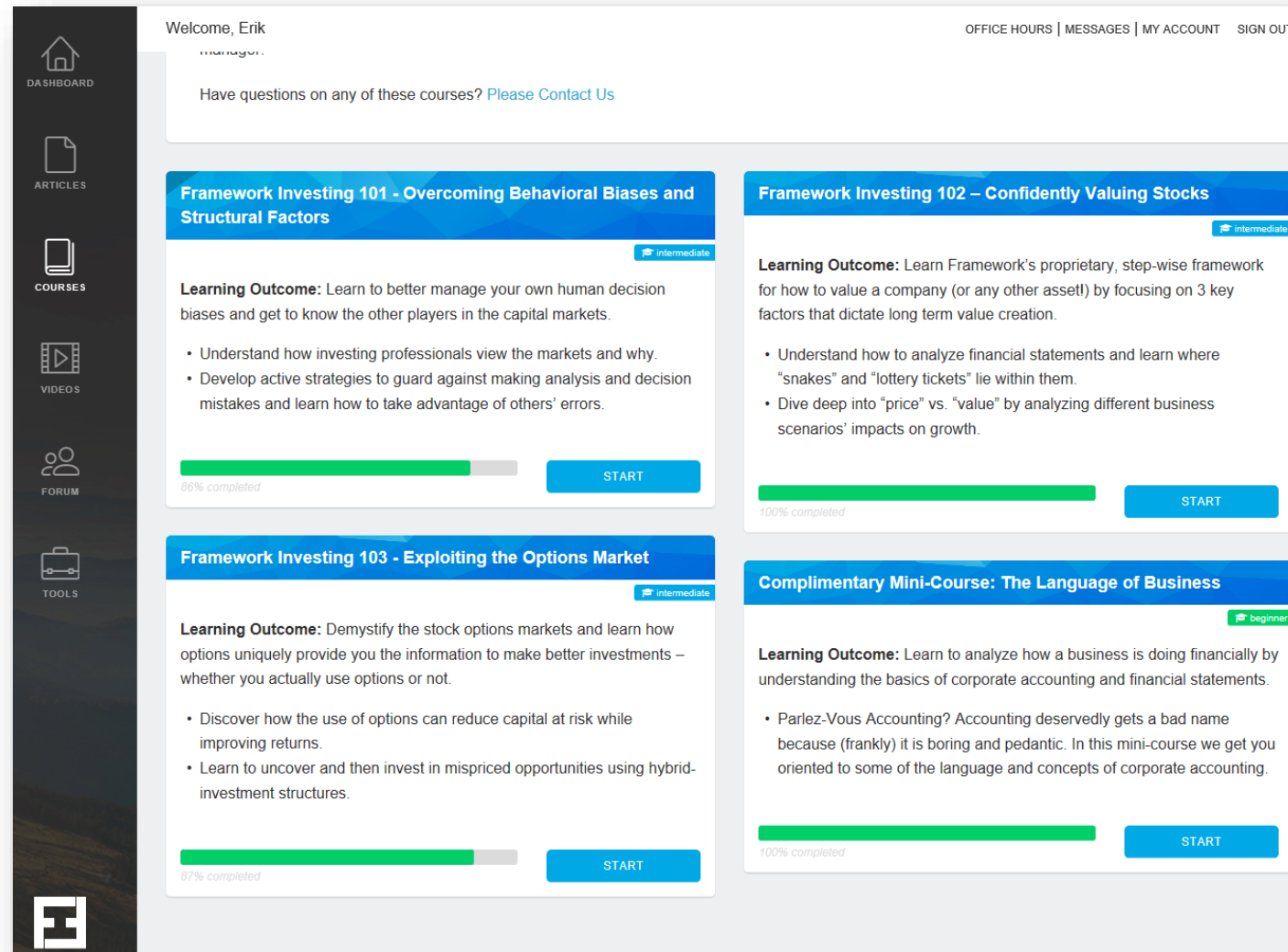




Leverage

The basics of an important but dangerous investment tool

103 Class on Structuring



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manager

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Have questions on any of these courses? [Please Contact Us](#)

Framework Investing 101 - Overcoming Behavioral Biases and Structural Factors

Intermediate

Learning Outcome: Learn to better manage your own human decision biases and get to know the other players in the capital markets.

- Understand how investing professionals view the markets and why.
- Develop active strategies to guard against making analysis and decision mistakes and learn how to take advantage of others' errors.

86% completed

START

Framework Investing 102 – Confidently Valuing Stocks

Intermediate

Learning Outcome: Learn Framework's proprietary, step-wise framework for how to value a company (or any other asset!) by focusing on 3 key factors that dictate long term value creation.

- Understand how to analyze financial statements and learn where "snakes" and "lottery tickets" lie within them.
- Dive deep into "price" vs. "value" by analyzing different business scenarios' impacts on growth.

100% completed

START

Framework Investing 103 - Exploiting the Options Market

Intermediate

Learning Outcome: Demystify the stock options markets and learn how options uniquely provide you the information to make better investments – whether you actually use options or not.

- Discover how the use of options can reduce capital at risk while improving returns.
- Learn to uncover and then invest in mispriced opportunities using hybrid-investment structures.

87% completed

START

Complimentary Mini-Course: The Language of Business

Beginner


Learning Outcome: Learn to analyze how a business is doing financially by understanding the basics of corporate accounting and financial statements.

- Parlez-Vous Accounting? Accounting deservedly gets a bad name because (frankly) it is boring and pedantic. In this mini-course we get you oriented to some of the language and concepts of corporate accounting.

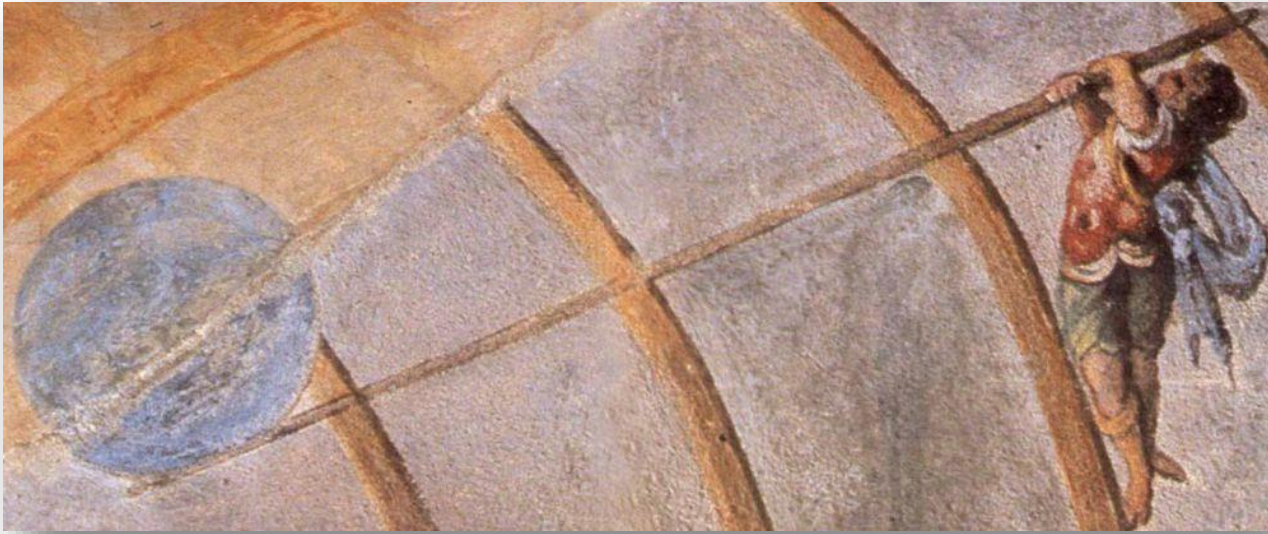
100% completed

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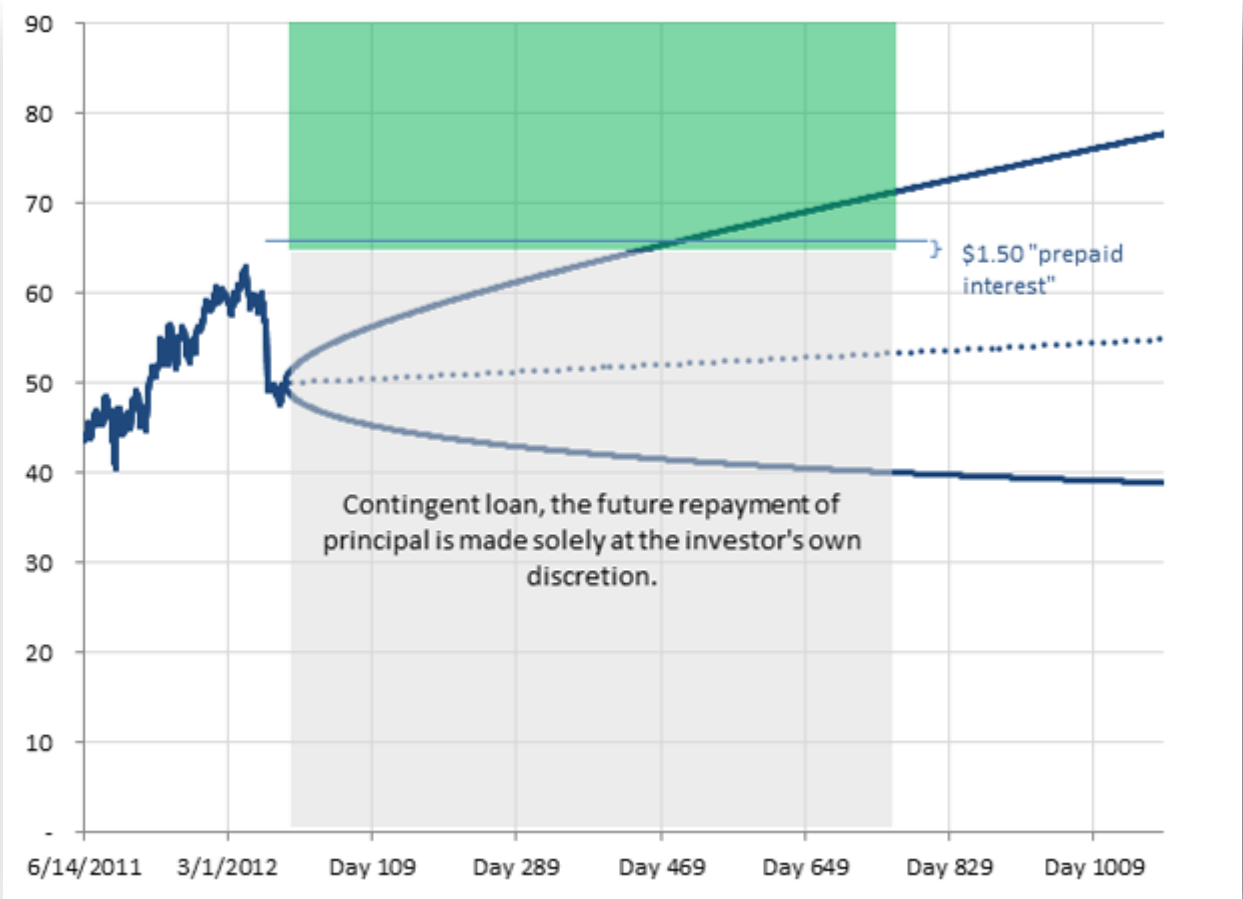


Leverage Basics



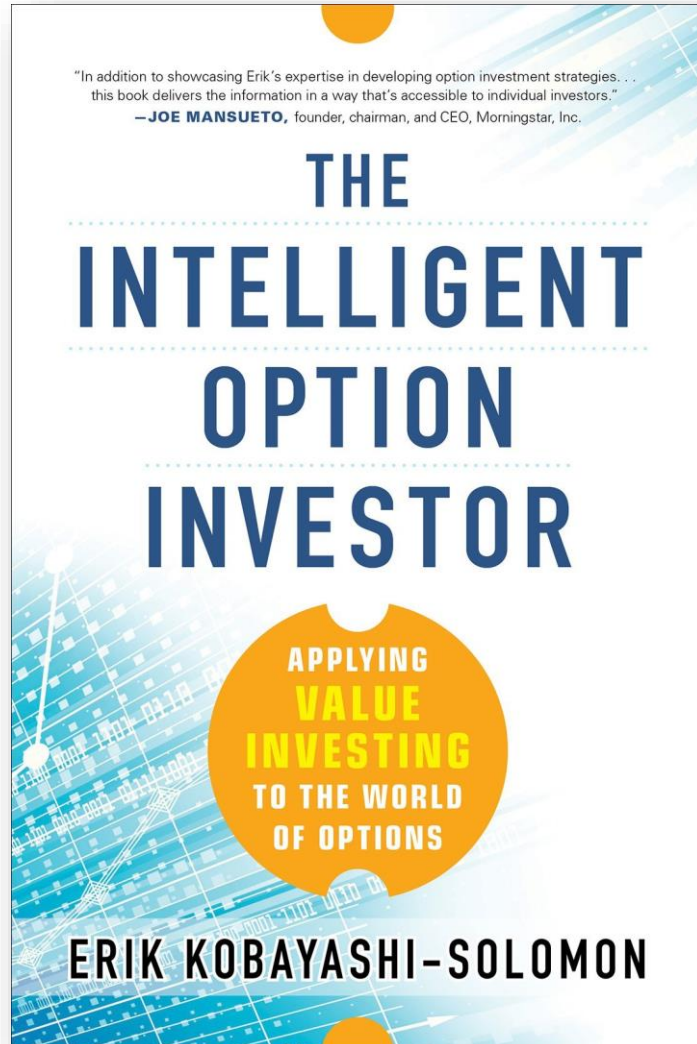
- Leverage always involves altering capital at risk to affect the percentage return of an investment
- Leverage always involves borrowing money – actually or virtually

Leverage Basics



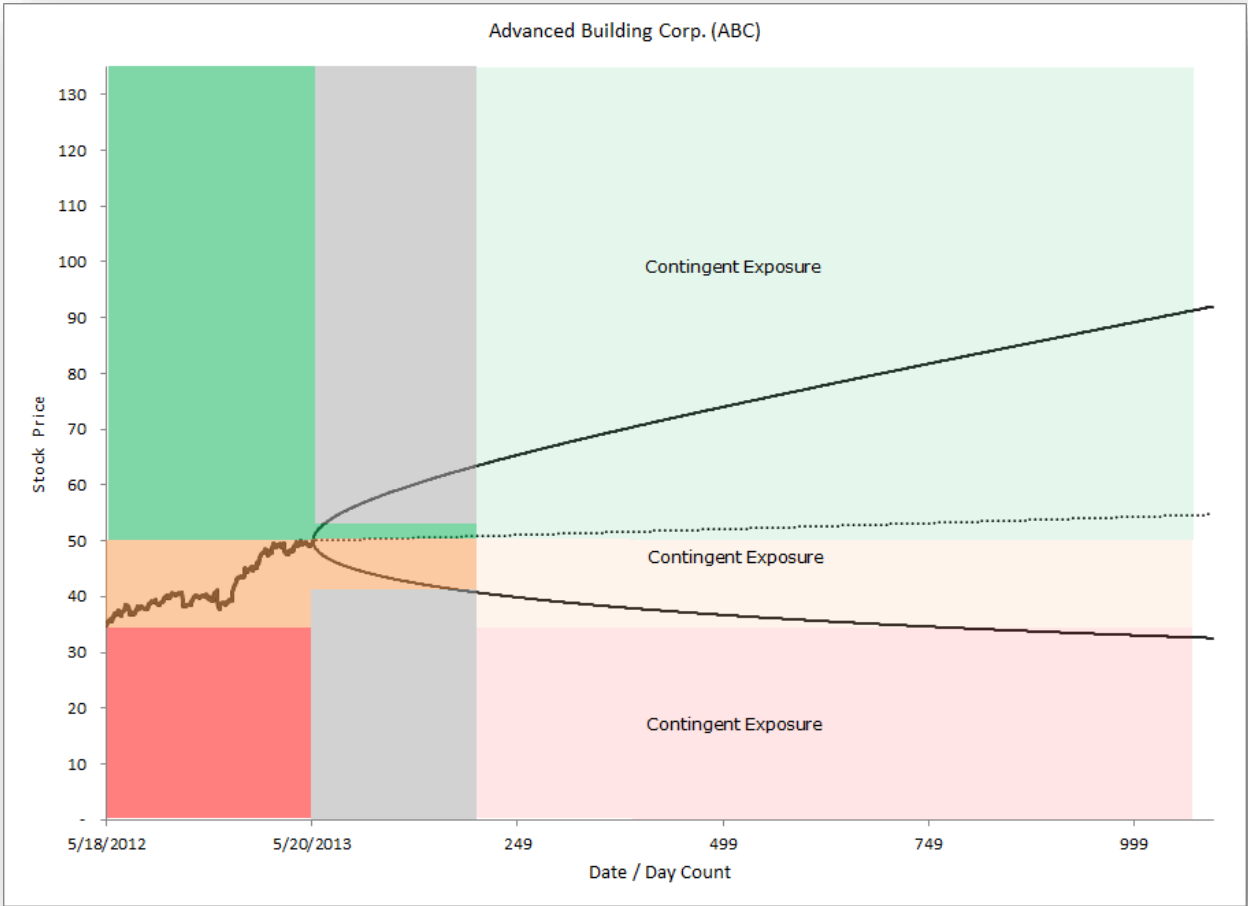
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Leverage Basics



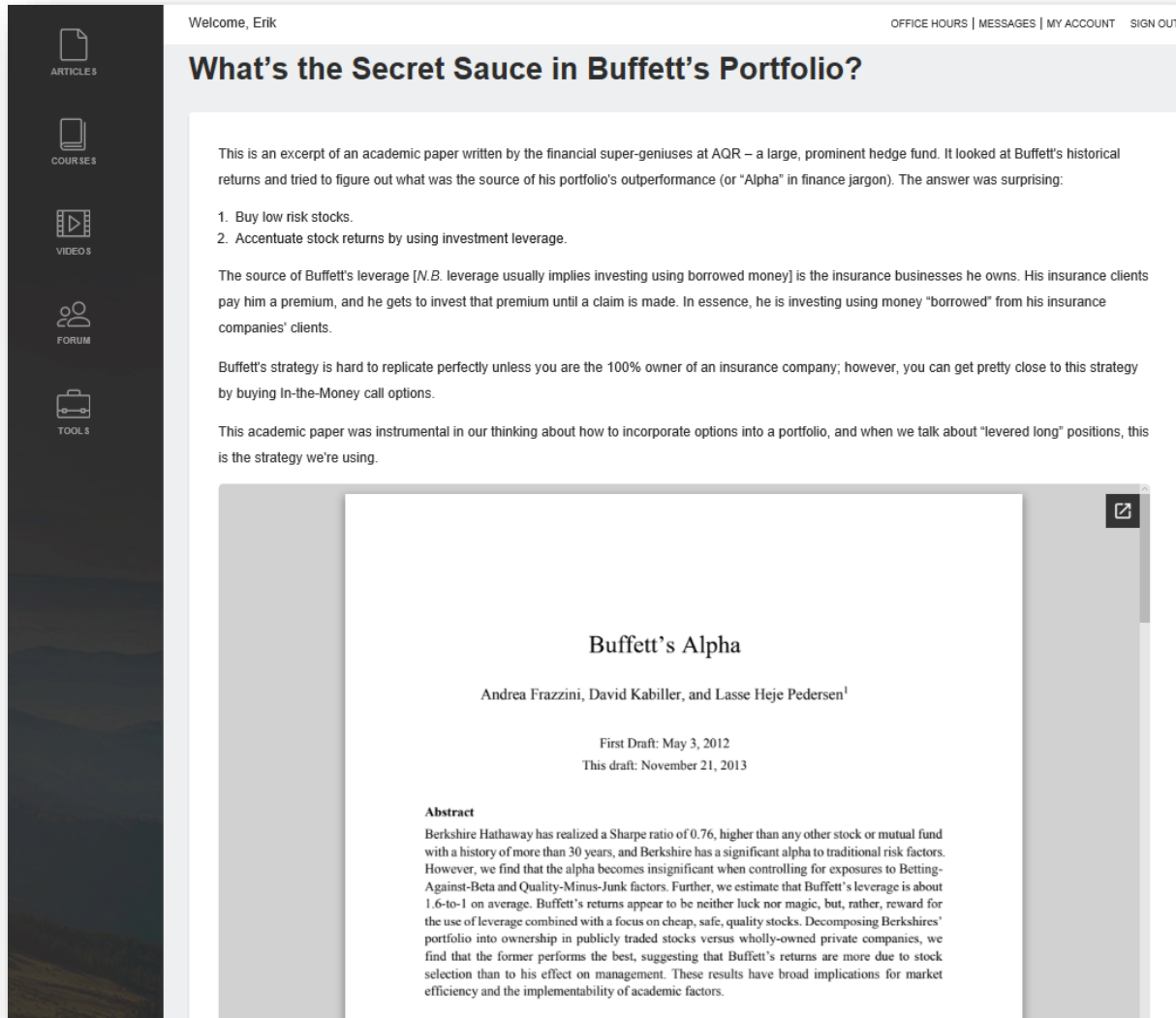
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- Leverage has a different effect on the upside and the downside: “IOI Leverage”

Leverage Basics



- Leverage always involves altering capital at risk to affect the percentage return of an investment
- 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 Pedersen¹

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.

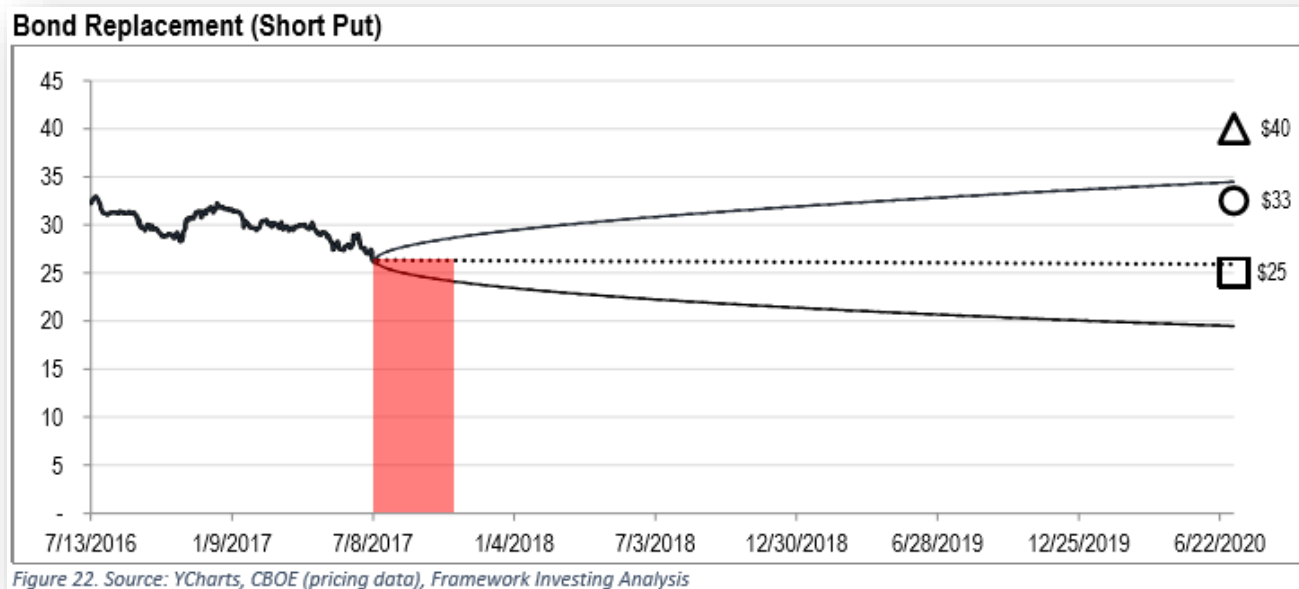
- “Sound Framework for Managing Portfolios” LaunchPad



Bond Replacements

Accepting downside exposure

Bond Replacements



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

Bond Replacements

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Video: Bond Replacement Investment Overview

June 30, 2016

Bond replacement investments – selling covered calls and cash-secured puts – represent a popular, but often misunderstood class of option investments. Most investors untrained in options fail to properly frame these strategies correctly, and often lose out in the process.

This 14-minute video first takes a look at tactical issues involved in structuring a bond replacement investment and lays out the two key elements an investor should focus on to maximize returns and minimize risk.

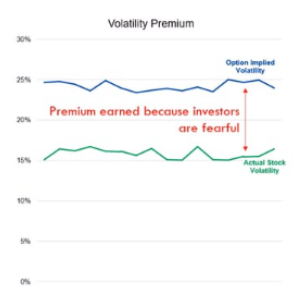
Next, we take a step back to take a more strategic view of bond replacement strategies and discuss how bond replacement transactions might function within an income-producing investment portfolio.

We finish up by doing a quick run-through of the monthly IOI Covered Call Corner screen, and show how this worksheet aids investors on the tactical and strategic level to make actionable investment decisions.

Given the popularity of covered calls, we are in the midst of designing a longer, more in-depth mini-course on bond replacement investment structures, but this video will at least help you start to see these useful strategies in a new light.

IOI Bond Replacement Strategy Overview
from Erik Kobayashi-Solomon

Bond Replacement Key #2: Volatility



#1 Rule for Selling Anything
Sell at the maximum price possible

"Selling Volatility"
Be alert when volatility suddenly increases
Volatility is "stored" in an option's time value
Sell where time value is greatest
Time value is greatest At-the-Money

[Download PDF Version](#)

- Covered Call / Short Put
- Usually executed as an unlevered strategy
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- Best uses:
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<https://frameworkinvesting.com/video-bond-replacement-investment-overview/>



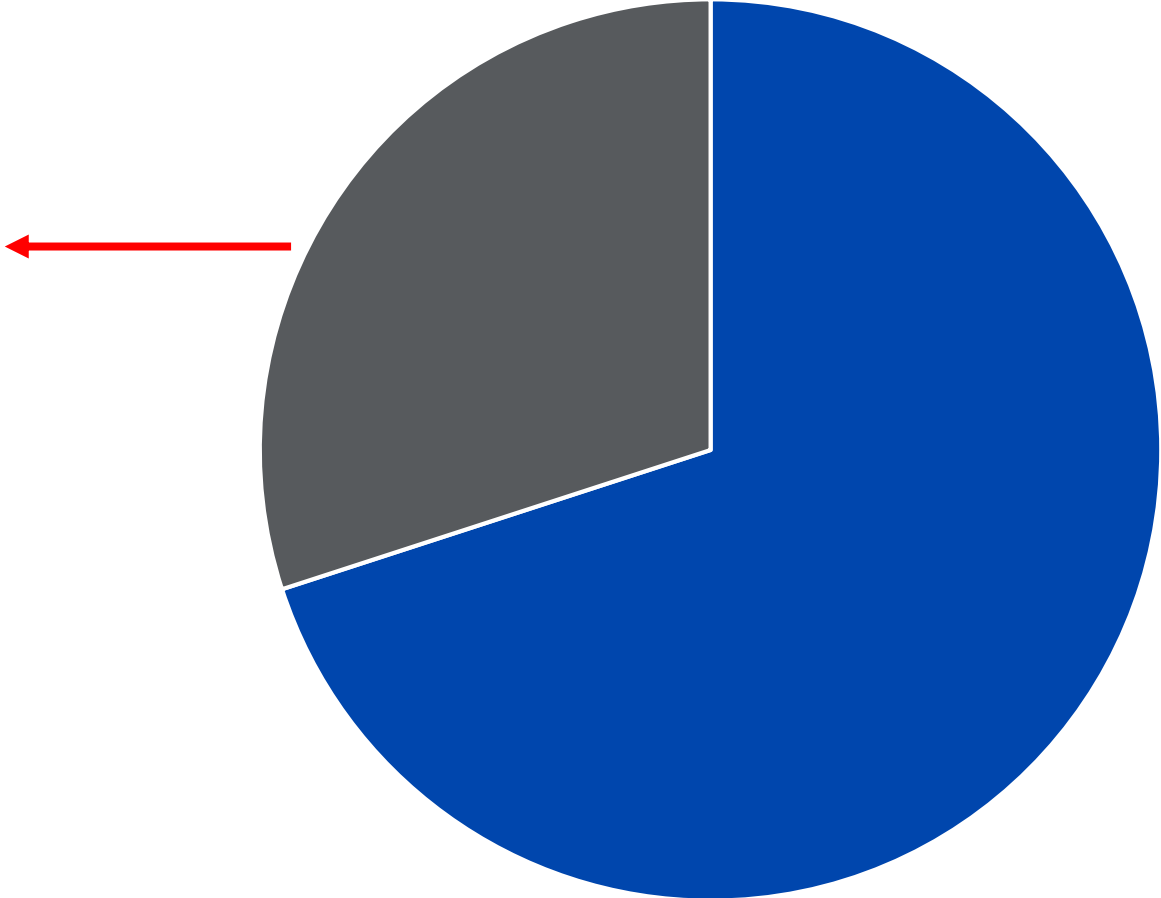
Layering

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

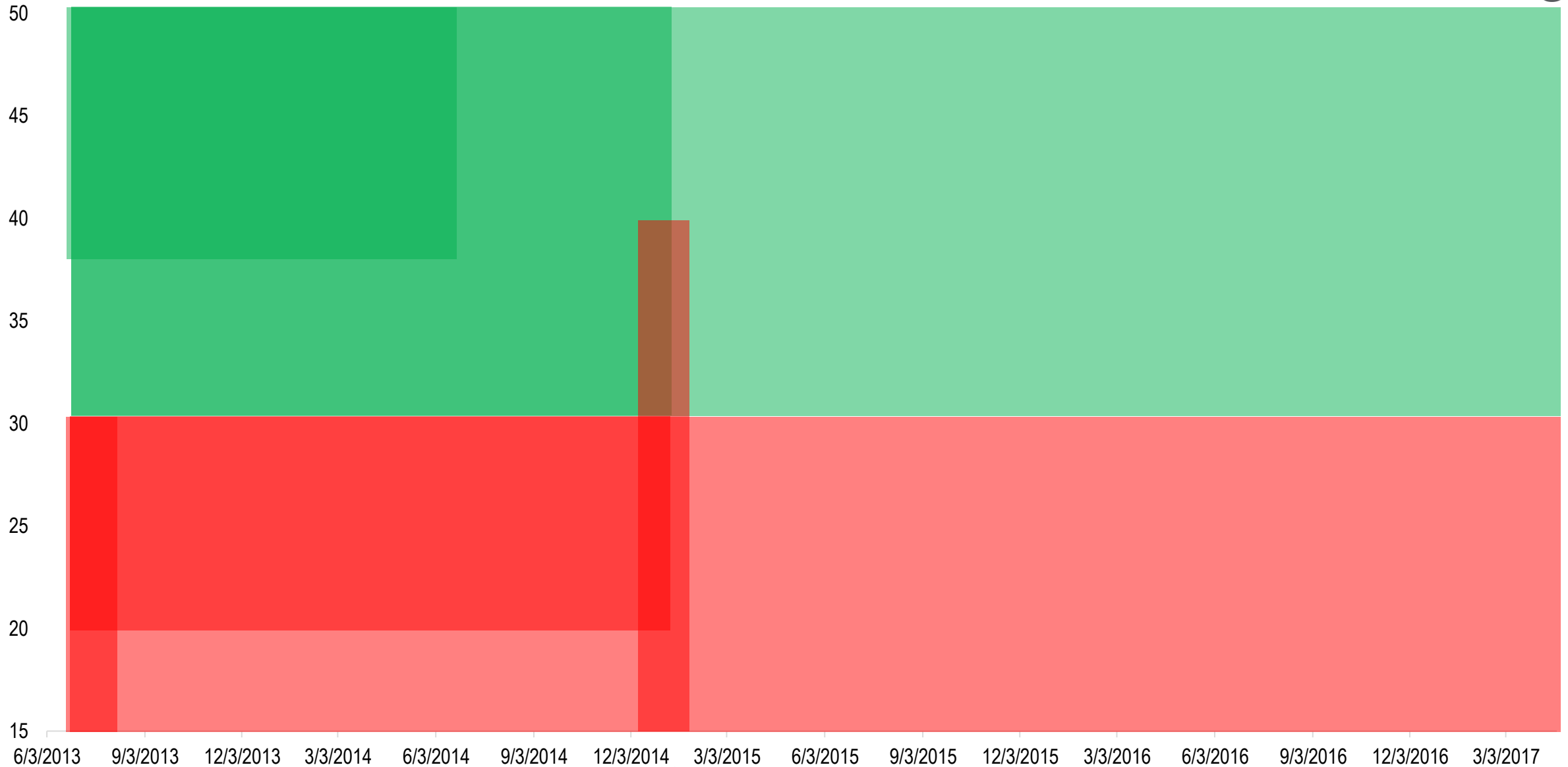


Low valuation uncertainty
Extremely undervalued

Special Occasions



Theory into Action - Oracle





Thank You

Q&A Session

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