

## Why worry about portfolio construction?

Contributed by Travis Morien

The information you have is not the information you want.

The information you want is not the information you need.

The information you need is not the information you can obtain.

The information you can obtain costs more than you want to pay.

(A quote taken from Peter Bernstein's *Against the Gods: The Remarkable Story of Risk*, which he attributes to a note-passing friend.)

Most people seem to be quite aware of what they need to do in order to make the most money, if you could get it right you would make the most money by perfect:

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Market Timing

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Securities Selection

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Asset Allocation

For sure, if you could forecast market movements and choose the perfect times to buy and sell you would quickly end up with more money than you knew what to do with. You would be very wealthy, very quickly. People know this, and therefore the majority of market participants occupy themselves with timing decisions, which accounts for technical analysis and trading being so popular, despite the low probability you'll have of making any genuine money this way, at least if the real-world success of actual market participants is anything to go by.

Securities selection (stock picking) is also a high profit area, though again it is quite difficult to do. The most successful investors of all time, Warren Buffett, Peter Lynch, John Templeton, John Neff and others occupy themselves primarily with selection decisions first, though Buffett and Templeton, in particular have also demonstrated good timing skills, though this was a side-effect of their value selection methods. There are many more examples of people gaining success via selection than via timing, but not as many as you would think.

The poor cousin of timing and selection (in the public's perception) is perhaps asset allocation. Few people, amateur or professional really appreciate what asset allocation is all about, adding it in as an after thought while being at least dimly aware that diversification is a good thing.

Studies\* examining quarterly performance data have shown that it is asset allocation, and not security selection, that tends to dominate how a portfolio will perform over the short term. These studies have shown that asset allocation accounts for between 80% to over 90% of the observed variation in returns from quarter to quarter, and that on this time frame stock picking and timing have very little impact.

These studies are often misinterpreted, as you'll find when reading up on portfolio theory on the web. Many people see these studies and get the impression that asset allocation makes over 90% of the difference in the long term, this is untrue.

William Jahnke, a 1997 winner of the Graham and Dodd Award for an outstanding article published in *The Financial Analysts Journal*, pointed out that while asset allocation accounts for over 90% of quarterly performance variations, quarterly results mean little in the long term. His conclusions were that in the long term, asset allocation amounted to only 15% of observed variations.

Interestingly, the dominant factor he found was costs, when looking at managed funds cost is the single most important determinant of performance). See William Jahnke, "The Asset Allocation Hoax," *Journal of Financial Planning* (February 1997), pp 109-113. The lesson from this is that investors should focus on cost reduction first, asset allocation second, security selection third and not worry about anything else.

Asset allocation has the unique advantage that it is the simplest part of portfolio construction and requires no special

genius to pull off with success. Unlike timing, which nobody gets right, and selection, which very few people are good at, good asset allocation is something that virtually everyone can do a good job of. While timing and selection are obviously bigger effects, the very difficulty of their implementation makes gains from this area so improbable that most people would be better off paying more attention to asset allocation than either of these others.

To paraphrase someone originally talking about Lotto, I figure that your chances of "winning" via timing or selection are probably about the same whether you play or not. Why do so many people figure that they will succeed where so many others have failed? Overconfidence, probably.

Asset allocation does more than just put your "eggs in more than one basket" and thereby reduce risk, it is the basis of Modern Portfolio Theory itself, and not only reduces risk, but also has the potential to provide greatly enhanced returns as well.

There is more to asset allocation than choosing a basket of asset classes, the portfolio needs to be maintained as well. "Rebalancing" is where you reset the portfolio back to its original allocation parameters following market movements that change the makeup of the portfolio. If done correctly, this disciplined simultaneous profit taking and purchase of out of favour assets can actually lead to superior performance.

In fact, studies have shown that rebalancing alone can give you an extra percentage point or two of performance over and above the separate gains made by each asset class. People knock themselves out trying to get timing right and pick the next great growth stock, but something as simple as rebalancing a portfolio would give you an edge over the majority of professional managers, there are very few professional managers that have a long term track record of beating the indexes by over a percentage point, it is ironic that a technique so simple has been largely ignored for so long, but I hope the following few articles will convince you to pay a bit of attention to asset allocation.

\* For more info see:

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Ibbotson survey based on 94 balanced US mutual funds, for a 10 year period ended March 1998

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Roger G. Ibbotson and Paul D. Kaplan "Does Asset Allocation Explain 40, 90 or 100 percent of performance?" Association for Investment Management and Research, Jan/Feb 2000.

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Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower, "Determinants of Portfolio Performance", Financial Analysts Journal, Vol 42, No. 4 (Jul/Aug) 1986

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Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update", Financial Analysts Journal, Vol 47, No. 3 (May/Jun) 1991.