

Madison Avenue Investing vs. Evidence-Based Investing

There's been a lot of press lately indicating that financial advisors are searching for new investment strategies. No surprise, since this pattern predictably happens at every financial market downturn, let alone one of the magnitude that we've seen recently. Those seeking to profit from playing on investors' emotions and fears is nothing new. Some alternative strategies being touted include the use of quantitative models, structured products, tactical allocation and alternative investments.

Before we look at each of these "new strategies," it's important to consider that as far as financial assets, there are really only a few investable asset classes. The primary asset classes are equity, fixed income, and cash. All other investment approaches are simply derivative (their value is derived from the underlying asset class) of these core investment options.

The investment returns that financial assets generate over time are normative, meaning investors are compensated with extra return for assuming extra risk. From 1926 through the end of 2008, the S&P 500 advanced 9.6% on an annualized basis. Over the same time period long-term corporate bonds returned 5.9%, long-term Treasury bonds gained 5.7%, and 30-day Treasury bills gained 3.7%. The excess return generated through equity over fixed income, or the equity risk premium, is the compensation for the added volatility of owning equity. There's no free lunch, and you can't expect to earn added return without enduring added volatility. The desire to receive something for nothing is what alternative investment strategies hope to exploit.

Let's look at some of the options that are being touted.

Quantitative Models

These approaches use complex computer models to determine segments of the market that may exhibit an improved risk/return tradeoff. The two types of quantitative analysis involve reliance on mathematical or statistical models. One of the most famous quantitative managers was John Meriwether of Long Term Capital Management. You may remember John because when his quantitative models failed in 1998, his hedge fund collapsed exerting an extreme amount of stress on the financial markets. As quantitative models seek to forecast the future relative value of different asset classes and benefit from that perceived valuation, they inherently lack diversification. This type of programmed trading also increases frictional costs as a result of a high level of trading. The long-term merits of inadequate diversification and higher costs are questionable at best.

Structured Products

Generally, this approach is a pre-packaged investment strategy that combines derivatives and an underlying security or asset class. These products are created through financial engineering. The value of derivative securities, such as options, forwards and swaps, is determined by (respectively, derives from) the prices of the underlying securities. As there are a great variety of structured products, there is no uniform definition. The proper use of derivative securities can have a hedging effect; the improper use can have a dramatic leveraging effect.

An example of hedging is when a farmer grows wheat and wants to lock in the price he will get for the grain. In this case, he sells a futures contract at the current market price and promises to deliver the commodity at that price. An example of the misuse of derivatives securities is the trading of credit default swaps without owning the underlying real estate mortgage. These highly leveraged vehicles are at the center of our current real estate and financial system imbalance. Regardless of whether these contracts are used properly or improperly, they add expense, complexity and a lack of transparency to a portfolio.

Tactical Asset Allocation

This method of investing is where investors modify asset allocation according to their perceived valuation of the markets in which they are invested. Thus, someone invested heavily in stocks might reduce his position when he perceives that other securities (such as bonds) are poised to outperform stocks. Unlike stock picking in which the investor predicts which individual stocks will perform well, tactical asset allocation involves only judgments of the future return of complete markets or sectors. Tactical asset allocation *relies on* market timing, while a fair amount of academic research has demonstrated that market timing is counter-productive to successful investing. In addition to questionable trading practices, this approach increases trading expenses and reduces tax efficiency.

Alternative Investments

Alternative investments are investment products other than traditional investments, such as stocks, bonds or cash. This broad definition makes it impossible to list all alternative strategies, but the most important areas are real estate, private equity, and commodities. To the extent that people own their homes, they already have exposure to an alternative asset class. Private equity is much like public equity; however, you're trading a lack of liquidity and increased risk due to a lack of diversification for higher expected returns. Commodities have historically generated returns in line with inflation and, as such, don't provide compelling long-term return enhancing benefits.

These alternatives all have several elements in common with one another. They generally have higher turnover (lower tax efficiency), higher expenses, less transparency and increased complexity. Some add in increased leverage. The advantages that these strategies tout are speculative, while the added costs and complexity are ensured.

There's a Better Way

Sometimes it takes a market correction before investors truly understand their risk tolerance. If you find that your portfolio is excessively risky for your appetite, there's a simple way to correct the problem without exposing yourself to the potential downside of these questionable strategies: Alter your bond to equity ratio. A change to your portfolio's asset allocation should be considered a permanent shift in your planning, rather than an emotional reaction or short-term market prediction. Investors likely felt the most compelled to switch to a new investment allocation on March 9, 2009, the market low for this cycle. Since then, patient investors have been rewarded with a market advance of 40%. While we're still a long way from getting back to market highs, the rebuilding process has likely begun.

Conclusion

At the end of the day, successful investing has always been about the intelligent assumption of risk. Successful investors must distinguish between speculation and investing. As portfolios become more complex and less transparent, it's more difficult to make an informed assessment of your risk. A globally diversified portfolio with the correct mix of stocks and bonds, based on your investment objectives and risk tolerance, remains the most efficient method to maximize the probability of achieving long-term financial success.

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