ABR Dynamic Funds' Portfolio Construction Series: Part 15

Everyone is a long-term investor, until volatility hits

A worthwhile goal in portfolio construction is seeking to maximize the reward for each dollar put at risk. Return is widely agreed upon as the best measurement of portfolio reward (and it's true, of course), so we won't spend any more time on it. However, some investors object to the use of volatility as the measurement of portfolio risk.

Nevertheless, volatility is the best measurement of risk in the academic literature (please see installment 4 for more on this topic). It has enabled a reduction in portfolio fluctuations both for a given level of return and over various market conditions. **In short, using volatility as the measurement of risk and seeking to maximize the reward for each dollar put at risk in a portfolio has led to well-diversified portfolios with better results, samples of which we will construct in future installments.**

This installment will build on the idea of volatility as risk, with three observations about dangers associated with high risk portfolios, which are often the result of forgoing optimal diversification for excessive equity concentration. Some data may indicate that it has been difficult to stick with an excessively concentrated investment plan. In other words, **well-diversified portfolios, based on volatility as risk, haven't just provided better results; they may have been easier to stick with.**

1. Everyone is a long-term investor, *until a crisis hits*

Volatility causes non-systematic investors to make costly mistakes. To illustrate, consider the fact that, according to the Dalbar Quantitative Analysis of Investor Behavior, **over the 30-year time period from 1985-2014, the average equity investor achieved just a 3.8% annual return. The S&P 500 gained 11.1% per year over that same time frame.** The 7% lag has little to do with the oft maligned fees; it was primarily driven by bad hedging and timing decisions investors have made, especially during rapidly fluctuating markets. In fact, again according to Dalbar, **the five worst months for the average equity investor, in terms of underperformance of the S&P 500, all occurred in months in which the S&P 500 moved 10% or more.** In those five months, the average S&P 500 move was 15.2%, and the huge moves may have caused and magnified investor errors. **Investors underperformed the S&P 500 by an average of 5.4% in each of those months. That's 27% of underperformance in just five months, all of which occurred at highly volatile times.**

A well-diversified approach to investing, based on volatility as risk, has smoothed swings and drawdowns throughout various market conditions, likely making it easier to weather such a storm and stick with a long-term investing plan. These statements are quantitatively supported in installment 4 and in upcoming installments.

2. Everyone is a long-term investor, *until a bull market hits*

A misguided criticism is occasionally leveled at a well-diversified approach to investing: even if diversification is a better long-term approach, it can be psychologically difficult to maintain the necessary diversification while watching part of a portfolio regularly lag other parts, or even outright lose. However, the cost of succumbing to this difficulty during a bull market may be excessive

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concentration in equities (including the equity-like risk we have been exposing in the "Fooled by the Wrapper" installments) by the later stages of that bull market.

In fact, as the Dalbar figures indicate, it may be more difficult to stick with concentrated equity investments during a crisis than diversified investments during a bull market. In the case of a highly concentrated portfolio, the psychological difficulties apply to most of the portfolio instead of a smaller part of it; engender fears of "blowing out" instead of just lagging a bit; and inspire the extremely costly mistakes noted in the previous section.

In other words, the criticism is misguided; it is more aptly aimed at a strategy of excessive equity concentration. And let's be honest. This "criticism" amounts to little more than noting that discipline is difficult and performance chasing is tempting. However, the reward for enduring this difficulty has been a better long-term result. For more on this topic, please see installment 7.

3. Everyone is a long-term investor, *in theory only*

Capital rarely has a truly infinite time horizon with no liabilities to fund. Most investors are preparing for or funding anything from a personal retirement to state pension obligations. A fixed funding requirement becomes a larger percentage of capital after larger losses. It can even overwhelm expected returns, causing depletion, instead of growth, of capital. For example, consider an investor with $1M to invest and $60k per year in liabilities. Of course, this investor needs to make 6% per year to fund his/her liabilities without depleting the capital. After a loss of 20%, this investor needs to make 11.5% per year in order to fund the $60k in liabilities and replenish the principle within 5 years. However, after a loss of 40%, this investor needs to make 19.1% per year in order to do the same.

Installments 4 and 15 collectively address volatility as the best measurement of portfolio risk and lay out just a few of the benefits of maximizing the reward for a given level of risk. Future installments will use this idea to build sample portfolios and more fully demonstrate the benefits of the resulting diversification.

Next Week's Preview: There is evidence that systematic decisions may have improved results while discretionary decisions may have worsened them.

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