EUROPEAN CONFERENCE ON FINANCIAL SERVICES, Brasov, Romania, oct 2017

Wealth edifice for today's financial citizen: Investment bricolage/DIY

Edificarea averii consumatorului modern de servicii financiare: bricolajul investițional individual

Dr. Adrian T. Mitroi, CFA. adrian.mitroi@fin.ase.ro
Conf. Univ. Facultatea de Finanțe, ASE București
Consiliul Științific, Institutul de Studii Financiare

MATCHING ASSETS AND LIABILITIES IS KEY FOR A GREAT FINANCIAL PRODUCT

- The modern consumer of financial services has a choice from a variety of offers that promise to protect against risk (insurance), to guarantee income (pensions) or to increase wealth (investment)
- individual or family investment portfolio should be considered depending on the risk profile, the professional objectives, other personal circumstances specific to the "*modern financial citizen*".
- decision to choose a financial product should be made in a *wider context*, ***with a longer perspective***
- constructing a financial individual portfolio (individual investment bricolage, DIY) ensure the capital protection and the **edification of personal wealth in correlation w/ investment risk profiling**.

MACHINES DO NOT SELL

PEOPLE DO

Source: Visual Capitalist, Zero Hedge; own research

MATCHING ASSETS AND LIABILITIES IS KEY FOR A GREAT FINANCIAL PRODUCT

- If A and L do not have same growth, deficit has to be made up by higher contributions, but how value liabilities? market indexes do not reflect pensioner unique liability schedule, true objective
- Market v. of A/market v. of L | mismatch lead to deficit, poor asset allocation; in loss domain, people assume undue risk
- By using the wrong benchmark the portfolio returns can still beat a market index with assets but still underfund with liabilities; the family **investment portfolio objective should be liability driven** not asset driven: pay dues, mortgage, kindergarten…
- *A great insurance product should insure event costs not amounts*

REPRESENTATIVE INVESTMENT MOTIVES FOR FAMILY INVESTORS

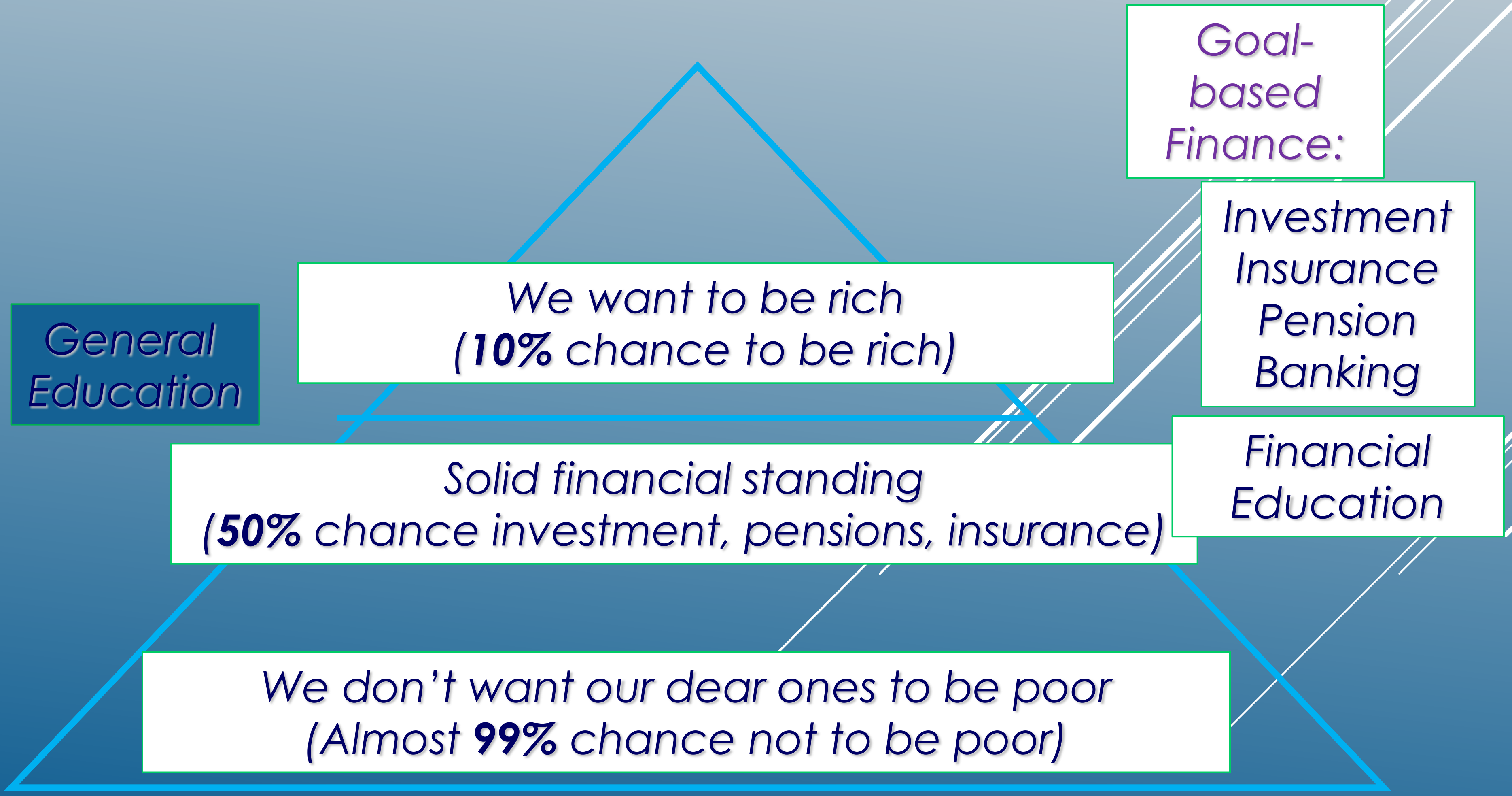
Short-Term Goals

- Children's education, excursions, fun, social image
- Saving for technology upgrade, being connected, cool
- Starting a business, not having a boss

Long-Term Goals

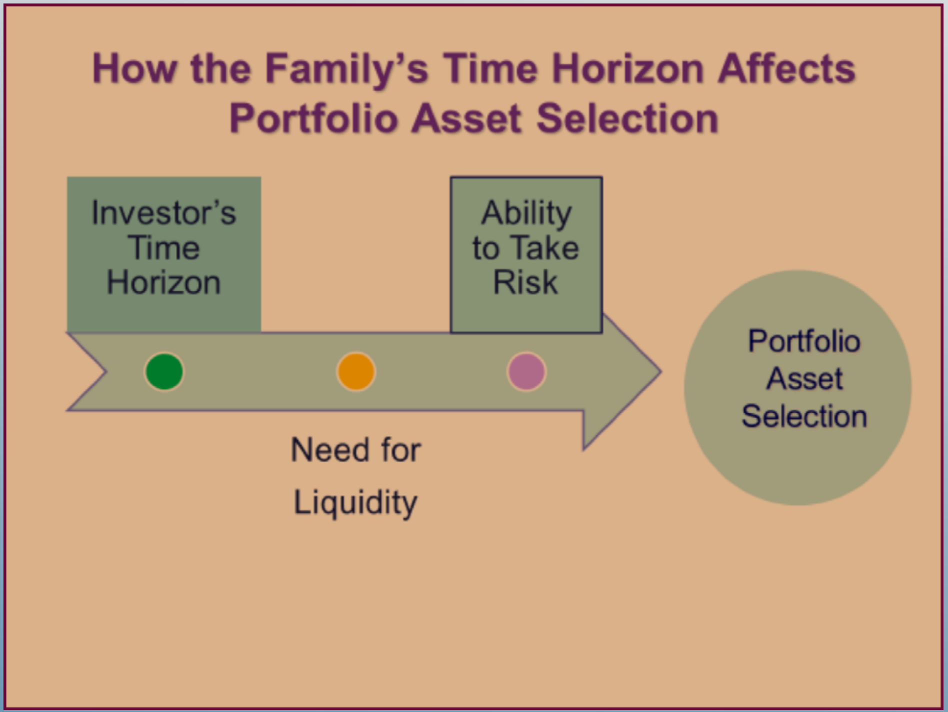
- Retirement (DC plan vs. DB plan)
- Major purchase, housing, education
- Have fun, see world, help kids, nephews
- Hobbies. Health. Harmony
- Social recognition of personal, professional success
- Give back to society

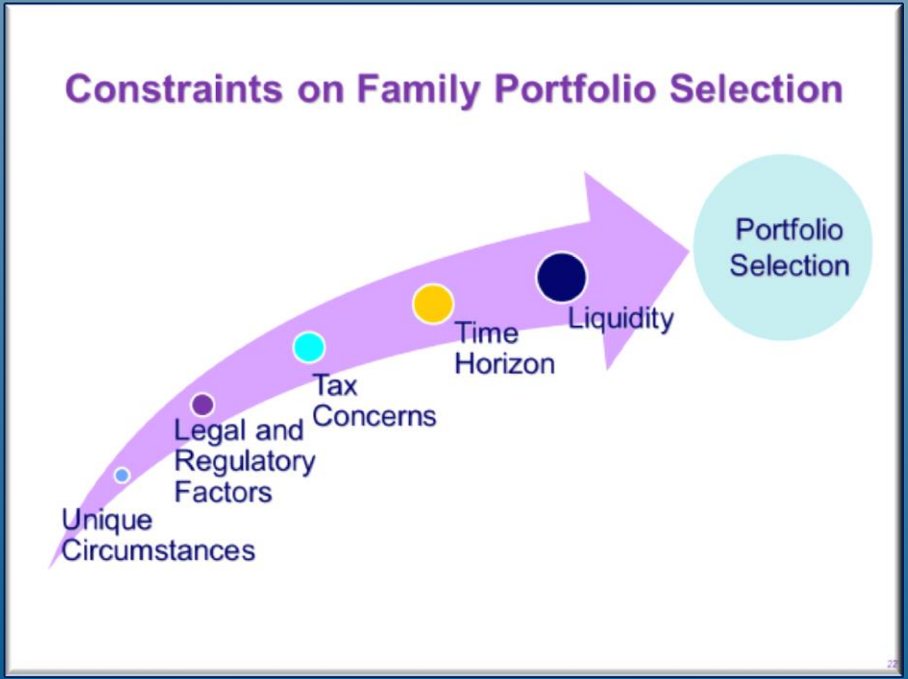
COMPORTAMENTUL FINANCIAR INVESTIȚIONAL AL CONSUMATORULUI-UN BUN INDICATOR PROXY AL ASPIRAȚIILOR SALE PERSONALE
FINANȚELE COMPORTAMENTALE ȘI ASPIRAȚIONALE *(GOAL-BASED FINANCE)*

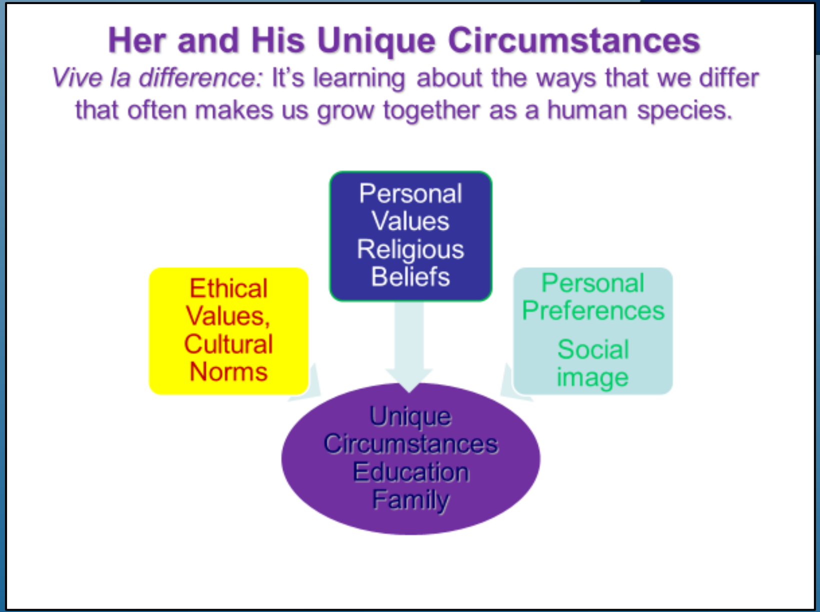


FAMILY FINANCIALS

- Introduction | what is
- Purpose | what for
- Duties and Responsibilities
- Procedures| how
- Investment Objectives
- Investment Guidelines
- Evaluation and Review
- Appendices | Rebalance







IN FAMILY MONEY MATTERS, HOW DOES THE WILLINGNESS TO TAKE RISK DIFFER FROM THE ABILITY TO BEAR RISK?

Willingness to Take Risk

Ability to Bear Risk

Risk Tolerance

Personality type?

Kid must succeed where we did not?

Self-esteem?

Independent thinking?

Time horizon?

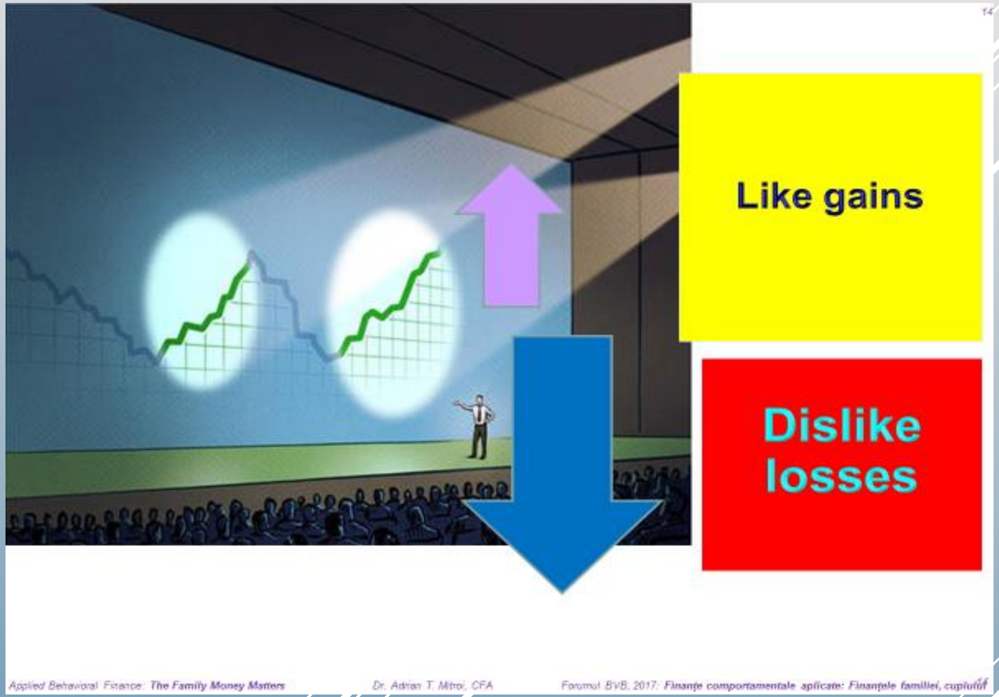
Are we better off than…others?

Expected income? Wealth relative to liabilities?

Household chores are very expensive

Negative scenarios: low probability high outcome

Scenario Probability	Outcome Expected	Weighted Outcome
75%	+1%	0.75%
25%	-5%	-1.25%
100%		-0.5%



Risk

A little more risk

A lot more risk

X

X

Money

All of your money

Some of your money

=

=

Portfolio risk

Addition to portfolio risk

Addition to portfolio risk

Sufficient Return and efficient portfolios: More Risk or More Capital

stimulus induced return made up for lost principal

1995-2005

	Probability	Equity fund %	Bond fund %	50% equity + 50 % bond
Recession	1/3	- 7	17	+ 5
Normal	1/3	+ 12	+ 7	+ 9.5
Boom	1/3	+ 28	- 3	+12.5
Expected return		11	7	9
Variance		204.7	66.7	9.5
Standard deviation		14.3	8.2	3.1

- Cov(s,b)= 0,3333(-7-11)(17-7)+0.3333(12-11)(7-7)+0.3333(28-11)(-3-7) = -116.67
- ρ(s,b) = cov (s,b) / σaσb= -116.66 / [(14.3) (8,2)] **= - 0.99**

Insufficient Return, inefficient portfolios: both More Risk and More Capital

it takes a lot of extra interest to make up lost principal

2005-2015/20

	Probability	Equity fund %	Bond fund %	50% equity + 50 % bond
Recession	1/4	- 10	5	-2.5
Normal	1/2	+ 6	- 2	+ 2.0
Boom	1/4	+ 12	- 5	+3.5
Expected return		3.5	-1	1.25
Variance		81	9	4.5
Standard deviation		9	3	2

- Cov(s,b)= 0,25(-10-3.5)(5+1)+0.5(6-3.5)(-2+1)+0.25(12-3.5)(-5+11) = -20
- ρ(s,b) = cov (s,b) / σaσb= -20 / [(9) (3)] **= - 0.75**

Sharpe $_{1995\text{-}2005}$ > 5 x Sharpe $_{2005\text{-}2015/20}$

PRACTICAL CONCLUSIONS

- individual or family investment portfolio should be considered depending on the risk profile, the professional objectives, other personal circumstances specific to the "*modern financial citizen*".
- financial product should be made in a *wider context,* ***with a longer perspective: great products should address ladies not gentlemen***
- individual investment bricolage for capital protection and **edification of personal wealth, correlate w/ investment risk profiling**.