MARKET OUTLOOK

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Active management beats passive diversification

Articles in financial publications often tout the need for investors to have a diversified portfolio. According to the theory, one can gain a measure of protection against market risk if investments are divided among a variety of asset classes. Unfortunately, true portfolio diversification is difficult to achieve and often does little to help investors reach their financial objectives.

Sit down with most investment managers across the country and they will advise you to put a portion of your investment assets in large cap stocks, another portion in small cap stocks, a portion in government bonds, another portion in international stocks, etc.

The assumption is that during times when small caps stocks are doing poorly, government bonds will do well. When bonds falter, then international stocks might perform better, etc. Because one never knows which asset class is likely to perform best, this is generally practiced as a buy-and-hold type of investment management.

There are a number of flaws in this line of reasoning. The most glaring is the implicit acceptance that while some of the assets might go up, it is just as likely that other asset classes will go down.

This type of portfolio allocation did well during the 1980s and 1990s, because most asset classes were going up. Things fell apart starting in 2000, because when the market corrected, almost every asset class plunged. That's because there is a high level of correlation among most market-based financial products. As a result, one really can't achieve true portfolio diversification by purchasing different categories of stocks.

A good friend of mine, Ken Trester, teaches investors how to insure their stock portfolios by buying put options (put options rise in value when the price of the underlying stock goes down). He says that as long as the options are highly undervalued, the underlying stock is not important. In the event of a major market crash, virtually all stocks will go down and almost all undervalued puts will go up.

Most of us tend to think of investing as a two-dimensional game: is the market going up or is it going down? But the complexity of global investing requires more of a three-dimensional view. In addition to market cycles, we must also consider the movement of business cycles.

For example, a major market crash like we saw in 2000 sends many investors fleeing to bonds. While bonds generally outperformed stocks in ensuing months, falling interest rates also meant a decline in bond yields. So while bond prices rose, yields declined and a bond investor's overall return might have actually declined.

An investor following a passive, diversified approach would hold a position through any downturns, even if it meant giving up all the gains and sustaining a loss. The rationale would be that it is just a small portion of the overall portfolio and some other asset class will likely take up the slack. We would rather adhere to an active approach that shifts at-risk asset classes to cash or to another investment that is performing well.

There are several methods investors can use to minimize market risk other than traditional asset

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If you haven't visited our web site recently, we invite you to check it out. We recently added a number of improvements.

The modifications include a direct link to our weekly market analysis and commentary—www.marketowl.com. Done in a blog format, the comments provide market education, overviews and insight, as well as occasional references to specific positions.

The web site also includes a redesign that should make navigation faster and easier. If you have other suggestions, please email them to: support@strategisfinancial.com.

allocation. We call this *active diversification* or *active management* and it involves allocating assets toward sectors that are doing well and away from those that are performing poorly. In addition, assets can be protected using hedging strategies or by moving to cash when market conditions warrant.

At right is a chart that shows some components of a traditional asset allocation process. The following indices and classes are represented:

Black line—Dow Jones Industrial Average, large cap stocks

Gold—Russell 2000, small cap stocks

Blue—iShares MSCI - EAFE Index Fund, international stocks

Red—Philadelphia Gold and Silver Index, precious metals

Orange—Vanguard Bond Index, bonds

Notice that the only period where these positions showed the type of negative correlation necessary for real diversification was 1999-2002. Since then there has been a fairly high level of correlation. So an investor who bought these sectors looking for diversification was instead actually buying increased volatility and decreased return--exactly the opposite of what he was hoping to achieve.

Instead of this passive approach, let's consider active diversification in the context of a horse race with 10 horses running. Because I want to increase my chances of winning, I go to the betting window and place bets on five of the 10 horses. I choose my five horses based on their performance in recent races.

While I have increased my chances of picking a winner, there is still a chance that one of the five horses I didn't choose could win. But what if I could wait until the middle of the race to place my bet? This time three of the horses are well ahead of the pack, so I bet on each of them. The fourth horse is rapidly losing speed, so I elect to bet instead on horses five and six.

There is still no guarantee that one of those horses will win, but we can argue that it is easier to make a good decision in the middle of the race. We've seen how the horses are running and can eliminate any that have dropped well behind the pack.The difference between the two racing/betting examples is similar to the difference between active and passive management. Active diversification allows us to bet during the race. For instance, a look at the chart above shows that during the past 10 years an investor would have gained nothing by being invested in government bonds. The same is true of gold for seven of the 10 years.

Since the beginning of 2003, investors would have been wise to overweight their portfolios toward international and small cap positions. But doesn't overweighting defeat the purpose of diversification? It certainly can, so it is important to use some common sense.

Even though international funds are the top performers right now, it would not be smart for an investor to put all of his assets into international positions. But instead of allocating assets to sectors that are currently doing poorly, our pproach will be that when a horse starts to lag, we will move our bet to one that is running better.

As someone who has watched and investigated dozens of investment methods over the past two decades, I must admit that this type of approach is much easier to describe than to implement. On the other hand, it can work and certainly makes more sense to me than to hang on to losing positions simply for the sake of diversification.

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