Portfolio Construction For the Long Run (and Now)

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INTRODUCTION

At the most basic level, people achieve financial security through the combination of disciplined saving and prudent investing over the long term. The term financial security has a different meaning depending on each individual's goals. However, history has shown us that the chances of achieving those goals are enhanced through the use of professional investment management. And while managers do not have ultimate control over how much that their clients save, they may be able to increase the output of those savings through prudent investing.

Prudent investing begins with portfolio construction taking into account many individual and market factors. Portfolio returns can be unpredictable and may result in one falling short of achieving their goals. The good news is that this risk can be reduced through the construction of a well-diversified portfolio of investments. Diversification works by combining assets that have low and/or negative correlations with each other – do not behave in the same manner – during market ups and downs. In addition, combining investment strategies such as shorting (the opposite of owning) can offer diversification benefits. All of this lessens the unpredictable nature of returns and can even help defend against losses. That defense can be critical in helping ensure goals are reached. As a result, the goal of portfolio construction is to build a diversified portfolio that either maximizes the return for the amount of risk taken, or minimizes the risk taken for the necessary level of return.

The focus of this paper is on the construction issues as it relates to the equity portion of diversified portfolios. It is divided into two sections: the first section considers broad investor issues that affect returns over time, while the second section offers suggestions for proper portfolio construction.

THE EQUITY MARKET & ITS PARTICIPANTS

"In the short run, the stock market is like a voting machine, but in the long run it is a weighing machine."[1] -Benjamin Graham

Graham, a prolific economist who is widely considered to be the first proponent of value investing, created a fictional investor, Mr. Market, in an effort to personify the potential effects of shifts in investor sentiment over time. Graham posited that Mr. Market's prices in the short run may not reflect fair value since they are partly the product of emotion and not solely of reason.[2] However, through careful analysis and management of emotions, the opportunities created in the short run can be very accretive to wealth over time due to Mr. Market's proper recognition of value.

Another way of thinking about the importance of Mr. Market is through market-based investing which is better known as indexing. At a minimum, indexing can benefit those not capable or interested in careful security analysis. It represents a form of investment humility. Moreover, there is strong empirical support favoring the long-term benefits of investing in broad market indices versus the practice of security analysis.[3] These favorable results are primarily due to the extremely low costs of index management.

Mr. Market is supported by the "wisdom of crowds" in which the diverse collection of independently thinking individuals makes better decisions and predictions than individuals or even experts.[4]

An issue with this wisdom is that crowd intelligence can fail. Wisdom can and does at times more resemble madness. "Men, it has been well said, think in herds; while they only recover their senses slowly, and one by one."[5] There are situations in which the crowd's wisdom has failed because the members of the crowd were too conscious of the opinions of others and began to emulate each other and conform rather than thinking independently. Indeed, it is very likely that Mr. Market would have been deeply invested in the technology stock bubble in which tech stocks were being bought (bid up) simply because others were buying (they were going up.) When wisdom denigrates to madness, long run returns pay the price. For example, NASDAQ peaked in early 2000, and as of 2008, eight years later it is still lower by some 50 percent.

History has shown us that bubbles are unfortunately, regular occurrences: gold in the 1970s, the Nikkei stock index in the 1980s, NASDAQ in the 1990s, commodities and housing (?) for the 2000s. Why does this happen when Modern Portfolio Theory (MPT), the foundation of portfolio diversification decisions, assumes investors are rational and always risk-averse?

> "...the greater a portfolio **deviates** from its benchmark, the greater **potential** for alpha from active management."

Part of the answer can be found in behavioral economic research. For example, here are the results of one experiment that shows how behavior violates one of the main tenets of MPT:

SITUATION A	SITUATION B
• Win $3,000 or gamble…	• Lose $3,000 or gamble…
• 80 percent chance of winning $4,000 and a 20 percent chance of winning nothing	• 80 percent chance of losing $4,000 and 20 percent chance of losing nothing

The experiment asked individuals in both situations whether or not they wanted to gamble. In Situation A, only 20 percent gambled, risking the gain. In Situation B, 92 percent gambled trying to avoid the loss. The experiment is part of what formed Prospect Theory,[6] which has established investors to be risk-averse with gains and risk-seeking with losses. One of the theory's authors, Daniel Kahneman, was awarded the Nobel Prize in Economics in 2002 for "having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty." Part of Prospect Theory represents Loss Aversion in which studies have demonstrated that losses are twice as motivational as potential gains. More specifically, investors are loss-averse not risk-averse as assumed by MPT. This ties with why investors tend to hold onto losers and sell winners, just the opposite of what is considered a "best practice" when it comes to investing.

It is in those instances when emotions supplant reason that bubbles can form. The bubbles can even be considered rational if one considers the human need to belong, which can trigger herding, and ultimately hysteria. During these times, profitable investing becomes fundamentally more challenging and requires a shift from holding long positions to either holding cash or "shorting" positions to benefit from the coming losses. The importance of diversification and a flexible mandate (i.e., holding cash or shorting) are critical during times like these.

PORTFOLIO CONSTRUCTION

Proper portfolio construction can mitigate many of the issues described above. Building a portfolio can be thought of as a three-step process: setting the portfolio's policy or diversification across asset classes, setting the portfolio's diversification or diversification within asset classes, and selecting the investment management(s) to execute the strategy. A logical goal for the portfolio would be to leverage the wisdom of the long run's weighing machine while not denying the potential madness of the short run's voting machine.

For the purpose of this three-step approach, it is assumed the investor would use mutual funds and/or exchange-traded funds as the investments. In addition, it is assumed that investors or their advisors will stay current on developments in the arena of portfolio theory. Finally, the due diligence efforts necessary to hire and monitor funds is beyond the scope of this paper.

> "Active strategies take on **"active risk"** by differing in some manner... from their most closely related benchmark index."

ASSET ALLOCATION – STEP 1

This policy decision is the result of a financial needs and goals analysis. It can be broadly described as the split among equity and debt securities. It is the most critical part of portfolio construction. In fact, studies[7] have indicated that over time a portfolio's return variability is primarily due to the asset allocation decision.

Once the asset allocation is set, only changes to the financial needs and goals analysis should alter the policy. Maintenance is straightforward and consists solely of rebalancing. Rebalancing can be implemented in many different ways, but at its core it is the selling of winners and buying of losers within the portfolio in order to maintain adherence to the policy. Policy adherence and rebalancing are the best defenses against "bad" behaviors. In addition, rebalancing helps to control risk.

ASSET DIVERSIFICATION – STEP 2

Once the asset allocation policy has been set, the next step is the diversification of both the equity and debt allocations.

There are varied approaches to diversification. However, in basic terms it can either be based on markets, or over/underweighting segments of the market. Market segments can be thought of as different investment styles such as large cap, small cap, value or growth. Style diversification that does not essentially re-construct (have a high correlation to) the market is by definition less diversified, and less diversification increases risk. Regardless of the level of diversification, 92 percent of a portfolio's performance is attributed, explained, by its style.[8] The study by Sharpe illuminated the importance of which segments you're invested in and how that compares with what segments in the market performed well.

Once the asset diversification is set, the only maintenance that may need to be done is rebalancing.

ASSET MANAGEMENT – STEP 3

The third and final step in the process involves the selection of the asset management(s) that will fulfill the diversification objectives.

Not unlike the varied approaches to asset diversification, there are many varied perspectives on the best type(s) of management(s) to retain. Once again, there are two basic management approaches: passive and active. Passive strategies are another label for index[9] management. A more formal description would refer to these as beta strategies in which the portfolio's beta represents its level of market risk (volatility) and expected return. Active strategies take on "active risk" by differing in some manner – either in stock selection and/or the timing of the buys/sells – from their most closely related benchmark index. These strategies differ from pure beta strategies in their pursuit of alpha, either less risk and/or more return, for its proportional level of beta.

Recent research by Cremers and Petajisto has found that the decision to retain active management should consider that management's willingness and ability to take positions that are different from its benchmark – its "Active Share."[10] The study demonstrated that the greater a portfolio deviates from its benchmark, the greater potential for alpha, risk-adjusted return, from active management. It is important to note that the portfolio deviations in the study were only under/over weights of the benchmark's holdings.

In instances when specific styles become out-of-favor, active management may take positions that are outside of their benchmark's holdings. This issue is referred to as style "drift." Consider an equity portfolio assembled out of multiple active managers in which each manager was hired based on their demonstrated competencies in a specific style of management. If one of those active managers begins to own non-benchmark securities (outside of his/her style of management), then that style drift could simultaneously leave a gap in the diversification and/or become over-invested in another of the styles. This reduction in the level of diversification, by definition, increases the portfolio's risk, and could render ineffectual the alpha, if generated, from the active management.

SHORTING IN LIEU OF DRIFTING

What if in lieu of drifting, management chooses to actively underweight benchmark positions via shorting benchmark holdings to maintain the integrity of the diversification strategy? While the study on Active Share does not cover shorting specifically, it found that "...funds are most active when their benchmark index has gone down in the past few years relative to the other indexes."[10] Furthermore, "...on average, more style-consistent funds outperform less style-consistent funds.

..., this finding appears to be driven by the performance of style-consistent funds in rising markets; in down markets, less style-consistent funds exhibit relative outperformance."[11] The literature seems to support the benefit of greater active risk-taking even including style drift when the markets are experiencing reversals (losses). In fact, "the ability to short a modest amount allows a skilled manager [author's emphasis] to increase the expected active return with no commensurate increase in active risk . . ."[12] Shorting in lieu of drifting seems to be the better option within the portfolio context.

The key ongoing responsibility regarding active asset management, is to monitor the portfolio managers for the quality of their results and adherence to their style. Finally, the importance of expenses is critical. It only makes sense to incur higher expenses when management is truly active – high Active Share – and offers at least a perception of skill as both a manager and within the portfolio context.

CONCLUSION

The goal of portfolio construction is to build a diversified portfolio to best meet an investor's financial goals. This can best be accomplished by minimizing the risk(s) taken for the required level of return.

In the long run the market may be rational (the weighing machine), but in the short run human judgment and decision-making (the voting machine) may be less than rational even resembling madness on occasions. When this occurs, the losses incurred not only reduce wealth, but also inhibit future growth since the growth cannot begin again until those losses are regained. This means losses also have another cost — time. Since time is one of the enablers of compound interest, the reduction in time will result in less growth. Avoiding losses in the short run can be very accretive in the long run since ". . . the long run is nothing more than a sequence of short runs."[13]

A well-diversified portfolio that includes skilled active management with the ability to short can provide a portfolio with one of the greatest measures of protection when the wisdom of the crowds fails. The result is a greater ability to meet the goal of the portfolio – financial security.

Investors should bear in mind that shorting, or short selling, involves special risks and requires specialized investment expertise. One cannot invest directly in an index. Diversification does not assure a profit or protect against loss in a declining market.

ENDNOTES

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9 The term "index" is used to describe capitalization-weighted benchmarks.

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