

# Investment Decisions

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## Introduction

Competition in financial services, like in all other retail markets of society, can result in some strange oddities. Take, for example, the enormous array of low-fat milk products in major Australian supermarkets. Likewise, consider the list of funds which manage Australian fixed interest investments. Are they any different inside? And if they are, is there any significance to the differences, or are factors such as better diet and exercise (asset allocation and fees) much more significant for a person's health (investment portfolio)? It does not matter, because all those brands of milk sell in volume, so they continue to occupy supermarket shelf space. However, supermarkets are also aware that too many product choices confuse shoppers and reduce store profitability, so management carefully controls the choice of products. Approved product lists serve a similar function in that they narrow the universe of investment options presented to advisers. However, there are still many choices to be made in constructing an investment portfolio. Using the supermarket analogy, is it best to make a meal from scratch using primary ingredients (*e.g.* direct shares), or to buy some processed products such as a simmer sauce (managed fund), or to simply buy a pre-made meal from the refrigerator section (simply use a multi-manager fund)?

Part of the problem with all the different points of view about investing is that each viewpoint is built upon its own foundation, whether that foundation consists of biases or interests, reference points or assumptions, or whether the

foundation is simply a reflection of heterogeneity in the circumstances and or personalities of investors. A simple example would be active fund managers extolling the benefits of active management because they are *biased* or it is in their *interest*. But similarly, it is in the interest of index fund managers to extol the benefits of index funds. Yet at the same time, the argument for indexing depends on a *reference point* which is that an active fund manager is the alternative. When an index fund is compared to the median active fund manager after fees and taxes, the argument for indexing is seemingly infallible, but when the *assumptions* are altered and alternatives such as direct investing or non-mainstream fund managers such as Dimensional are proposed, the case for indexing is not so convincing. Nevertheless, the merits of the *other* alternatives of direct investing or using Dimensional managed funds depend on other factors, further complicating the maze. For instance, advising on direct investments requires a larger investment portfolio for it to become economically competitive to a managed fund (active or passive), so this decision is influenced by a client's financial *circumstances*. Likewise, a client's *personality* may influence the decision of whether or not to go direct. A client's personality may reflect an affinity for a direct share portfolio over the use of an index fund, even if it is not economically advantageous to do so.

## Methodology

The findings of this research study are based upon the interviews of three financial advisors from diverse parts of the financial advice industry, the subject's course material and other reading material. A significant portion of the findings came from other reading material which was much more detailed than what could be conveyed in a one-hour interview. Notwithstanding that, some of these reading sources were actually discovered in the course of conducting the interviews, so the interviews were still an important contributing factor to the study.

## Asset Allocation

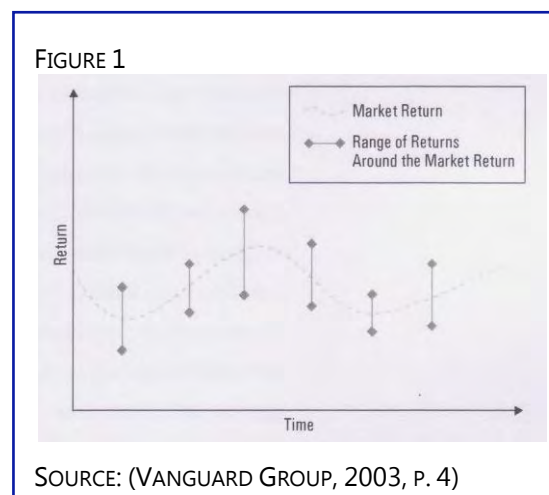
### A Starting Point

The Vanguard Group (2003) presents asset allocation as the most significant determinant of long-term performance over and above factors such as security selection (*e.g.* share picking) and market timing. Broadly speaking, the weighting given to shares, bonds and bills accounts for all but a fraction of a portfolio's long-term performance.

To provide an intuitive explanation, the article states that if, in a given period, the best performing security (such as a share) earns 10% and the worst performing security (such as a bill) earns 0%, then the theoretical performance range of a long-only portfolio is 0%–10%. The point of this is to emphasise the *theoretical* limits of security selection and market timing, even before any attention is focused on the *practical* difficulties of reaching the upper limit.

When the practical difficulties of index outperformance are considered,

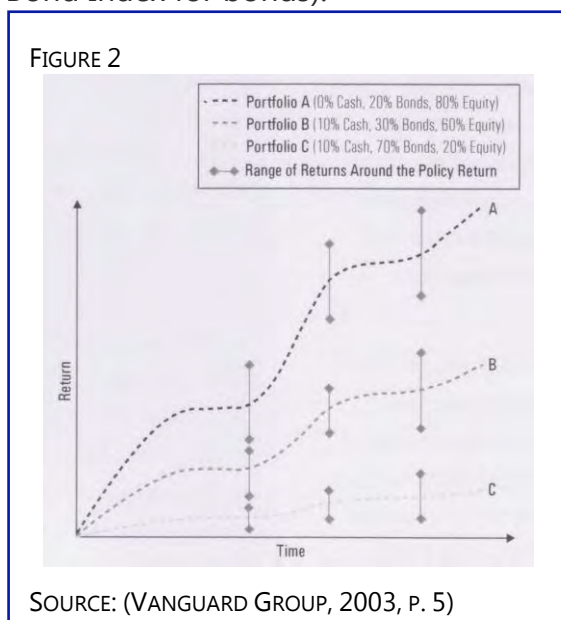
the performance difference of most active single-sector fund managers (bar occasional outliers) and the relevant index is small compared to the long-term performance of the index. In other words, exposure to the asset class in the first place is more significant than the choice of active or passive management as shown in figure 1.



Next, the concept is extended into scenarios involving different asset class allocations. To again highlight the primacy of asset allocation in determining long-term performance, the article states that 'you can't expect to earn equity-like returns in a money market fund'. As is conceptualised graphically in figure 2 (next page), the choice of asset allocation is of far greater significance than the potential effects of active management.

The Vanguard Group justifies this notion with its US study of 420 balanced managed funds over the period 1962–2001. In the study, of the 7% of funds that generated positive alpha over the period, 74.7% of the actual return was determined by the asset allocation. This percentage is obtained by way of a simple division with the actual return in the

denominator and, in the numerator, the equivalent return that would have been achieved for a policy with the same time-varying asset allocation invested in the relevant indices (e.g. Lehman Aggregate Bond Index for bonds).



While this simple division shows that for the top 7% of funds, asset allocation accounted for 74.7% of long-term performance, for the 41% of funds that generated negative alpha, the equivalent percentage is 136.6%. Although it would be nonsensical to conclude that asset allocation accounted for over 100% of long-term performance in these instances, it can be concluded that security selection and market timing

did not, after fees, add to the long-term performance of the fund. In contrast, the inference is that any positive alpha was more than offset by fees. Likewise, in the remaining 52% of funds which generated no alpha of statistical significance, security selection and market timing, after the payment of fees, did not affect long-term performance.

Setting aside the debate about active versus passive management and the fact that the Vanguard Group has an interest in the promotion of index funds, it is clear that asset allocation is a large determinant in long-term portfolio performance. In the aforementioned study, asset allocation explained 74.7% of long-term portfolio performance for the top 7% of funds where the average alpha was 3.5% *p.a.* Obviously, in cases of higher alpha, the percentage of long-term performance attributable to asset allocation would decrease, but for all but a minority of canny and or lucky investors, asset allocation determines over three-quarters of long-term performance.

It is also interesting to note that asset allocation likewise determines the majority of a portfolio's periodic (e.g. monthly) volatility of returns, with various studies returning figures in the range

The 2003 study by the Vanguard Group aimed to replicate the well-known 1986 study by Brinson, Hood and Beebower, *Determinants of Portfolio Performance*, which concluded that 93.6% of the quarterly variation (*i.e.* volatility) of pension fund returns was determined by asset allocation. The respective percentage calculated by the Vanguard Group was 76.6% which is comparable to the figure of 81.4% in Ibbotson and Kaplan's 2000 paper. Some of the difference may be attributable to the methodology (e.g. Brinson, Hood and Beebower used quarterly data whereas the Vanguard Group used monthly data which could contain more statistical noise) and the difference in time periods. Nevertheless, all three studies confirm that the majority of a portfolio's periodic volatility (variability of returns) is determined by asset allocation.

75–80% (see inset, previous page). The result is that the two most important characteristics of portfolio returns—long-term performance and periodic volatility—are determined by asset allocation. It follows, therefore, that the determination of a portfolio's asset allocation is the most important decision.

## Recommending an Asset Allocation

While deciding on a portfolio's asset allocation is often seen as relatively dull compared to security selection and market timing, it is nevertheless generally recognised in the financial advice industry as the primary decision in terms of both the order of decisions and importance. A principle common throughout the industry is that an investor's portfolio, in terms of asset allocation (e.g. defensive, balanced, growth), should be related to the investor's *risk tolerance*, a view echoed in ASIC's Regulatory Guide 175 (104(d) and 104(e)).

So while asset allocation is the starting point, there is a temptation to make the asset allocation decision a function of an investor's risk tolerance. In an oversimplification of the decision-making matrix, the proportion of shares, property and bonds (in order of decreasing significance) in an investor's portfolio increases with the investor's risk tolerance. Consequently, this section will begin with a focus on risk tolerance in line with industry convention.

## Risk Tolerance, Risk Capacity, Etcetera

A preliminary issue with *risk*, aside from the issue of its tricky definition, is the

issue of the perspective from which the risk is measured. For instance, in focusing on an investor's ability to tolerate risk, the measurement is one of *risk tolerance*. Similarly, in focusing on an investor's capacity for risk in relation to the investor's personal circumstances, the measurement becomes one of *risk capacity*. Furthermore, in focusing on the performance characteristics of different types of investments (e.g. bonds versus bills), the measurement becomes one of *risk profile*.

The difficulty is that industry terminology lacks consistency and so the above terms are sometimes used interchangeably without distinction. For example Roszkowski, Davey & Grable (*Insights from Psychology and Psychometrics on Measuring Risk Tolerance*, 2005, p. 1), of which one of the authors—Geoff Davey—is a co-founder of FinaMetrica, states:

Bad questions are those dealing with constructs other than risk tolerance, such as risk capacity (how much risk the client can afford to take), time horizons, liquidity, and goals. Although important to the financial planning process, these issues are not part of the construct of risk tolerance.

In contrast, Kaplan (*Risk profiling – getting it right*, 2009, p. 44) quotes Wayne Stevens, managing director of Emohruo Financial Services as follows:

[B]ut risk tolerance ... goes down to individual questions and really starts to examine the individual person's way that they feel about investments and it also goes into things like timeframe, their age and so forth.

Similarly, the same Kaplan publication (*Risk profiling – getting it right*, 2009, p. 44)

then quotes Wes McMaster, adjunct professor at RMIT University as follows:

Risk tolerance means financial capacity to take risk.

So on the one hand, industry commentators associated with FinaMetrica distinguish risk tolerance from risk capacity and factors influencing risk capacity such as timeframe, whilst on the other hand, there are other industry commentators for whom risk tolerance is a function of timeframe and risk capacity.

Furthermore, Kaplan (Risk profiling – getting it right, 2009, p. 44), exemplifies the lack of consistency when the other co-founder of FinaMetrica, Paul Resnik is quoted referring to another term, *risk needed*:

Often when risk profile is talked about in terms of individuals it conflates three things. The risk tolerance, which is a psychological construct, an innate characteristic of individuals and then risk needed, the amount of risk needed to achieve goals and risk capacity, how much somebody could afford to lose without having their goals messed up. Very often people don't quite understand how all those things fit together.

In fact, FinaMetrica co-founder Geoff Davey takes this one step even further with another term, *risk perceived*. In an excellent article, Davey (2009), outlines the following framework:

Risk has four primary aspects:

- Risk required – the risk associated with the return required to achieve the client's goals, a financial projection.
- Risk perceived – the risk perceived by the client in the course of action being considered, how risky the action feels to the client.

- Risk capacity – the risk that the client can afford to take, a financial characteristic.
- Risk tolerance – the risk normally chosen by the client, a personality characteristic.

Using Davey's above framework, it becomes clear that Resnik's term *risk needed* is synonymous with Davey's term *risk required*. Likewise, Kaplan's term *risk profile* is similar in meaning to *risk required* although a client's *risk profile* is often a reflection of (1) a client's score in a risk profiler and (2) the advisor's evaluation of the client's circumstances, both of which together result in the recommendation of a portfolio with a given risk profile (e.g. defensive, balanced, aggressive).

As a consequence, the terminology is not so complicated, keeping in mind that different terms (e.g. required, needed, profile) sometimes refer to the same perspective of risk and that some industry commentators do not see the distinctions made in Davey's above framework.

## Risk Tolerance

Kaplan (Risk profiling – getting it right, 2009, p. 43) states that 'it is common industry practice to identify a client's risk profile' and anecdotally, this is affirmed by two of the three interviewees (see backgrounds on the interviewees from page 8 onwards)—Broadway and Adams—who each use FinaMetrica for measuring risk tolerance. In contrast, Morien does not use a formal series of questions to determine risk tolerance:

Well we don't use a formal third-party sort of Mercer questionnaire or something like that. We have questions we ask clients but a lot

of this stuff doesn't really lend itself very well to those quirky kind of questionnaires which for the most part are just a rather dumbed down form of risk profiling designed to work with the dumbed down financial planners that work at the large dealer groups.

So while the use of a risk tolerance questionnaire is common throughout the industry, there are many dealer groups, another example being Prescott Securities, which do not use a risk tolerance questionnaire.

## Risk Perception

This term is important because a client may not always be aware of the level of risk in an investment, or conversely, may perceive some investments—such as shares—to have a higher level of risk than is actual. Davey (Risky Business, 2009, p. 4) emphasises that a mismatch between actual downside risk and the perception of downside risk can lead to comments such as:

What's more I didn't understand the risks because they weren't explained properly. If they had been I would not have proceeded.

## Risk Required

This term can be thought of as the flipside of return required, the point being that risk and return are generally positively correlated. If an investor is only targeting a small level of returns, then the corresponding level of risk required is low. However, an investor targeting a high level of returns must be aware that the corresponding level of risk is high. This measurement is relevant because if the risk required to achieve an investor's objective exceeds the investor's risk tolerance or risk

capacity, then there is a problem—an issue which is discussed further below.

## Risk Capacity

Davey (Risky Business, 2009, p. 1) introduces risk capacity with this sentence:

Risk capacity has to do with whether, for a given level of risk, the individual's financial situation can withstand the impact of a worst case outcome.

Davey then provides an example where three of these risk measurements intersect:

A client's risk required may be achievable through a portfolio that could fall by 30% and such a fall may be consistent with her risk tolerance, so far so good; but an evaluation of her risk capacity shows she can lose no more than 10% without putting her important goals at risk. Risk capacity is an absolute measure and overrides the other two.

Consider an investor who has sold his or her home, is currently renting and who intends to purchase a new home (of very similar value) in the short term. Assuming the investor does not have significant other capital or income then the risk capacity of the investor is nil. But in many other scenarios, it is not so easy to make comments such as: 'her risk capacity shows she can lose no more than 10% without putting her important goals at risk'.

Throughout history, share markets have shown that large losses are possible. In the US, the 2000–02 internet bust resulted in a negative real return of 42% whilst the oil shock and recession of 1973–74 resulted in a negative real return of 52%; faring even worst, the period 1973–74 in the UK produced

investors with a negative real return of 71% (Dimson, Marsh, & Staunton, 2009, p. 25). But relative to other investors, US and UK investors suffered mildly. In Russia and China during their respective revolutions, investors lost everything.

So in a literal absolute sense, the risk capacity of most investors is severely limited. Consider a 65-year-old retiree with a balanced portfolio containing a 50% exposure to shares and property. As demonstrated by history, this investor's portfolio *could* decrease in value by 50%. But does this mean the investor should have a lower exposure to shares because there exists the remote risk of a global catastrophe such as a massive meteorite impact or another world war?

The use of confidence intervals in statistics serves as a good analogy. Whether or not something is *statistically significant* depends on the confidence intervals used. It is common for the results of a study to be deemed *statistically significant* at a confidence interval of 90%, 95% or 99%. But the choice of confidence levels is somewhat arbitrary. The results of the study may be *statistically significant* at the 95% confidence interval but not statistically significant at the 99% confidence interval.

In practice, it would not be prudent to define risk capacity at the 99.99% confidence interval, because the resultant bias away from equities and like assets would expose portfolios to other risks such as inflation risk and longevity risk. Such a bias away from equities would also expose portfolios to the risk of underperformance on a probabilistic basis. So risks of one kind must be weighed up against risks of another

kind, although the weights given to the various risks are subjective and depend on the reasoning applied by each investor or advisor.

## Bridging the Gap

An axiom of economic theory is that we have unlimited wants, in which case, there is really no upper-bound on our *risk required*. In contrast our *risk capacity* is bound by our financial means, so there is often a *gap* between an investor's risk required and risk capacity. Alternatively, an investor may simply not have sufficient retirement savings to fund a lifestyle comparable to that enjoyed in his or her working years. Then there is *risk tolerance*. While it may have a weak positive correlation with risk capacity, some studies conclude no statistically significant relationship between the two (Kaplan, 2009, p. 45). Therefore, a common problem faced by investors is the existence of a so-called *gap* in the various measurements of risk and the resultant trade-off decisions.

Davey (Risky Business, 2009, p. 4) provides a very comprehensive list of solutions to the so-called *gap* which all investors must bridge. For exemplification, the typical issue of an investor funding his or her retirement is addressed:

### Goal Limitation

This method of bridging the gap involves the downward adjustment of goals (or risk required) towards the investor's risk capacity and risk tolerance. Specific approaches include (1) lower spending ambitions in retirement, (2) saving more in the accumulation phase (*present* goal limitation), (3) delaying the date of retirement or increasing the



transition period wherein part-time work is undertaken, and (4) an increased preparedness to drawdown on capital in retirement as well as a preparedness for higher rates of capital drawdown (e.g. use of a reverse mortgage which will deplete one's estate upon death).

### Means Augmentation

This method of bridging the gap involves the upward adjustment of risk capacity through higher income so as to save more in accumulation phase (with the trade-off being higher effort and or less leisure time). Conversely, an investor can increase his or her savings in accumulation phase by spending less—a form of *present* goal limitation to augment *future* means.

An investor can also increase his or her means through a more efficient use of capital. This means avoiding capital investment in lifestyle assets (such as a luxury car) and preferring capital investment in passive investments (such as shares) and or active investments (such as a small business). Likewise, an investor may make a means augmenting investment in his or her human capital, such as an investment in self-education to increase future earnings. The focus on capital efficiency may also involve the *conversion* of assets (e.g. the sale of a luxury car to invest in human capital through further education).

Ultimately, all these forms of means augmentation are a trade-off of one type or another. Whether it be working longer hours, scrimping on groceries, buying shares instead of a new car, or investing in one's own future earnings, all of these tactics involve the conversion of one of life's enjoyments (e.g. buying

things, having things, not working, not having to study) into an expectation of money at some stage of one's life. So bridging the proverbial gap through means augmentation does come at a cost, even though it is not a financial cost measurable in dollar terms.

### Taking More Risk

Finally, if the gap is still big and the investor is unwilling or unable to increase risk capacity or decrease risk required, then the only remaining solution is, in terms of the analogy, to build a bigger bridge. Building a bigger bridge may work; it may simply be a matter of having the risk tolerance to get from one end of the bridge to the other—as investment markets go through a rollercoaster ride of crashes and booms. But it may also fail if investment markets go through a prolonged downturn; that is where the risk becomes real.

### Conclusion

It should always be remembered that the risk in an investor's portfolio should never be significantly higher than either the investor's risk tolerance or risk capacity. If the level of risk is above the investor's risk tolerance, a market downturn will cause discomfort and the investor may want to sell, resulting in a capital loss. Likewise, if the level of risk is above an investor's risk capacity, a market downturn will reduce the investor's ability to achieve a given goal such as the purchase of a home or the funding of adequate pension payments in retirement.

Having completed an overview of risk measurements, the focus will now return to investments.

## Portfolio Construction

### Lindsay Broadway:

#### BGO Accounting

Lindsay Broadway is a CPA and he runs his own accounting and financial planning business in Kew, close to Kew Junction in Melbourne. His approach to portfolio construction is to assess an investor's risk tolerance using Fina-Metrica and then recommend an asset allocation commensurate with the Fina-Metrica result, adjusted so that the level of risk does not exceed either the investor's risk capacity or a level of risk required, beyond which, the level of risk would become unreasonable or reckless.

Broadway then matches the investor with one of six *model portfolios* provided

by research house Lonsec, each of which has a different allocation to growth and income assets:

Model Portfolio Name	Growth Assets (%)	Income Assets (%)
Secure	0	100
Defensive	20	80
Conservative	40	60
Balanced	60	40
Growth	80	20
High Growth	100	0

Furthermore, each of the above model portfolios has a *traditional* and an *alternative* variant, the latter of which includes alternative assets and hedge funds. Compare, for example, the two variants of the balanced model portfolio:

Managed Fund	Asset Category	Model Portfolio	
Australian Equities	Growth	Traditional	Alternative
Fortis Australian Equity Fund		7%	6%
Tyndall Australian Share Fund		7%	6%
Ausbil Australian Active Equity Fund		6%	6%
Aviva Investors High Growth Shares Trust		5%	5%
<b>Sub-total</b>		<b>25%</b>	<b>23%</b>
Global Equities	Growth	Traditional	Alternative
Zurich Global Thematic Share Fund		8%	7%
Templeton Global Equity Fund		8%	7%
Platinum International Fund		7%	6%
<b>Sub-total</b>		<b>23%</b>	<b>20%</b>
Property and Infrastructure	Growth	Traditional	Alternative
Vanguard Index Property Securities Fund		6%	6%
ING Global Property Securities Fund		6%	6%
<b>Sub-total</b>		<b>12%</b>	<b>12%</b>
Alternative Assets / Hedge Funds - Aggressive	Growth	Traditional	Alternative
Barclays Global Markets Fund		0%	5%
<b>Sub-total</b>		<b>0%</b>	<b>5%</b>
Fixed Interest and Alternative Income Assets	Income	Traditional	Alternative
Vanguard Australian Fixed Interest Index Fund		14%	14%
EQT PIMCO Global Bond Fund		15%	15%
Macquarie Income Opportunities Fund		6%	6%
<b>Sub-total</b>		<b>35%</b>	<b>35%</b>
Cash	Income	Traditional	Alternative
No specific money market fund prescribed		5%	5%
<b>Sub-total</b>		<b>5%</b>	<b>5%</b>
<b>Growth Sub-total</b>	<b>Growth</b>	<b>60%</b>	<b>60%</b>
<b>Income Sub-total</b>	<b>Income</b>	<b>40%</b>	<b>40%</b>
<b>Total</b>		<b>100%</b>	<b>100%</b>

As the above table clearly shows, the difference between the two portfolios is minor with the *alternative* portfolio reallocating 5% from shares to alternative assets, the aim of which is to increase the portfolio's *alpha* and decrease the portfolio's *beta* or correlation with share markets. Therefore, Broadway considers the choice between the two variants to be personal in nature and not a crucial portfolio decision. Given the negative coverage of hedge funds since the Global Financial Crisis started in 2007,

many investors have become wary of hedge funds and consequently choose the traditional variant.

While Broadway maintains the core asset allocations in the model portfolios, he does make adjustments in cases where clients would like exposure to direct shares. When recommending direct shares, Broadway uses one of the Lonsec *direct equity model portfolios*. Lonsec provides two such portfolios—an *income* and a *growth* portfolio—the latter of which is more aggressive. Each portfolio

contains well-known large-cap shares such as Telstra, BHP and Westpac which account for most of the 8–12 recommended shareholdings.

In any case, where Broadway deviates from the model portfolio, he does so by substituting like-for-like investments. So direct ASX-listed shares are substituted in the place of managed funds invested in Australian shares. Furthermore, there are instances where the managed fund recommended by Lonsec is not available on the administration platform used by the investor. In anticipation of this problem, Lonsec lists *second-choice funds* for every managed fund in its model portfolios. In instances where neither is available on a particular administration platform, Broadway uses his judgement to select a managed fund with similar characteristics.

Finally when it comes to reviewing investment portfolios, Broadway lists three main issues: changes by Lonsec to the model portfolio, the costs involved in rebalancing, and the behavioural psychology of investors in relation to rebalancing.

From time to time, Lonsec changes its model portfolios which then raises the issue for Broadway of whether to recommend corresponding changes to his clients' portfolios. On this dilemma, Broadway made the following comment:

[T]he recommendation of the researcher, often is say, the change might be the result of the loss of a key staff member, so they'll take the fund from recommended and make it investment grade or fund watch, and then six months later restore it to recommended or highly recommended because the new employee has shot the lights out.

Consequently, Broadway recommends exercising caution and weighing up the benefits of any change with the costs (e.g. fund managers' buy-sell spreads, capital gains tax, his processing fees). He therefore emphasises the importance of *informing* the investor and *further discussion* so that the investor can make a sensible decision.

Likewise, Broadway is cautious about rebalancing when a portfolio's actual asset allocation is close to its strategic asset allocation because of the costs involved. While automatic rebalancing has the advantage of reducing the fees the client pays to him (as no manual rebalancing is involved), more frequent rebalancing can be wasteful in terms of buy-sell spreads and capital gains tax.

Notwithstanding that, automatic rebalancing can also be beneficial in terms of behavioural psychology. In a bull market, Broadway comments that investors often prefer to be overweight in shares:

[I]nvariably, when the markets are *running*, then the client wants to share in that *run* and doesn't really care if he has to sell some shares to fund his pension. He'd rather be in the market and on the *run*.

However, in a bear market, the opposite occurs. Investors prefer to be underweight in shares and overweight in cash. This of course, can make manual rebalancing hard in practice because investors are often reluctant to sell shares in a bull market or buy shares in a bear market, a phenomenon which Broadway summarises as 'greed versus fear'. Consequently, automatic rebalancing has the advantage of overriding

investor reluctance to rebalance towards his or her strategic asset allocation.

## Timothy Adams:

### Ord Minnett

Timothy Adams works for Ord Minnett in its Melbourne office which is located on Collins Street. Being a financial planner, he works in Ord Minnett's *Private Wealth* division and his qualifications include being a CPA and CFP.

Adams' approach is similar to Broadway's in that both use FinaMetrica to assess an investor's risk tolerance, making adjustments for risk capacity and so on. As a side note, Adams provided an interesting example of where actual risk and perceived risk differ. When discussing fixed interest, Adams noted, in relation to failed fixed interest type investments such as Westpoint and Basis Capital:

Investors think of fixed interest as the old term deposit sort of thing and I think that is the perception. They might like some advice from an advisor saying well we can get better than that but their expectation is that it's still going to be there like a term deposit. And I think that's a fair expectation so I think you can't really depart from that.

While Adams recognises some of the advantages of model portfolios, he also draws attention to some of their disadvantages:

I'm actually not a massive fan of model portfolios, so I don't tend to do that. I know it might be efficient for the advisor, but I think, different clients come from different

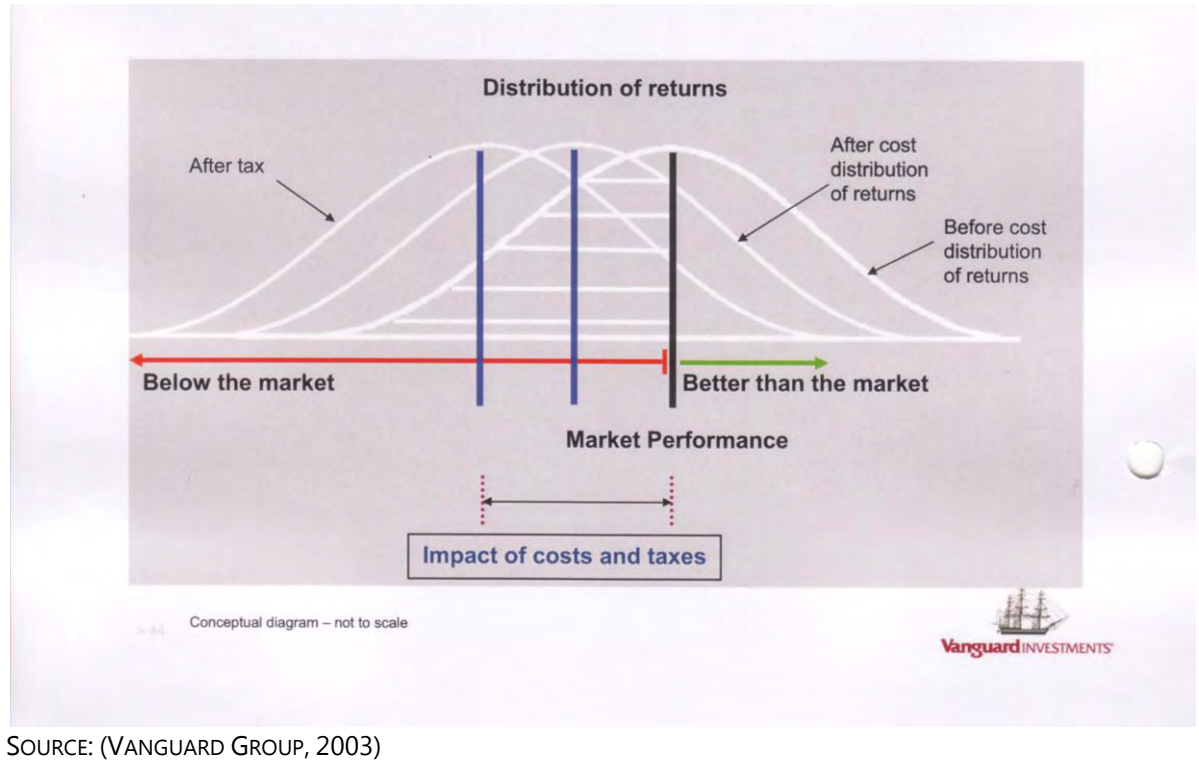
backgrounds. Some of them have inherited, you know, I've got clients with pre-capital gains tax, good quality shares, you know BHPs of the world and things like that and to say to them well look hey we don't deal with those, sorry you should sell them all and go into this product—well I think you're thinking of yourself and not the client.

Adams also focuses on fees in his approach. Usually, Broadway does not *specifically* focus on fees as he generally selects managed funds which form part of the Lonsec model portfolios. In contrast, Adams considers fees to be a decisive factor:

I'm often quite happy to use an index fund ... Asset allocation's one thing, but you've got to actually get the outcomes, you know. If you're wanting a certain return from a market you need to get the market return. If the way you're doing it is to chop half the returns away with costs or whatever it is, that's not delivering what the client wants. So you got to be pretty mindful. And sometimes direct shares are nice and cheap. And it can be that holding a 20-stock portfolio or a 30-stock portfolio with the major stocks and the major parts of the industry, exposures, you're going to get pretty much a market return, without much cost—and the client gets to choose when they take a capital gain hit or not.

This type of philosophy is promoted by the Vanguard Group (see figure 3, next page) which argues that minimising taxes (through lower portfolio turnover) and costs is the best way to achieve close to the market return:

FIGURE 3



SOURCE: (VANGUARD GROUP, 2003)

Interestingly, Adams is also accredited with fund manager Dimensional (which requires advisers to meet accreditation standards before they can buy or sell Dimensional managed funds on behalf of clients). This is interesting because the third interviewee, Matthew Ross, is also accredited with Dimensional.

### Matthew Ross: Australian Independent Financial Advisers (AIFA)

Ross, as the name of his company suggests, is an *independent* financial advisor. He is one of three advisors who work for Australian Independent Financial Advisers Pty Ltd (AIFA). All three are also directors in the company. Ross is a CFP and runs the Melbourne office which is located on Burwood Road, Hawthorn. During the interview, Travis

Morien who runs the Perth office of AIFA was linked up by telephone, answering some of the questions.

AIFA uses the Fama-French model which not only looks at the equity risk premium but other less well-known premia such as the size premium and the value premium. Dimson, Marsh, & Staunton (Credit Suisse Global Investment Returns Sourcebook 2009, 2009, pp. 39–52) provide an excellent analysis of these premia which is summarised in the following paragraphs:

### Equity Premium

This is the premium that investors *typically* enjoy for the risk of investing in shares as opposed to bonds or bills. This premium is quite well-known and forms the basis of asset allocation theory in investment portfolios. Like the following two premia, investors do not

always receive the equity premium, even when investing over long time-frames of in excess of 20 years. Nevertheless, over the last 109 years, the real equity premium (relative to bills) on the world index was a compound average of 4.2% *p.a.*

## Size Premium

This is the observed premium enjoyed by those who have invested in small-cap shares relative to those who invested in large-cap shares. Over the last 109 years, an investment in US large-cap shares would have returned an annualised 9.4% versus a respective figure of 11.5% for small-cap shares and 11.7% for micro-cap shares.

However the occurrence of the size premium is patchy and streaky as the following extract (Credit Suisse Global Investment Returns Sourcebook 2009, p. 40) demonstrates:

It may well have been the excellent performance of small-caps from 1975 that helped attract Banz's attention and persuaded him to research the size effect. The publication and dissemination of his work [in 1981] led to considerable interest in small-caps among US investors, which was helped by their strong outperformance starting in 1975. This spurred the launch of many investment vehicles specializing in smaller companies. The honeymoon period lasted for approximately two years, until the end of 1983, and during this period, US small-caps continued to outperform. Subsequently, as we reported in Dimson and Marsh (1999), US small-caps began to underperform, becoming a victim of Murphy's

Law. Over 1984–1997, the small-cap premium turned negative; though ironically, after we highlighted the demise of the size effect, US small-caps performed very well over 2000–2006 in relative and absolute terms.

Furthermore, it seems that since Banz's research was conducted in 1981, the size premium is not as high as initially reported. In fact, the concluding sentence (Credit Suisse Global Investment Returns Sourcebook 2009, p. 43) on the size premium is as follows:

Over the long run, however, investors should plan on no more than a normal reward for risk, illiquidity and management costs associated with running a small-cap portfolio.

## Value Premium

This is the observed premium for shares which sell on relatively low multiples of earnings, book value or dividends. Over the last 109 years, an investment in UK growth shares would have returned an annualised 7.7% versus a respective figure of 9.2% for the general market and 10.8% for value shares.

As is the case with the other premia, the occurrence of the value premium is streaky and patchy (Credit Suisse Global Investment Returns Sourcebook 2009, p. 44):

[T]he 1990s was mostly the era of growth stocks, and value strategies fared poorly. But after March 2000, value investing came back into its own, with value stocks performing very well relative to growth stocks, until growth stocks reasserted themselves in 2007–08.

FIGURE 4



It is unclear whether the value premium is simply a market inefficiency (e.g. because value shares are uninteresting) or simply a reflection of higher risk (e.g. that the low trading multiples reflect the heightened risk of companies in distress).

### AIFA's Approach

From figure 4, it appears that AIFA considers small-cap shares to be inherently more risky than large-cap shares. It is also interesting to note that AIFA has placed large-cap shares as having roughly the same risk as value companies, but with lower returns, thereby placing them below the efficient frontier. Morien, however, did note that there was debate as to whether or not the value premium represented a form of risk or a market inefficiency.

Morien likes the Dimensional managed funds because, being restricted to accredited financial advisors, they avoid the *hot* money which places them at an advantage:

[Dimensional] do a lot of tax management and block trading within their portfolios. Block trading being a form of trade where they are purchasing a large block of Telstra off some fund manager who is desperate to get rid of it. And Dimensional pays a good [i.e. cheap] price in order to take it off the guy's hands quickly. Now, for Dimensional to do tax management and block trading effectively, they've got to have reasonably predictable cash flows. Now if you look at the cash flows of Dimensional and compare them with Vanguard, Vanguard even as an index manager has a lot more hot money ... So Dimensional's whole process is basically to keep the people out who might be saying doesn't the DFA Australian Value Trust have a really great 12 month return, let's pile our money in there and then 12 months later *values* have a year when its under-performed, so they pull all their money out



and stick it in small caps. Now if they had advisors doing that they would have a lot more churn and it would be very difficult for them to do all these other cost and tax management things effectively. So Dimensional's whole point with the accreditation process is to keep the riff-raff out who are going to do performance chasing. That's the main thing.

## Momentum

Dimson, Marsh, & Staunton (2009, p. 47) also provide an excellent analysis of the *momentum* phenomenon as follows:

In well functioning markets, it should not be possible to achieve consistently superior performance from the naïve strategy of buying past winners and selling past losers. Yet there is extensive evidence, across time and markets, that momentum profits have been large and pervasive. The evidence is so strong that Fama and French, the world's leading experts on stock returns, describe momentum as the "premier anomaly" – a genuine tribute, as they were not its discoverers.

The authors then describe (Credit Suisse Global Investment Returns Sourcebook 2009, p. 49) the process of a basic momentum strategy:

Studies of momentum, including our own research, adopt the methodology used by Jegadeesh and Titman (1993). The procedure is to rank stocks at each month-end on their past returns over the last (say) 3, 6, or 12 months (the ranking period). The portfolio comprising stocks within the top X% of ranking-period returns is referred to as the winner portfolio, and the bottom X% of stocks makes up the loser portfolio. Researchers have used breakpoints of X=10%, 20% or 30% ... The investment

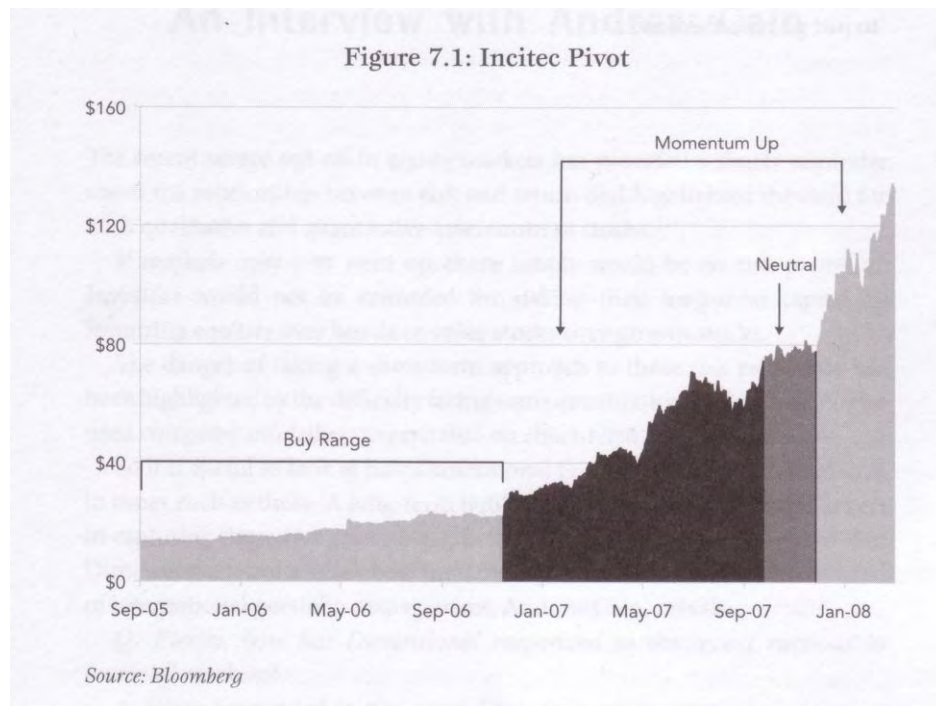
strategy, which is self-financing, is to buy the winner portfolio and short-sell the loser portfolio, with a holding period of (say) 1, 3, 6, or 12 months. To avoid contamination by microstructure effects and the bid-ask bounce, there is usually a skip period between the ranking and holding periods. In standard notation, R/S/H denotes a momentum strategy with a ranking period of R months, a skip period (if any) of S months, and an H-month holding period. The strategies most frequently used are 6/1/6 and 12/1/1, although many studies show results for a wide range of alternatives.

The viewpoint espoused by Dimensional's Parker (Outside the flags 2, 2009, pp. 121–124) is that profiting from momentum is hard in practice, especially because 'the phenomenon is most pronounced in illiquid small cap stocks'. However, he does emphasise avoiding the negative effects of momentum which means not selling shares showing upward momentum and not buying shares showing downward momentum.

Parker also points out that Dimensional sorts shares daily to measure momentum based on six-month performance. As an example, Parker refers to the recent share price of Incitec Pivot (see figure 5, next page). Dimensional acquired shares in the company during the period marked *buy range*, but did not immediately sell its position once the share price increased:

Instead of selling the stock, the trading team respected the momentum signals and held on to see what happened.

FIGURE 5



SOURCE: (PARKER, 2009, P. 123)

...  
The trading team sold a small portion early this year [2009] to raise some needed cash. But otherwise the stock has remained a component of the value strategies.

...  
Momentum may still be a mystery to academics, but sometimes it pays to just go with the flow.

## Conclusion

The conventional starting point in making investment decisions is to look at an investor's risk tolerance. However, the investor's risk capacity, risk required and risk perception are all relevant. All measures must be put together to target a given level of investment risk. It should also be noted that cash is not risk-free. An investment in cash is susceptible to inflation risk and, for superannuants, longevity risk.

In terms of investment selection, asset allocation is the most important decision. Decisions such as active versus

passive, direct or indirect are of minor importance. Fees and taxes are easily controlled so should be a focus of any investment portfolio. Likewise, helping investors with the *behavioural psychology* aspect of investing is another area where advisors can really add value to clients.

Lastly, market outperformance is an area in which an advisor may be able to add value. Beyond the asset allocation decision, or the equity premium, other premia or market inefficiencies have been observed. These include the size premium, the value premium (or value inefficiency) and the momentum inefficiency. Some advisors may be able to generate outperformance for their clients, after fees, but in general this will not be possible for most advisors. This is because most advisors (and or investors) *are* the market, which means that only a minority can ever consistently outperform the median.

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Postscript: This paper was originally completed under a deadline, so it unfortunately included a couple of typographical errors. In 2014, some editing of a non-material nature, without the pressure of a submission deadline, was made to clean up the paper and update the appearance. The changes did not materially alter the substance of the paper — Zane McKean.