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Traditional Risk Management—Not New Products—Will Save Client Portfolios

By Barry Mendelson, CIMA
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Market downturns inspire new products that promise to remedy whatever most recently ailed us. They rarely deliver. What will really save clients in the long run is a back-to-basics allocation among assets that don't correlate.

After the recent economic downturn and violent market performance, banks, trusts, wealth managers, RIAs, law firms, and other financial institutions are asking how to survive another three-sigma event and rebuild for the future. Everyone wants to immunize themselves from a recurrence of recent events and anticipate the changing competitive arena. This is smart business. So what are wealth managers talking about most?

They are reconsidering:

1. **Asset allocation strategies.** It was hard to explain the role of asset allocation (i.e., strategic models, [core/satellite](#), and [tactical overlay](#) approaches) when portfolio values were sharply declining.
2. **Products in use.** Advisors got burned because of [insufficient knowledge of the products](#) in client portfolios.
3. **Business cost structures and client fees.** There is a renewed sensitivity to costs.
4. **Investment program features.** Advisors are rethinking [performance reporting](#) and UMA vs. other implementation approaches

I raise a caution flag about what I see happening in asset allocation. Advisors need to hear a countervailing perspective to the "strategy de jour" activity now becoming more prevalent in the industry. Maybe I am old-fashioned (or just old!), have been through too many bear markets (since 1981, when the Dow was around 800), or am wary of the Wall Street product-push, but I am concerned that advisors may be sowing the seeds of future problems for themselves.

It happens with every crisis: new products are launched to solve the shortcomings that hurt the industry in the previous cycle. I see new products, tactics, and strategies being developed now—and sold to consumers—that promise diversification with which to immunize portfolios against three-sigma events. Remember: activity does not equal advice! One of the fundamentals of [Markowitz's MPT](#) is that three-sigma events are subject to a probability distribution. New products will not make those probabilities go away.

It all boils down to risk

Here is my main point: take our industry's granular obsession with short-term results, combine it with human nature, and it is all too easy to forget that the only way to achieve higher returns is by embedding more [risk](#) in a portfolio. I don't mean to call this nearsightedness greed, per se, but a kind of laziness and a failure to see the picture of the whole market over history. Investment theory is founded on decades of results—not just a few years. God forbid a client's portfolio fails to keep up with the Joneses for a year or two!

A simple example: if an investor's portfolio had 50% in dividend-paying blue-chip stocks and 50% in Treasury securities, the maximum annual 12-month decline in the past two years would have been 20%. If any cash had been in the portfolio, the relative results would have been even better. Through September, this portfolio would be even with a year ago.

This is a simple stock-and-bond portfolio—nothing fancy. The key is the allocation. Most investors would have been relieved with results like that. No alternatives necessary for immunization, just stocks and bonds that in fact have sustained only a modest correlation (see Figure 1, below). That is proven [diversification](#). We have found it is difficult for advisors to resist the competitive pressures to over-invest in equities and embed more risk in a client's portfolio in pursuit of returns today.

Keep it simple

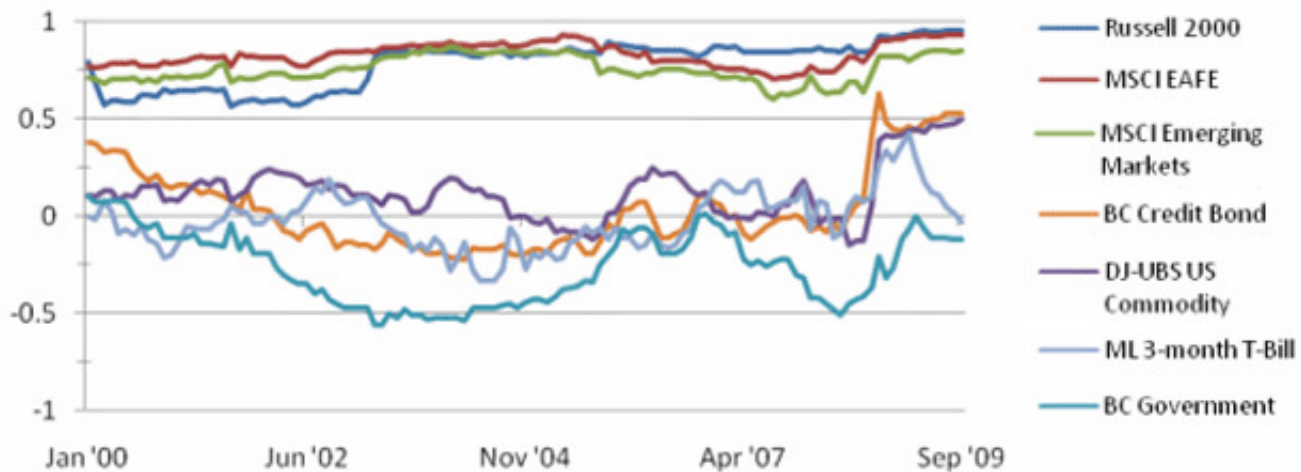
After what just happened, do you really want to create the potential for more difficulties when simplicity and "back to basics" has proven to be a sound solution? Virtually all the new products promising benefits come to the market with promise and no track record. Much is written to sell these products, but they are often sold on back-testing in a cool office laboratory, not in the heat of the battle of the marketplace, where the best-laid plans are crushed on the hard rocks of reality. I am not intransigent and I am willing to change my personal perspective on this notion, but only after I have observed these new strategies over a few market cycles.

The proliferation of new and unseasoned alternative products, as well as new tactical approaches (which are really a form of market timing), concerns us. Our caution is about veering off into uncharted territory and making too radical a change in portfolio management approach. This could only expose you and your clients to a new set of risks.

Watching correlations

As we know, the cross-sectional correlations of most asset classes converged toward 1.0 over the past few years. But just how valid is the assumption that asset-class correlations we have seen of late are going to approximate 1.0 in the future? Not likely, we think.

Correlation with S&P 500



Source: CMC Research

If you rely on near-term inter-asset-class correlations in your optimizer (e.g., three-year rolling period), they will likely continue to tighten as the impact of the market free fall drags values toward 1.0. This will begin fading from history in the next few years, and correlations will move toward more normalized levels, we believe.

Perhaps instead of making portfolios sexier with untried concepts hawked by Wall Street, you just might want to stick to the basics. Take client risk statements with a big grain of salt—there is no harm in taking less risk than the client claims he or she can tolerate as long as you are not sacrificing the person's goals. In the end, the best thing you can do is to pay homage at the altar of risk control, not pagan returns.

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