



Some Core Themes for Portfolio Planning

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When markets are whipping around, it is easy to lose sight of the core themes that investors should concern themselves with. One of our clients sent me a link to an article that does a great job of covering the important themes—and this article also ties in to a number of our earlier articles. This article, written by Rob Arnott and John West on *Thoughts From the Frontline* (www.2000wave.com), covers issues ranging from the equity risk premium to why it is quite simple to beat the S&P500:

<http://www.2000wave.com/article.asp?id=mwo083107>

I was struck by the parallels between articles that I have written over the past couple of years and the points that Arnott and West raise, though we sometimes come to different conclusions. In this article, I will discuss some of these key themes and discuss the ways in which we agree and disagree.

Theme 1: The Equity Risk Premium

Arnott and West start by pointing out that stocks have generated considerably higher returns over the twenty five years than can be expected in the future. They argue their point based on the standard fundamentals of dividend yields. Using common sense arguments, they suggest that stocks (think S&P500) will return no more than 7% per year, on average, going forward. This is far lower than investors have received in recent decades. They are talking nominal returns (before adjusting for inflation). This means that investors would be looking at real returns (after inflation) of no more than 4%-5%--and that's before taxes. The authors point out that those who are planning on long-term returns of 8%-10% will be in bad shape if the market ends up returning 5%-7%. This is an important point—and one that I discussed at length in an article in June of 2006:

<http://seekingalpha.com/article/12293-the-800lb-gorilla-of-long-term-portfolio-planning>

The question of how much stocks will return—and how volatile they will be—is typically dealt with in terms of what is called the *equity risk premium*. The stock market works because it rewards investors who take on risk in equities with higher long-term returns than they will receive in risk-free investments. A high equity risk premium means that

investors are richly rewarded for taking on a given level of risk. It is important to understand that any discussion of the future expected return on stocks (as in Arnott and West's article) should be accompanied by discussion of the volatility that goes with it. Investors can cope a lot better with lower returns from stocks if stocks also have lower volatility. Back when I wrote my article on the equity risk premium, a lot of people were starting to think that market volatility had shifted permanently into a lower risk regime. Far fewer people think that now. The reality is that we can estimate the future expected returns and volatility on asset classes with very limited confidence. We have to assume some basic parameters, though. This is one of the best reasons to use Monte Carlo simulations like Quantext Portfolio Planner (QPP). Whatever happens, it makes sense to plan to ensure that bad outcomes are survivable. I think that Mr. Arnott's expectation is pretty pessimistic, but it's certainly possible. A shift in the equity risk premium for stocks as a whole has implications for all asset classes. QPP accounts for this, but do most investors have any way to account for this effect?

Theme 2: Bonds as Diversifiers

Arnott and West point out that a portfolio with 60% in the S&P500 and 40% in a bond index is correlated to the S&P500 at better than 90%. They say 99% correlated, but I get more like 92% when I calculate on total returns (i.e. including dividends). What does this mean? Bonds have low correlation to the S&P500—and therefore should provide diversification value---and they do. The reason that you still get a high correlation is that the volatility in the S&P500 is so much higher than the volatility in bonds. Good diversification means something far more intelligent than simply buying bonds to offset your exposure to the S&P500.

Theme 3: Diversifying Across Asset Classes

While John Bogle would have us believe that all we need is a few index funds to build our best portfolios, Arnott and West point out that there are substantial benefits to be gained from looking beyond simple equity indices. You will get the most diversification

(and thereby get the highest return for the risk that you bear) by combining assets which have low correlation to one another. In their Figure 1, the authors show the risk and return for a series of asset classes—and most are greater than the S&P500 for the period from 2001-2006. I have some different interpretations of their numbers from this table, however. One of the major topics in this section is to discourage an over-reliance on equities as an asset class—but their own data do not support this theme as far as I can tell. While the S&P500 has delivered very anemic returns over the 2001-2006 period, the equally-weighted S&P500 index (SPEW) has actually done very well during both 2001-2006 and 1995-2000. It is also instructive to consider the impact of compounding. I look at the results in their Figure 1 and I see a solid argument for equities—just not for a market-capitalization-weighted index. The major point of Figure 1—that there are high-return asset classes that exhibit low correlation to stocks—is very important. This point is important because combining these assets in a portfolio makes it very straightforward to beat the S&P500:

<http://seekingalpha.com/article/24588-portfolio-building-with-forward-looking-asset-allocation>

It would have been useful if Arnott and West had shown some risk-equivalent portfolios that combined these various asset classes. While Arnott and West emphasize that their statistics show the value that is lost in an over-emphasis on stocks, I am struck by the fact that these results demonstrate the enormous range in performance that you can get simply by how you allocate to stocks! If the S&P500 returned only 19% from 2001-2006 and the SPEW returned 68%, this means that how you assign weights to stocks is enormously influential. An extension of this idea is that a strategic allocation to stocks can add a great deal of value—i.e. assigning weights to stocks rather than simply buying the S&P500 index. I have written about this in a number of articles—such as this one:

<http://seekingalpha.com/article/13877-all-etf-portfolios-vs-strategic-mix-of-stocks>

Amidst all of this, it is very important to understand that there is a consistent relationship between risk and return across asset classes and over long-enough periods of time:

<http://seekingalpha.com/article/21808-getting-the-most-return-for-your-risk>

Theme 3: Rebalancing

Arnott and West also advocate rebalancing as a way to enhance returns. Their single example shows the benefits of a single rebalancing event for a hypothetical portfolio over 12 years. Their specific re-balancing event – in the middle of the twelve-year period that they are using in the analysis—occurs right about 2000-2001 when we saw the collapse of the dot-com bubble and the subsequent resurgence of asset classes like real estate and emerging markets. In other words, I am saying that their timing in the example is too fortuitous to make this example very relevant. I recently wrote an article about rebalancing and some of the current thinking:

<http://seekingalpha.com/article/42892-rethinking-rebalancing-a-risk-reward-analysis>

The overall evidence, as I see it, is that the more often you rebalance, the more you will reduce the risk (but also the average return) of your portfolio. Re-balancing makes sense, in my opinion, not when one asset class exceeds a certain weight, but rather when your entire portfolio's risk-return balance changes sufficiently that it is no longer at the right level to meet your needs.

Theme 4: Chasing Performance

In a word: don't. Morningstar's star ratings are driven by trailing performance and we know that the vast majority of investor dollars flow to funds with high star ratings. Investors overwhelmingly chase performance and this leads to bad results. While there is an academic argument for momentum effects (i.e. what's winning will tend to continue to win), it is estimated that the average equity fund investor 'pays' at least 2% per year through bad timing choices—and this is almost always to sell what's not doing well and to buy what has been doing well. Arnott and West cite one of the nicest proofs of this effects—average fund returns vs. investor-weighted returns. Morningstar calculates the average returns from funds as well as what they call “dollar-weighted returns.” Dollar-weighted returns reflect the size of the fund when it get's certain returns. A small fund that generates high returns, and then sees a massive inflow of dollars, and subsequently is

less impressive (what usually happens) will have dollar-weighted returns that are substantially lower than the average returns in time. Arnott and West cite research from Morningstar that shows that the average equity mutual fund has *dollar-weighted annual returns* that are 2.8% per year lower than *average returns*. This means that investors are chasing hot-performing funds and paying a penalty for it.

Theme 5: Cap-Weighting in Stocks

This is an area in which Mr. Arnott is very well-known. The S&P500 index has weighting to its components by market-cap, the total market value of a company. The larger a company, the more weight it gets. Further, the more a stock goes up, the higher the weight in the index. Further, stocks that are very low-priced simply by being out of fashion or due to short-term events, will have a lower weight in the index. In some sense, then, market-cap weighting in an index fund is a form of ‘chasing performance.’ Read Mr. Arnott on this--- this is an issue on which he is second to none. John Bogle is a strong advocate of market-cap weighting (read his *Little Book on Common Sense Investing*, for example). I believe that Mr. Bogle makes many valid points, but this is not one of them. The one point in favor of market-cap weighting that Mr. Bogle makes that is really valid is that market-cap weighting minimizes transaction costs because the weighting simply moves with the market. Consider, however, the enormous difference between an equal-weighted S&P500 index and the standard market-cap weighted index (shown in Arnott and West’s Figure 1) and it is clear that the superiority of market-cap weighting is far from a foregone conclusion. My take on this issue is that there is evidence for the importance of minimizing costs in investing (including taxes, expenses, etc.) but this does not lead directly to the best choice being to buy a market-cap weighted index fund.

The Take Away

If you are familiar with Mr. Arnott, you will know that he is a major advocate of what is called *fundamental indexing*. A fundamental index weights allocations to the stocks in

an index based on fundamental measures of value such as price-to-earnings ratio or dividend yield. Mr. Arnott claims that fundamental weighting provides about 2% per year in return in excess of market-cap weighting---and has delivered this level of benefit over the last 45 years. I find Mr. Arnott's point compelling—he makes it well. This argument is directly linked to the issue of investing with a focus on 'value' as opposed to 'growth.' A value-oriented strategy is analogous to fundamental indexing and growth-oriented investing is more consistent with market-cap indexing. The whole issue of value vs. growth investing remains controversial and there are good people on both sides:

<http://www.quantext.com/GrowthVsValue.pdf>

Where does this leave us? I have a personal bias towards value investing, and I am therefore sympathetic to fundamental indexing. That said, I don't see a total indexing approach as the optimal approach in any form because it is so diffuse, as I discussed in this article:

<http://seekingalpha.com/article/13877-all-etf-portfolios-vs-strategic-mix-of-stocks>

To add support to this thinking, consider the following Q&A in an interview with Charlie Munger (Warren Buffett's right-hand man) and Kiplinger's:

Kiplinger's: What would a good investor's portfolio look like? Would it look like the average mutual fund with 2% positions?

Munger: Not if they were doing it Munger style. The Berkshire-style investors tend to be less diversified than other people. The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasizes feeling good about not having your investment results depart very much from average investment results. But why would you get on the bandwagon like that if somebody didn't make you with a whip and a gun?

<https://www.kiplinger.com/personalfinance/features/archives/2005/11/munger2.html>

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