

EUREKA *report*



Whoops, your portfolio bias is showing

By Doug Turek

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PORTFOLIO POINT: It only takes one bad stock to ruin a portfolio's performance. Here's how to approach rebalancing.

The art of asset allocation continues to elude most investors, no matter how experienced. Whether influenced by personal or institutional bias, the fact is that many investors have great difficulty in matching their investment needs to their risk profile.

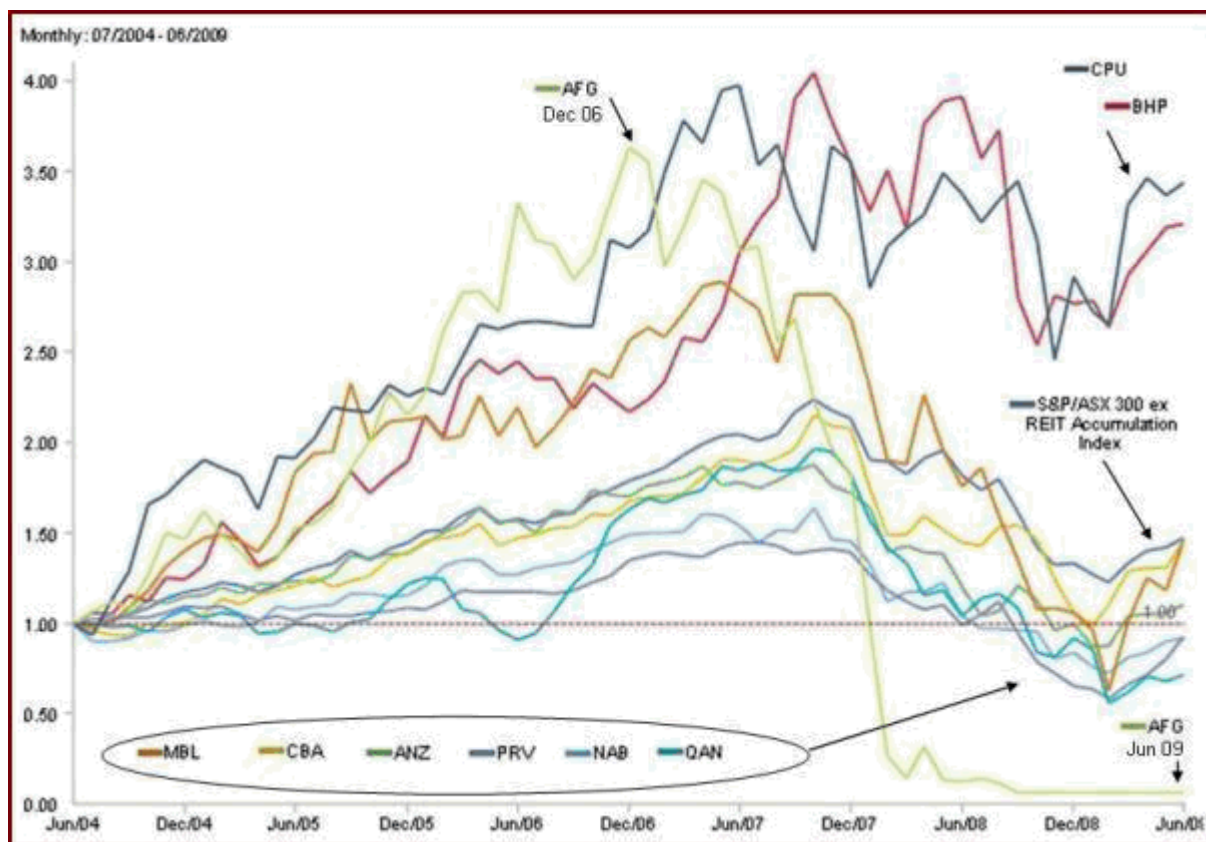
Although no two portfolios are alike, I wanted to share three important themes that emerge time and again in the process of rebalancing client portfolios to an optimal mix of risk and return.

Do you feel lucky?

Only about one in three direct stock portfolios outperform the benchmark, less if you adjust for risk. In an inadequately diversified portfolio, just one bad egg can destroy all your gains. On the flipside, one or two lucky selections are all you need to beat the market.

The chart below shows the growth in the underlying investments of a sample portfolio studied over the five years to June 30, 2009, which includes both recent bull and bear markets. It shows how just a 6% initial exposure to Allco Finance Group (AFG) undid the chance of this portfolio beating the index, which incidentally includes in it the failures of Babcock & Brown, ABC Learning, Centro, Great Southern, Timbercorp and more.

nGrowth of wealth



Source: *Wealth Benchmarks*

The key lessons here are:

- Stocks in a portfolio perform wildly differently. Your portfolio return is an average of a lot of noise superimposed on the general movement of the broader market.
- Beating or underperforming the market comes down to the outliers. In this case the outperformance of BHP and Computershare were not strong enough to cancel out Allco's failure.

Investors need to minimise bad luck through diversification, and by taking profits from good luck before it turns bad. A failure to rebalance is a common culprit in many underperforming portfolios.

Other examples of accidents waiting to happen I have seen include:

- 60% of family wealth in executive shares.
- 50% of portfolio value in three stocks, often 33% in just one.
- 66% exposure to bank shares.
- 40% of portfolio value in frozen unlisted property syndicates.
- 50% of non-guaranteed wealth loaned via bonds and deposits to one bank.
- 50% of portfolio value in a single investment property

Sometimes, instead of concentration we find duplication and fragmentation. Duplication exists where a relatively well diversified direct share portfolio sits side by side with several managed funds and listed investment companies. Duplication is an expensive way of ensuring an index return.

Fragmentation also arises where a lot of energy goes into administering a long tail of small holdings whose performance will deliver little material effect on the quality of your retirement; say if their combined portfolio value amounts to less than 5%.

How you invest depends on who you invest with

It is perhaps not surprising that the way many people invest depends on who they invest with. This reflects differences about how players think you, the investor, can obtain best advantage and often how they make their money. In the case of the do-it-yourself investor it comes down to access limitations, not just preference. Here are a few common patterns, although not the rule.

DIY investors. A common pattern is to split assets between a dozen or so blue-chip, dividend paying Australian shares and high-yielding cash. It is not always clear the mix between these two counter-balancing assets is appropriate. Many are stuck all in cash or all in equities. The dual asset approach has nevertheless served many investors well, providing the control that independent investors demand. Few manage to introduce a managed fund or two to access offshore markets, with those from Platinum a favourite.

Industry super funds. Investors are default invested in a multi-sector fund achieving instant and low-cost diversification. Most of the underlying managers are active, although index managers are being employed more and more. Investors get an unusually high exposure to alternative investments (see Scott Francis' feature, ***Why MTAA's wheels fell off***), whose illiquidity remains untested because of the inertia of employee super. Trustees and their consultants believe there is excess reward for this patient capital and are also more willing to tactically move money between assets.

Retail super funds. These investors similarly attain instant diversification but have more access to sector-specific branded fund managers ranging from low-cost index funds to expensive fund of fund (or fee on fee) products. The many who opt out of default funds take on the responsibility for both asset allocation and fund selection. In my experience, many of those who tinker with their asset allocation would have been better to have stuck to the balanced option.

Clients of financial advisers. In my experience, the range of investments used are wide and depend on the investment philosophy of the adviser or dealer around

Advisers affiliated with retail banks favour menus of actively managed funds. Surprisingly, no two portfolios are alike, which means rightly or wrongly, you get a front-line adviser's investment views rather than an institutional house view. House products or services inevitably play a role. More independent advisers might put together Australian stock portfolios but most don't. Advised portfolios are generally diversified although overall asset allocation can sometimes be misaligned. Some advisers and accountants were happy to recommend more unique and aggressive products, which, unfortunately, have included agribusiness schemes and unlisted syndicates. Few practices seem to have embraced index funds, promising instead to help you beat the market.

Clients of investment banks and stockbrokers. Client portfolios tend to be heavily dominated by popular large and mid-sized researched Australian company stocks. Access to other asset classes are facilitated mainly through ASX listed investments, including listed property, listed investment companies and listed hybrid income securities if represented at all. For wealthier clients, complex and expensive structured products find their way into portfolios as do companies underwritten by the investment bank. Of course the appeal of these institutions can be access to their "deal flow" but only so long as it doesn't hurt your "cash flow". In my experience these organisations are the least able or willing to benchmark individual client investment performance; many investors have no idea how their portfolio performed overall but should.

Australians just don't 'get' bonds

Our retail market is undeveloped compared to other mature economies. This means investors are forced to use various approaches to access what is a critically important asset (see Alan Kohler's feature **Safe and sound**), one in which Burton Malkiel says you should match your percentage asset allocation to your age.

A few intrepid self-directed investors can buy Australian government bonds from the **Reserve Bank**, but this does not compare to friendlier retail offers available to **US** and **UK** investors. Bond brokers will only sell bonds in chunks above \$500,000. More bite-sized offers have originated from AMP and Tabcorp recently, but more and better credit quality issues are needed.

In this recent crisis hybrid securities proved they were neither true defensive investments nor a proxy for bonds. In portfolios we've analysed, they contributed to underperformance. While the new PERLS 5 offer from the Commonwealth Bank is attractive, I wonder to what extent new issues cannibalise "interest" among old issues (see **Taking a shine to PERLS 3**). Worse still, some stumbled into complex and risky bond like products including the failed Westpoint, Basis Canital Fincorn and more

Most DIY investors use cash as a proxy for bonds. However when the Reserve Bank cut rates investors found cash and bonds behave differently. Rates on cash halved to 3–4%, while Australian bonds persisted and returned 10% last financial year.



There are of course many exceptions to the rule and I apologise to those who feel unfairly represented. I hope that after examining how the investment choices of other others are influenced that you feel more comfortable with your own choices, or perhaps for some, sufficiently uncomfortable to cause you to rethink how your money is managed.

For some investors it may be as simple as including index funds or ETFs in your portfolio. Other may need to rebalance and reduce single investment exposures to positions smaller than 10% of your total investment capital. There is no such thing as a portfolio that is “beyond rebalancing”. The trick is to do so before your good luck turns bad.



*Doug Turek is principal adviser with Professional Wealth and also founder of financial information service **Wealth Benchmarks**, which provides detailed portfolio reviews to investors, accountants and others.*