See Part 1 - Here In this second installment relating my trip to the Research Affiliates Advisor Symposium in Newport Beach, CA, I will discuss the firm?s second major line of research, which involves the appraisal of global asset classes. The firm manages the PIMCO All Asset (PAAIX), and All Asset, All Authority (PAUIX) funds. These are global asset allocation funds that seek the maximum real return, often by emphasizing non-mainstream asset classes. The funds own stocks, bonds, commodities, and currencies through underlying PIMCO funds. Over the long haul, the goal of All Asset is to beat TIPS and inflation by 5 percentage points, while the goal of All Asset, All Authority is to beat the S&P 500 and inflation plus 6.5 percentage points. Research Affiliates thinks these inflation goals are tall orders currently. For example, a glance at the asset allocation part of the firm?s website shows that U.S. stocks are poised to deliver no return over inflation over the next decade. Stocks from developed countries, by contrast, are expected to deliver a little more than a 4% annualized real return, and those from emerging markets are expected to deliver nearly a 6% annualized real return. Besides emerging markets stocks, no asset class, save private equity,

is likely to deliver more than a 5% real return. First, Chris Brightman, CIO of Research Affiliates, led the attendees through the firm?s asset class returns. Bonds returns, of course, follow starting yields closely throughout history with a correlation of 0.96 between starting yields and future 10-year returns. Similarly, strong correlations exist globally. In equities future returns follow starting earnings yields, using the inverse of the CAPE Ratio (Price relative to the past decade?s worth of real average earnings). The correlation between starting earnings yields and subsequent 10-year returns is 0.75 since 1926, though admittedly, returns have been higher lately. Again, similar correlations exist in other countries. The current level of the CAPE implies a roughly 80% overvaluation of stocks. Other metrics, including Market Capitalization relative to GDP, Tobin?s Q, and Hussman?s PE show similar overvaluation. There?s hardly a way to look at US stocks, and not conclude that they are overpriced. Among Western developed countries, only the UK appears as if it is priced to deliver a real return of more than 5% for the next decade. **A Demographic Interlude** During his talk, Brightman speculated on why valuations seem to be higher than in the past. He remarked that macroeconomic volatility is lower today than it?s typically been in an agrarian economy where bad weather can wreak economic destruction. There are arguably lower risks in a post-industrial economy, and perhaps this is properly reflected in lower return prospects. There is also a greater ease in investing with the advent of index funds and ETFs; it?s easier to obtain a more diverse, lower-cost portfolio. Brightman also made a demographic observation ? an increasing percentage of older people in an economy tends to lower productivity growth. This, in turn, has an influence on real rates of return. Brightman used the example of teenagers who consume a lot and produce nothing. But when teenagers get to be, say 25 years old, the rate of change in their productivity from the time they were 15 is extremely high. Similarly, there is a great rate of change in productivity from the ages of 25 to 35. But then there is a lower rate of change from 35 to 45, and after 45 there is no difference in growth. Then, when adults become old, they revert to being teenagers again ? consuming a lot, but producing little. The difference is that teenagers have parents and senior citizens have assets ? and that?s why asset prices are higher and return prospects lower. All of this means that the U.S. enjoyed a period of superior growth as the baby boom generation matured and entered the work force. In other words, the post-war demographic trend flattered the superior growth of that period, and without similar demographic trends, the growth likely can?t repeat. It?s possible that stocks can deliver higher returns if earnings-per-share growth increases, but for three or four decades the ratio of profits to GDP has been growing. Brightman was skeptical that corporate profits could continue growth faster than the economy because, if that trend continued, it would likely violate rules of social equity. It?s likely that corporate profits will not grow faster than GDP from this point. **Non-Mainstream, Better Beta, and Rebalancing** Investors have a few options to boost returns. First they can consider non-mainstream stocks and bonds. Emerging markets, as previously mentioned, are poised to deliver higher returns than financial assets from developed countries. In fact, Rob Arnott, in his talk on after-tax returns, volunteered that one-third of his liquid net worth is in emerging markets equities. Second, investors can potentially extract greater returns from low-returning asset classes by using smart beta strategies such as fundamental indices. Capitalization weighted indices can?t deliver excess returns, and active management cannot collectively beat the market. Third, investors can rebalance diligently across asset classes instead of buying and holding, which tends to overweight recent winners. ?Tactical over-rebalancings,? as Brightman puts it, can help boost returns. Brightman?s three recommendations make me think investors need good advisors now as much as ever. Individual investors aren?t always comfortable choosing non-mainstream asset classes. They also aren?t as able to pick smart beta funds as they are plain index funds. Moreover, investors aren?t likely to pick the best smart beta funds, which, as Brightman?s colleague FeiFei Li noted, are not always characterized by the lowest expense ratio. Last, advisors are probably better equipped to accomplish the rebalancing that Brightman thinks will be a significant part of a successful investor?s future returns.