

# It's All About Process

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Over the last few years, investors have experienced among the most challenging equity markets in decades. The confluence of economic and geopolitical events has reminded us of the risks of investing in the financial markets, the risks that seem to have been dormant during the bull market of the late nineties. For many investors, this shift in market sentiment has given cause for concern and bewilderment. It's during such confusing times that gaining some perspective may be helpful. This perspective should consider the cause and effect of portfolio performance. It should focus us on those actions that we can control so that we can best position our portfolios to take advantage of market rises and weather the market declines. In short, it's timely that we revisit the investment process that is at the heart of many institutional and pension portfolios and ensure that we adopt those best practices for individual portfolios.

## Why an Investment Process?

Having a well thought out and defined investment process is critical to investment success. A good investment process is a long-term commitment that positions you to benefit over time. The stock market often seems like a casino where, to the average player, the odds of success are random. However, the casino owner understands that the long-term odds are predictable. Clearly, you want to take the position of the casino and not the player. Casinos make profits by being right fractionally more often than they are wrong. They have figured out the math so that the odds are stacked in their favour. They give away millions of dollars everyday and some weekends, lose more than they win. However, over the long term, the casino comes out ahead of the player.

Institutional investors, like the casinos, have figured out the math in order to benefit from long-term odds. They focus on factors that they can control and try to avoid making any bets on factors that they cannot control. They evaluate the long-term risks, potential returns and the correlation between investments. These factors underlie their blueprint for creating an optimal portfolio. The blueprint establishes carefully determined targets that guide investment decisions through up and down markets. As the markets move around the targets, the portfolio is rebalanced by taking profits on positions that have appreciated and reinvesting in positions that have depreciated (i.e. selling high and buying low). Market volatility is more manageable and can be beneficial when you have a disciplined process to follow.

## Pitfalls of Not Having a Process

*Making Unintended Bets* – Performance is determined by what we invest in, as much as how we invest. It is possible to have a poorly structured portfolio with strong stocks in it. Without a clear plan, your portfolio may contain numerous unintended bets that cause underperformance. Portfolio bets can be found at the asset class, geographical, market capitalization and investment style levels. When the bets go wrong, they can overwhelm stock or bond selection, and years of gains can be jeopardized. For example, Between 1984 and 2000, during the greatest bull market of the century, the average individual investor earned less than 1/3 of the return of the stock market!<sup>i</sup> During the bull market few of us noticed the underperformance. However, in a bear market underperformance rarely goes undetected. Like a house that has not been well designed, the best construction materials may not prevent it from falling apart. Unfortunately the poor design tends to become evident in times of storm or earthquake, and poorly designed portfolios only become evident when markets decline.

## The Pinnacle Program™



*Timing the Market* – Warren Buffet, one of the most revered investors of our time, is renowned for his planning and patience. Forecasting short-term market movements is surprisingly difficult. Lasting market trends do not typically develop overnight. Furthermore, event-driven “noise” often disguises these long-term trends. Current events like war, disease, terrorism and scandal drive short-term movements of stock and bond markets, and have little to do with market fundamentals. Institutional investors do not try to time the market. Years of modest gains can be wiped out with a single bad guess. They understand that the odds of consistently guessing correctly are poor. They rely on long-term planning to deliver performance. Evidence shows that instead of beating the market, most individual investors underperform the market by buying and selling at the wrong time.

## The Well Tempered Investment Process

Fundamentally, a well-tailored investment process balances the objectives of the investor with the level of risk with which the investor is comfortable. In striking this balance, we focus on those portfolio factors that we can control.

*Identify Risk Tolerance* – Assessing one’s risk level is a blend of art and science. While we can quantify risk in terms of how much loss one can tolerate, there is a psychological element that is more unpredictable. A dialogue with your advisor may be very helpful in helping you determine how much risk you are comfortable in assuming, given your stated objectives.

*Managing Portfolio Bets* – Your portfolio is really a composite of asset class, geographic, capitalization, and style bets. The impact of these aggregate bets often determines more of a portfolio’s performance than the stocks and bonds held within. Unsuccessful and unintended bets are among the primary reasons why investors underperform. A sound investment process provides a framework to identify and manage portfolio bets.

## The Quest for Predictable Returns

Every portfolio’s return will vary with the markets, but unpredictable swings in performance are a sign of unmanaged bets. Let’s compare two portfolios that we have back tested over rolling 3-year periods from December 1999 to March 2003. Portfolio A is an RRSP that is constructed with three leading mutual funds, representing 60% stocks and 40% bonds, and 30% foreign content. No attempts have been made to manage the portfolio bets. Portfolio B has the identical structure, but has no unintended bets on characteristics like capitalization, geography or style<sup>ii</sup>.

The result shows how frequently each portfolio would have beat the market benchmark and by how much, demonstrating the impact of managing bets. Portfolio A is inconsistent. In some 3-year periods it beats the benchmark by as much as 34% and in others, it underperforms the benchmark by -22%. Portfolio B is much more consistent with positive returns throughout the rolling 3-year periods. Interestingly, Portfolio B outperforms Portfolio A over the test period, with much less volatility.

Portfolio B is an example of an optimized portfolio, one that deliberately manages portfolio bets. It was built to maximize return and minimize volatility. The result is a much more consistent performance. The investment process disregards which manager, market, stock or investment style is in favour and focuses on long-term trends. It makes no attempt to time the market.

## The Pinnacle Program™



As the markets move, the portfolio is rebalanced to its target. Rebalancing reduces exposure in the market sector or style that outperformed and reinvesting in the market sector or style that underperformed (enforcing the sell high and buy low discipline).

Developing a sound investment process is best achieved working with an advisor. Institutional investors work with consultants, but advisors have access to the same portfolio tools that consultants use and can help you assess your long-term goals and targets. More importantly your advisor acts as your coach, steering you away from decisions that may detract from performance and helping you to stick to the investment process when current events drive the markets up and down.

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<sup>i</sup> Study compares median performance of U.S. large-cap equity portion of U.S. pension plans to median performance of U.S. equity mutual fund investor. Period is 1984 – 2000, gross of fees. Source Dalbar, Bogle Financial Center and Callan Associates.

<sup>ii</sup> Represents the performance of an optimized portfolio in the ScotiaMcLeod's Pinnacle Program (PML 123). The portfolio is constructed to the same 30% Canadian equity, 30% foreign equity, and 40% fixed income allocation as Portfolio A, and is benchmarked against the same benchmark. The fees were equalized with Portfolio A so that the comparison is meaningful. There are 14 managers in Portfolio B. The performance of this portfolio was also back tested using the same period as Portfolio A. It does not represent an actual historical portfolio.

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