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August 2017

What's a Portfolio?

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Merriam Webster defines a portfolio as "the securities held by an investor". That, in fact, is how most investors think about their portfolios: the collection of securities that they own. But at PMA we think of a portfolio as an intentionally constructed collection of securities designed to behave within risk and return constraints that meet the investor's goals. While that might seem to be a small distinction, it is actually based on a very robust set of ideas about how and why to construct such a portfolio.

In the first case, the portfolio results from individual investments in stocks, bonds and maybe mutual funds or ETFs. Presumably, the investor chooses these particular investments because he finds them compelling. He might even have some overall criteria for security selection that guides his choices, but those choices are largely centered around "how good" a particular investment seems to be. The investor has the added comfort that if one of those investments doesn't work out – fails to deliver the expected return or even loses its principal value – the other investments that he owns might balance out the loss with gains. He might even tell himself that his portfolio is "diversified" because he owns more than one security.

The essential difference in these two approaches is that in the first case, the portfolio is what the investor ends up with after selecting securities that appeal to him. In PMA's thinking, by contrast, securities are selected based on the role they will play in the portfolio. In the first, the individual investments are the primary focus. In the second, the behavior of the entire portfolio, not the individual securities, is what matters. Let's explore some of the big ideas behind this seemingly small distinction.

Diversification is basically the idea that you shouldn't put all of your eggs in one basket. It informs portfolio construction on several levels. At the security level, diversification suggests that you own more than one security of each type that you want to include in your portfolio. If you only own Google and Google under-performs, you're stuck. If you own Google and Apple and Amazon, maybe all three won't tank at the same time.

At the portfolio level, diversification suggests that you not invest all of your money in one asset class. You may like large-cap value stocks very much, but in a market where large-caps do poorly and small-caps do well, you will want to own some of each. In fact, you will want to own at least a small piece in each of the style and size segments available in the equity market in order to be well positioned as the market moves from favoring one sector over the other. Otherwise, you will inevitably miss the majority of these market moves since market timing – moving in and out of market segments to benefit from gains and to avoid losses – is the investment equivalent of the philosopher's stone in alchemy: thrilling to contemplate, but impossible to achieve.

Having decided that a diversified portfolio is the way to go, we still have some issues to consider if we are concerned with risk and return. The first issue is how to weight your investments within your portfolio. For the sake of argument, let's say that you've decided to divide the domestic equity in your portfolio into four size/style segments: Large Value, Large Growth, Small Value and Small Growth. This makes sense, since size and style have been shown to be important determinates of risk and return. Generally, larger capitalization and value oriented companies are less risky and offer steadier returns, whereas smaller capitalization and growth oriented companies are riskier and offer larger but less consistent returns. If you are concerned about risk and return, should you weight each segment equally, at market weight, or according to some other scheme?

If you want market risk, then choose market weighting. If you choose equal weighting, you will greatly increase overall risk (since the market is weighted much more to less risky large companies than to riskier small ones). If you have a way of assessing the risk and return of each segment, then you can create a weighting that optimizes the mix to provide the maximum return for less than market risk.

This kind of risk return analysis applies to all of the asset classes of your portfolio – domestic equity, international equity and fixed income. Another important concept – correlation of asset class returns – also comes into play. Assessing correlation is important in assessing diversification. If asset classes are highly correlated, meaning they often move together, the degree of diversification they offer is less than if they were less correlated. If a less risky asset class is correlated with a highly risky asset class, it might make more sense to overweight the less risky asset and underweight the riskier asset class.

Intentionally constructed portfolios also have implications about how to think about investment income. In a portfolio that results from security selection, you might have a situation where different securities were purchased with different goals in mind: equities may have been selected for long term appreciation, whereas fixed income securities may have been purchased to generate current income.

Intentionally constructed portfolios act as a whole, however, with the goal of optimizing return and limiting risk. In this context, we think of the return of the portfolio as a total return made up of both security appreciation and current income. Rather than thinking “I’ll have $xx in bonds for income and $xx in stocks for appreciation”, total return thinking flows from the risk return analysis outlined above and focuses on overall portfolio risk and return. The equity/fixed income allocation is not the result of calculating desired income and appreciation; the allocation results from designing a portfolio with a particular risk/return profile. Spending, in turn, is not determined by current income but rather by setting a spending rate that is sustainable in the context of the expected return.

These small differences in thinking about portfolios can have a very big impact on investor success as portfolio asset allocation has been shown to be the single most important decision of the many that an investor must make.

At PMA, portfolio construction is at the core of what we do.