

Portfolio Mismanagement Asset Class Concentration Risks

If the first rule of portfolio management is diversification, why do most investors unwittingly concentrate their risks?

Many investors believe that a portfolio constructed with numerous stocks and bonds is diversified. That approach has its roots in the principles of Modern Portfolio Theory (MPT). Yet when MPT is misapplied, it does not provide the roadmap to secure investing and leaves investors vulnerable to substantial risk.

MPT was developed in the early 1950's by Nobel Prize winner Harry Markowitz. His principles were simple to understand and striking by their implications: diversification can eliminate the risks that don't provide returns, while retaining the risks that do provide returns. Dr. Markowitz and his colleagues Merton Miller and William F. Sharpe further developed these principles into the Capital Asset Pricing Model (CAPM).

From Jonathan Burton's interview with Dr. Sharpe, he reports: *"Every investment carries two distinct risks, the CAPM explains. One is the risk of being in the market, which Sharpe called systematic risk. This risk, later dubbed 'beta,' cannot be diversified away. The other—unsystematic risk—is specific to a company's fortunes. Since this uncertainty can be mitigated through appropriate diversification, Sharpe figured that a portfolio's expected return hinges solely on its beta—its relationship to the overall market. The CAPM helps measure portfolio risk and the return an investor can expect for taking that risk."*

In combination, MPT and CAPM have been the basis for structuring investment portfolios for

the past several decades. Based upon an investor's risk profile, allocations are made across the investment alternatives. Decades ago, there were stocks and bonds, and occasionally an alternative. As a result, portfolios were developed from a very limited palette. Yet, the groundbreaking MPT and CAPM principles helped investors and advisors to structure diversified portfolios of stocks and bonds rather than concentrated portfolios.

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As simple as that sounds, since today those concepts are second nature in investing, the Nobel Prize winning team determined that market risk is the only risk that investors are paid

to include in their portfolios. Since the risks associated with individual companies can be diversified away, the systematic market risk is the source of returns. Most investors have heard this principle said another way: 'that 80% to 90% of the returns come from being in the market and a fraction comes from stock selection.' Actually, if an investor is diversified sufficiently to achieve academic theory, then CAPM indicates that the percentage should be the entire 100%. Proper diversification should provide investors with investment returns that are consistent with the market returns.

Let's relate these principles first to stocks and then to bonds. A diversified portfolio of stocks tends to provide the returns of the general stock market. Once individual company risk is diversified, the pure stock market risk remains. Thus, the portfolio moves with the stock market. Stock market returns are driven by earnings growth and valuation changes (as measured by the price/earnings ratio, known as P/E). If P/E's increase, stock market returns are generally high since the P/E ratio

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multiplies the effect of rising earnings. If P/E ratios decrease, stock market returns will be low or negative since declining P/E's generally offset the benefit of rising earnings.

Similar principles apply to bonds. Once the individual company risks are diversified, the portfolio moves in concert with the bond market. The bond market is largely driven by trends in interest rates. As many investors have experienced, when interest rates decline, bond values increase. Likewise, rising interest rates cause bond values to decline. Thus, if interest rates are falling, the yield from the bond portfolio is supplemented with increases in the value of the bonds; or, if rates are rising, the decline in bond prices offsets some of the portfolio yield resulting in lower total returns.

Therefore, an investment portfolio that is structured with allocations of 60% in a diversified stock portfolio, 30% in a diversified bond portfolio, and 10% in other investments is concentrated 90% across two risks: stock market risk and bond market risk. And over longer periods of time, those two markets tend to move in the same direction.

This does not indicate that the principles of MPT and CPM are not solid; the issue is that the application of the principles has not evolved as the financial markets have become more complex and sophisticated. Dr. Markowitz's publication of MPT in 1952 discussed the concept of "*performances of available securities.*" In 1952, there wasn't much more than stocks and bonds. A portfolio allocated across the two asset classes was about as diversified as you could be.

Many investors today may not realize that mutual funds were uncommon before the 1980's (there were less than 300 in the 1960's and there are more than 10,000 today). In addition, the investment choices and available securities have exploded over the past two decades. The menu of securities now readily includes asset-backed, foreign, real estate, options, commodities, investment trusts, hedge funds, inflation-protected bonds, etc.

As well, most investors only remember the market risks and conditions of the past two decades, when the annual trends were strongly in favor of stock and bond investors. Interim dips were always buying opportunities. However, for those with battle scars from the 1970's and before, stock and bond market risks have not always been so forgiving. The driver of stocks, the P/E ratio, is again at historical highs. The driver of bonds, interest rates, is at historical lows. Given where both of the traditional asset classes are positioned, the odds appear to favor Mr. Risk over Mr. Return for stocks and bonds.

Over the past several decades, the financial community has also realized that the theories of market efficiency, an important assumption for MPT and CAPM, may not be as strict as originally hypothesized. Financial markets are an efficiency process, rather than an efficient condition. In other words, markets function to find the right prices over time, but don't always reflect all of the information all of the time. Many of the alternative investments today, hedge funds as an example, operate to identify and profit from mispricings and inefficiencies and contribute to the efficiency of the markets.

Returning to Dr. Markowitz, diversification in a portfolio applies to risks, not securities. Other than not being familiar with the investment alternatives, what other rational reason would explain why investors concentrate their portfolios into two major risks when so many options are available?

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