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# Portfolio Management Summary

We employ Modern Portfolio management techniques which are concerned with investment analysis, portfolio design, and performance evaluation. These methods express quantitatively our views regarding risk and its relationship to investment return. They focus attention on the overall composition of the portfolio rather than the traditional method of analyzing and evaluating the individual components. As your investment advisor, we are able to examine and design portfolios predicated on explicit risk-reward parameters and on the identification and quantification of portfolio objectives.

Most Investment professionals focus their attention on the evaluation and selection of specific issues rather than on the portfolio as a whole. It is a common belief that skilled professionals, with their financial resources and information gathering abilities, should be able to consistently “beat the markets”. It is assumed that this can be done with sophisticated securities analysis and selection, and by adroitly timing moves in the markets. This assumption is further predicated on the concept that markets are inherently inefficient, thereby allowing investors with superior skills in selecting issues and timing markets to outperform benchmarks of market performance.

To some degree the markets are inefficient. For example, equities with low price-to-earnings ratios tend to outperform equities with high price-to-earnings ratios over time. This may result from an absence of sufficient information regarding those securities, an indifference towards the specific issues, or an absence of a large analytical following. In most cases the information is readily available, however, only a relative few investors are willing to take the time to evaluate it.

Most academic and industry research supports the concept that markets, at least in the broadest sense, are efficient. Asset classes, (i.e. equities, bonds, and real estate) are generically efficient. The nature of efficient markets is such that all participants have the same information regarding the markets in general, and specific issues in particular, at the same time, although they may come to opposite conclusions as to an appropriate price for individual securities. In an auction market such as the New York Stock Exchange, buyers and sellers meet to find mutually acceptable values for securities. The buyer believes that the security is worth more than the money, while the seller believes that the money is worth more than the security. In most cases the buyer and the seller are equally well informed and have virtually instantaneous access to all publicly available information concerning the value of the security. In such a market it is generally believed that transaction cost associated with active management will result in below-average performance. It is, perhaps, ironic that the sophistication of money managers and their virtually instantaneous access to information create greater efficiency in the marketplace, thereby making above average returns extremely difficult to achieve. As performance numbers have demonstrated, it is statistically unlikely that anyone will consistently outperform the market averages. In fact, Werne F.M. De Bondt, Ph.D. has demonstrated that managers that out-perform the markets in one year will probably not match or exceed market performance the next year.

# Our Approach to Asset Allocation

Simply stated, asset allocation is the process of selecting a mix of asset classes and the efficient allocation of capital to those assets by matching rates of return to a specified and quantifiable tolerance for risk. Risk tolerance is essentially the percentage of an investment portfolio that an investor is willing to risk to achieve a specific rate of return. It is no longer a one-dimensional process of selecting the right stock, bond or property to place in a portfolio.

Modern portfolio theory methods have as their foundation four basic premises. First, that investors are inherently risk-averse. Investors are not willing to accept risk except where the level of returns generated will fairly compensate for that risk. It is probably reasonable to assume that investors are more concerned with risk than they are with rewards. The problem in the past has been to quantify risk and its relation to return.

The second premise to modern portfolio theory is that the markets are basically efficient. As discussed above, most studies support this concept. With the advance in information technology and more sophisticated investors, the markets are likely to become even more efficient.

The third premise is that the focus of attention should be shifted away from individual securities analysis to consideration of portfolios as well as a whole predicated on explicit risk-reward parameters and on the identification and quantification of portfolio objectives. Today it is more likely that the efficient allocation of capital to specific asset classes will be far more important than selecting the “right” components of that asset class. A study by Merrill Lynch in 1979 showed that in a typical, diversified investment portfolio, diversification eliminates so much of the specific risk that roughly 90 percent of all the portfolio risk is market risk and only 5 to 7 percent is specific risk. Specific risk being the risk associated with a specific issue (stock, bond or property). In another study by three leading financial analysts it was determined that on average 93.7% of the variability in the risk and returns of a portfolio could be explained by the asset allocation policy.

These studies have dramatically supported the concept that asset allocation is the primary determinant of portfolio performance, with market timing and security selection playing minor roles. The fourth premise for modern portfolio theory is the optimality of portfolio returns vis-à-vis portfolio risk. In other words, for any level of risk that one is willing to accept, there is a rate of return that should be achieved.

## Asset Allocation Continued...

Quantitative methods are used for measuring risk and diversification, making it possible to create efficient and theoretically optimal portfolios. Portfolio diversification is not so much a function of how many issues are involved, as it is of the relationships of each asset to each other asset and the proportionality of those assets in the portfolio. In other words, investors should search for those assets, which tend to have negative relationships to each other and should include assets, which go up in value as the value of other assets declines.

The extent to which knowledge of one asset return provides information regarding the behavior of another asset is measured by the correlation of returns. Are they moving in the same or opposite directions at the same time? If they are moving in the same direction at the same time, it is said that they have a positive correlation. A perfect positive correlation between two variables would represent a perfectly positive linear relationship and would be represented by a correlation of + 1.0. The perfectly negative relationship between two variables would be described by a correlation of - 1.0.

Measurements of the risk and return characteristics of individual investments are inadequate in explaining what happens when investments are combined in portfolios. The true measurement of diversification between assets is called the covariance of the assets. Covariance measures the timing, direction and momentum of the movement of each variable. By calculating the covariance and expected returns for all assets in any given portfolio it is possible to calculate the optimal portfolio mix for any degree of risk. Each portfolio on this “efficient frontier” will generate the highest possible rate of return for any specific level of risk, with risk being measured by the standard deviation (variance) of returns. Any other portfolio, which exhibits the same standard deviation, will generate lower returns and will therefore be considered inefficient.

The number of assets in the portfolio is less important than the relationship of those assets. Therefore having many assets in a portfolio will not reduce the systematic risk in the portfolio as much as having negatively correlated assets. Further, it is a misconception, albeit a widely held one, that investors must accept higher levels of risk to achieve higher returns. By using asset allocation methodologies, investors may achieve higher returns with less risk.

The process of asset allocation may include one or all of the following approaches.

### **STRATEGIC ASSET ALLOCATION**

Uses historical data (mean rates of return, standard deviations and covariance) in an attempt to understand how the asset has performed and is likely to perform over long periods of time. The goal is not to “beat” the market, but to establish a long-term investment strategy using a core mix of assets.



## Asset Allocation Continued...

### TACTICAL ASSET ALLOCATION

Uses periodic assumptions regarding the performance and characteristics of the assets and/or the economy. This approach attempts to improve portfolio performance by making “mid-course” changes in the long-term strategy based on near-term expectations.

The economic environment and investment alternatives today are substantially different from those of the past. We believe that investors can no longer be myopic in their view of investments in so far as they restrict their analysis to domestic markets or investment vehicles. The traditionally domestic portfolio is clearly inadequate in today's internationally based investment world requires access to, and proficiency with superior analytical tools and databases. We fully recognize that developing successful investment strategies and competing for investment capital depends on our ability to employ the most sophisticated analytical techniques.

# Five Keys to Portfolio Design and Maintenance

- 1.) Standard Deviation** The measure of volatility or risk associated with a portfolio. A portfolio's Standard Deviation should be 60% or less than its historical Rate of Return.
- 2.) Sharpe Ratio** A key measure of a portfolio's risk adjusted performance. It quantifies portfolios in a way that allows one to compare risk-adjusted historical returns. A portfolio's Sharpe Ratio should be 1 or higher.

$$S = \frac{ROR - R(f) (mm)}{STD}$$

ROR = Historical Rate of Return   R(f)= Risk-Free Return   mm = money market   STD= Standard Deviation

- 3.) Asset Correlations** The portfolio should have assets with varying degrees of correlations. Measured from (+1) high to (-1) low, asset classes within the portfolio that are not highly correlated will help reduce portfolio volatility.
- 4.) Fees and Transparency** Fees for portfolio management should not exceed 1.00%. Too many portfolio owners pay excessive fees. Some owners are not aware of all of the fees they are charged. It should be clear what the total cost of management is.
- 5.) Tax Efficiencies** A low turnover approach to investing greatly reduces the portfolio's annual tax burden. This, in turn, dramatically affects the annualized after-tax Rate of Return.

# Conclusion

Successful investors require the development of long-term plans arrived at in an objective and dispassionate manner. Too often, investment decisions are based on isolated, short-term consideration, **without regard to the portfolio or the inter-relationships of the asset used.**

Our approach to money management ignores the narrow approach of attempting to beat the performance of individual markets and applies a much broader method of devising strategies, which will achieve investor's long-term policies and objectives within specified risk parameters. If 90% of future portfolio performance is determined by asset allocation policies, then it should be at the asset allocation and investment policy level that investors address issues of risk and return. To provide the services that our clients require today, we utilize integrated investment systems, which include all of the computer models and ancillary services required to develop and manage your portfolio in a sophisticated asset allocation program.