MV Capital Management Thought Leadership

A Healthy Dose of Agnosticism
July 26, 2011

With all the headaches that peripheral countries in the Eurozone have been causing in recent months it is perhaps appropriate that we start off this commentary with a lesson in the Greek language.

"Agnostic" has a loaded meaning when rendered into the English language – it generally is used in a religious context to describe a person's lack of conviction in the existence of a deity. In the mother Greek tongue, though, the word carries no such ecclesiastical baggage – it simply means "not knowing" – *a-gnosis*. It calls up a memorable statement attributed to Socrates: "all I know is that I know nothing". Socrates was not professing himself to be stupid, nor was this an extravagance of false modesty. Socrates engaged his fellow Athenians in intellectual debate by beginning with the assumption that because you don't know, you need to examine an issue from all sides and keep challenging the arguments even when they sound very persuasive. Anyone who has ever gone through a Socratic dialogue knows that it can be a frustrating experience – we want to prove a point and move on, not keep coming back to challenge it from yet another angle. Yet it can be profoundly enlightening for those with the patience to stick it out.

At MVCM there is something of an agnostic, Socratic flavor to one of the key pillars of our investment philosophy. We call this a "Chaos of Wisdoms". Now, that phrase itself may seem strange. "Wisdom" is a word which, to be grammatically correct, should appear in the singular form only. We use this unusual twist on the spelling to draw attention to the fact that there are many different points of view in the investment world, each of which could be considered a "market wisdom". Typically what happens is that the proponents of a particular point of view will develop empirical evidence for it – back-test returns and volatility as far back as the data will go, stress-test it under hypothetical economic scenarios and make the case for why this point of view is valid and makes sense for investors in their portfolio construction.

Lots of these viewpoints make sense – but in our opinion there is no single one that supplies all the right answers. In this chaos of competing claims we attempt to distill insights by considering all of them, poking holes in their proponents' arguments, scouring the data to see where their assumptions and data points may not ring true, testing alternative hypotheses, and ultimately arriving at strategic and tactical allocation decisions. "Distilling clarity from complexity" is how we describe the practical approach we employ to execute our Chaos of Wisdoms philosophy.

Part of the rigor of this kind of Socratic approach is to never assume the conventional wisdom always prevails. That discipline is particularly important in the frothy climate of today's markets, where a great many conventional assumptions seem to be turned on their heads. Here's an example: international developed versus emerging equities. What we have to say here may surprise you (or maybe not, if you've been following the economic news lately).

It has long been a standard assumption in the art of asset allocation that portfolios should treat these two types of non-US assets as distinct. "Developed" markets, prominently Western Europe, Japan, Singapore, Australia and Canada, are seen as safer investments reflecting a more mature political, economic and legal/regulatory infrastructure. By contrast emerging markets, while faster growing, are still finding their footing in these areas and thus riskier. That assumption has been borne out by empirical evidence for most of the last 25 years or so. For example, for the ten years from 2001-11 the MSCI EAFE Index, a benchmark for non-US developed equities, had on average about 8% less annual volatility than the MSCI Emerging Markets Index. Investors would accept that 8% of higher volatility in exchange for the potential to attain higher returns. A typical portfolio with moderate growth objectives might allocate 15-18% to

developed non-US equities and 3-5% to emerging markets – this would be deemed prudent (percentage levels of course would vary with the investor's risk tolerance, but the ratio would be similar).

For the last twelve months, however, that established relationship has flipped. From July 1 2010 through June 30 2011 *volatility on the EAFE index was actually 2% higher than that for emerging markets*. The source of much of the instability, of course, has been the persistence of sovereign debt crises in the Eurozone. Looking at the year-to-date stock market performances in peripheral Eurozone countries from Greece to Ireland and Spain is enough to make your head spin – up 15% one week, down at -5% the next. These markets have been caught in the vortex of the "risk on / risk off" paradigm that dominates markets today – with seemingly irrational gyrations producing excessive amounts of volatility. By comparison the likes of China, Brazil or Malaysia look positively sedate.

So if you are making an asset allocation decision what do you do? The conventional wisdom approach is to look at long term norms and assume mean reversion. And perhaps that is the right thing to do – to assume that for the next ten or fifteen years the EAFE – EM risk differential will revert to historical levels. Here's the problem with the conventional wisdom: it tends to work well when past trends maintain a reasonable degree of continuity into the future. But there are certain junctures where that assumption is highly flawed, and there is a good case to make that we are in one of those times – the "interesting" times of the old Chinese adage. Europe may handle the impending Greek default and even take spillover crises in stride – but the implications run far beyond the technical details of how investors in sovereign European bonds are compensated. In Europe, as in the United States and Japan, there are enormous and deep-seated economic pressures that are disrupting the political and social fabric. These pressures create new risk factors that have not been baked into historical norms. How will investment models look if and when Treasury bonds, the ultimate risk-free asset, no longer come with a triple-A rating? What happens if Japan, with a near-200% ratio of debt to GDP, becomes the next financial crisis flashpoint.? These are not exercises in idle speculation – they are scenarios very much related to market realities.

These questions defy simple, magic-bullet answers. They are loaded with complexities and uncertainties. They cannot be solved by a simple linear algorithm. In short, they require a healthy dose of agnosticism and the patience and discipline to evaluate and challenge all strands of thought in the Chaos of Wisdoms.
With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2011 0044
DOFU: July 2011

MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

This email and any attachments are intended only for the use of the individual addressed and may contain privileged and confidential information that is exempt from disclosure. If you are not the intended recipient, you are hereby notified that dissemination, distribution, retransmission or copying of this communication is prohibited. If you have received this communication in error, please destroy it and notify us immediately.