

Smart ideas about wealth

Pure asset class portfolios - two years on

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Abstract

Two years into the process of running our clients' portfolios on an asset class basis, we look at the performance of the components and, more importantly, the portfolios as a whole. Despite a volatile set of asset class returns over the period, by and large the pattern has been as expected, with the riskier equity assets having higher returns and higher variability than the fixed interest ones. The fact that the movements of each asset do not occur in the same directions at once gives a diversification benefit and this is exploited by periodic rebalancing. Using historic data for the asset classes which comprise the portfolios, adjusted by the current annual costs, we show simulated annualised returns over the last 30 years for the 60% equity portfolio model. Finally, we look at the benefits of a disciplined rebalancing approach in the period from 1973-75, when the equity market experienced its worst falls of the second half of the 20th Century and show how this delivered superior returns to a non-rebalanced portfolio.

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The passing of two years since we started moving our clients' portfolios to a pure asset class approach is perhaps an appropriate time to consider how effective the approach has been.

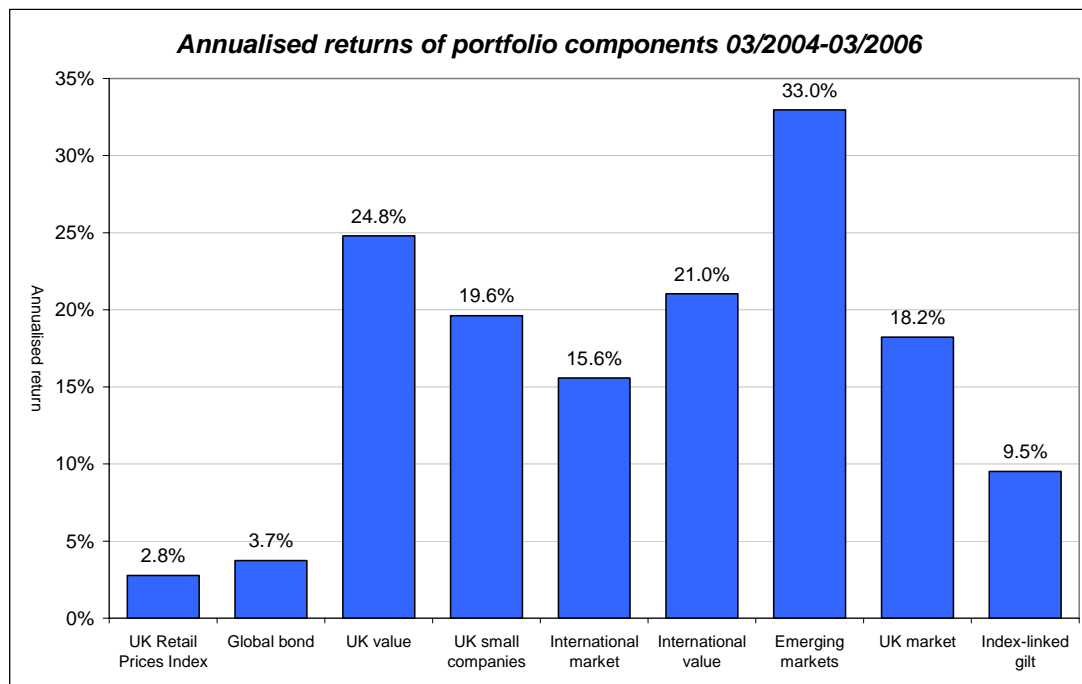


Figure 1

The last two years have shown some impressive gains for equities, in emerging markets in particular, but as Figure 2 shows, this has not been without some large movements in both directions within individual areas of the market and in the last couple of months, some reverses in equity markets. While not universal, the smaller capitalisation, value and emerging markets components have generally exhibited larger monthly movements and higher returns than the broad market ones and the fixed interest assets have done as intended and delivered the lowest returns and the lowest variability. Indeed, this is largely what would be expected over the long term – the higher risk assets compensate for this with a higher return, otherwise investors would have no reason to own them in preference to less risky assets.

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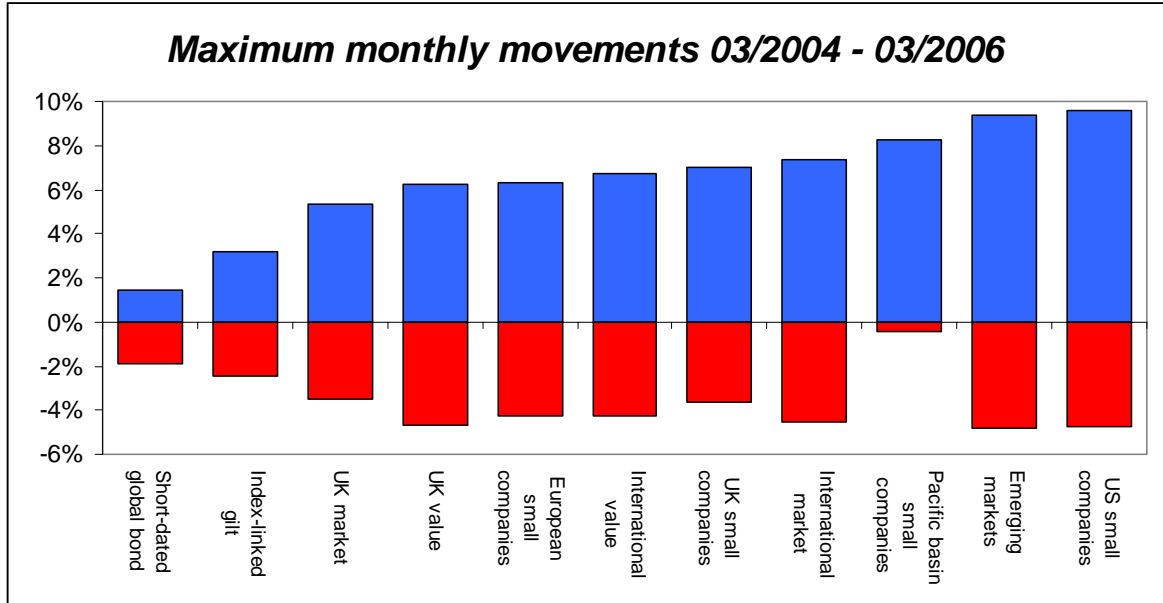


Figure 2

Of course, the whole point of a diversified portfolio is that these individual movements, which occur at best on a chaotic basis, do not all occur in the same direction at the same time. This lack of correlation between assets is what provides the diversification benefit and by regular rebalancing, those in excess of the expected return can be captured and reinvested into those whose prices have fallen in relative terms.

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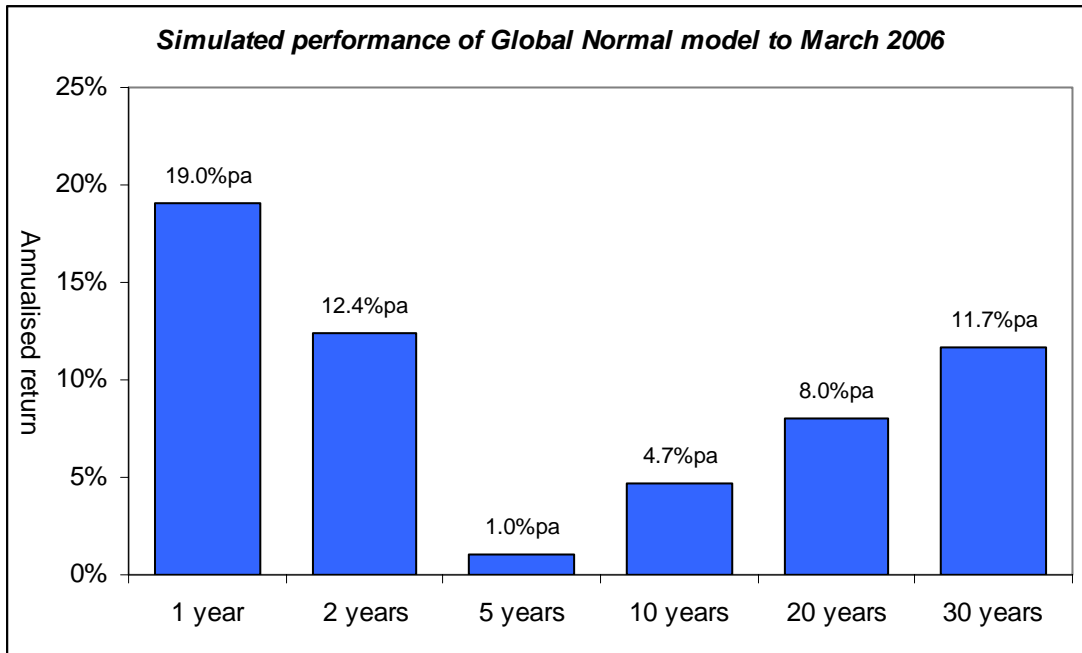


Figure 3

The data for the portfolio model shown here is calculated on the basis of being rebalanced on a quarterly basis – in reality, Bloomsbury portfolios are rebalanced when the actual weightings of portfolio components diverge by more than a specified percentage from the target weights of the model, although the difficulty of representing this makes the quarterly rebalancing a close proxy. Individual clients will also see that their own portfolio's performance may diverge from that of the models due to cash movements and rebalancing at more or less frequent intervals.

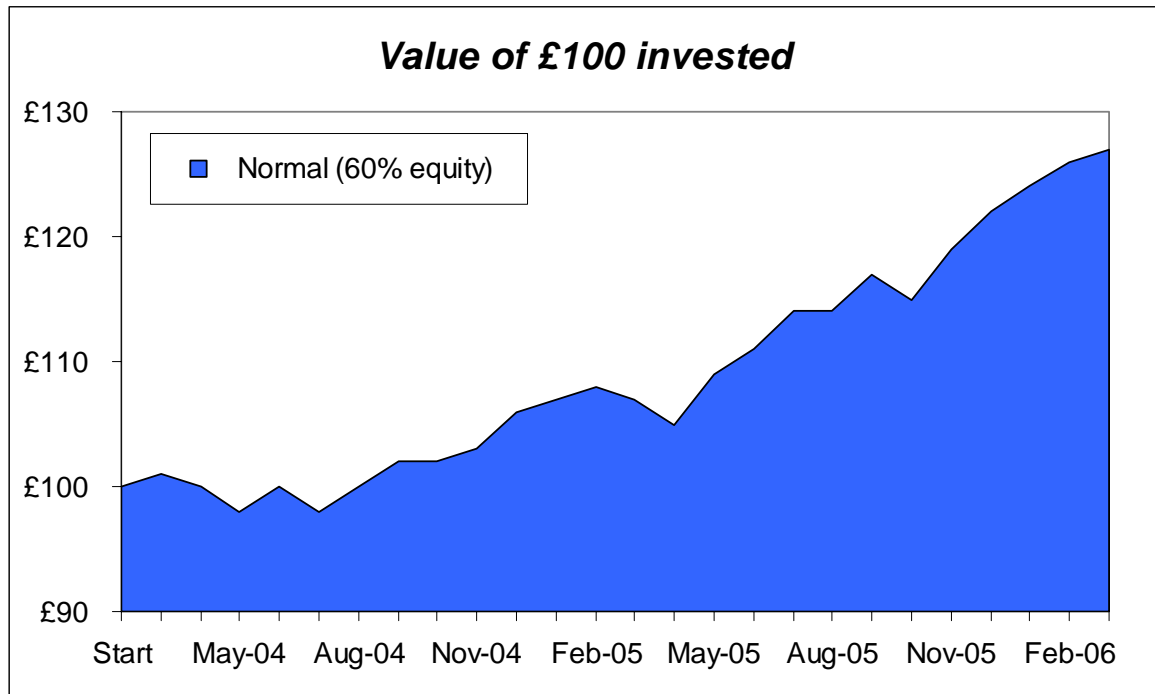
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Figure 4

It will be observed that we have not attempted to offer reasons for the rises or falls; apart from the fact that many commentators have already done so, we see the changes as reflecting the very simple effect of imbalances between buyers and sellers – when the buyers outnumber the sellers, prices rise and when the opposite is true, they fall. For an investor's perspective, where one is not attempting to play the fool's game of predicting unanticipated events before other investors have factored them into prices, the causes of such changes in sentiment are irrelevant as long as the portfolio is positioned to deliver the market return that is consistent with each investor's risk tolerance and need (or desire) for returns.

In fact, the disciplined approach to rebalancing offers benefits compared to a strategy which relies on skill to identify and attempt to exploit market turning points. Consider the period from 1973-75, for example, when we experienced the most extreme movements in the equity markets in the second half of the 20th Century, with a portfolio consisting of 50% UK broad market equities (as measured by the FTSE A

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All Share index) and 50% cash. In the interests of simplification, it is assumed for the purposes of this exercise that all transactions take place at the year end only and do not take account of costs or taxation.

In 1973, the UK equity market fell 28%. Investors then had three options: they could hold on in the hope that things got better, they could bale out or they could rebalance their now depleted portfolio back to the previous 50/50 split in line with their original allocation. Whichever option they took, the total value at the end of 1973 would be the same – about 10% down.

In 1974, the UK market fell another 50%, testing the resolve of those who did anything except liquidate all their equity exposure at the end of 1973. Those who held all cash now looked to have made the right decision. By dint of the previous year's fall, those who continued to hold their nerve and stayed put actually ended up in second place as their portfolios were already underweight equities when the fall occurred. Anyone who rebalanced to increase their equity exposure back to the target 50% weighting at the end of 1973 were now rather poorer as they had just bought into an asset which lost half of its value.

However, in 1975, investors came to realise that despite the turmoil, there were still profits being made by the companies which comprised the market and that these profits could be bought for significantly lower prices than in the previous two years. In 1975 the market rose by 149%.

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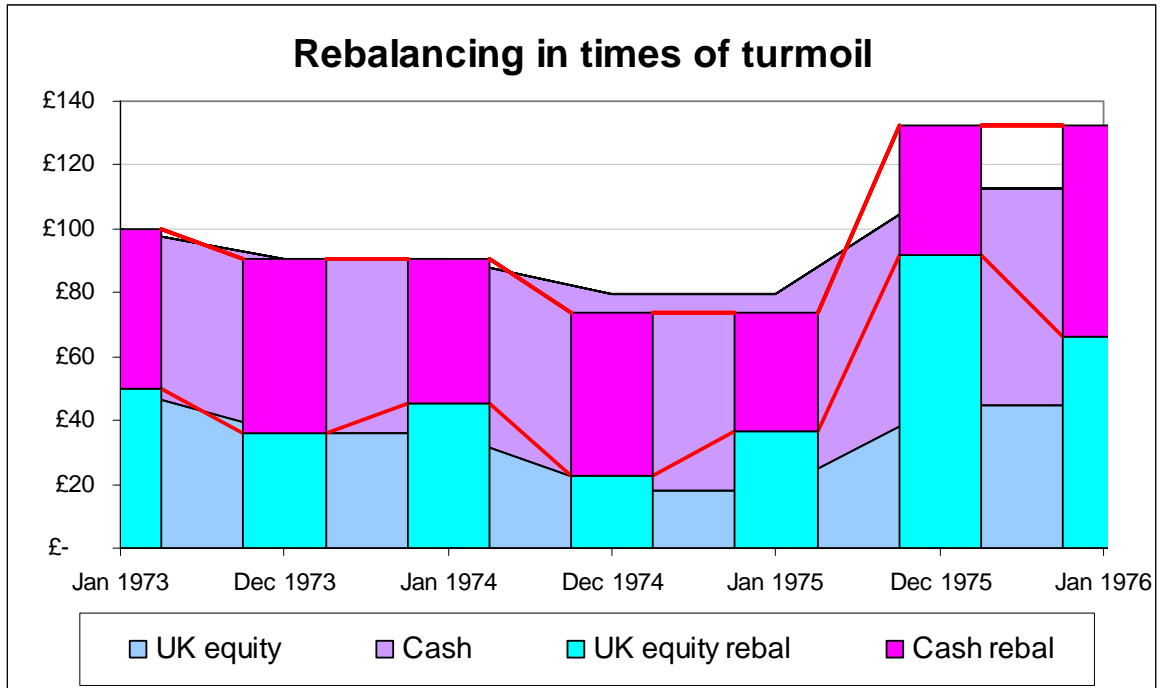


Figure 5

The disciplined rebalancing approach now showed its worth, as 50% of the rebalanced portfolio was exposed to this gain, while the investors who liquidated at the end of 1973 missed out on it completely and those who merely held on in hope or fear had only 23% of their portfolio exposed to the stockmarket. The interesting result is that the rebalanced portfolio finished the three years with a gain of 32% compared to almost identical returns of 13% for both the other options. Anyone who held on at first and only sold out at the end of 1974 was down 12% over the period, helped to a large extent by the fact that interest rates were over 10% at the time. Of course, the rebalanced portfolio would then have been rebalanced again at the end of 1975, capturing the year's gains and realigning it with the agreed split. – those who follow a disciplined approach do not fall victim to either greed or fear when faced with extreme returns in either direction.



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Caveats

It should be noted that the period covered by this document is extremely short in terms of the anticipated time horizon for Bloomsbury clients' long term portfolios, which in most cases is at least ten years. In any event, we anticipate that most portfolios will be invested for considerably longer than this. Some of the assets shown are not yet held in all portfolios and have only been held for less than 12 months as they were not available for the full two years, although the portfolio returns calculations take account of this. Bloomsbury's own charges and the costs of the global custody service are not included in the figures quoted as these vary between clients according to the size of the portfolio, which determines whether discounts or quarterly minima apply.

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