

BWMG RESEARCH COMMENTARY - Portfolio Construction Strategy

There have been numerous studies over the years examining the key components of returns in an investment portfolio. While stock selection is obviously very important, asset allocation is the most fundamental of investment decisions. Studies have concluded that asset allocation decision accounts for over 90% of the variation in returns over time. We would like to take this a step further and discuss three important strategic decisions that need to be made beyond the initial asset allocation selection. These are: specialty asset class managers versus balanced managers, Global Equity managers versus separate US and International managers, and a passive versus active management of bonds.

Specialist Managers or Balanced?

Hiring a balanced manager can be compared to paying the mechanic to not only work on your car, but also to repair the leaky faucet, reshingle the roof and fix your computer. While some might be able to handle all these tasks, you might prefer to hire a person that has special skills in each area. Portfolio construction can be viewed in the same way. If a portfolio is large enough, specialist managers are a logical choice. This is not to say that solid Balanced managers do not exist, but the reality is that most managers have their strengths and their weaknesses. A Balanced manager may have excellent returns in the Canadian bond and equity markets and respectable returns outside of Canada but the goal is to seek out the best managers in every asset class and utilize their strengths. We analyzed the returns of some of the top performing Canadian Equity managers (that also manage Global Equity) over various time frames. Of the top 10 performing Canadian Equity managers over the last 7 years, only 2 have generated first quartile Global Equity returns. Furthermore, most of the top Global Equity managers (which are typically found outside of Canada) do not offer Canadian Equity mandates. Another benefit of employing a specialist approach is a reduction in fees that results from paying less for the bond component.

Global Equity or US/International Equity?

Having already decided to invest outside of Canada, the next decision is how to invest globally. The Global Equity market consists of 55% US and 45% EAFE (Europe, Australia, Far East) Equities. So one needs to decide whether to constrain weightings in these asset classes or to allow the manager discretion on deciding where the money is best employed. Leave the decision to “over/under weighting” the US market to the investment manager. Simple logic dictates that a broader

range of investment options will allow a manager to more readily demonstrate their skill as this approach gives the manager the freedom to select the best companies in the world without restraint. Each of these markets has struggled in absolute terms over the past 5 years but the relative numbers demonstrate the benefit of using Global Equity mandates. The median Global Equity manager over this time period has outperformed the Global index by 3.8% annually while the median US and International mandate have outperformed by only 1.3% and 0.8% respectively. Furthermore, globalization has blurred the distinction between what constitutes a US or International company as both are likely to generate significant revenues from outside their home country. Is Nestle really a Swiss company when less than 2% of their sales are from Switzerland while 30% are from North America? They have factories in 83 countries around the world (with less than 40% in Europe). If a manager selects this company we want them to do so not because of where head office is located but because they view it as the best investment at that time. Furthermore, a manager that wants to fully diversify a US (or International) Equity mandate by holding 30-50 names may be forced to invest in US (or International) companies that would not otherwise be included in a Global portfolio.



Fixed Income (Active versus Passive)?

A quick look at the Canadian bond universe and the returns associated with it show a limited amount of “value add” for managers running a conventional bond portfolio. Over the 10 year period to June 2005 the median manager returned only 4 basis points (4/100^{ths} of 1 percent) ahead of the index. Historically, indexing bonds has generated roughly the same return as the median active manager and for a much lower fee. An alternative method of passive management is the implementation of a laddered bond portfolio. This is created by purchasing a series of bonds with stepped annual maturities and simply holding the bonds to maturity. As bonds expire on the short end, new bonds are purchased at the long end. This approach helps smooth out the effects of interest rate fluctuations because bonds are being replaced annually at current rates. When it comes to higher-yielding products active management becomes more beneficial. High yield bonds (typically those rated lower than BBB) offer a higher interest rate and improved diversification due to their low correlation with other sectors of the fixed income market.