February 2014

The Importance of Active Portfolio Management

It's All About Finding the Right Balance

Stéphane Rochon, CFA, Equity Strategist
Richard Belley, CFA, Fixed Income Strategist

Is buy and hold dead? Not necessarily, but it is far from the optimal portfolio management strategy. Neither are "market timing" or high frequency trading strategies in our view. We believe that above all else, investors should continuously focus on adjusting the level of risk in their portfolios, and this requires a disciplined buy and sell approach. Not only will this approach help avoid catastrophic losses in very difficult periods (i.e. the 2008 financial crisis), but it also increases returns in healthier environments.

With any investment, there is a trade-off between risk and return. In general, the greater the risk associated with an investment the greater the potential return. While risk cannot be eliminated, it can be controlled and adjusted. We concede that effective portfolio risk management is easier said than done but believe it can be achieved through at least a quarterly portfolio review and, if necessary, rebalancing at the asset, sector and single security level. The traditional "dynamic asset allocation" framework generally involves reducing positions in the best-performing asset class, while adding to positions in underperforming assets to reduce portfolio overweight and the associated risk. In essence, you would be selling the more expensive asset class and buying the cheaper one (the notion of buy low/sell high). There is some merit to this approach as controlling position size is, after all, a cornerstone of sound risk management, but we believe that there is a better alternative.

The market offers active managers significant structural and tactical opportunities to potentially produce higher returns than passively managed portfolios. Active managers can exploit a number of inefficiencies in the market to consistently provide excess returns relative to a targeted benchmark, while maintaining a risk profile similar to the benchmark. Tactical strategies may be based on broad macroeconomic views; returns on different sectors of the market are often not correlated with one another offering opportunity for added value. Clearly, the first step remains to construct an asset mix that is aligned with each individual's age, risk tolerance, capital growth objective and income needs. The next decision in the process is the need to decide how to manage the asset mix, either on a static basis (buy and hold) or active basis. Your BMO Nesbitt Burns Investment Advisor can help you navigate through these steps, reviewing your objectives and constraints to identify the appropriate long term investment strategy for your portfolio.

Our recommendation is also to make sure that the portfolio risk level is adjusted within an individual's risk tolerance. Rather, than blindly selling the best performing positions and buying underperformers, our recommendation is to adjust the portfolio periodically to take advantage of long term secular trends and extreme valuation discrepancies when they present themselves.

Key Portfolio Risks to Consider

Risk management is key to the success of active management strategies. It requires the ability to continually monitor a portfolio on the basis of individual security and total portfolio risk. Risk controls usually employed by active managers include limitations on position size and sector ranges. Also, a manager's ability to factor the correlation of stocks within the portfolio and across sectors helps minimize the effects of unintentional market exposure.

Member-Canadian Investor Protection Fund

All figures in C$ unless otherwise noted

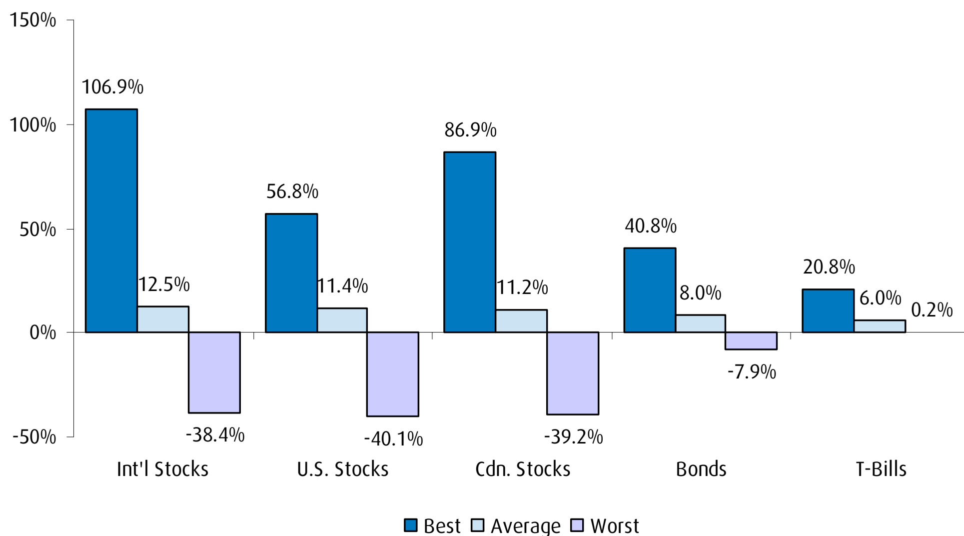
BMO Nesbitt Burns

Some of the most important risks that investors must consider include:

- Capital risk resulting from a decline in the market value of a security (equities are particularly vulnerable to this risk and bonds more recently in the context of a rising interest rate cycle);
- Volatility of returns due to market fluctuations;
- The loss of purchasing power due to inflation (one of the largest drawbacks to having too high a proportion of cash in portfolios);
- Reinvestment risk resulting in reduced income due to reinvesting at lower interest rates (a major issue for longer-term bonds and preferred shares);
- Credit risk — the risk that the issuer of a debt security is unable to make timely payment of principal and/or interest;
- Currency risk is an added unpredictable factor in foreign investing. However, Canadian investors can benefit from currency fluctuations if the Canadian dollar depreciates relative to the currency of the investment (as has been the case recently). This was the case for Canadian investors in the U.S. stock market for much of the 1990s.

The graph below shows how volatile different asset classes have been since 1960. International stocks for example have had the best average annual return at 12.5% but the variance has been tremendous: -38.9% to +106.9%. Conversely, T-Bills have provided the lowest return but also suffered far less volatility.

Figure 1: Asset Class Returns 1960–2013: 12-Month Total Returns (Rolling Returns)



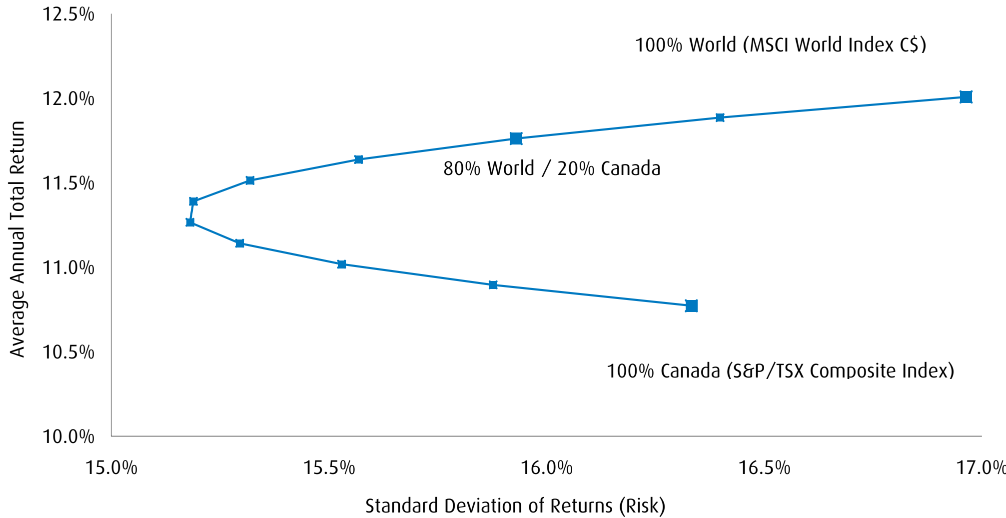
Stocks have experienced the most volatile returns and can present a risk of capital loss.

Bonds and T-Bills have provided more stable returns than stocks but expose investors to the risk of eroding purchasing power due to the impact of inflation (and taxes). These risks can be managed by combining different asset classes in a portfolio.

Source: Bloomberg, PC Bond, Bank of Canada

Modern portfolio studies have demonstrated that return can be increased by adding different investments which are not perfectly correlated (i.e. they do not move in lockstep with existing portfolio holdings) while lowering the overall level of portfolio risk. This is one of the rare "free lunches" available in the investment world.

Figure 2: Impact of International Equities for Canadian Investors 1960–2013



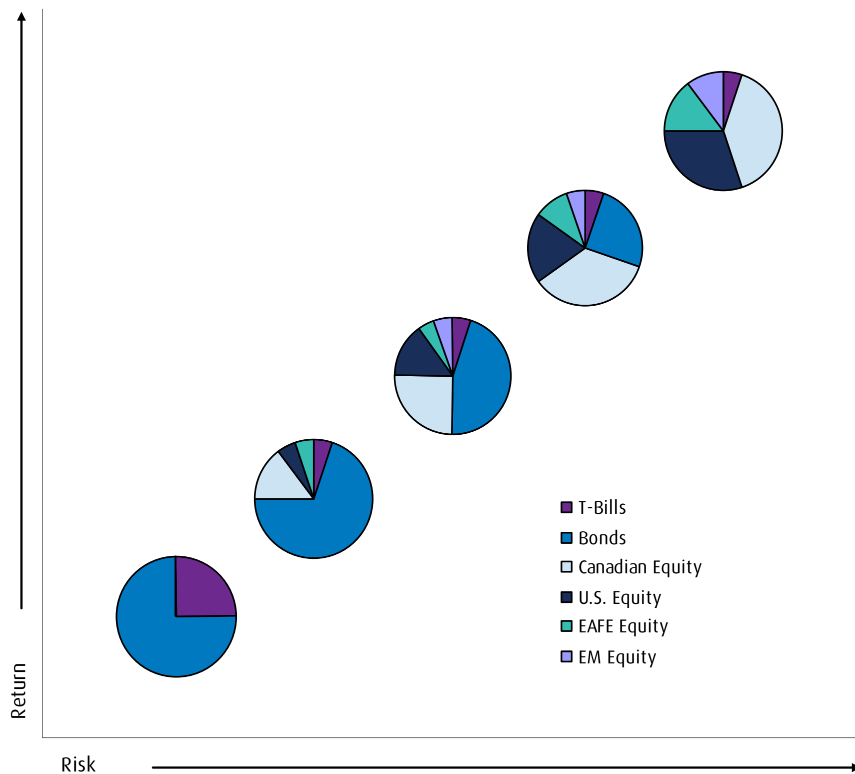
Source: Bloomberg,

Figure 2 illustrates that a combination of roughly 80% of MSCI World Index and 20% of S&P/TSX Composite Index had a lower level of risk than a 100% investment in the S&P/TSX Composite Index, but provided a superior return.

As such, including foreign investments in an equity portfolio can enhance returns and reduce risk.

Putting these concepts together, the chart below shows that a superior risk/reward scenario can be achieved by combining assets classes and diversification.

Figure 3: Asset Classes — Risk versus Return



Source: BMO Nesbitt Burns Private Client Research

Risk can be managed with diversification, which can be achieved on a number of levels: by asset class, by investment style and by security.

In general, the longer the investment time horizon the greater the need for growth. And, the higher the tolerance for risk the greater the proportion of equity should be in a portfolio.

A Case Study

In a recently published report, the BMO Portfolio, Action, and Research Team (PART) ran different portfolio return scenarios for the period from December 31, 2004 to December 31, 2011, including the financial crisis and the associated meltdown in risky assets. We believe the analysis validates the critical importance not only of asset diversification but also of adjusting portfolio risk; ultimately it is the "how much" more than the "what" you own that matters the most.

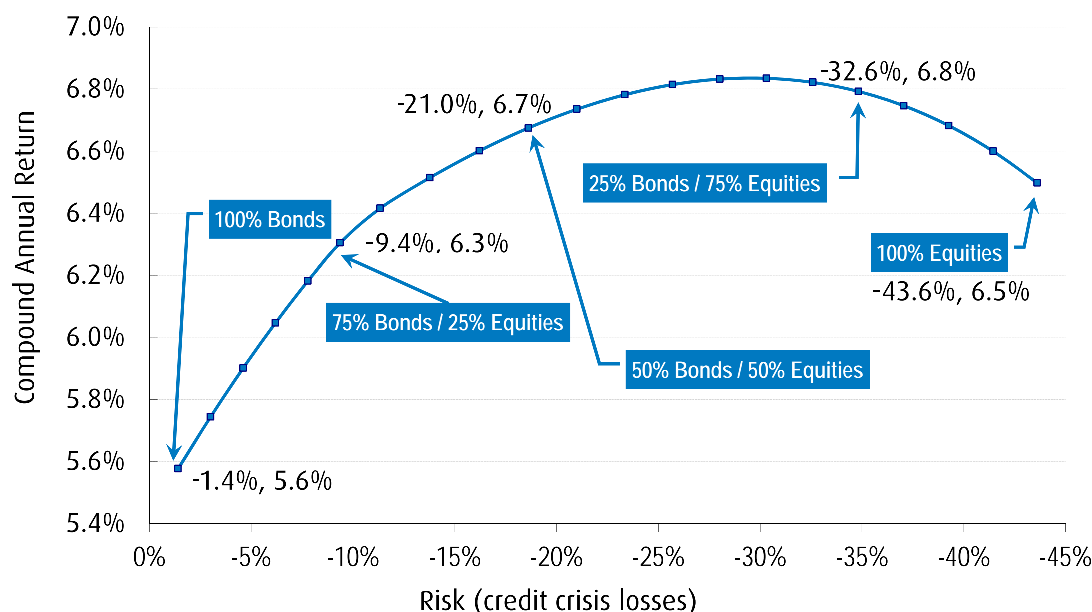
Notably, we concluded that cash and cash-like equivalents have a place in an investor's portfolio; however, the bulk of one's financial assets should be invested in long-term securities. We believe that an individual should keep his/her income requirements for a 3- to 12-month period in cash and cash-like assets, in addition to funds that he/she anticipates needing for major purchases (e.g. home, school, car, etc.). Collectively, we will call these investments "short-term financial assets".

The balance of an individual's portfolio—henceforth called "long-term financial assets"—should be invested in equities and bonds. This point is important, particularly in the current low-yield environment where cash and cash-like investments effectively pay near zero percent, especially after taking into consideration the cost of inflation.

Figure 4 plots the risk and return for 21 portfolios. From the evaluation of the portfolios based on their risk and return characteristics, we note the following:

- The portfolios are comprised of Canadian bonds, Canadian equities or a combination of the two. Canadian bonds are represented by the iShares DEX Universe Bond Index ETF (XBB-T), while equities are represented by the iShares S&P/TSX Capped Composite Index ETF (XIC-T).
- Each "dot" represents one portfolio beginning with a portfolio fully (100%) invested in bonds in the bottom-left corner. Each subsequent dot, moving from left to right, assumes a 5% increase in the weighting towards equities, at the expense of bonds, until you reach the portfolio that is fully invested in equities in the top-right corner.
- Each portfolio is rebalanced semi-annually (i.e. June 30 and December 31).
- The "return" for each portfolio is in fact the compound annual return for the period December 31, 2004 to December 31, 2011 (i.e. 7 years).
- The "risk" for each portfolio represents the losses experienced during the credit crisis. It is our hope that the credit crisis represents the worst bear market we will experience. To the extent that our hopes are fulfilled, then the losses that follow should represent reasonable estimates of the maximum "pain" investors may suffer going forward.

Figure 4: Risk/Return Characteristics for 21 Portfolios Comprised of Canadian Bonds and Canadian Equities



Source: Bloomberg

What We Learned from the Analysis

- **Equities should not be avoided.** A portfolio comprised only of Canadian bonds delivered a compound annual return of 5.58% and experienced a loss of 1.4%. However, by allocating 25% of the portfolio to equities, an investor improved his/her compound annual return by 72 bps (i.e. 6.30% from 5.58%) while adding only a modest amount of risk (i.e. the "credit crisis" loss remains below 10%). Although further increases to the allocation to equities (e.g. from 25% to 50%) generate higher returns, it should be noted that the incremental return diminishes, while the incremental risk accelerates.

- **Bonds should not be avoided.** A portfolio comprised only of Canadian equities delivered a compound annual return of 6.50% and experienced a loss of 43.6%. However, by allocating 25% of the portfolio to bonds, an investor improved his/her return by 32 bps (i.e. 6.82% from 6.50%) and reduced portfolio risk (i.e. the credit crisis loss dropped to 32.6% from 43.6%). The allocation to bonds plus the commitment to rebalance the portfolio semi-annually allowed the investor to sell some bonds to buy some equities (i.e. buy-low) in the midst of the credit crisis and sell some equities (i.e. sell-high) to buy some bonds during the subsequent rally. By contrast, someone fully invested in stocks had no such ability.

- **Cash should not be overweighted.** An over-allocation to cash and cash-like equivalents may help preserve capital and reduce the risk of large losses during extreme negative market conditions. However on a longer-term investment horizon, maintaining a large allocation to short-term financial assets could considerably reduce a portfolio's total return—an underperformance that even with time will likely be difficult for investors to recover.

Applying These Principles in the Real World

Lest our readers think our approach is strictly a theoretical construct, we have applied it to our recommended asset mix and portfolios. Over the last one, two, three and five years our "Balanced Investor" asset mix has outperformed its relevant benchmark by a very robust 2.82%, 1.93%, 1.41% and 1.35% respectively.

Looking at individual stocks, emphasizing long-term themes and focusing on valuation disconnects has helped the BMO Private Client Research team generate market beating results in all four of our twenty-stock Equity Guided Portfolios (Canadian, U.S., North American and Dividend & Income) in 2013 and for the last five years. For example, the Canadian Guided Portfolio was up 27% in the last year, beating the S&P/TSX Composite Index (TSX) by a full 1400 basis points.

Looking forward we believe that two of the most important cyclical trends facing investors are the end of both the bond bull market and the commodity super-cycle. If we're right on this, the investment implications are profound. This will mean generally avoiding/underweighting interest rate-sensitive securities such as long-term bonds, perpetual preferreds, and stocks in the real estate investment trust (REIT) and utility sectors. From a secular standpoint, our preferred investment themes include: 1) the coming Mergers & Acquisitions Wave; 2) the U.S. Housing and Auto Recovery; and 3) the Commercial Construction Recovery and Re-Industrialization of America.

These themes are the driver behind our current recommended asset allocation:

Figure 5: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5	0	5
Fixed Income	65	70	35	45	15	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	10	15	20	25	25	35	20	40
U.S. Equity	15	5	30	15	35	20	50	30
EAFE Equity	5*	5	5*	5	10*	10	15*	15
Emerging Equity	0	0	5	5	10	5	15	10

** Within EAFE, we specifically recommend Continental European equity.*

Source: BMO Nesbitt Burns Private Client Strategy Committee

Conclusion

The true value of an active portfolio management strategy is both the incremental returns it can create for a portfolio, as well as the risk controls it provides. Furthermore, these added risk controls do not have to come at the expense of sacrificing returns. Active management provides investors with the opportunity to take advantage of these market inefficiencies. Over time, our disciplined investment strategy has shown the ability to capitalize on these opportunities, from both an asset allocation and stock selection standpoint.

Should you have any questions about active portfolio management and our asset allocation recommendations, please do not hesitate to contact your BMO Nesbitt Burns Investment Advisor.

General Disclosure

The information and opinions in this report were prepared by BMO Nesbitt Burns Inc. Portfolio, Action & Research Team ("BMO Nesbitt Burns"). This publication is protected by copyright laws. Views or opinions expressed herein may differ from the views and opinions expressed by BMO Capital Markets' Research Department. No part of this publication or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, or otherwise reproduced, stored, disseminated, transferred or used, in any form or by any means by any third parties, except with the prior written permission of BMO Nesbitt Burns. Any further disclosure or use, distribution, dissemination or copying of this publication, message or any attachment is strictly prohibited. If you have received this report in error, please notify the sender immediately and delete or destroy this report without reading, copying or forwarding. The opinions, estimates and projections contained in this report are those of BMO Nesbitt Burns as of the date of this report and are subject to change without notice. BMO Nesbitt Burns endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Nesbitt Burns makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected in this report. This report is not to be construed as an offer to sell or solicitation of an offer to buy or sell any security. BMO Nesbitt Burns or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. Bank of Montreal or its affiliates ("BMO") has lending arrangements with, or provides other remunerated services to, many issuers covered by BMO Nesbitt Burns' Portfolio, Action & Research Team. A significant lending relationship may exist between BMO and certain of the issuers mentioned herein. BMO Nesbitt Burns Inc. is a wholly owned subsidiary of Bank of Montreal. Dissemination of Reports: BMO Nesbitt Burns Portfolio, Action & Research Team's reports are made widely available at the same time to all BMO Nesbitt Burns investment advisors. Additional Matters TO U.S. RESIDENTS: Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. ("BMO CM") and/or BMO Nesbitt Burns Securities Ltd. ("BMO NBSL") TO U.K. RESIDENTS: The contents hereof are intended solely for the use of, and may only be issued or passed onto, persons described in part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001. BMO Nesbitt Burns is a Member of Member-Canadian Investor Protection Fund. BMO CM and BMO NBSL are Members of SIPC. ® BMO and the roundel symbol are registered trade-marks of Bank of Montreal, used under license. If you are already a client of BMO Nesbitt Burns, please contact your investment Advisor for more information.

Company Specific Disclosures

For Important Disclosures on the stocks discussed in this report, please go to:
http://researchglobal.bmocapitalmarkets.com/Public/Company_Disclosure_Public.aspx

The authors of this report (or their household members) directly or beneficially own securities of this issuer: None.

Ratings and Sector Key

BMO Capital Markets uses the following ratings system definitions:

- OP = Outperform — Forecast to outperform the market;
- Mkt = Market Perform — Forecast to perform roughly in line with the market;
- Und = Underperform — Forecast to underperform the market;
- (S) = speculative investment;
- NR = No rating at this time;
- R = Restricted — Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company.

Other Important Disclosures

For Other Important Disclosures on the stocks discussed in this report, please contact your BMO Nesbitt Burns Investment Advisor or go to **http://researchglobal.bmocapitalmarkets.com/Public/Company_Disclosure_Public.aspx** or write to Editorial Department, BMO Capital Markets, 3 Times Square, New York, NY 10036 or Editorial Department, BMO Capital Markets, 1 First Canadian Place, Toronto, Ontario, M5X 1H3.

Technical Analysis Disclaimer

Recommendations and opinions contained herein are based on Technical Analysis and do not necessarily reflect fundamental recommendations and opinions and may relate to companies which, in some instances, are not followed on a fundamental research basis.