The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate. - Benjamin Graham

Very Freaky

Steven Levitt, a professor economics at the University of Chicago, and Stephen Dubner, an author and journalist, have written several books centered on a way of thinking that they call *Freakonomics*. Their first books, Freakonomics and Super Freakonomics, tell fascinating stories of their attempts to tackle various problems common to society.

In their latest book, Think Like a Freak, Levitt and Dubner set about trying to teach the rest of us how to apply their methodologies in problem solving. The introductory chapter tells us to imagine we are a soccer player attempting to make a penalty kick to win the World Cup Championship. The odds are in our favor – "Roughly 75% of penalty kicks at the elite level are successful." The goal is 12 yards away; it is 8 yards across and 8 feet high. The proximity, the speed of the kick, and the dimensions of the goal suggest the goalkeeper must take a guess and fling his/her body in the direction of the guess.

Our best shot is a kick to one of the corners – perhaps out of reach even if the goalie guesses correctly. However, a kick to the corner leaves us with little margin of error – we could miss the goal completely. We must also decide between the left and right corners.

The goalie knows that a right footed kicker's *strong-side* is to the left. Goalies jump to the kicker's left corner 57% of the time.

So, strong-side or weak; go for the corner's edge or play it safe? What do we think the goalie's is thinking and what do we think the goalie is thinking about what we are thinking?

The chance of being a hero is about 75%. How can we increase our odds a little? Goalies jump left 57% of the time and right 41% (98%). About 2% of the time the goalie stays in the middle.

What if we do the unimaginable and silly by kicking to the middle? The data shows that a kick toward the center is seven times more likely to succeed than a kick to the corner.

Here's the rub – a penalty kick toward the center of the goal is significantly more likely to succeed. Why then are only 17% of kicks aimed there? One reason is likely to be that kicking the ball straight at the goalkeeper seems like a terrible idea – unnatural, a violation of common sense. Another is the mystery – if kickers did the same thing every time, goalies would adapt.

A third and important reason why kickers don't aim for the center: fear of shame. Although no soccer player will ever admit it. What is the true incentive here? At one level it is obviously to score the goal to win the game for our team and country. If that is the case, kick the ball to the dead center. But is winning the game our true incentive?

If the goalkeeper doesn't dive and we kick the ball straight to his/her gut: the other country is saved without the goalie having to budge. We seem pathetic and the goalie is the hero.

If, instead, we take the traditional route and kick to a corner – even if the goalie guesses correctly and makes the save – we will have made a valiant effort. We may not become heroes, but we won't seem pathetic.

In our work in portfolio management and theory we are (fortunately) not limited to one kick. Diversification is described as the only free lunch on Wall Street – over the long-term diversification has been shown to provide equivalent returns to other strategies with the benefit of lower risk. Returns are the lunch, risk is the cost.

TD Capital is now in its 21st year of providing service to our clients. Never have we felt that focusing on diversification was more important, and never have we had as many tools to help us accomplish our objectives on behalf of our clients.

Diversification is typically considered a *horizontal* concept (our terminology). The idea is to spread our investment exposures over multiple asset classes to produce the desired effects – equities / bonds; large-cap / small-cap; international, emerging markets, value, growth, treasuries, corporates, long maturities, short maturities, and so on and so on. This concept is most prominent in our *core equity* and *core fixed-income* allocations.

Somewhat unique to the current investment atmosphere is what we refer to as *vertical* diversification. This concept suggests employing multiple strategies to further enhance diversification. These diverse and diversified strategies make up our allocations to *dynamic equity*, *alternative strategies* and *risk-managed fixed-income.*

It's comforting to know that we are not limited to one kick. We are very pleased and confident that our current portfolio approaches are appropriate for current economic market environments. However, candidly, we look forward to opportunities to reduce the complications and intricacies necessary in these times of economic uncertainty, high valuation stock markets, and low yield fixed income. The time should come, but for now we'll keep our focus on risk control through multiple dimensions of diversification. We'll aim for both corners and the center of the goal at the same time.

Call or come see us to discuss these or other issues.

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