

PITTSBURGH BUSINESS TIMES

Dec. 6-12, 1993

Don't play games with your money; be patient to avoid market valleys

Forget timing and concentrate on time for profitable investing

Selecting investments doesn't have to be a game of chance. While luck may play a role, good investment management can play a bigger one.

The rate of return and risk in a portfolio can be managed with about a 90 percent confidence factor — in other words, with about 90 percent success, but not by market timing or security selection, as many people believe. These factors account for only 7.4 percent of portfolio performance, according to the research firm of Ibbotson Associates in Chicago.

Good portfolio management can minimize the certain risk that must be assumed — some securities will go down in value — while maximizing return by following four principles: time, diversification, balance and asset allocation.

Notice I said time, not timing. Although one knows the right time to invest, the longer the period of time an investment is held, the greater the opportunity to lessen the influences of market peaks and valleys.

Over the past 65 years — through the Depression, wars, economic booms and busts — the average annual return of the Standard and Poor's 500 stock average was 10.4 percent. During the last 25 years alone, the average annual return was 12.3 percent. An investment held over either period of time would have earned an acceptable rate of return, and the impact of the ups and downs, called average volatility, would have lessened.

Timing, on the other hand, isn't worth the significant risk for incremental reward. An investor who held common stocks from 1962 to 1991, for example, would have realized a compound annual return of more than 10 percent, according to Ibbotson Associates. Eliminating the impact of the 12 worst months would have increased the return to more than 15 percent. However, an equal chance existed of investing without benefit of the 12 best months, which would have significantly reduced the return to about 5.5 percent.

The second principle in our strategy is diversification, a way to mitigate value swings. If our portfolio has stocks, for example, the impact of any one stock is reduced by increasing the number of holdings, thus minimizing risk. Reward is maximized because of greater opportunity for

With one stock, to earn money, we must be 100 percent right in our choice. With two stocks, one must go up to be ahead, so we have a 50-50 chance of being right. The mathematical probability of net gain increases with more stocks in a portfolio.

Looking at performance of an individual stock further points out the impact of diversification. During a recent 12-month period, IBM

INSIDER'S VIEW

By Robert Fragasso

stock had a high of 88 3/4 and a low of 40 5/8, a 54 percent swing. For the same period, the S&P 500 had a high of 458.58 and a low of 410.72, only a 10 percent variance, attributable solely to diversification.

Taking diversification one more step requires balancing assets, our third principle. While a portfolio of only stocks can be diversified with stocks in different industries, balance is achieved by investing in other asset categories, such as bonds, real estate as well as domestic and foreign issues.

Compare two portfolios during the 1970s and 1980s, one with stocks and one balanced with 40 percent stocks, 40 percent bonds and 20 percent cash. Each starts out and ends at about the same value. There is no difference in performance because the balanced portfolio would not have declined as much during the crashes of 1974 or 1987. It would not, then, have had to recover as much in the good times to arrive at the same ending point. Lower peaks and shallower valleys spell lessened volatility and, consequently, less risk, yet with the same return over time.

This occurs because the markets for stocks and bonds do not always move in tandem. Usually, one rises while the other falls. There is only a 14 percent correlation between long-term government bonds and large-company stocks: both move in the same direction 14 percent of the time and in different directions 86 percent of the time. These are "noncorrelating" assets. Overseas bonds have a negative correlation with our domestic stock market, and would be expected to move in offsetting directions.

From diversification and balance, the final step is allocating assets among various investment categories — more than just the two in the

ical factor in managing risk and reward.

Asset allocation involves applying diversification, balance and noncorrelating assets to achieve an "optimized" portfolio, which offers either the greatest return for the risk an investor is willing to assume or, conversely, the least risk for the return sought.

In other words, it is the process of selecting a defined mix of asset categories — bonds, stocks, real estate, gold, silver — and allocating capital to those categories so that the desired rates of return are matched with the desired tolerance of risk levels.

The expected rates of return and commensurate risk levels are determined primarily by historical data — the longer the period, the more likely the expected result — and secondarily by economic projections for a similar future period.

For example, using a stock index, such as the S&P 500, for the last 12 months, we cannot be sure that any future 12-month period will reflect similar return and risk numbers. In fact, we can be fairly sure it won't. If, however, we take average return and risk for the last 25 years, we can be more confident projecting those numbers into the future.

Asset allocation makes two assumptions: the markets are efficient, especially over intermediate and longer time periods; and over-concentration in any one security or category of security is more risk than an investor needs to take.

Assume, for example, that an investor has a diversified portfolio and is about 90 percent sure of receiving an average return of nearly 14 percent over five years. In any one year, the portfolio may go up more than 23 percent or down about 4 percent. While the investor may think this is acceptable, the question is whether the assumed risk is more than necessary for the rate of return.

That can be determined by charting the volatility of the portfolio, called the standard deviation, against the expected rate of return. In so doing, an investor can see if the return warrants the risk assumed.

If not, the capital can be re-allocated using the current or additional asset categories.

While no strategy can eliminate risk, unless we are willing to accept 2 percent or 3 percent on our investment capital forever, our goal becomes lessening risk to the greatest degree possible commensurate with the rate of return desired. Asset allocation provides the investor with the ability to manage a portfolio with confidence, leaving time and providing the cash to enjoy games of chance as simple pastimes, while serious money is busy at its real job of being productive.

Mr. Fragasso is a certified financial planner, consultant and senior vice president at Smith