I’m a Believer, Now What?

Overview of effective portfolio management

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You are armed with the knowledge that only 1 in 5 of market timers are able to outperform the market in the long run; and picking them before they deliver exceptional performance is near impossible, now what?

The indexer purist might believe you should simply purchase the entire market utilizing one low-cost index fund. Though this approach will likely produce results exceeding most actively managed funds, there are many problems with it including:

- Each investor’s time horizon is unique
- Index funds are largely arranged according to the value its constituents
- Some market segments are not appropriate for the individual investor
- Some market segments do not reduce a portfolio’s anticipated risk while increasing anticipated return
- Purchasing the entire market according to the value of its constituents does not take advantage of momentum in the marketplace which history has shown us does exist from time-to-time

I will now attempt to address each of these issues.

Each investor’s time horizon is unique

Purchasing the entire market forces the individual to conform to a specific mix of stocks and bonds. This is simply not prudent.

When it comes to investing the two major risks are inflation and volatility. As an investor, you should be aware of both risks and develop your strategy to deal with them in conjunction with your time horizon.

Volatility is easy to understand. If you will need funds to make a necessary purchase in the near term you should not invest in a highly volatile asset that may or may not be able to provide you with funds when they are required.

Inflation is more insidious. Let’s say an investor earns a steady “risk free” rate return of 3.5%. This may sound pretty good to investors currently earning less than 1% in their money market accounts, but in the long run this investor’s real return will be much less than 3.5% due to inflation. Most likely this investor will realize a net real return of .5% at best. This doesn’t leave our investor with a lot of cushion for potential periods of high inflation in the future. Not exactly as “risk free” as it first sounds.

Similarly, a long term investor that assumes cash is safer than stocks will be even worse off in the future since a dollar today will be worth much less down the road. In the long run, it is important to realize cash is actually one of the riskiest investments to own.

So how do we manage these two major risks? First off, we should realize the solutions are competing. That is:

	Bonds	**Stocks**
Strength	Low volatility	Hold up to inflation
Weakness	Crushed by inflation	High volatility

An understanding these competing solutions is the key to understanding the importance of properly targeting your portfolio's allocation. A long-term investor over-allocated to bonds will likely be crushed by inflation, while a short-term investor over-allocated in stocks will face a good chance of getting crushed by volatility.

Most of us are both short and long term investors. That is, we will each have both short and long term needs. A major responsibility of an investment advisor is to help his clients determine the extents of each, then identify a targeted mix of bonds and stocks the client is comfortable with.

A client's comfort level with an investment program is critical. If the client is not comfortable with a program, they will eventually make damaging decisions based on emotion. More on this later.

Index funds are largely arranged according to the value its constituents

Most index funds are weighted according to the size of the underlying companies. That is, the larger the company the greater its representation in the index.

Large international companies are highly correlated with one another. That is, they tend to rise and fall together. Utilizing asset classes that do not rise and fall together provides more consistent returns, therefore is less volatile. All things being equal, lower volatility increases returns over the long run.

Smaller companies, though more volatile, have historically also provided higher returns than larger companies. Adding these companies to a portfolio in a weight greater than suggested by the market actually reduces long term risk and increases long term returns.

Real estate holdings also help to reduce risk, increase returns, and act as a hedge against inflation. Market weighting these holdings leaves them represented at a lower level than would be optimal.

Market weighting your bond allocation is probably the most potentially damaging aspect of "buying the market". Bonds come in multiple forms, but only certain ones are prudent for the individual to own. An individual should own relatively high quality low duration bonds. If the individual is subject to higher tax brackets, this will also be a consideration. Market weighting an entire bond allocation is simply not appropriate or prudent.

Additionally, most funds do not cover the entire investable market. This creates a void that could be filled with investments likely to reduce anticipated risk for a given level of anticipated return.

Some market segments do not reduce a portfolio's anticipated risk while increasing anticipated return

When evaluating performance it's critical to also weigh the risk taken. Why? Here's an example: Let's say there are two people that want to borrow money from you. One person has a steady job and good credit history. The other: not so much. In the end you know you will receive your money plus interest from the first person, but you may only have a 50:50 chance of receiving money from the second. This means that if you were to charge each person 10% interest, even if both eventually pay you back, the first person is a better investment since the risk is less.

Investing is very much the same. For any given level of anticipated return, you should seek to minimize the anticipated level of risk; and vice-versa. The anticipated or realized risk and return of a portfolio is known as the portfolio's "risk/return profile". Diversification can help optimize the risk/return profile of a portfolio, but only by adding components that would cause the profile to improve. To do this you will need to completely understand the investment vehicle and how the vehicle will compliment the portfolio. If you do not understand how the vehicle will improve the risk/return profile of the portfolio or if you know that it will not, you should not own it. Purchasing the entire market does not allow the exclusion and/or inclusion of certain components that could be helpful or harmful.

Purchasing the entire market according to the value of its constituents does not take advantage of momentum in the marketplace which history has shown us does exist from time-to-time

It's hard for believers in the *Efficient Markets Hypothesis* to admit market segments are occasionally subject to price bubbles or being over-sold. A study of history shows this to be the case, however. The existence and recurrence of price bubbles and over-sold markets are quite real and will each recur in the future. This is a fact we need to accept.

Though bubbles and over-sold markets are quite apparent in retrospect, they are very difficult to identify as they are happening. Once we realize they do occur we can adopt a portfolio strategy to benefit from these cycles without being forced to

call market bubbles or bottoms. This strategy will also allow us to maintain a market position as a hedge against being incorrect.

As stated previously, it is critical for an investor to understand and be comfortable with an investment program. Both bubbles and over-sold markets will test an investor's resolve to the extreme. Most cannot resist the urge to jump into markets when they most overheated and abandon them when they are most depressed. Doing anything different is running in the exact opposite direction of the crowd, but time and again the more disciplined approach has been proven to be a winning strategy.

Parsing market segments then formulating asset allocation targets forces the investor to *buy low* and *sell high* while never abandoning a market segment altogether. A solid portfolio management program that you are comfortable with will take emotions out of the equation and force reasoned thought and process. Again, your full understanding and comfort with an investment program is critical to your long term success.

Putting it all together

By constructing a portfolio utilizing a specified set of individual indexed investment vehicles instead of simply purchasing the entire market via one or two indexed products you will be able to:

- Construct a portfolio according to your own time horizon and risk tolerance
- Construct a portfolio utilizing and weighting asset classes anticipated to maximize the portfolio's risk/return profile
- Gain exposure to bonds most suited to your unique situation
- Exclude asset classes not anticipated to improve the portfolio's risk/return profile
- Take advantage of upward and downward momentum in the marketplace

This is a broad overview of the reasoning and methodology for constructing a portfolio of indexed investment vehicles. I will later discuss the basics of why and how diversification works in *Can 1+1 Really Equal 3?*