

- Client Information Summary -

Getting More from the Power of Diversification

It is quite possible that the first investment advice many of us ever received came on the knees of our parents who said “Don’t put all your eggs in one basket!” It is sound advice that has stood the test of time and almost universally, prudent investors practice it. A good example of how this concept has taken hold can be seen in the explosive popularity of mutual funds. It is estimated that more than half of all investors now own mutual funds. The appeal is clearly the immediate diversification that can be achieved with a single investment. The average equity mutual fund, for example, holds 70 – 100 stocks, a level of risk reduction through diversification that would not likely be possible to achieve on an individual basis.

So, if diversification is good for us, can we extend the concept beyond the traditional notion of owning a large number of stocks to achieve even greater risk reduction? The answer is “Yes” — by including in our portfolio varying approaches to the market and management styles. Essentially, there are three opportunities to diversify by approach or style. They are:

- ✓ Active vs. Passive Management
- ✓ Strategic vs. Tactical Asset Allocation
- ✓ Growth vs. Value

The cornerstone of the diversification model is the choice between active and passive management, so let’s start by defining these two approaches.

Active management proponents believe:

- § There is an art and a science to security selection
- § Professional money managers can do better than individual investors due to knowledge, skill or technology

Passive management supporters, on the other hand, contend:

- § Investment markets are so “efficient” that prices reflect all available information and adjust too quickly for active security selection to add value
- § After transaction costs, active managers cannot “beat the market”

In simpler terms, *active* management requires the manager to have a hand in what is happening, trying to gain advantage by buying and selling the correct securities, rotating the portfolio from one sector to another or shifting the asset mix. *Market timing* would be considered an extreme form of *active* management. *Passive* managers are perceived as just “going along for the ride”. That isn’t quite accurate because *passive* managers often do make active trading decisions. However, they respond to widely known information about individual securities, market or economic conditions rather than trying to outguess the markets.

Index Funds – The most extreme form of *passive* management is *indexing* which is the practice of buying or mirroring a major market index, like the TSE 300 Index or the Dow Jones Industrial Index. There is no active security trading so without those costs, ‘*indexers*’ should have returns very close to those of the markets themselves. (There are some management expenses that must be covered in any circumstance.) Index mutual funds tend to increase in popularity when markets are rising, particularly if the increases are substantial. In that circumstance, there is a strong case to be made for using lower cost

index funds to participate in the upswing. The real test for these funds, however, comes when markets decline for some extended period, as they inevitably do. Then the index funds fall in parallel and true indexers have to be psychologically prepared to stand back and watch that happen.

Which is Better? – This debate will never end simply because the investment world is too dynamic. When markets are climbing, the argument shifts in favour of *passive* management. Why pay the extra costs of active management when so many managers fail to outperform their respective indices? When markets start to tumble, however, many investors want the expertise of a professional *active* manager to cushion the fall. In fact, this is the most frequently cited argument in favour of active management — managing risk — and isn't that what it is all about?

Generally, we believe in active management because:

- § It offers potentially better downside risk management
- § The number of passively managed investment products is very limited in comparison to those that are actively managed. Consequently, it may be impossible to achieve the level of diversification considered necessary in a portfolio or to incorporate all the desired asset classes, sectors, specialty securities or management styles (growth vs. value, for example).
- § There is a legion of good money managers who have consistently outperformed their respective indices. Their expertise is only available through actively managed products.

And finally, but perhaps as important as anything else, is the fact that we are human beings, which means we bring emotions into the investment arena with us. There are psychological rewards that come from utilizing active management services:

- § We feel more involved in the process
- § We feel more comfortable that someone is doing something when things go awry
- § We have a sense of hope and optimism that they will 'beat the market' sometimes

Here, then, is our summary advice on how to deal with the active/passive debate — *take an active role in manager selection and a passive role in security selection*. This will give you the best of both worlds.

Strategic vs. Tactical Asset Allocation

The comparison between strategic and tactical allocation is very similar to the debate over passive vs. active management. In this instance, however, we are more concerned with the portfolio mix across various asset classes than diversification among individual securities.

At its purest level, *strategic asset allocation* is the process of calculating the optimal percentage of each asset class (typically among stocks, fixed income and cash) in a portfolio that yields the maximum expected return for any given level of risk. Conversely, we could be trying to achieve the least amount of risk for a targeted rate of return. In other words, we can approach the asset allocation decision from either side of the risk/reward trade-off — by attempting to maximize expected return or minimize risk.

The calculations to “optimize” the portfolio, that is to determine the most efficient trade-off between risk and reward, involve three variables; historical return and volatility (standard deviation) for each asset class and the degree to which the asset classes fluctuate compared to each other (correlation). We get a sense of the importance and complexity of the computations to determine the “best mix” when we realize that a fellow named Harry Markowitz was awarded the Nobel Prize in Economics in 1990 for his work in this area. Fortunately, today the power of modern computers allows us to use these same advanced techniques for individual investors that in the past were only available to multi-million dollar portfolios.

The outcome of the “optimization” process is an asset mix that can be used as a long-term guide for investing — the portfolio's *strategic asset allocation* plan. The target weightings assigned to each asset class remain fairly consistent throughout the lifetime of the plan, unless the underlying assumptions change or the investor decides that their objectives or risk tolerance have altered. The portfolio would then be “optimized” again, based on the revised input.

In addition, the portfolio has to be periodically “re-balanced” to restore it to its original mix, as actual performance over time will cause at least one of the asset classes to grow at a rate more or less than expected. Left unattended, the portfolio would eventually become distorted from its optimal allocation. From this description, it should be apparent that once the portfolio mix is established, the process is more passive than active.

Tactical Asset Allocation (TAA)

Tactical asset allocation is deviation from the long-term strategic asset allocation in an attempt to capitalize on shorter-term market trends. The most extreme example of TAA is *market timing*, where an investor directs all or most of their money to the asset class they feel will outperform the others. For example, if they forecast that bonds will yield the best return over the next few months, they will sell their stocks to buy bonds. Conversely, when they feel bond prices have peaked and are about to give way to stocks, they will sell their bonds to repurchase stocks. When market timers don’t like *either* stocks or bonds, they will revert to cash holdings. As noted, this is an extreme example and in practice, few investors are so bold as to attempt a 100 percent market timing strategy. Furthermore, there is no empirical evidence to prove that many investors have been sufficiently accurate in predicting market movements to have a consistent result. Remember - to be successful as a market timer, you have to make two accurate predictions in a row – when to get in and when to get out!

That being said, with the overall higher volatility of investment markets today, more and more investors are being emotionally challenged to maintain their traditional “buy and hold” strategy as they watch certain market segments or asset classes rise and fall in dramatic fashion. Consequently, a modified version of TAA, less dynamic than pure market timing, is gaining favour. With this approach, investors set “ranges” for the various asset classes in their portfolios and adjust within those ranges when they feel it is appropriate. For example, if the *strategic* asset allocation suggested a 60% stock weighting, the investor may choose to consider that as falling within a *tactical* range of, say 50% to 70%. Then, if stock markets are appealing, he or she could increase their stock weighting up to as much as 70%. If stocks are less promising, they may reduce the proportion down to as low as 50% and so on, for each asset class. In this way, the original portfolio mix is more or less maintained, which is important because it reflects the risk profile of the investor and their long-term return objectives. At the same time, however, assuming the market forecast is accurate, the investor can participate, to a certain extent at least, in the better performance of one asset class over another.

Growth vs. Value

Growth and *value* are labels that are often applied to the investment “style” of mutual fund managers, although the terms more accurately describe the type of securities they tend to favour in their portfolios. While not perfectly accurate, the analogy that comes to mind when comparing value and growth is the age-old story of the tortoise and the hare. Essentially, it is the quick and fleet of foot against the slow but steady.

Value managers look for stocks that they feel are, in fact, *under-valued*, because they are out of favour with investors at large. This may come about for a number of reasons; temporary decline in an industry’s profitability, bad publicity, misunderstood corporate story, or a short-term setback in the firm itself. To the trained analyst, however, the underlying core value of the firm may be strong but simply not being recognized by investors with the result that the stock price underestimates the future potential of the firm. All other things being equal, value managers will purchase these stocks because they feel they are cheap, in comparison to what they should be. They will then hold them until the market catches onto the story and pushes the stock price up to its real value. This is the “tortoise” in the analogy.

The other reason that stocks may be undervalued is that everyone’s attention is focused on the fast-rising stars. Consequently, no one wants “steady and sure” when great short-term gains are being made by companies that sharply outpacing all the others. *Growth* stocks are generally described as those that are increasing in price faster than the market itself.

The best and most recent example of growth and value jockeying for position is the rise and fall of the high tech industry worldwide, in particular, the *dot.com* boom/bust. When technology firms were growing at a furious pace, often with no profitability in sight, *growth* was “the place to be”. The mantra was “Get on board the bullet train and enjoy the ride” (however wild it might be!) The plodders - the traditional “low tech” industries, couldn’t get investors’ attention and, consequently, their stock prices often languished at very low levels. Like the “hare”, however, many of these firms eventually ran out of steam as the investing world came to realize how extraordinarily out of whack their share prices had become as measured by their longer-term potential and real value. Thus “growth” became less attractive and there was a “return to value”.

Summary

Asset allocation and diversification are the foundation stones for successful investing. Smart investors create a “triple safety net” by diversifying among:

- ✓ Securities
- ✓ Asset classes
- ✓ Style

Such an approach truly harnesses the full power of investment markets and works intelligently with them to move towards long-term objectives with the least amount of risk.