

# Constructing Investment Portfolios for All Seasons

by  
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Each year time, effort and money are needlessly wasted by investors on issues that have little or no potential to help them maximise their assets, or achieve their goals. Greed and fear, an investor's worst enemies, routinely misdirect investors. The unfortunate result is that most individuals end up with expensive, poorly diversified and disorganised investment portfolios.

In addition, many investors lack a structured investment strategy. As such, they are easily "sold" inappropriate investments in the endless pursuit of the next hot manager or "sure thing." Generally their investments rarely serve them in an organised and optimal manner.

Because most investors lack a disciplined investment strategy, they tend to make investment decisions based on forecasts of future events. They attempt to "time the market" by moving investment dollars in and out of the market in an effort to be fully invested during rising markets and out of the market when prices are falling.

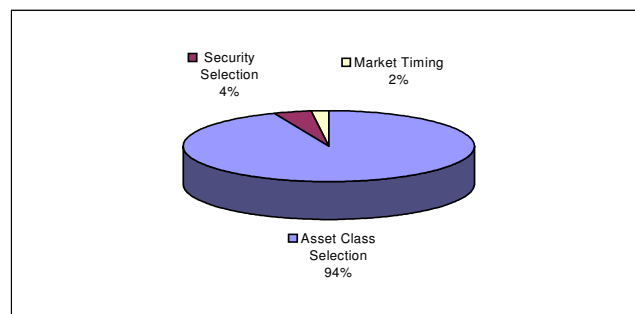
The purpose of this article is to explore the issues that really do matter—those issues that, if properly harnessed, allow you to build better portfolios that maximise investment returns while reducing and controlling risk.

## □ Asset allocation is the most important tenet of successful long-term investing.

The asset allocation decision should be the epicentre of the entire investment process. According to Nobel Prize winner William Sharpe, "It is generally agreed by theoreticians and practitioners alike, that the asset allocation decision is by far the most important one made by an investor."

A hallmark study by Brinson, Hood & Beebower, published in the *Financial Analysts Journal*, confirms the importance of asset allocation. The study analysed the investment results of 91 of the largest U.S. pension plans.

The purpose of the study was to determine the relative contribution of asset allocation, market timing, and security selection (**stock picking**) to overall portfolio performance. As shown in Figure 1, asset allocation, *the location of investment dollars*, explained 94% of investment performance.



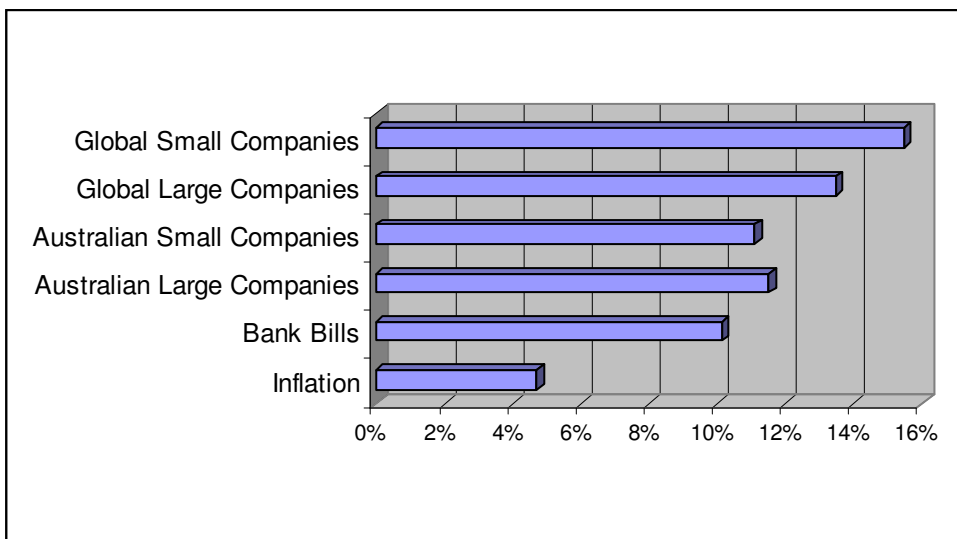
Unfortunately, most investors, even most professional investors, spend the majority of their time and resources trying to achieve superior returns by focusing on market timing and security selection, with little emphasis placed on asset allocation. The great majority of resources are

consumed focusing on the very factors (selection and market timing) that matter the least. In fact, such activities actually detract from performance over time.

The investment industry's most respected experts confirm the futility of market timing and security selection. Regarding market timing, renowned investor Warren Buffet has said that he has "long felt that the only value of stock forecasters is to make fortune tellers look good."

Contrary to popular opinion, asset allocation is actually quite simple. It refers to how your investment dollars are distributed among various **asset classes** such as those illustrated in the following table. In simple terms, portfolios allocated primarily among **equities** provide stock-like returns. Investors owning **bonds** get bond-like returns.

Annualised Investment Returns For various asset classes (November 1980 – October 2004)



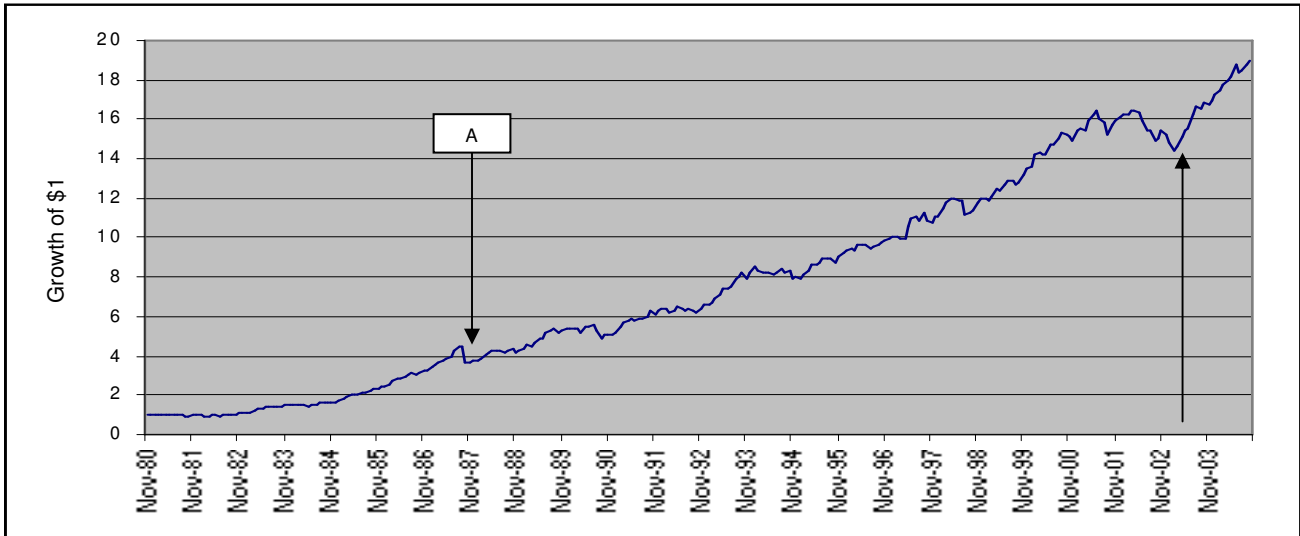
This decision, more than any other, will determine an investor's long-term results. Said another way, the decision to be in equities instead of certificates of deposit has a far greater long-term impact than the decision to be in Equity Fund A instead of Equity Fund B.

#### □ **Effective Asset Allocation Reduces Risk and Improves Return**

Few investors place all of their money in a single investment. To the contrary, most investors own several securities. This produces a desired effect known as **diversification**. Similarly, successful investors do not invest all of their money in a single asset class. Investors using properly diversified asset allocation strategies own several separate and distinct asset classes. It is this diversification among asset classes that results in reduced risk and enhanced long-term returns.

All broadly diversified asset classes grow "*over time*." This is inherent to financial markets and testimony to the fact that capitalism works. But in the short term, individual asset class performance is remarkably less certain.

#### 4. Globally Diversified Equities / Bond Portfolio



Asset classes rarely all experience losses at the same time. Short-term losses in one asset class are frequently offset by gains in others, thus smoothing returns. This “smoothing effect” reduces short-term risk and enhances long-term return. The above chart illustrates this “smoothing effect.”

The above globally diversified portfolio is diversified evenly between Australian large companies, global small companies and Australian short term fixed interest. The end result being a smoothing of returns over the period, and a return that exceeds both Australian large companies and Australian short term fixed interest, with less volatility. Each of these asset classes grows over the long run; however, each asset class’s short-term gains and losses show distinctively different patterns. Short term gains and losses often offset each other. Notice that at point labelled A, which reflects the 1987 sharemarket correction, both Australian and international shares experienced short-term losses while Australian fixed interest earned positive returns.

Technically, this is called **negative correlation**. Negative correlation reduces risk by causing the “smoothing effect” evident in the combined, diversified portfolio. Risk reduction is possible because *different* asset classes respond differently to economic and world events. As a result, different asset classes follow unique short-term growth patterns. For example, while most asset classes declined in 2000, bonds and U.S. small company value stocks performed very well.

Investors that maintained exposure to these previously out of favour asset classes performed better than most investors during this difficult year. Diversifying among *different* asset classes also increases long-term returns.

Asset allocation has consistently added value and return over long periods of time in both a quantifiable and statistically proven manner. Asset allocation has been proven to be critical in helping investors accomplish their financial objectives.

#### □ Modern Portfolio Theory <sup>1</sup> Balances Risk Reduction with Improved Return

(<sup>1</sup> William F Sharpe, Harry Markowitz and Merton Miller shared the Nobel Prize in Economics in 1990 for their pioneering work in Modern Portfolio Theory.)

Investors who adopt effective allocation strategies are not limited to simply increasing return or reducing risk. Investors can structure portfolios that incorporate any combination of these two objectives.

Modern Portfolio Theory (MPT), the technique used to design properly diversified portfolios, has completely transformed the way institutional investors manage risk and return. **The Money Managers Ltd** in Melbourne, Australia, applies this same approach when constructing individual investors portfolios.

Asset allocation techniques do not limit investors to choosing between “only” more return or “only” less risk. Many investors prefer to accomplish a combination of these benefits. Some investors are willing to sacrifice some return in order to further reduce risk. Other investors are willing to accept even higher risk for additional return. Sophisticated computer technology allows creation of efficient investment strategies to meet any investor’s risk and return requirements. The hundreds of possible portfolio combinations form what economists call the Efficient Frontier Curve.

Unfortunately, most investors typically do not receive full compensation for assumed risks. In other words, most investors are receiving too little return for the level of risk they take.

It is also worth noting that it is impossible to consistently earn returns above the Efficient Frontier Curve but there is no such thing as high return with low risk so investors are best served by choosing portfolios that fall directly on the Curve.

#### ❑ **Effective Asset Allocation Strategies Utilise Modern Portfolio Theory**

Modern Portfolio Theory techniques require a thorough understanding of financial markets, use of sophisticated statistical tools and the ability to maintain a highly disciplined approach to investing. **The Money Managers Ltd** (Melbourne) helps investors put these techniques into practice via our model investment portfolios (see below).

We design, maintain and monitor these models, making long-term strategic changes as deemed appropriate. Each model offers investors a unique balance of risk and return and may be customised to each individuals’ special circumstances.

Knowledge and discipline, combined with the rapid evolution of computer technology allow us to apply Nobel Prize winning technology to develop individual portfolios. Only recently have individual and small institutional investors gained access to appropriate asset class and **Index Funds** required for the effective application of this approach.

Growing numbers of institutional **Asset Class** funds now allow investors to utilise the same investment vehicles traditionally reserved for large global pension plans. Our collective institutional buying power allows our clients to access these restricted funds, where the minimum investment is typically \$100million.

#### ❑ **Successful Investing Requires Learning About Short and Long-term Risk**

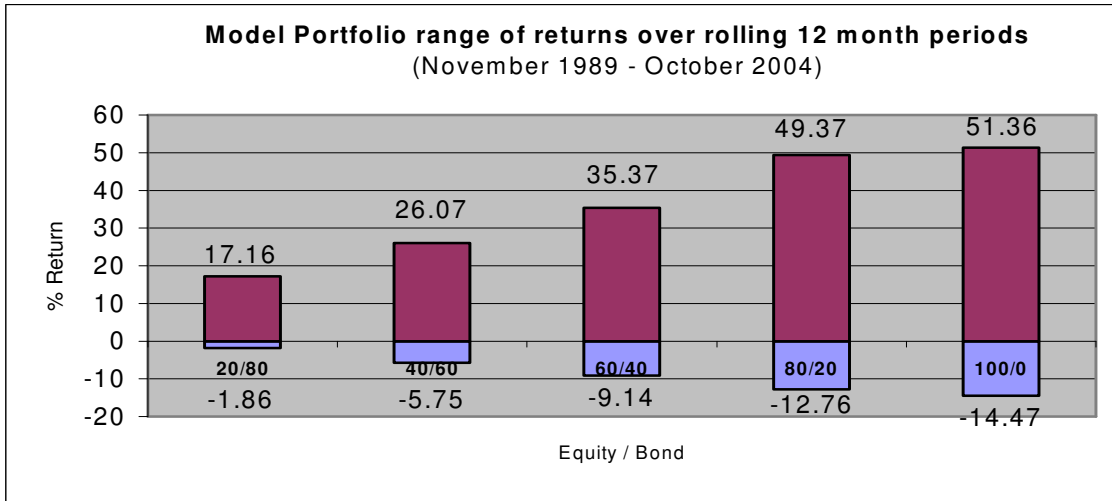
An understanding of investment risk allows investors to develop and maintain a disciplined long-term investment strategy. Without a disciplined and well-defined strategy, fear and greed inevitably result in self-sabotaging investment decisions. Over the long run, well-diversified investments *must* increase in value.

There is a commonly accepted hierarchy of expected returns. Small stocks outperform large stocks. Large stocks outperform bonds and bonds outperform cash. While this hierarchy is very predictable over long periods of time, short-term returns are much less certain. This uncertainty is called “risk.”

Because short-term risk is unpredictable, most investors rarely understand the good and bad implications of risk. This naivete often leads to poor investment decisions.

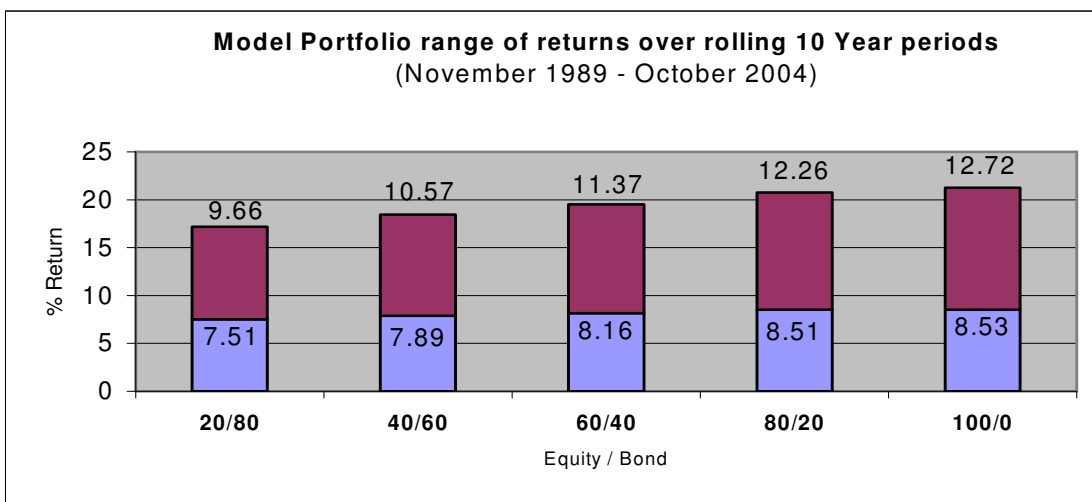
In the short term, investors often define risk as “losing money.” Short-term risk is related to stock and bond market fluctuations caused by the economy, world events, interest rates, inflation, investor sentiment and a myriad of other factors.

The diagram below illustrates short-term risk, reflecting the best and worst 12-month returns for **The Money Managers Ltd** model portfolios ranging from 20% equity and 80% fixed income (extremely conservative) to 100% equity (aggressive) during the period of November 1989 – October 2004. As can be seen, the range of 12-month returns is wide.



The 20/80 portfolio clearly had the least amount of short-term risk. Between 1989-2004, its worst 12-month return was - 1.86%. In comparison, the 100% share portfolio (100/0) lost 14.47% in its worst year.

Many inexperienced investors often over-react when their investments experience short-term losses. They fear their money is gone forever. This is untrue if the portfolio is properly diversified. Investors lose money only if they sell their portfolio when its value is down. Rather than sell, investors should understand that patience and time work to their advantage. Over long periods of time, disciplined investors are nearly assured of earning positive returns, even if they initially experience short-term losses. The next chart illustrates this, representing **The Money Managers Ltd** model portfolios over the last 10 years to the end of October 2004. The range of historical returns for investors with 10 year investment horizons is narrow.



The *worst* 10-year return was a *positive* 7.51%, compounded annually, which was generated by the extremely conservative 20% equity 80% bond model portfolio. Interestingly, the worst 10 year return for the aggressive 100% equity portfolio was 8.53% and actually performed better than the worst-case return for the extremely conservative portfolio at 7.51%.

#### □ **Controlling Costs Enhances Benefits of Global Asset Allocation Strategies**

Low costs are critical to improving the benefits of effective asset allocation as investment costs consume principal. Internal investment management fees fall into two categories—expense ratios and transaction costs. Conventional retail managed funds charge an average annual expense of 1.8%. Internal transaction costs often add an additional 1.0% per year in hidden expense. We recommend no entry fee institutional, index and asset class funds.

While not free, total internal costs are greatly reduced. Costs typically amount to 0.3% annually. Assuming a gross annual return (before costs) of 10%, “institutional” index funds allow investors to retain 9.7% compared to 7.2% for conventional “retail” managed mutual funds (allowing for additional transactions costs incurred annually).

Bottom line, the only thing guaranteed in investing is that if you spend less, you keep more. Focusing on low cost, no entry fee investments assures higher long-term returns through time.

#### □ **Successful Long-Term Investing Requires a Disciplined Plan**

Successful investors adopt disciplined investment plans. Investment plans should be formalised in writing, implemented cost effectively, and maintained with a systematic rebalancing strategy. Most investors buy high and sell low, exactly the opposite of what is required to be successful. Fear and greed cause investors to lose track of their long-term perspective and react abruptly to short-term market events.

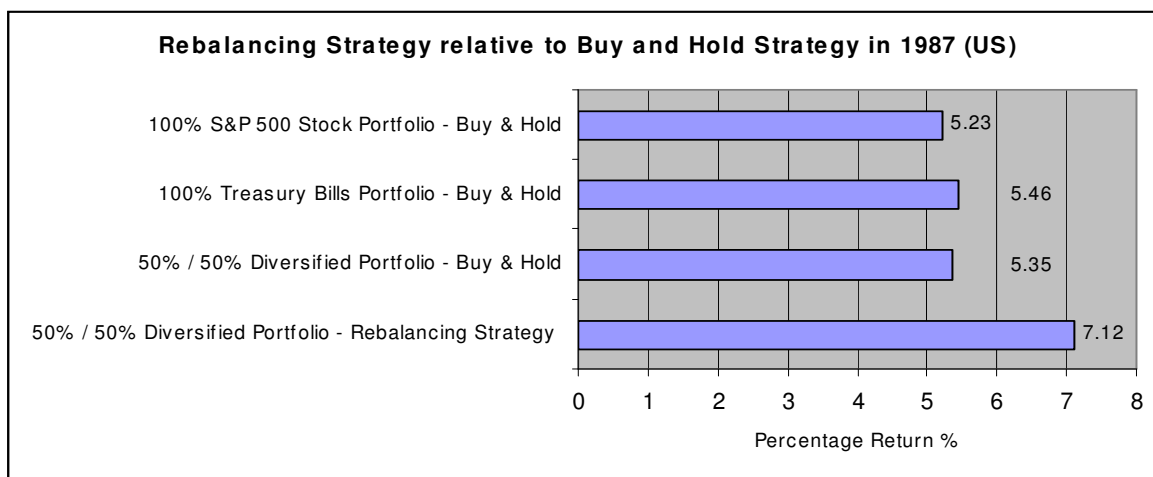
In any given year, a few investment managers earn above average returns. More often than not, this is the result of luck, being in the right spot at the right time. Like clockwork, naïve investors flood the successful manager with money, investing *after* the superior performance. Managers often lose money after a period of above average performance. The naïve investor now suffers losses. Disillusioned and fearful of losing even more money, the naïve investor sells the remainder of the investment, at a *low*, and the cycle starts over.

Disciplined investment strategies help investors maintain long-term focus and reduce temptations to make short-sighted decisions. To avoid self-defeating behaviour, **The Money Managers Ltd** believes investors should be protected by a written Investment Policy Statement.

This document describes in great detail, the long-term asset allocation, risk tolerance, investment style, objectives, core principles, policies and return expectations for each investor. This document also establishes a foundation for routine investment decisions and helps maintain long-term focus. To maintain a disciplined strategy, investors need to identify the specific percentages of their portfolio they wish to allocate to different asset classes.

Once invested, ongoing supervision of portfolio assets is critical. Different investments grow at different rates. Left unchecked, investor portfolios grow out of balance causing increased portfolio risk and reduced long-term performance.

Periodic rebalancing alleviates this problem. Systematically rebalancing client portfolios takes the emotion out of buying and selling. A rebalancing strategy maintains a constant level of risk, automatically buying low and selling high. Studies also show that rebalancing may add 0.5 to 0.75% to annual performance over time.



The graph above illustrates the strategy if applied in 1987. In this example the investor adopted a simple asset allocation strategy—50% shares and 50% cash. Early in 1987, the stock market grew quite fast. By June 30, the investor was 5% over concentrated in stocks.

The rebalancing strategy resulted in the excess share exposure to be sold and reallocated to cash. Later, the stock market crashed, causing investors to become over concentrated in cash. This time, rebalancing sold excess cash and re deployed capital to shares to restore the 50/50% asset allocation model. By year-end, the rebalanced portfolio was up 7.12% versus 5.35% for the buy & hold strategy.

□ **Adding Value with a Common Sense Approach to Investing**

Successful investing is neither an art nor a science, but rather a strict discipline. And, while there are few certainties in the world of investing, **The Money Managers Ltd** believes that investors can significantly improve their chances of success by developing and maintaining a disciplined investment strategy. Such a strategy should be based on simple, time-tested strategies that make intuitive sense.