PORTFOLIO MANAGEMENT

Active or Passive Management?

Active Investment management

The predominant investment strategy today is active investing, which attempts to outperform the market. The goal of active management is to beat a particular benchmark. The majority of managed funds are actively managed.

Analysing market trends, the economy and the company-specific factor, active managers are constantly searching out information and gathering insights to help them make their investment decisions. Many have their own complex security selection and trading systems to implement their investment ideas, all with the ultimate goal of outperforming the market. There are almost as many methods of active management as there are active managers. These methods can include fundamental analysis, technical analysis, quantitative analysis and macroeconomic analysis.

Active managers believe that because the markets are inefficient, anomalies and irregularities in the capital markets can be exploited by those with skill and insight. Prices react to information slowly enough to allow skilful investors to systematically outperform the market.

Passive Investment management

Passive management, or indexing, is an investment management approach based on investing in exactly the same securities, and in the same proportions, as an index such ASX All Ordinaries. It is called passive because portfolio managers don't make decisions about which securities to buy and sell; the managers merely follow the

same methodology of constructing a portfolio as the index uses. The managers' goal is to replicate the performance of an index as closely as possible. Passive managers invest in broad sectors of the market, called asset classes or indexes, and are willing to accept the average returns various asset classes produce.

Passive investors believe in the efficient market hypothesis (EMH), which states that market prices are always fair and quickly reflective of information. EMH followers believe that consistently outperforming the market for the professional and small investor alike is difficult. Therefore, passive managers do not try to beat the market, but only to match its performance.

Passive or Active Management – Which is the Best Approach

A debate about the two approaches has been ongoing since the early 1970s. Supporting the passive management argument are the researchers from many universities and privately funded research centres. Large financial management firms, banks, insurance companies and other companies that have a vested interest in the profits from active management support the other side of the argument.

Each side can make a strong logical case to support their arguments, although in many cases, the support is due to different belief systems, much like opposing political parties. However, each approach has advantages and disadvantages that should be considered.

Active Management - Advantage/Disadvantage

The main advantage of active management is the possibility that the managers will be able to outperform the index due to their superior skills. They can make informed investment decisions based on their experiences, insights, knowledge and ability to identify opportunities that can translate into superior performance.

If they believe the market might turn downward, active managers can take defensive measures by hedging or increasing their cash positions to reduce the impact on their portfolios.

A disadvantage is that active investing is more costly, resulting in higher fees and operating expenses. Having higher fees is a significant impediment to consistently outperforming over the long term. Active managers, in an attempt to beat the market, tend to have a more concentrated portfolio with fewer securities. However, when active managers are wrong, they may significantly under-perform the market.

A manager's style could be out of favour with the market for a period of time, which could result in lagging performance.

Passive Management - Advantage/Disadvantage

The main advantage of passive investing is that it closely matches the performance of the index. Passive investing requires little decision-making by the manager. The manager tries to duplicate the chosen index, tracking it as efficiently as possible. This results in lower operating costs that are passed on to the investor in the form of lower fees.

A passively managed investment will never outperform the underlying index it is meant to track. The performance is dictated by the underlying index and the investor must be satisfied with the performance of that index. Managers are unable to take action if they believe the overall market will 'correct' in the near term.

While this concept usually applies to Managed Funds, it can also be applied to a portfolio of directly held investments such as within a self-managed super fund.

Dollar Cost Averaging (DCA)

About Dollar Cost Averaging

Ideally when investing in shares, we'd all like to buy low and sell high. But experts agree that 'timing the market' in this fashion is virtually impossible. One response to this is dollar cost averaging.

Investing small, equal amounts regularly over time, or dollar cost averaging, is a common strategy used to build up investment balances including superannuation. It effectively 'averages out' your purchase price for shares.

How Dollar Cost Averaging works

By contributing an equal amount to your portfolio regularly you will buy more shares or units of an underlying investment at lower prices, and fewer at higher prices.

Consider this example. Bob contributes $100 per month to his portfolio, which is invested in an Australian share fund.

Month	Amount invested $	Unit price $	Units purchased
1	100	100	1.00
2	100	95	1.05
3	100	98	1.02
4	100	92	1.09
5	100	86	1.16
6	100	90	1.11
7	100	85	1.18
8	100	89	1.12
9	100	93	1.08
10	100	95	1.05
11	100	98	1.02
12	100	100	1.00
Total	**$1,200**		**12.88**

	Amount
Total Amount Invested	$1,200
Total End Value (Total Units Purchased x End Value per unit)	$1,288
Gross Capital Gain	$88

A capital gain was achieved without the price per unit ever going above the starting price of $100. Dollar cost averaging does not guarantee a profit but with a sensible and long-term investment approach, dollar cost averaging can smooth out the market's ups and downs and reduce the risk of investing in volatile markets.

DCA Pitfalls

All risk-reduction strategies have their trade-offs, and DCA is no exception. First of all, you run the chance of missing out on higher returns if the investment continues to rise after the first investment period. Also, if you are spreading a lump sum, the money waiting to be invested doesn't earn much of a return by just sitting there. Still, a sudden drop in prices won't damage you as much as if you had put it all in at once.

Some investors who engage in DCA will stop after a sharp drop, cutting their losses; however, these investors are actually missing out on the main benefit of DCA - the purchase of larger portions of stock (more shares) in a declining market, thereby increasing their gains when the market rises again.

When using a DCA strategy it is important to determine whether the reason behind the drop has materially impacted the reason for the investment. If not, then you should stick to your guns and pick up the shares at an even better valuation than before.

Another issue with DCA is determining the period over which this strategy should be used. If you are dispersing a large lump sum, you may want to spread it over one or two years, but any longer than that may mean missing the general upswing in the markets as inflation chips away at the real value of the cash.

Lump Sum investing

Perhaps you've inherited a sum of money; the Saturday Lotto results finally have your numbers; you are giving consideration to rebalancing your asset allocation; you have a maturing term deposit or maybe you've been parking some money in cash waiting for the 'the market to bottom' and now is that time. In cases like these, you may want to at investigate the merits of lump-sum investing. Several academic studies have compared dollar cost averaging to lump-sum investing and concluded that, because markets have risen over the long term in the past, investing in the market today tends to be better than waiting until tomorrow, since you have a longer opportunity to benefit from any increase in prices over time.

For example, a 2009 study by the Association of Investment Companies found that an investor who put a lump sum into the average British investment company at the end of April 2008 (talk about bad timing!) would have been down 30% one year later. Someone who invested the same total amount divided over 12 months would have been down only 7%. However, when the study examined the previous 5 years rather than a single year, the lump-sum investment made in April 2004 would have been up 26% by April 2009, compared to the periodic investment strategy's loss of 10% over the same time. Several U.S. studies over several decades reviewed overall stock market performance and reached a similar conclusion: the longer your time frame, the greater the odds that a lump-sum investment will outperform dollar cost averaging.

Dangers investing a lump sum

The lump-sum studies reflect the long-term historical direction of the stock market since record-keeping began in 1925. That doesn't mean the markets will behave in the future as they have in the past, or that there won't be extended periods in which stock prices don't rise. Even if they do move up, they may not do so immediately and forever once you invest.

Even if you don't have a large lump sum to invest now, you may be able to save smaller amounts and invest the total in a lump sum later. However, many people simply aren't disciplined enough to keep their hands off that money. Unless the money is invested automatically, you may be more tempted to spend your savings rather than investing them, or skip a month - or two or three.

Even seasoned investors have difficulty timing the market, so ignoring fluctuations and continuing to invest regularly may still be an improvement over postponing a decision indefinitely while you wait for the "right time" to invest. Don't forget that a lump sum invested in a single security inherently involves more risk than a lump sum put into a more diversified portfolio, regardless of your time frame.

Conclusion

Deciding between lump-sum investing and dollar cost averaging illustrates the classic risk-reward trade off. Even if you're convinced a lump-sum investment might produce a higher net return over time, are you comfortable with the extra volatility and level of risk involved?

It's important to know yourself and your limitations as an investor. Understanding the pros and cons of each approach can help you make the decision that best suits your personality and circumstances.

Rebalancing your Portfolio

A simple explanation

You have established an asset allocation strategy that is right for you, but at the end of the year, you find that the weighting of each asset class in your portfolio has changed! What happened? Over the course of the year, the market value of each security within your portfolio earned a different return, resulting in a weighting change. Portfolio rebalancing is like a tune-up for your car: it allows investors to manage their risk.

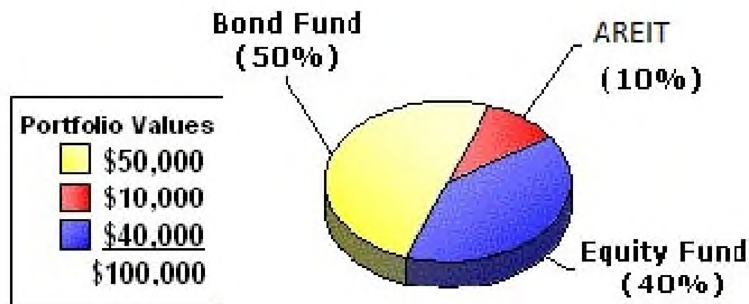
What is Rebalancing?

Rebalancing is the process of buying and selling portions of your portfolio in order to set the weight of each asset class back to its original state. In addition, if an investor's investment strategy or tolerance for risk has changed, he or she can use rebalancing to readjust the weightings of each security or asset class in the portfolio to fulfil a newly devised asset allocation.

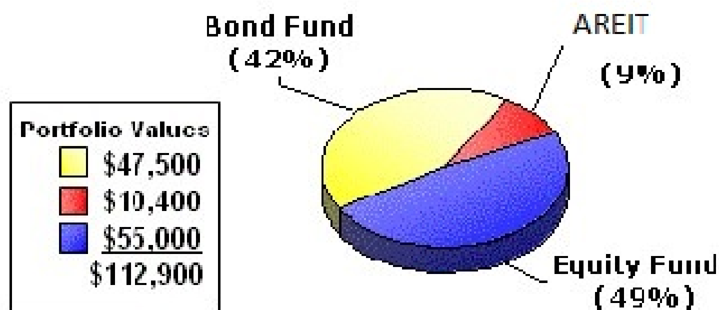
Blown Out of Proportion

The asset mix originally created by an investor inevitably changes as a result of differing returns among various securities and asset classes. As a result, the percentage that you've allocated to different asset classes will change. This change may increase or decrease the risk of your portfolio, so let's compare a rebalanced portfolio to one in which changes were ignored, and then we'll look at the potential consequences of neglected allocations in a portfolio.

Let's run through a simple example. Bob has $100,000 to invest. He decides to invest 50% in a bond fund, 10% in an AREIT (Australian Real Estate Investment Trust) fund and 40% in an equity fund.



At the end of the year, Bob finds that the equity portion of his portfolio has dramatically outperformed the bond and AREIT portions. This has caused a change in his allocation of assets, increasing the percentage that he has in the equity fund while decreasing the amount invested in the AREIT and bond funds.



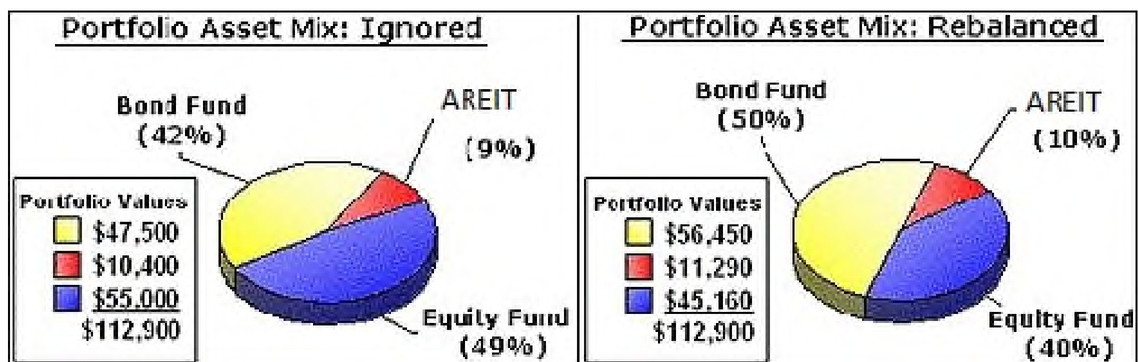
More specifically, the above chart shows that Bob's $40,000 investment in the equity fund has grown to $55,000, an increase of 37%! Conversely, the bond fund suffered, realising a loss of 5%, but the AREIT fund realised a modest increase of 4%. The overall return on Bob's portfolio was 12.9%, but now there is more weight on equities than on bonds. Bob might be willing to leave the asset mix as is for the time being, but leaving it too long could result in an overweighting in the equity fund, which is more risky than the bond and AREIT fund.

The Consequences of Imbalance

A popular belief among many investors is that if an investment has performed well over the last year, it should perform well over the next year. Unfortunately, past performance is not always an indication of future performance - this is a fact many managed funds disclose. Many investors however, remain heavily invested in last year's "winning" fund and may drop their portfolio weighting in last year's "losing"

fixed-income fund. Remember, equities are more volatile than fixed-income securities, so last year's large gains may translate into losses over the next year.

Let's continue with Bob's portfolio and compare the values of his rebalanced portfolio with the portfolio left unchanged.



At the end of the second year, the equity fund performs poorly, losing 7%. At the same time the bond fund performs well, appreciating 15%, and AREITs remain relatively stable with a 2% increase. If Bob had rebalanced his portfolio the previous year, his total portfolio value would be $118,500, an increase of 5%. If Bob had left his portfolio alone with the skewed weightings, his total portfolio value would be $116,858, an increase of only 3.5%. In this case, rebalancing is the optimal strategy.

	Rebalanced		Ignored	
	Opening	Closing	Opening	Closing
Bond Fund	$56,450	$65,000	$47,500	$55,100
AREIT Fund	11,290	11,500	10,400	10,608
Equity Fund	45,160	42,000	55,000	51,150
Total	$112,900	**$118,500**	$112,900	**$116,858**

However, if the stock market rallies again throughout the second year, the equity fund would appreciate more and the ignored portfolio may realise a greater appreciation in value than the bond fund. Just as with many hedging strategies, upside potential may be limited, but by rebalancing, you are nevertheless adhering to your risk-return tolerance level. Risk-loving investors are able to tolerate the gains and losses associated with a heavy weighting in an equity fund, and risk-averse investors, who choose the relative safety offered in AREIT’s and fixed-income funds, are willing to accept limited upside potential in exchange for greater investment security.

How to Rebalance Your Portfolio

The optimal frequency of portfolio rebalancing depends on your transaction costs, personal preferences and tax considerations, including what type of account you are selling from and how your capital gains or losses will be. Usually about twice a year is sufficient; however, if some assets in your portfolio haven't experienced a large appreciation within the year, longer time periods may also be appropriate. Additionally, changes in an investor's lifestyle may warrant a change to his or her asset-allocation strategy. Whatever your preference, the following guideline provides the basic steps for rebalancing your portfolio:

Record - If you have recently decided on an asset-allocation strategy perfect for you and purchased the appropriate securities in each asset class, keep a record of the total cost of each security at that time, as well as the total cost of your portfolio. These numbers will provide you with historical data of your portfolio, so at a future date you can compare them to current values.

Compare - On a chosen future date, review the current value of your portfolio and of each asset class. Calculate the weightings of each fund in your portfolio by dividing the current value of each asset class by the total current portfolio value. Compare this figure to the original weightings. Are there any significant changes? If not, and if you have no need to liquidate your portfolio in the short term, it may be better to remain passive.

Adjust - If you find that changes in your asset class weightings have distorted the portfolio's exposure to risk, take the current total value of your portfolio and multiply it by each of the (percentage) weightings originally assigned to each asset class. The figures you calculate will be the amounts that should be invested in each asset class in order to maintain your original asset allocation. You may want to sell securities from asset classes whose weights are too high, and purchase additional securities in asset classes whose weights have declined. However, when selling assets to rebalance your portfolio, take a moment to consider the tax implications of readjusting your portfolio. In some cases, it might be more beneficial to simply not contribute any new funds to the asset class that is overweight while continuing to contribute to other asset classes that are underweighted. Your portfolio will rebalance over time without you incurring capital gains taxes.

Conclusion

Rebalancing your portfolio will help you maintain your original asset-allocation strategy and allow you to implement any changes you make to your investing style. Essentially, rebalancing will help you stick to your investing plan regardless of what the market does.

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