

Thesis

Investing is a term that falls in between a wide risk spectrum. There are investors with a purpose of entering the market place with the expectation of making money quickly. In order to achieve this, these investors need to take on considerable risk. These investors must be right, consistently. They must time their purchase and sale ahead of price increase and before market losses. The risk of loss is not fully appreciated by this strategy. Risk and return are interrelated. A better terminology for this would be trading or perhaps even gambling. This is a “bet” that a stock will either go up or down in the short term. This volatility is very uncomfortable for many if not most investors. This is the high risk end of the investment spectrum.

Other investors expect great consistency. These investors expect exact amounts of very predictable earnings. Their desire is not to see the market price of their accounts decrease in value. They only want their accounts to increase in value. These investors want to prevent market losses. This would more consistent with savings, not investing. Even investments in U.S. Government Bonds will both increase and decrease in value, daily. U.S. Government Bonds are backed with the full faith and credit of the US government and they must be held from purchase to maturity to prevent market loss. Every day investors reprice these bonds and as the price increases or decreases investor’s accounts will either rise or fall. Therefore, even U.S. Government Bonds are investments and carry a degree of loss between purchase date and maturity date.

The interrelation between risk and return is necessary for investors to understand prior to making a decision to invest. Not fully appreciated is the investor’s personality or emotional reaction to gains or losses. Over time both gains and losses are almost a certainty for any investor. In order for investors to be successful in the market place, they must assess their personality and their personal goals and objectives for their portfolio, their risk tolerance, and an asset allocation that will achieve those goals and objectives. Thankfully between these two extremes of savings and high risk investing

there is an ability to invest using various investment components which can accommodate most investors.

Goals and Objectives

Investors tend to have three goals in mind when it comes to investing – capital appreciation, income, or a mixture of both. In addition, reducing the risk of loss is important to most investors if not critical. Capital appreciation/depreciation, or investment return, is the gain or loss of a security plus any income generated on that security during a particular period of time. Additionally, all investors take on various levels of risk to generate returns. To evaluate risk and returns investments are frequently benchmarked commonly to the S&P 500.

Investment Components

Investors who tend to stick to “income investing” invest in securities that provide a steady income. Income can come from two sources. Income from stocks come from investing in dividend paying stocks. In addition to the potential for the price of a security to increase in value, income investors in stocks evaluate stocks that have the potential to pay consistent or even rising dividends. The second area of income as a source for investments is interest income from bonds. Interest income is the promise of an entity (e.g. government or corporation) to pay a stated interest rate for a period of time. At maturity – the end of the time period of the bond – the entity pays the investor the principle value of the bond back.

In order to invest in stocks that create income, investors would choose stocks that pay, and have paid, consistent and potentially rising dividends. A dividend is a sum of money that is paid out of a company on a regular basis – monthly, quarterly, semi-annually, or annually – to its shareholders of record as of a certain date. If a company has a very profitable year, they may be enticed to increase their dividend payment to shareholders. A higher dividend payment can [possibly] tell investors the financial strength, or weakness, of a company at a particular time, as well as give investors insight of a

company's previous financial history. Dividend-paying stocks do have the ability to increase in value and they are generally more mature companies. Mature companies do not typically have the same growth potential as other ["younger"] growth companies.¹ There are some exceptions to this rule.

Real Estate Investment Trusts (REITs) are companies that offer a specific type of income investment. REIT's are organized under the IRS tax code to pay a high percentage of income to maintain a tax advantaged status. REIT's are typically known for paying out relatively high dividend yields compared to the market average. REIT companies may borrow money and use both loans and equity (ownership similar to the down payment on a house and a mortgage similar to a loan on a home) to buy property or invest in mortgage securities. The REIT category is required to payout at least 90% of earnings for this tax code status. The consequence of this tax code makes REITs a selection of income oriented investors. Like all investments, REIT companies can lose their value.

Bonds are investments that provide loans to entities. An investor who purchases a bond is purchasing a loan. The entity that borrows the money promises to repay the investor a stated interest rate, for example 3%, for a period of time, for example 5 years. The more risk that an investor takes the higher the interest rate. The longer a bond investor invests the more interest a bond investment generally must pay.

All companies are not equally able to pay investors back. Lower rated companies are less able to pay investors back. This is the risk of loss of both principal and interest payments. These bonds are called high yield bonds. They pay a higher interest payment for that reason. The risk an investor takes is the ability of the entity to pay back the investor both interest and the principal at maturity.

The length of time or investment maturity of a bond is also an investor risk. Any entity may experience detrimental events over time and these can negatively impact the ability to pay back the investor. The likelihood of events negatively impacting investors in a bond is deemed to increase as

¹ Larry R. Lang and Thomas H. Gillespie, *Strategy for Personal Finance*, (McGraw-Hill Inc., 1984, 1981, 1977), 543.

time of the loan increases. Because the ability to repay the investor the stated interest rate and the money due to the investor becomes less certain, higher dividend payments by investors are generally required.

There are investors who desire both capital appreciation and income. These investors tend to be willing to take on a little bit of risk but still need the safety that comes with income investing. Some popular asset allocations that seek to generate returns and dividends are 50% stocks/50% bonds, 60% stocks/40% bonds, and even 70% stocks/30% bonds. Regardless of one's investment objectives, there is not one single method that is proven to generate long term prosperity in the financial market.

The Marketplace

There are many factors that go into evaluating what makes an investment increase or decrease in value. In the simplest of terms, an investment increases in value when people are buying and decreases in value when people are selling. This is simply known as supply and demand. Markets in the United States, like the New York Stock Exchange (NYSE), and throughout the world are all organized differently to serve the country or citizens specific needs. These rules that govern exchanges affect these exchanges as supply and demand does.

Markets create a centralized location that brings together clients looking to buy and clients looking to sell According to *Managing Investment Portfolios: A Dynamic Process*. This in turn creates market liquidity. Market liquidity allows investors to trade in reasonable volume without a major impact on the stock price(s). The continuous interaction of many buyers and sellers is both the cause and effect of liquidity. A diversity of opinion, information, and investment needs among market participants; a readily accessible location, either physical or electronic, operating continuously during convenient market hours. A reasonable cost of transacting so that investors can trade positions without excessive loss of value. Investors who receive fair and honest treatment in the exchange process will trade again. And to ensure the certainty of trade completion, participating brokers guarantee the trade

to both buyer and seller.² Without the proper and complete execution of any of these factors, the market as a whole runs the risk of investors losing faith in the market, thus reducing the liquidity among most investment vehicles. The market crash of 2008 was considered a liquidity market crash originating in the mortgage area of the economy.

Trading Activity

A price factor that goes into the movement of an individual investment's price is the types of traders, or trading activity, that is taking place for a particular investment. There are four main types of traders, or trading activity – Value-Motivated Traders/Trading, Information-Motivated Traders/Trading, Liquidity-Motivated Traders/Trading, and Passive Traders/Trading.

Value motivated traders develop independent assessments of value and wait for market prices to move into the range of their assessment. This type of trading activity requires strict discipline, and are usually executed in large batches at attractive pricing. Because this type of trading activity happens at specific times and prices, there is typically little to no effect on the stock price of the underlying holding.

Information-motivated trading activity occurs when the traders believe that based on some recently acquired information about the underlying company; they need to trade immediately and in large quantities. This type of trading typically causes volatile price movements, or volatility, as the demands for high liquidity on short notice may overwhelm the ready supply or demand of a security in the market.

Liquidity-motivated traders are motivated to trade based on reasons other than information or current price. Liquidity-motivated trading activity is typically used to release cash proceeds to facilitate the purchase of another security, adjust market exposure, or fund various cash needs. Liquidity-

² John L. Maginn and Donald L. Tuttle, *Managing Investment Portfolios: A Dynamic Process* (Virginia: The Association for Investment Management and Research, 1990), 12-37.

motivated trading activity typically happens urgently in small(er) batches and has little effect on the overall price of the underlying security.

Passive traders tend to focus on low cost trading strategies, even though they are liquidity-motivated in their portfolio rebalancing operations. Passive trading activity tends to favor the use of limit orders, third and fourth market orders and crossing networks in order to create advantages such as certainty of price, low commissions, low market impact, and the possible elimination of the inside spread. These orders and markets are best suited to low-information trading in which rebalancing needs are either not large or not heavily concentrated in high-returns-correlated market sectors, meaning Passive Traders tend to stick to markets or sectors that are generally lower risk and lower return in order to achieve steady portfolio growth and income.

Different types of investment strategies exist because every single investor and manager has a different investment objective, philosophy, and risk tolerance. Without a wide range of investment strategies, the markets would start to see the majority of investors and managers flock to one, or a handful of, industries and sectors, which would, in turn, cause a large liquidity gap among the financial industry as a whole.

Diversification

A common phrase used among the investment community is “Don’t put all of your eggs in one basket,” one that simply explains the term ‘Asset Allocation’ or ‘Diversification.’ Harry Markowitz, a 1990 Nobel Memorial Prize winning economist who developed Modern Portfolio Theory in the early 1950’s, is long credited for emphasizing what is commonly known as ‘Asset Allocation.’ He emphasized the importance of portfolios, risk, and the correlations between securities and diversification using a mathematical process. Asset allocation is an investment strategy that aims to balance risk and reward by allotting a portfolio’s assets according to an individual’s goals, risk tolerance and investment horizon. The consensus among financial professionals is that the selection of individual securities is secondary to

the way you allocate your investments in stocks, bonds, cash and cash equivalents. The rationale behind modern portfolio theory is to obtain the best possible expected return given the level of risk assumed. In order to achieve this goal, modern portfolio theory focuses on combining assets whose expected returns are not highly correlated to one another. That is to say market influences cause differing investments to behave differently.

Modern Portfolio Theory

The general principal of investing states that the higher the risk, the higher the return and to the contrary, the lower the risk, the lower the return. However, according to Markowitz and Modern Portfolio Theory, an investor could use a higher risk investment to achieve a lower risk for a portfolio, provided the investments react differently to market stimuli. For each level of risk, Modern Portfolio Theory concludes that there is an “optimal” asset allocation that is designed to produce the “best” balance of risk versus return. In other words, by implementing diversification, an investor can produce better potential returns, while at the same time reducing risk. Individual securities make up baskets of securities. Baskets of securities make up investor’s portfolios. Still, one must evaluate a security to choose or a basket of securities to choose in a portfolio.

Value Investing

Value investing has become another metric when it comes to finding the best opportunities in the market at a given time. Value investing is an approach widely used today by individual investors and portfolio managers, and was originally coined by Benjamin Graham some 60 years ago. Value investing focuses on the concept of an intrinsic value that is justified by a firm’s assets, earnings, dividends, and financial strength. There are many different criteria for finding value stocks, some of which include: Positive earnings for at least five years, a strong dividend history over the past twenty years, strong earnings per share growth over the past ten years, a moderate price-to-earnings ratio in that the P/E ratio should be no more than 15 times average earnings for the past three years, and a moderate price-

to-book-value ratio in that the current price should not be more than 1 ½ times the last reported book value. Benjamin Graham felt that it would be difficult for investors to beat the market, or in other words, find stocks that do much better than the overall long-term market average. Furthermore, stocks that will do better than average over the long term are those with a greater growth potential, but the challenge lies in finding those stocks ahead of time.

According to *Benjamin Graham on Value Investing: Lessons from the Dean of Wall Street* by Janet Lowe, finding securities that seem “undervalued” lies in what Benjamin Graham calls the “margin of safety,” or the discount of the market price to the intrinsic value of the security. The intrinsic value is the discounted value of all future distributions, however, the future distributions and the appropriate discount rate can only be assumptions, which leads to the difficulty in finding undervalued securities.³ Furthermore, as Maria Crawford Scott wrote in her article *Value Investing: A Look at the Benjamin Graham Approach*, even stocks with obvious growth prospects do not necessarily translate into extra profits for an investor because many times those prospects are already incorporated into the price of the stock. Secondly, there is risk that the investor will be wrong in their evaluation of the firm’s growth prospects. Over the long term, most investors can only expect an average return, but that does not discount the added risk of underperformance due to misjudgment.⁴ Just as it is important for investors to try and locate undervalued securities, it is equally important to be disciplined on the sell side of investing as well. According to Graham, stock holdings should be reviewed *at least* annually, ignoring share price fluctuations and instead focusing on the returns and the operating results of the company.

Aside from deciding on the proper asset allocation and investment objective, developing a strategy for helping investors find undervalued securities relative to their industry and their peers is critical during the investment selection process. Some valuation metrics commonly used include Market

³ Janet Lowe, *Benjamin Graham on Value Investing: Lessons from the Dean of Wall Street*, (Penguin Group USA, 1994)

⁴ Maria Crawford Scott, *Value Investing: A Look at the Benjamin Graham Approach*, Pages 1-4

Cap, Price/Earnings ratio, Price/Book ratio, Price/Cash Flow ratio, Return on Equity (ROE), Debt/Equity ratio and Dividend Yield. Market cap is the total dollar market value of all of a company's outstanding shares. Price-to-Earnings is a ratio used for valuing a company and is calculated by measuring its current share price relative to its per-share earnings, or Earning per Share (EPS). Price-to-Book is a ratio used to compare a stock's market value to its book value.

Here are some metrics to evaluate individual securities. Typically, companies with a Price-to-Book in the lower single digits can tell an investor that the stock is selling at a discount, but can also warn investors of a company that could have financial issues. Price-to-Cash-Flow is a ratio of a stock's price to its cash flow per share. Price-to-Cash-Flow is not as commonly used as other metrics, such as Price-to-Book, but can be useful when determining whether or not a stock is of any value. Return on Equity, or ROE, measures the rate of return for shareholder's equity of common stock. Debt-to-Equity is a ratio used to measure a company's financial leverage, or debt, and is used to evaluate a company's level of financial risk. Dividend Yield indicates how much a company pays out in dividends each year relative to its share price. It is important for investors to evaluate all, or as many of, these valuation metrics as possible when determining whether a stock is of value or not. No single valuation metric tells an investor the whole story, but just as Benjamin Graham and now Warren Buffett have done throughout the past half century or more, by evaluating them relative to the industry and competitors, investors can get a better idea of which stocks are of better value.

Rebalancing

Rebalancing is a critical step in the management of investment portfolios, but rebalancing does come at a cost. According to *Managing Investment Portfolios: A Dynamic Process* by Maginn and Tuttle, Rebalancing portfolios involves one of two costs: the cost of trading versus the cost of not trading. The costs of rebalancing a portfolio include commissions, the impact that a trade of large size may have on

the market, and the cost of desirable trades that never occur. Furthermore, the costs of not rebalancing may mean holding onto an asset that may have become overpriced, limiting future rewards.

Not rebalancing a portfolio may include holding onto an asset, or assets that no longer fit the needs of the client. This can result in a diversified portfolio that becomes riskier than it needs to be or more conservative than desired. The core of rebalancing, or portfolio management, lies in weighing and balancing these countervailing costs.⁵ Rebalancing too frequently incurs unnecessary trading costs, however, rebalancing too infrequently presents the possibility for investors to lose out on potential gains or suffer outsized losses. Investors may also lose out on buying opportunities that have presented themselves in the marketplace.

How frequently an investor rebalances their portfolio, which is ultimately up to the portfolio manager, depends on the investor's risk tolerance, investment objectives, investment goals and cost sensitivity. The portfolio construction in part determines the need for rebalancing. If an investor's portfolio holds a majority in a portfolio of investments like an ETF or a mutual fund portfolio management in part happens within this basket of securities. It is not as necessary for the investor or portfolio manager to frequently rebalance the portfolio, albeit evaluating the portfolio for sudden market stimuli could change the asset allocation dramatically. Sudden events can cause an evaluation of rebalancing at the event time. Rebalancing does not become an eliminated exercise considering the market and the volatility of a portfolio's components.

Portfolios which hold higher risk, more volatile securities or security baskets may need for the investor or portfolio manager to more frequently evaluate and rebalance the portfolio. Investors should evaluate the portfolio as earning events of a single security may only affect that security or industry. The recent oil surplus or historical Arab oil embargo of the 1970's would be event driven for both single securities and baskets of securities in the oil sector. Therefore, by not actively evaluating and

⁵ Maginn and Tuttle, *Managing Investment Portfolios: A Dynamic Process*, (13-2).

rebalancing a portfolio when necessary, an investor runs the risk of missing out on market opportunities or potentially suffering excess market losses.

To illustrate the importance of rebalancing we will use a hypothetical 60% stock and 40% bond portfolio. We will also assume stocks suffer a market loss of 20% and bonds gain 10% during a market event. A portfolio that is 60% stocks in this example would grow to 70% stocks. If the stock market were to drop 20%, a 14% drop in the portfolio would result rather than a 12% market drop. Conversely, if bonds rise 10% during this stock market drop that a 3% rise in bonds rather than a 4% rise would be realized. The portfolio for this event suffers 3% more by not rebalancing the portfolio. Rebalancing the portfolio does not guarantee market outperformance or missing market losses. Rebalancing is designed to continue to keep portfolios generally aligned with client goals and objectives for both risk and return.

Risk/Return Interrelation

There is a common misconception among investors that a portfolio is poorly constructed if it does not outperform the S&P 500. The S&P 500 is an index made up of 500 United States corporations with the largest market caps, and is weighted accordingly. Typically, asset allocation is more concerned with not only the types of securities in the portfolio (equity versus fixed income), but is also concerned with the weights placed on individual sectors or industries within the market. In order for an investor to truly compete with the S&P 500, they would have to weight their portfolio according to the S&P 500 or 100% stocks in equal measure to the index. For example, if Apple is currently the largest company in the S&P and its market cap made up 7% of the S&P 500, an investor would have to hold at least 7% of their portfolio in Apple, which is called market cap weighted portfolio, just as the S&P 500 is called a market cap weighted index. A 100% stock portfolio is considered a high risk portfolio. Within the index, individual securities still make up the underlying components of the index.

Many investors do not desire index performance of their portfolios considering both risk and return. Investors may need dividends from stocks or income from bonds to meet spending needs. If

spending needs are not met, an investor may need to sell a portion of the portfolio during a market correction or loss of value in the market. The same is true for a portfolio of only bonds. Investors also may not desire to suffer the market losses associated with the stock market index where 5%, 10% or even 20% losses are not that uncommon. These market loss events can be measured in days, weeks or even years. Having a diversified portfolio could allow an investor cash flow from the portfolio to spend or potentially dampen market losses and the effect on a client's goals and objectives. Making as much money as possible is not a goal and objective. It is a statement which also implies unlimited risk and the potential for total loss.

Portfolio Optimization

An optimization software is a tool widely used by portfolio managers and is used to measure the level of risk and return a portfolio's asset allocation has over a certain period of time. Rather than assuming that the portfolio's asset allocation is properly reducing the portfolio's risk, a portfolio manager uses the optimization software to tell the investor and portfolio manager how much risk has been reduced, and how much potential return has been gained. The process of portfolio optimization begins once the asset allocation process has been defined in order to fine-tune a portfolio against other measures of risk and return. Optimization can be tailored to a client's lifestyle, needs, and risk tolerance that can make portfolio managers valuable to a specific client.

Conclusion

Every investor has a different goal and objective when it comes to investing. Investors may have portfolios each with differing objectives combined into a total client objective. Portfolio managers need to assess these goals and objectives in order to design and implement a client strategy. Portfolio construction starts with determining the investing style of each individual investor, and then constructing the best possible portfolio based on asset allocation, risk tolerance, time horizon, goals and objectives. However, past performance does not guarantee future success. No matter what kind of

investment vehicle an individual chooses, there will always be some level of risk associated with investing. By using different methods created by some of the by successful investors, such as Benjamin Graham and value investing, Markowitz and Sharpe modern portfolio theory, and portfolio optimization, and rebalancing investors present themselves with an opportunity to succeed in a market. No one step of the process is more important than the other. Each step or portfolio construction should be crafted and tailored to the client's needs. The portfolio as a whole should focus on the certain level of performance desired and risk undertaken.

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Investment in securities do not offer a fix rate of return. Principal, yield and/or share price will fluctuate with changes in market conditions and, when sold or redeemed, you may receive more or less than originally invested. No system or financial planning strategy can guarantee future results. Therefore, no current or prospective client should assume that future performance or any specific investment, investment strategy or product will be profitable.

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