August 18, 2008

Spotlight

Managing Risk: Is Your Portfolio Truly Diversified?

There's more to diversification than just asset classes and the style box.

By now, most investors are well aware of the benefits of diversification in constructing a portfolio. In mixing different asset classes and investment styles—small-growth or large-value classifications, for example—investors seek to maximize their return while attempting to minimize risk. Unfortunately, for many the concept of diversification works better in theory than in practice. Once again, the onset of a bear market has flipped conventional wisdom on its head as traditionally defensive stalwarts such as value and large-cap stocks have suffered along with everything else, raising doubts about the case for diversification.

The problem, however, may belong more with the execution than the concept of diversification. Today, reducing risk—the potential for something to go wrong in the future—commonly equates to using backward-looking measures to limit volatility among styles and asset classes. This despite the fact that most investors would actually welcome upward volatility, the achievement of large gains, even as they hope to avoid the losses associated with downward volatility. Diversification based on the volatility of past returns misleads investors into thinking that they are accounting for current risk, when all that they are really doing is tracking where a portfolio or investment has been. A more useful way to look at risk is as the potential for unwelcome future outcomes. Viewed this way, diversification works best when it can account for as many uncertainties as possible. By acknowledging the potential for uncertainty, investors are more likely to consider factors influencing returns other than style or market-capitalization that may also be at risk.

Shop Risk

One seldom discussed facet of risk actually concerns the people that run the money—the asset manager itself. Owning multiple mutual funds or strategies from a single manager increases the element of danger for an investor because it's another form of putting too many eggs in one basket. Heavy dependence on a single asset manager may lead to a number of hazards—including research bias, size constraints, strategy similarities, or combinations of all three—that may not necessarily manifest themselves until the worst possible time.

A classic example of this was on display during the late 1990s when investors in a prominent retail fund family who thought they had built diversified portfolios using several different offerings from the firm received a rude awakening when the technology bubble burst in 2000. These investors belatedly discovered that these seemingly distinct funds not only shared a similar process for picking stocks, many were, in fact, heavily weighted toward the same sectors and even the same stocks. While an obvious case in hindsight, more subtle manifestations of shop risk can also undo the benefits of style box diversification if left unrecognized.

Large investment firms often centralize their research staffs to maximize efficiency for purposes of management and allocating resources. While likely contributing to a more disciplined, standardized process, such an approach can lead to homogenized, or even biased, research—one where analysts are encouraged to look at stocks through a common, narrow prism imposed from above. Making matters worse is that such centralized research likely supports a variety of strategies ranging from value to growth and small-caps to large-caps that often require unique perspectives not served by a central research mentality. Furthermore, few asset managers start out by offering a broad lineup of funds. Most get their start specializing in one area of the market or another, and expand into other areas only as the firm grows—possibly jeopardizing the integrity of the original strategy or philosophy when sliced into slightly different flavors or expanded into less applicable areas of the market.

In some cases, the sheer size of a firm may limit its research capabilities as well. Many investors recognize the influence of asset size within individual funds, but an enormous asset base can also have a negative impact across a centralized research platform. Stocks with insufficient trading volume may no longer be covered because of size limitations on growing funds, regardless of the investment merits. In addition, compensation schemes that reward security analysts more for ideas that get into the biggest funds serve as a disincentive for researching opportunities for lesser offerings—typically small- and mid-cap, as well as niche, funds. Finally, in an attempt to serve too many funds, a central research team may become experts in supporting none.

Strategy Risk

Even across different asset managers investors may be subject to the problem of strategy risk—the method by which a firm researches its investment ideas. A number of highly regarded mutual fund managers have faced a comeuppance the past 18 months as their overreliance on a 15-year tailwind in Financials and a relative-value oriented approach shocked them, and their shareholders, when the credit crisis struck. Conversely, a number of growth strategies have traditionally shunned energy or commodity stocks as "too cyclical" or "too macro", missing out on a tremendous opportunity the past five years. These biases transcend simple style box diversification, affecting performance beyond simple large- or small-cap and value or growth trends.

Still, strategy risk can go deeper than just the surface sector and industry weights of a fund. Deep-value, relative-value, growth-at-a-reasonable-price (GARP), and momentum are examples of common research philosophies for choosing stocks. Within those frameworks additional methodologies—quantitative models, dividend discount models, free-cash flow models—or valuation techniques such as the use of price/earnings, price/sales, price/earnings to growth (PEG), and return on equity (ROE) metrics all entail biases and assumptions susceptible to the vagaries of the market. In truth, strategies that work in some market and economic environments fail in others. Individual investors too focused on past returns often fail to recognize all of the drivers behind those results, thus increasing the risk of a portfolio full of similar strategies or methodologies declining in unison.

Indeed, investors need to recognize their own biases as well. Typically, people lock in on funds with strategies that they philosophically agree with—whether they are value-oriented or quantitative or index driven—across the market-cap and value-growth spectrum, thinking that style box diversification alone is adequate. Such a narrow approach, however, runs counter to the principles of diversification—mixing together investments expected to behave differently. Prudent investors could benefit by countering their own instincts and adding, for example, a momentum fund to a fundamentally-based lineup or quant offerings to a portfolio of more traditionally-researched funds—and vice versa.

Different is Good

Many call diversification the only free lunch in finance, but it's not automatic. With the advent of technology, the trend has been to use mathematics to quantify the management of risk and deliver pre-packaged structures for diversification. Unfortunately, this too often focuses the investor on the past instead of the future, where a careful examination may aid in identifying potential risks that lie in wait. In recent years, investors have gone beyond the traditional asset classes of stocks, bonds, and cash to invest in so-called alternative assets ranging from private-equity to timber. That's a step in the right direction, but further action is required within asset classes to provide a proper balance of low correlated investment approaches to reap the free benefits of this powerful tool. The result, when done properly, is lower volatility, but the process for achieving that goal over time is to develop as thorough a mix of styles, strategies, and management teams as possible.

Article written by:
Kerry O'Boyle is an Investment Strategist with Aston Asset Management. Prior to joining Aston he wrote on a variety of investment topics as a Mutual Fund Analyst for Morningstar, Inc. Kerry is a graduate of the U.S. Naval Academy, and holds an M.A. in Liberal Arts from St. John's College, Annapolis, MD.

For more information about Aston Asset Management LLC and its subadvisors, please call 800-597-9704, or visit www.astonasset.com