

Bringing strict discipline to your portfolio



By Dan Richards

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Setting out a strict way of managing your asset allocation – and sticking to it no matter what – is a way to follow in Warren Buffett's footsteps.

One of life's great puzzles is why so few investors can point to a track record of consistent success. It can't be lack of information and certainly not insufficient interest or motivation – so what then is at the root of this investing mystery?

The answer lies in our emotional reactions to market movements, creating an impulse to buy and sell at exactly the wrong times. One of the storied investors of the modern era was Peter Lynch of Fidelity, who turned in a phenomenal annual return of 29 per cent from 1977 to 1990. Mr. Lynch has said that he never ceased to be puzzled by the extent to which the investors who owned his funds had dramatically lower returns than the funds themselves.

The reason for this, quite simply, is the typical investor's inability to stomach the market's ups and downs. This led to the remarkable feat of

investors consistently buying as Mr. Lynch's fund was nearing its peak and selling as it was bottoming out from one of its periodic dips. In the words of Walt Kelly's 1950's cartoon character Pogo: "We have met the enemy and he is us."

Warren Buffett is the consensus pick as the greatest long investor of our time. Mr. Buffett has been quoted that his big advantage doesn't stem from superior intellect or better information, but rather the discipline to dispassionately stick to his investment principles, no matter how difficult that might be. In his career, Mr. Buffett has sat on cash for extended periods and famously took a pass on tech stocks, looking foolish as markets rose and rivals prospered. He then moved in and bought at what turned out to be market bottoms, at times when we were surrounded by pervasive gloom.

In a column in The New York Times last October in which he announced that he was switching from U.S. government bonds to stocks for his personal account, Mr. Buffett summarized his investment philosophy: "Be fearful when others are greedy and be greedy when others are fearful."

Mr. Buffett's emotionless approach to investing is next to impossible for the average investor to replicate. Quite simply, we're hostage to the twin emotions of fear and greed arising from the gyrations of our portfolio, compounded by newspaper headlines and cable TV oracles. Look no further than the investors bailing out as markets plumbed new lows earlier this year – only to be asking now whether it's too late to get in and if today is the time to buy.

The good news is that our innate discipline doesn't have to be up to Mr. Buffett's standards for us to succeed as investors. Rather, we can

artificially inject discipline into our portfolios by borrowing two simple tools from successful pension plans.

The first of these tools is a detailed Investment Policy Statement (IPS). This IPS factors in the return required to hit our long-term goals and our tolerance for risk to identify a target allocation between stocks, bonds and cash.

Let's suppose we need a return of 7 per cent over the next 20 years to meet our retirement objectives. To achieve that, the IPS might stipulate a target allocation of 60 per cent equities, 30 per cent bonds and 10 per cent cash, assuming returns over that period of 9 per cent on stocks, 5 per cent on bonds and 2 per cent on cash, in line with historical experience. (The 9 per cent on stocks is actually below the long-term trend.) The IPS could also set a range around that target allocation – so depending on how you and your adviser feel about valuation and risk levels, at any given time stocks might represent 50 to 70 per cent, bonds 20 to 40 per cent, and cash 5 to 15 per cent.

By creating a range for each asset class, you impose a level of discipline that most investors would be unable to achieve on their own. In this example, no matter how optimistic you might be, your stock component would never be higher than 70 per cent, and, no matter how fearful, it would never fall below 50 per cent.

Once you've set your target allocation, the next step is to stick to it – and the way you do this is by automatically rebalancing your asset mix once or twice a year.

At every given point in time, some asset classes always do better than others – in cases like last year, dramatically so. As a result, your asset mix gets out of kilter and needs to be readjusted.

Let's say stocks were 60 per cent of your portfolio on July 1 of last year. Because of the

extraordinary events of the last half of 2008, in which stocks plummeted while government bonds gained value, by Dec. 31 your stock weighting would typically have fallen to well under 40 per cent.

At that point most investors' fear impulse kicked in – while they might have been prepared to hang in with their existing holdings, they could never have brought themselves to reduce the bond and cash positions that had done so well and heavy up their stock weighting. And yet that's exactly what investors committed to automatic rebalancing would have done. Because their stock weighting was below the minimum threshold of 50 per cent that they had set, they had no choice but to go against every impulse and lighten up on the winning asset classes in their portfolio, in this instance bonds and cash, and buy more of the loser, stocks.

Note that there are still lots of decisions to make on how to allocate your holdings – you have to decide on how to divide stocks among sectors and bonds between government, investment-grade corporate and high-yield issues. In large measure, this will be based on how aggressive or defensive you want to be. But using this approach, you've made the first big decision on allocation across asset classes.

It's too early to know whether investors who did that on Jan. 1 will be rewarded in the near term. But we do know a policy of consistently buying those asset classes that are beaten down and selling those that have had the winds at their back has paid dividends over time. We're unlikely to ever achieve Mr. Buffett's fame, but by rigorously setting asset-mix ranges and using regular rebalancing to stay within those ranges, we can bring some of his discipline to bear on our portfolio.

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