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Financial Advisory & Outlook

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What's salsa got to do with money?

I've spent a lot of time trying to understand the complex concepts of Modern Portfolio Theory and how to best utilize them to build and manage client portfolios.

Recently I read a book on asset allocation and portfolio management. The title of the book is "7TWELVE: A Diversified Investment Portfolio with a Plan" by Craig L. Israelsen. Dr. Israelsen is an Associate Professor at Brigham Young University in Provo, Utah.

Dr. Israelsen takes all this complex academic work and explains it using salsa.

Salsa is made with many different ingredients; tomatoes, onions, different kinds of peppers and other items that either add to or change the flavor. Portfolio construction is similar in that we use different ingredients (asset classes) to build a tasty salsa. Each time we make the salsa, the quality of the ingredients may change, but we still continue to use the ingredients even if they are of lesser quality.

We need all the ingredients to get the expected flavor in a hearty salsa.

A hearty portfolio begins with three ingredients; cash, stocks and bonds.

One of the ingredients is now coming into question – bonds. As interest rates begin to rise, the value of the bonds will diminish. Some question the merit of continuing to hold bonds even though we know their value will probably decline as interest rates rise to what historically has been a reasonable level.

Bonds are used for two purposes in portfolio design; first to provide income and second to dampen some of the market volatility or risks that stock investing adds to a portfolio. Some investing articles suggest that now is the time to reduce your holdings in bonds and buy dividend paying stocks.

Using the salsa recipe analogy – if stocks were the tomatoes in the recipe and we eliminated the peppers and onions just to add more tomatoes, all we would have is chopped up tomatoes, not salsa.

Stocks, like tomatoes come in various sizes and flavors. The different variations are often categorized as domestic or foreign.

To use a technical term, 'style drift' can become an issue. If a portfolio manager says their portfolio invests in domestic large cap stocks, are they really? Take for example a stock market index that is often used as a reference for market performance; the S & P 500. Is it a domestic large cap stock index – really?

American companies like Coke and McDonald's have a huge share of their revenue from foreign countries. So, are they really a domestic or a foreign stock?

You can alter the 'heat' in your salsa by using differing kinds of peppers. Some are sweet and some peppers will burn your tongue off just looking at them.

Bonds have varying attributes as well. Bonds with longer maturities usually pay higher interest

4500 SW Kruse Way, Suite 340
Lake Oswego, OR 97035
503 699-9200

Brent@WBHFinancialServices.com

rates than ones with shorter maturities.
In a normal bond market you can attempt to generate predictable income from bonds by mixing a combination of maturities.

Altering the mix– interest rate concerns?

Concern about rising interest rates have many fearing declining value of bonds in their portfolios. This may happen. The longer the maturity of a bond, the more pronounced the change in price of the bonds as interest rates change. To counter this, many portfolio managers have shortened the average maturity of bonds in their portfolios in anticipation of higher interest rates. The problem, if a portfolio is maintaining the same distribution pattern with shorter maturities, what have they done in the portfolio to maintain the income level? This can lead to a more complicated discussion about credit quality of the investments and use of derivatives within the portfolio that will probably glaze your eyes over and diminish the enjoyment of the salsa.

How do you get the right recipe in your portfolio?

Usually, a combination of stocks and bonds are used because when one is up the other is down. Over the long run performance of the portfolio is fairly stable because of this fact. Recent years have caused all of us to question the wisdom of how we are invested.

We trust that if we follow the recipe that the results over time will be good.

We create a system and stick with it. Yes, occasionally we tweak the use of the ingredients but in general we stick to the plan. So, unless there is good evidence that merits a change, my plan is to stick with the recipe. In fact, as we stir the salsa, rebalance the portfolio, the recommendation may be to buy more bonds. Think: Buy low sell high.

Growth of money versus performance.

Another issue Dr. Israelsen brings up is the concept of growth of money versus performance. Often when a new client comes in they want to know what kind of return they can anticipate for their portfolio. The table below provides an illustration of growth of money versus performance. If we look at the average return for the three portfolios we see they all equal 6%. If we look at Portfolio B and C there are periods of stellar returns. Growth of money for each of the three portfolios is very different.

	Portfolio A		Portfolio B		Portfolio C	
	Return	Value	Return	Value	Return	Value
Starting Value		$1,000.00		$1,000.00		$1,000.00
Period 1	6%	$1,060.00	-45%	$550.00	13%	$1,130.00
Period 2	6%	$1,123.60	28%	$704.00	-35%	$734.5
Period 3	6%	$1,191.02	35%	$950.40	40%	$1,028.30
Average	6%		6%		6%	

Even though B and C have good returns it is the periods of low returns that hurt their performance. Take for example Portfolio B; the second period will have to return 90% just to break even from the loss in the first year. If the return on the Portfolio does not at least equal 90%, then it will take some time just to get back to the initial investment. Time after time, study after study yields similar results. It's the old tortoise and hare dilemma; slow and steady wins the race.

Obviously, there is more to portfolio management than what I've discussed above. Studies have indicated that the most beneficial decisions in portfolio construction is the allocation to various asset classes. In his book Dr. Israelsen has provided data to support his premise that a simple system of asset allocation can be a successful investment scheme.

The question for you is – do you want to spend the time required to build and monitor your portfolio or would you rather spend the time having fun with your family and friends?

Brent