

The Benefits Of a Disciplined Investment Process

If the markets have taught us anything over the past few years, it's that, regardless of which direction the markets take in the weeks and months ahead, maintaining a disciplined investment process will continue to be a key driver in achieving long-term investment success.

As we have pointed out in the past, a disciplined investment process begins by gaining a thorough understanding of your risk and return objectives to arrive at the appropriate investment mix for your portfolio, and it continues through ongoing reviews and regular rebalancing to ensure that your portfolio is on track for helping you achieve your long-term goals. And yet, for many investors, these time tested strategies are too often forgotten when the markets charge ahead, as they have in recent months.

As John Steffens, former Vice Chairman and member of the Board of Directors of Merrill Lynch & Co. in the US, recently pointed out:

"The most expensive words in the English language are 'It's different this time'. Speculative stock market booms can't change the basic laws of business, like profits do matter for companies... but fantasy can take over, for a time."

One only need to look back to 1999, as an example. After one of the greatest bull markets in history, a number of investors experienced a significant run-up in the equity portion of their portfolios (in 1999, US equity markets had an all-time high 5 year return of 26.3%), only to be blindsided when the technology boom came to a crashing halt.

In many cases, those investors who suffered the greatest losses had failed to build an adequately diversified portfolio from the start. They did not have exposure to each of the major asset classes - cash, fixed income and equities - nor did they have exposure to different countries and investment management styles. And yet, studies have consistently shown that asset allocation can account for more than 90% of a portfolio's overall volatility.

Just as troublesome, however, were those investors who started off with an appropriately diversified portfolio, based on their initial risk and return objectives, but subsequently allowed their stated allocation to drift off course with the movement of the markets. And who could blame them? The concept of rebalancing can seem counterintuitive to even the most experienced of investors. Why, after all, would anyone want to sell those investments that have performed well to buy more of those investments that have performed less well?

The answer to this question is twofold. First and foremost, rebalancing brings discipline to your portfolio by ensuring that it stays in line with your stated risk and return objectives. Consider, for example, the following findings from Seth J. Masters of AllianceBernstein. From January 1997 to February 2000, US growth stocks, as measured by the Russell 1000 Growth Index, returned a stunning 140.9%, only to experience a subsequent 43.6% decline from March 2000 through October 2001.

To illustrate the impact of rebalancing, let's use a portfolio that starts with an initial allocation of 25% US growth stocks, 25% US value stocks, 20% international stocks and 30% bonds. Without rebalancing, this portfolio would have experienced a large deviation from its target allocation, driving growth stocks 13% over target, and bonds down to just 20%, or two-thirds of their stated target. When the markets finally declined, this portfolio would have fallen 16%, while a portfolio that had rebalanced to its target allocation would have fallen a more modest 12%. Why? Because the rebalanced portfolio was better able to manage the risk.

In addition to the disciplined risk management that rebalancing brings to your portfolio, there is also the benefit of reduced tracking error. Tracking error is a measure of the volatility of a portfolio's returns relative to its benchmark. If tracking error is high, your portfolio may outperform its benchmark for the additional risk that you have taken on by straying from your target allocation or benchmark, but, if the markets turn against you, it can also significantly underperform.

Consider, for example, a portfolio that has a target international equity weighting of 20%. Now assume that international equity markets perform poorly, causing the weighting to drop to 10%. An investor who rebalances their portfolio to the original 20% weighting will be well positioned to benefit from a subsequent rebound in international equities, while an investor who fails to rebalance will not. If, for example, international equities rebounded by just 15%, the investor who failed to rebalance will have underperformed their benchmark by as much as 1.5%, while the investor who rebalanced would have fared better.

The bottom line - It's all about a disciplined investment process.