Ophthalmology Times

Develop a sound investment strategy for retirement goals

Pay attention to risk assessment, asset allocation, manager selection, ongoing maintenance

Money Matters

By John J. Grande, CFP®, and Traudy F. Grande, CFP®

Q I currently have more than 90% of my investment assets in money market accounts. I am unsure of how to get back into the stock market without setting myself up for a loss similar to the one I sustained from 2000 to 2002. I do not want to lock my money up in long-term bonds, nor do I want to receive next to nothing in money market accounts.

A Working with an investment portfolio is similar to treating a patient. Effective treatment requires a systematic process to take the patient from diagnosis to treatment to ongoing preventative care. Extensive knowledge about where and how things can go wrong, supported by the proper diagnostic tools, is a critical prerequisite to delivering the proper care.

In today's market environment, many investors are suffering from a condition that we call "paralysis through uncertainty." Having lived through the sharpest market downturn since the 1930s, many investors, like yourself, moved into fixed income or out of the market altogether in an effort to stem their losses.

Unfortunately, most investors missed the 30% to 60% appreciation in most equity markets between March 2003 and March 2004. Today, sitting in fixed income and facing rising rates or sitting on cash earning 1% or less, it is not surprising that you are unsure of what to do or when to do it. Therefore, you do nothing, and doing nothing is not always the safest course to take over the long term.

Treating this condition requires a systematic process, usually administered by a professional financial advisor who has access to sophisticated investment tools. Most patients would never consider going to a doctor who practiced medicine only in his or her spare time, yet many investors try to manage their portfolios on a part-time basis. According to a Dalbar "Quantitative Analysis of Investor Behavior" report (which was generated from an updated study of cash flows into and out of mutual funds), the average equity-fund investor had an annualized return of 5.32% compared with 16.29% for the S&P 500 Index. This analysis was conducted using the timeframe from January 1984 through December 2000. We feel that this report clearly demonstrates the short-term effects that result from reacting out of greed and fear, rather than having a pre-established long-term investment policy.

A sound systematic investment process consists of four main components:

- **Risk assessment**.
- **Asset allocation**.
- **Manager selection**.
- **Ongoing monitoring and maintenance**.

Each of these is discussed in turn. We introduce a number of key investing concepts along the way, such as capital markets assumptions, efficient frontier, alpha, and beta. If you are unfamiliar with these concepts, please feel free to contact us for additional material.

Risk assessment is the process of setting your goals and objectives. What purpose is this investment designed to serve? When will the money be needed? How much is needed? Without a road map, it is difficult to know where you are going or when you have arrived. A professional financial advisor has access to risk assessment tools and, more importantly, can provide a second opinion about how much risk is too much. Many investors who thought they were well within their risk tolerance while the markets were rising found out they were taking too much risk when the markets started to fall.

Asset allocation is a critical component of the investing process because it drives approximately 90% of the total risk of the portfolio. To build the allocation properly, you must have an idea of what may happen in the future. What will the return of large cap stocks be when compared with small cap stocks? How much of a premium should you expect to invest in international stocks? These assumptions must be created with an explicit view toward the future, not based solely on the past. Putting these forward-looking "capital market assumptions" about risk and return into mathematical optimization software, it is possible to build the "efficient frontier."

On the efficient frontier, every portfolio maximizes the expected return at a given level of risk. This means that for a risk level *X*, there is one and only one combination of large and small cap international and fixed income, real estate, and alternative investments that maximize your expected return. You decided what your risk tolerance was in step one. Proper asset allocation ensures that you are compensated for the risk you take.

Manager selection is the step that seems most straightforward, but is in fact the most complicated in terms of the underlying in-

Figure 1 Up Market

	Manager A High Beta Beta = 1.5		Manager B High Alpha Alpha = 1.0
Benchmark return	8%		8%
+ Excess return			
Beta Return	4%		–
Alpha Return	–		4%
= Manager return	12%	versus	12%

OT Source

Ophthalmology Times / Source: Raymond James Consulting Services; Courtesy of John J. Grande, CFP®, and Traudy F. Grande, CFP®

Figure 2 Down Market

	Manager A High Beta Beta = 1.5	Manager B High Alpha Alpha = 1.0
Benchmark return	–8%	–8%
+ Excess return		
Beta Return	–4%	–
Alpha Return	–	4%
= Manager return	–12% versus	–4%

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vestment theory. To select managers properly, you must do far more than look at historical risk and return statistics. It is critical to separate the manager's skill from the impact of the market in the particular sector or style. This involves an understanding of alpha and beta, which are discussed below. Many "paralysis through uncertainty" investors are paralyzed because they do not understand why they lost money. They thought they had selected excellent managers who had consistently beaten their benchmarks. Without an understanding of why those managers suddenly underperformed dramatically, how do we know that the same thing will not happen again? It is primarily this nagging fear that the same thing could happen again that kept these investors on the sideline during the spectacular 12-month recovery and keeps many on the sidelines today.

To understand manager performance, it is necessary to understand alpha and beta. Managers can beat their benchmark in one of two ways: they can take on more or less risk than the benchmark (beta), or they can simply pick stocks in good sectors (alpha).

A manager who takes on more risk than the benchmark (i.e., a "high beta" manager) will outperform when the market is rising, but underperform when the market is falling. This is exactly what happened when many of the high-fliers of the late 1990s came crashing down.

In contrast, a manager who consistently adds alpha should be able to outperform in any market environment. The stock-picking skill of good managers is roughly constant, allowing the manager to outperform year after year.

Figures 1 and 2 demonstrate why alpha matters. Manager A has a beta of 1.5 and no alpha, while manager B has a neutral beta of 1.0 and generates 4% alpha. If the market rises by 8%, managers A and B both return 12%. If you are not looking at alpha and beta, it is impossible to tell the difference between these two managers. Unfortunately, the difference would only become clear in the down market. If the market drops by 8%, high beta manager A is now leveraged to a falling market, declining by 12%. However, high alpha manager B still adds 4% over the benchmark and declines by only

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4%, or two-thirds less than manager A. Picking manager B instead of manager A *before* the downturn hits can save a lot of losses.

High alpha managers consistently beat their benchmarks and protect your downside. High beta managers simply exaggerate the roller coaster ride of the market.

"Major institutions place trillions of dollars with managers by separating alpha and beta," said Jeff Holland, vice president of Raymond James Consulting Services. "Through Raymond James Consulting Services, we make this sophisticated analysis available to individual investors."

The information ratio, as defined by alpha over residual risk, is a risk measure that is used to determine the amount of excess return over specific benchmark per unit of risk associated with the securities within the portfolio and can, by definition, be diversified away. This risk measure helps determine the degree in which the "bets" taken within the portfolio are paying off.

Ongoing monitoring and maintenance is the final step of the process. Nothing is constant in life except change. Life events can cause changes in your risk tolerance. Macroeconomic conditions can cause changes in capital market assumptions and the resulting efficient frontier. Manager turnover, style drift, or a loss of focus can cause deteriorating performance in formerly excellent managers. Rebalancing no less than annually is a must, since it keeps you to your original investment policy statement and forces you to take profits and reposition to other asset categories that have yet to have their run. In today's changing environment, buy and hold is rarely a viable option. Sticking to the long-term plan requires adjustments along the way. **OT**

Editor's Note: *A disciplined process is the key to success in medicine as well as investments. If you would like more in-depth information about the investment process or any of the concepts discussed in this article, please contact the authors.*

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