Portfolio Design Compared to Portfolio Management©

Charles Ballou, CFP®

Michael Ballou, CFP®

Gregg Ballou, CFP®

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The financial services industry markets, sells and promotes investment and portfolio management services and products that generate those results and track records. Quite often what is missing in the conversation and education of the client is the topic and process of portfolio design. **Our experience and analysis indicates that portfolio design is equally important to portfolio management and in certain types of environments and client circumstances can be more important**.

The focus of the majority of portfolio managers and thus portfolio management is the generation of returns for said portfolio. Compensation and Industry stature is a function of beating or exceeding industry benchmarks and peers. While we agree that we want the preeminent portfolio managers we also realize that there is more to this process than choosing the best track record.

Financial industry benchmarks can be typically quite volatile. If the objective of portfolio managers is to beat a benchmark then what we further observe is that their results can be and are usually quite volatile. As a point of reference the Standard & Poor's 500 Stock Index experienced a decline of 49% from March 24, 2000 and October 9, 2002 and then experienced a 57% decline between October 9, 2007 and March 9, 2009. The magnitudes of such declines required a 100% increase and a 137% increase to get back to even from the start of the decline. While the declines were recovered it took four years to do so. This is not a risk profile that makes sense for many investors, especially those who are using the portfolio to support a standard of living.

The conventional wisdom for risk management is to add asset allocation and diversification to the investment mix. Asset allocation is essentially the inclusion of multiple asset classes (cash, notes, bonds, stocks, real estate, and tangibles) into the portfolio mix. This spreads out the risk amongst the different asset classes and normally reduces the volatility of the investment portfolio. There is a whole body of mathematical study that supports this concept and it seems to work most of the time. The operative consideration is; most of the time.

The deficiency in this application is asset allocation by itself does not consider or account for the reality that different asset classes can and will go through extended periods (cycles) of below and above average rates of return and risk. The mathematical analysis of the investment industry is mostly based on the use of average rates of return and risk. Our observation and study indicates there is no such thing as average. There are mostly periods of above and below average. Average is just a mathematical exercise which can mistakenly lead investors to an erroneous conclusion. Effectual analysis looks into the numbers to understand the factors and influences take place to create the above and below average cycles.

The observation that asset classes have cycles of above and below average can last a decade or more should be visibly apparent to anyone who studies or analyzes such cycles, especially the one starting in 2000. Periods such as 1950-1966, 1966-1982, and 1982-1998 also illustrates the same characteristics for those who care to observe and analyze such cycles. In the mid 1980's

we recognized this phenomenon and have been expounding on "**investment seasons**" ever since.

An additional consideration is to understand that correlations break down during periods of severe market stress. Without getting deeply into a discussion about statistics, the idea of non-correlated assets is that they can move in opposite or non-correlated directions under different environments and circumstances. That is the conventional wisdom and what we normally expect and is embedded in investment theory. What we have found is that during periods of extreme market stress such as 2008 almost all asset classes declined sharply as sellers overwhelmed the markets and rushed to cash as fear dominated the marketplace. Diversification did not work during this phase as typically non-correlated asset classes moved down in price simultaneously.

The next set of factors to consider in the portfolio design process is the inclusion of 1) style, 2) capitalization, and 3) market differences in the risk and return potential determinates of portfolio design.

Equity portfolio management style revolves around the "philosophy" of the Investment manager. Is his/her/their focus on growth or value? In addition there are various subsets to these two basic philosophies. One is not necessarily better than the other and they do have their own cycles within the overall market cycles. **As a general observation we have concluded that the value style has a tendency to be more risk adverse than growth and growth can have greater potential returns when its cycle is in vogue.**

The next factor is the market capitalization of securities, especially equities. These are typically addressed as large companies, mid-size capitalizations, small and even micro capitalizations. Here the risk/return attributes normally increase as the size of the companies decrease. **One observation of importance is that the mid and small capitalization "value" companies over a full market cycle tend to have higher returns with lower risk than the "growth" companies in this sphere of portfolio management. Our conclusion of why: The value companies have a tendency of not declining as much on a percentage basis which in turn allows for higher potential returns over time. (More on this concept as we discuss the "practical limit of risk")**

The additional variable to portfolio design is determining "where" to invest. It should be apparent to investors that we have a global economy. With a global economy comes global investment opportunity. This has been true throughout the post WWII era. It has become more so since the fall of the Berlin Wall in 1989. Central to portfolio design is global diversification with the same "style" and "capitalization" choices within 1) domestic 2) global 3) foreign markets. Additional sub categories to consider are; 1) developed, 2) developing 3) emerging and 4) pre-emerging markets and economies. Along with the return opportunities within a global economy we have to also consider the additional "political risk" and "transparency risk" associated with foreign economies and markets.

Beyond these factors are the industry and sector considerations that are incorporated within the realm of portfolio management. These are outside the portfolio design concept as is individual security selection. - We prefer to mostly leave those decisions to the portfolio managers chosen to implement the "portfolio management" within the designed portfolio.

Discussed so far have been many factors and variables that are inherent in the portfolio design process**. It is also important to understand that the factors and variables themselves experience cycles**. Theses cycles can be secular (long-term), intermediate or short term. Portfolio design has as one of its objectives: align with the secular and the intermediate term cycles and attempt to use shorter term cycles for tactical implementation of the strategic process that portfolio design fosters.

Specific portfolio managers within the portfolio design are chosen with specific expectations. The reason we believe it practical to have many pieces/managers in a portfolio is that if some of the managers disappoint us we can change, but it does not have an adverse effect on a high percentage of the portfolio. Within the design process the objective is for a multiple asset classes, multiple management styles, and multiple managers that are globally diversified in multiple markets.

Up to this point what we have discussed is definitely beyond the scope of conventional wisdom but is not totally unique within the whole realm of the financial services industry. There are a few firms and advisors that include this body of knowledge and understanding within their realm of expertise However we believe our next points you will find innovative and a different way of thinking about portfolio design and then management.

We are different in our non-conventional approach to rather conventional questions:

1) **What rate of return do you need/want?**
2) **What is the benchmark for your portfolio?**

Many firms use a questionnaire to assist clients determine their risk profile. We find this approach deficient because it uses subjective questions to solicit answers. This is deficient because the financial world is based upon quantitative relationships of risk and return and subjective feelings may make one feel good about decisions but falls short in understanding the variances of the financial markets and perhaps the needs of your portfolio.

The Benchmark of the markets or the portfolio managers you have chosen is your default benchmark unless you have thought about and considered this question. It may be a correct benchmark or it may have absolutely no relevance to your situation – that is why question one is principal to your situation.

Critical Observations:
If you take too much risk you will likely not make your needed rate of return.
If you take too little risk you will likely not make your needed rate of return.

So what is the right or good answers the two questions above?

Again in our approach that goes beyond conventional wisdom we have found that one statement (answer) answers both questions. Our answer is: **The required rate of return is an after tax return greater than inflation. This is the universal rate of return required to preserve the real value of a portfolio.** This can also be a benchmark.

This is not to say this is the absolute objective for everyone. If you have more resources than you will need then a lower rate of return can still provide for you needs. But this leads to another non-conventional thought; what is the purpose of the capital? If accumulated capital's purpose transcends multiple generations then one needs to preserve the real value of the capital. This consideration can be missed if only age-based objectives are considered.

A caveat that must be considered is that not all periods (cycles) allow one to accomplish this rate of return goal. If inflation or taxes are too high or capital market returns are too low then this objective is doubtful for that specific period or cycle.

The next thoughtful question is: How much risk is required to achieve this goal?

Here again we will take you beyond conventional wisdom. The most significant objective of our portfolio design process is to stay within what we deem as the practical limit of risk. If successful this will manage risk within an acceptable and understandable level and then provides a suitable opportunity to achieve the after tax return greater than inflation. (When you can)

So what is the "Practical Limit of Risk?"
This concept was born out of the respect of experiencing 40-50% market declines in the 1973-1974 and 1987. It was further refined during the 2000-2003 declines and strongly reinforced during the 2008-2009 market crises.

It was based on the thought process of defining what risk level was necessary to generate an after tax rate of return greater than inflation and not suffer declines that took years to recover from. It also is based on some simple math that has been observed and applied in the above mentioned market declines.

A critical observation of each period of decline was to understand what level of market rebound took place within the first year after the conclusion of the declines. In each case there was at least a 30-35% market increase in the year following the conclusion of the market decline, **The simple math observation is that a 20% decline required a 25% increase to get back to even. A 25% decline required a 33% increase to get even. This compares to a 100% increase if the markets decline 50% and even a 67% increase in the event of a 40% market decline.**

The practical limit of risk is defined by what level of a portfolio decline can an investor withstand and get portfolio values back to even in a matter of 12 months or less and not several years as was the case in the 2000 -2009 declines. If a portfolio can regain its value in a relatively short timeline then positive returns are once again to be had and you are not waiting several years to recover. This in turn goes a long way toward achieving an after tax rates of return greater than inflation.

Our process of risk management can be visually grasped by our "**Risk Class Asset Allocation**" matrix and a straight forward analogy we call our hurricane analogy. We simply consider each asset within a portfolio and assign it a risk classification based upon how much downside it has experienced in past financial storms or what we might experience in the next financial storm. Just like hurricanes we rank them from risk Category 1 to 5. In this process we classify anything that could potentially decline less than 10% as a Category 1. A risk Category 5 has potential to have a downside greater than 25%. Just like hurricanes a risk Category 5 can experience a lot of damage, a Category 1 not so much.

To put this in perspective we consider almost all stocks are risk Category 5. The principle in risk efficient portfolio design is to identify those investments of lower risk categories that can still provide potential for equity like returns.

Additional perspective, even some bonds will rank as 4 and 5s and individual bonds that have 20-30 maturities have historically experienced down cycles that exceeded 25% drops in market values when interest increased.

The essence of using risk class allocation is to better position investor portfolios to fall within the practical limit for risk as outlined above.

We have not been able to find or observe someone who can accurately forecast all the market tops and bottoms. Sometimes someone gets "one in a row" but seldom do they get the next one. If someone is too bearish they miss the up markets - if someone is too bullish they miss the next market decline. The purpose specifically of "portfolio design" which embraces the 'practical limit of risk" is to provide a portfolio strategy designed to overcome the behavioral emotions of fear and greed and further allows a respectable opportunity of achieving the desired portfolio returns without human emotions getting in the way of the investor.

This process uses the conventional tools of asset allocation and diversification, it then overlays manager selection with an emphasis on identifying those managers who have demonstrated a history of good returns with risk attributes less than their market or their peers. This includes style diversification and global diversification. If warranted we can add small percentages in positions that have the objective of above average rates of returns and even tactical positions that are market inverse if the environment seems to justify that position. These are not to be considered core positions but a smaller tactical part of a portfolio design that is strategic in nature. This is not a market timing process but it does consider opportunity timing for a

marginal part of the portfolio. When valuations become extremely high in the market or sectors of the market as in 2000 more risk aversion is also warranted.

Again the primary goal is to stay within the practical limit of risk and still add opportunity returns if deemed available.

Author(s) Note: The "Absolutes of Personal Wealth Management" provided the foundation for the insights presented in this commentary. This list of principles once recognized and evaluated provides a core understanding of the financial world we live in. This complementary body of work is a separate and essential discussion for those who would like to better understand our financial world and how to be more efficient in its use for specific purposes, goals and objectives. An additional discussion of this information is available upon request by contacting our office at (614) 457-8171 or gregg.ballou@raymondjames.com

Additional Note: With interest rates at or hovering near historic lows in 2015/2016 we are of the opinion that a primary role of fixed income (risk management and income) should be considered carefully by investors. Depending on policies and market responses we may face a period (cycle) in increasing interest rates and low or negative returns from the fixed income portion of portfolios. With this in mind we would welcome a conversation about our current approach to portfolio design that accounts for this potential negative impact to portfolio returns and risk management.