

AUTHORS



Cullen O. Roche
CIO, Discipline Funds
cullenroche@disciplinefunds.com



Erica A. Fries
CEO, Discipline Funds
ericafries@disciplinefunds.com

What's in This Report?

In this report we outline the “Total Portfolio” approach to financial planning and asset management.

- The “Total Portfolio” perspective is a holistic approach to financial planning and asset management that places the concepts of “savings” and “investment” in the proper perspective.
- This report provides a stock-flow consistent understanding of how an asset allocator earns income from their personal “investments” and how they can allocate their unspent income, their savings, in a more prudent and practical perspective.
- We conclude the report with a summary of how an asset allocator can place this concept in the proper perspective when it comes to protecting a savings portfolio from both permanent loss and purchasing power.

What is the Total Portfolio?

The Total Portfolio approach is a holistic view of income generation and asset allocation based on an understanding of the capital structure and the monetary system at its operational level. The Total Portfolio provides a practical perspective to this process using a stock-flow consistent understanding of the concepts of “savings” and “investment” in a manner that is more consistent with their traditional usages in economics.

What is “Savings” and “Investment”?

In economics, “investment” is spending not consumed, for future production. If you start a company and purchase materials for operations you are spending for future production as opposed to consuming. You are investing in your company with the hope that this investment will multiply future profits over time. Investment spending is done on primary markets, in the real economy whereas secondary markets are where we exchange the shares reflecting the value of that investment spending.

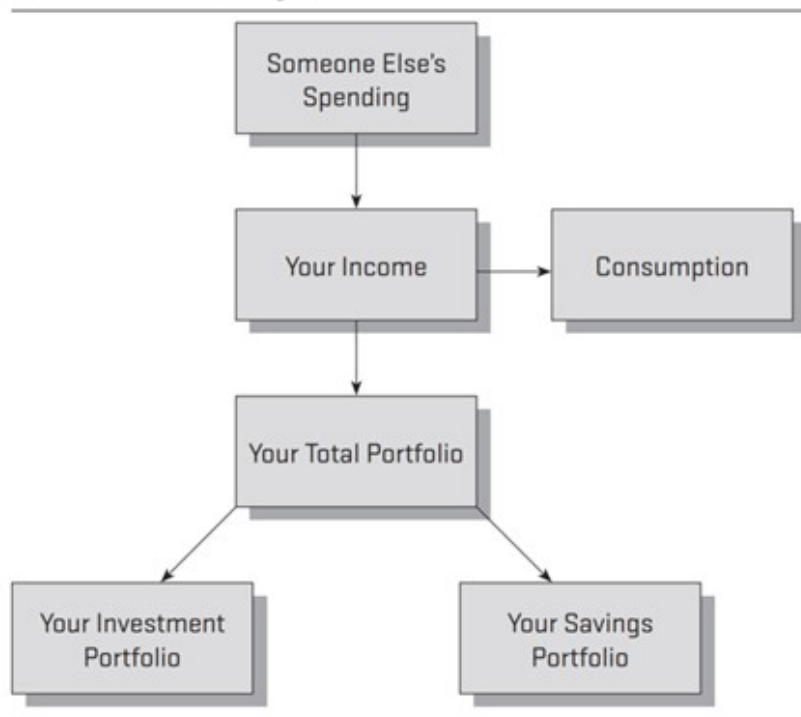
Saving, more specifically, is income not consumed. Much of our saving is done in cash instruments and more traditional “savings accounts”, but buying stocks and bonds is also a reallocation of savings. When we purchase stocks or bonds we are reallocating some of that savings to instruments that will earn a higher probable long-term return that is reflected by the future cash flows generated by actual investment spending. At the same time, someone else is exchanging their shares of stocks or bonds with the desire to save in cash.

Primary markets are different from secondary markets. Primary markets are where real investments are made. This includes purchases in the real economy. Secondary markets are where shares are issued and exchanged to help FUND potential investment by companies. Asset allocators who exchange shares are not “investors”, they are savers who exchange the composition of their savings.

But an odd thing has occurred over the years. We now refer to securities exchanges on the secondary market as “investment” even though this is not technically “investment”. When you buy securities on a secondary market like the New York Stock Exchange or through a brokerage account you are engaging in a simple exchange of cash for securities. The company whose shares you purchase does not obtain funds or new investment capital and your act of share purchases does not reflect actual investment spending. It is nothing more than an act of reallocating savings.

This is a useful first principles understanding because it draws a strict line between the act of being an “investor” and a “saver”. Most of us are earning an income and trying to generate a return across time that is consistent with certain financial goals. We are not engaging in the sexy, often high risk act of investment spending and managing a corporation. We are trying to allocate our literal savings in a prudent and practical manner. But too often these days the act of “investing” is depicted as a “get rich quick” endeavor and something it is not. We believe that bringing asset allocation back to the concept of “reallocation of savings” is highly useful for providing realistic expectations and perspective surrounding the process of asset allocation.

The Flow of Funds Through the Total Portfolio



A Stock Flow Consistent Model

“Stocks”, as in a stock of fish, not a share of corporate issued stock, reflect the pool of savings as reflected by the value of outstanding financial assets as seen on a balance sheet. Flows reflect the income generally depicted on an income statement that contributes to both saving and investment that can alter the value of the stock of savings.

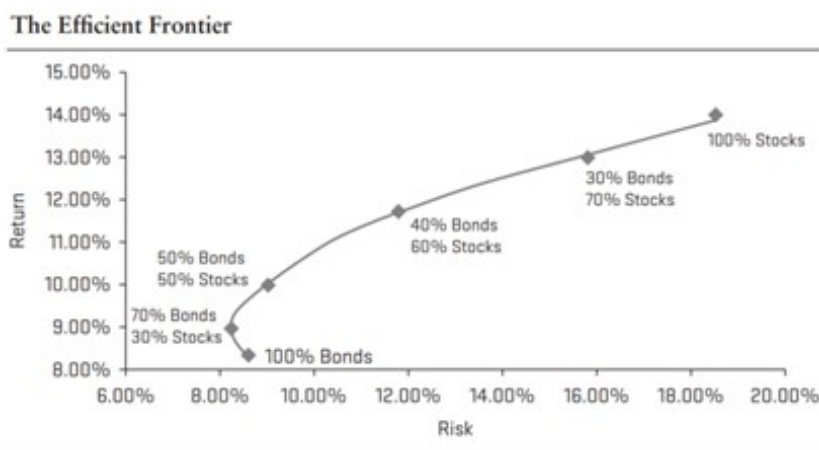
Flows reflect the income generally depicted on an income statement that contributes to both saving and investment that can alter the value of the stock of savings.

The Total Portfolio perspective shows how income flows through our income statement to alter balance sheets. This creates a specific delineation between the concept of savings and investment as investment is a flow item that can potentially change the value of savings, whereas savings is a stock item that is impacted by the way we spend for future production (invest). It is crucially important in this concept to understand that most of what we call “investing” has little impact on actual investment. That is, when Joe Schmo buys shares of Apple Corp from Jane Smith he is merely exchanging shares with another shareholder who is buying his cash. Joe and Jane are not impacting Apple’s corporate activity in any meaningful way and Apple Corporation doesn’t even care whether Joe owns the shares or Jane Smith owns the shares.

In this sense buying shares on a secondary market is a lot like buying a horse betting ticket. That is, once you own the ticket you cannot impact the speed of the horse or the outcome of the race. And much like horse betting, after taxes and fees the process of trying to predict the future's fastest horses too often turns out to be a fool's errand.

The Alpha Paradox

The core problem with the traditional line of thought here is that it creates a conflict of interest between the way we should implement prudent financial planning and asset management. In other words, most companies on a primary market are, by definition, trying to earn "alpha" or excess return. They are innovating and spending for future production in an attempt to *make* more return than their competition. Most people who buy those shares on the secondary market are reallocating their savings and trying to *take* the return that firms earn in aggregate.



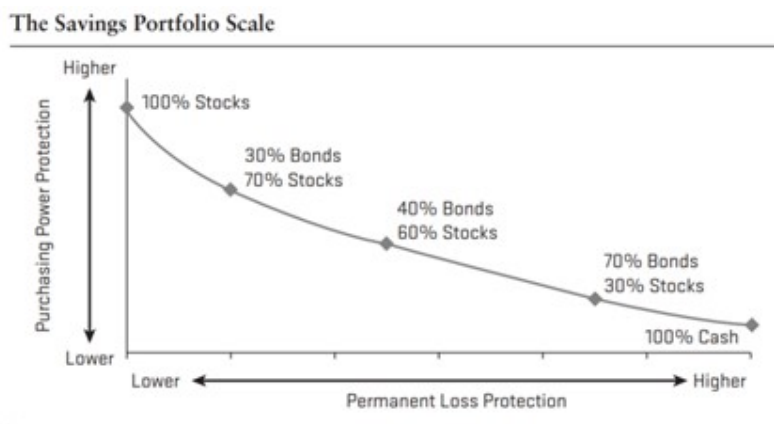
The asset management business creates a conflict of interest by selling the idea that they know where the "alpha" will come from when in fact we know that stock picking generally results in higher taxes and fees and lower average returns. Further, this pursuit of alpha in a secondary market portfolio can create behavioral risk for the underlying client as the primary way that the asset manager can earn higher returns is by taking *more* risk.

Modern Portfolio Theory exacerbates the confusion in these concepts by defining risk as standard deviation when, in fact, volatility varies across time and often, when assets become more negatively volatile, they become *less* risky.¹ For instance, when stocks decline rapidly in value they often become less risky, not more risky. Concepts like the efficient frontier lead investors to believe that a fixed weighting of stocks and bonds is "efficient" when in reality we know that the relative risks are dynamic not only at the aggregate portfolio level, but at the personal asset allocator level.

1—Markowitz, H. 1952. Portfolio Selection. Journal of Finance 7, no. 1: 77–91.

Asset allocators would be better served by abandoning the pursuit of an “efficient”, alpha generating optimal portfolio. They should instead start from a practical financial planning based foundation where they establish specific behavioral constraints and realistic goals that can be met within the bands of that behavioral constraint.

The Intertemporal Conundrum and Asset Liability Matching



More specifically, asset allocators should think of their portfolio as a “Savings Portfolio”. Most asset allocators have two primary goals that are consistent with managing their savings:

- 1) To maintain a stable portfolio.
- 2) To earn a real inflation protected return.

This means balancing permanent loss protection with purchasing power protection. This process involves a specific “intertemporal conundrum” where the asset allocator *wants* certainty of short-term principal, but *needs* long-term real returns. This paradox creates an asset-liability mismatch for all asset allocators because we all have uncertain long-term expenditures AND uncertain long-term returns. A specific asset-liability matching process can help better align certain future expenditures with assets that are likely to maintain principal across time while also earning a real return in the long-term.

Conclusion

At Discipline Funds we believe asset allocators would be better served by starting with a holistic approach to financial planning that is consistent with a more specific savings portfolio approach. This stock-flow consistent approach will help the asset allocator maintain a practical perspective that is more consistent with how they actually view their financial risks and goals. In taking this approach we believe asset allocators can improve the odds of meeting their financial goals.