Portfolio, Action & Research Team

Portfolio Management

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The Importance of Active Portfolio Management

Risk Management in an Evolving Market Environment

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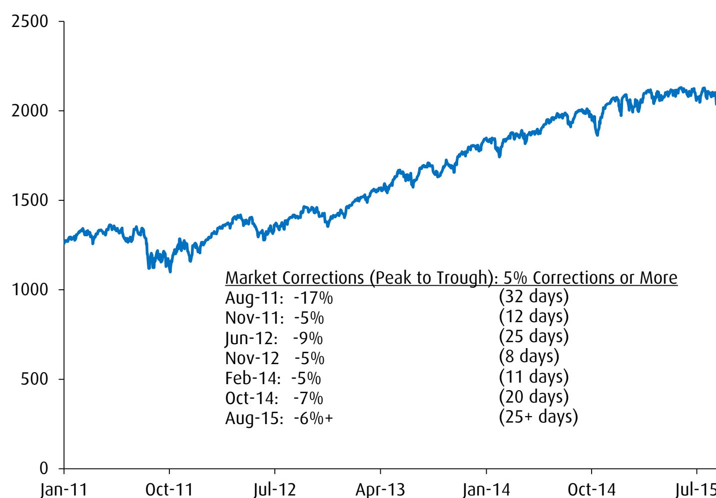
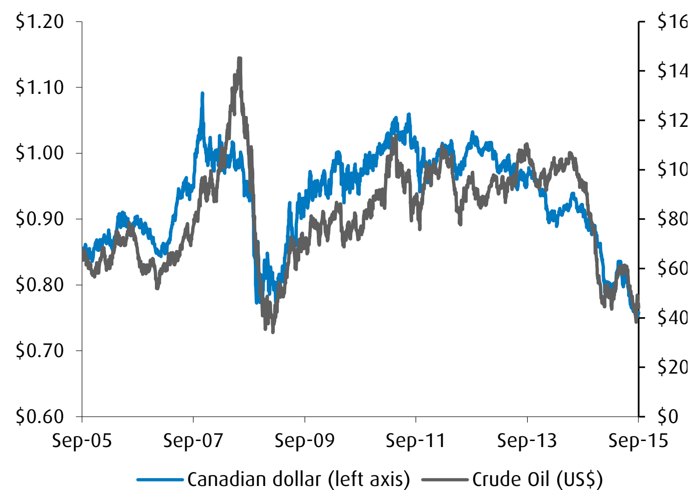
Few pundits and investors predicted the speed and magnitude of the oil price decline since the end of last year and the associated downdraft in the Canadian dollar. Fewer even predicted the Bank of Canada would cut its target rate twice this year driving all Canadian interest rates lower. More recently, the U.S. market experienced its first 10%+ correction since 2011. It had been a very long time without a major pullback by historical standards and the economic turbulence in China provided a clear catalyst for this selloff. But even in the relatively quiet stock market environment of the last five years, we have still seen a number of 5%+ pullbacks, as shown in Figure 1. The bottom line is that stocks do not go up in a straight line and there is a lot of truth to the old adage that stocks normally "grind up" but sometimes "gap down."

Figure 1: Recent Market Corrections in the S&P 500 Index



Source: Bloomberg

Figure 2: Crude Oil and the Canadian Dollar



Source: Factset

We open our article in this fashion, not to look in the rearview mirror, but rather to illustrate the crucial point that global economies and markets often move in volatile and unpredictable fashion. As we stated in our August 21 report entitled "The Made in China Selloff", it is human nature to fear further losses when the market undergoes a correction. It is never a good idea to sell stocks in a panic or to exceed a normal cash allocation for fear off rising interest rates as this tends to undermine the long term performance of portfolios. Remaining focused on long-term goals—through a diversified portfolio across asset classes and geographies—and the market's ability to recover over the long-run is the best course of action. As Figure 5 illustrates, over the years there has been a rotation of performance leaders which underlines the importance of both portfolio risk management and diversification. Effective diversification helps control the volatility of portfolios when certain assets move up as others are going down. For example, bonds tend to do well when the stock market sells off, thus reducing the ups and downs that typically lead to overly emotional reactions on the part of investors.

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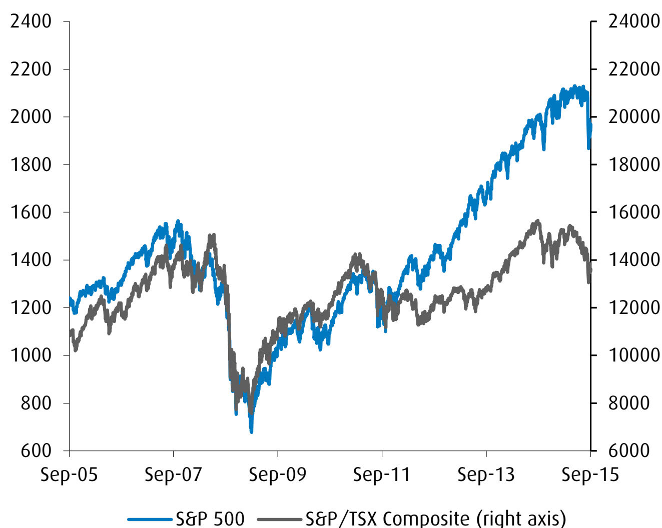
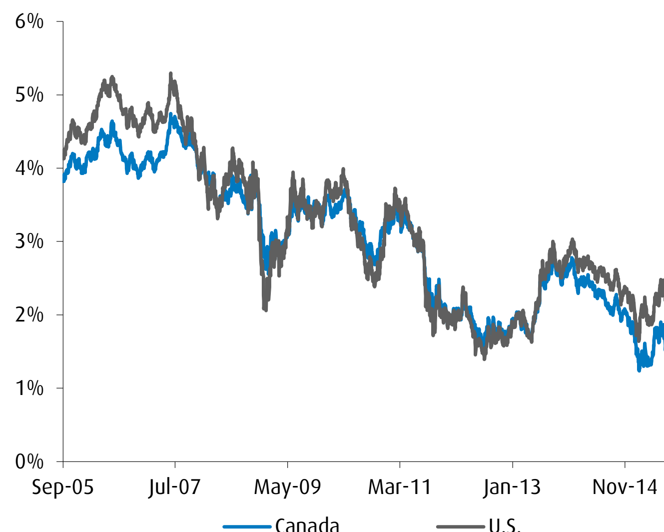
Figure 3: U.S and Canadian Equity Markets



Source: Factset

Figure 4: Canadian and U.S. 10-year Government Bonds Yields



Source: Factset

Figure 5: Leader's Rotation—Asset Classes Performances 2005-2015

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015-Q1	2015-Q2	2015-Q3
Emerging Markets Equities 30.50	Emerging Markets Equities 32.49	Emerging Markets Equities 18.93	Canadian Fixed Income 6.41	Emerging Markets Equities 54.48	Canadian Equities 17.61	Canadian Fixed Income 9.68	Emerging Markets Equities 16.05	US Equities 41.53	US Equities 24.00	International Equities 14.63	Canadian T-Bills 0.12	Canadian T-Bills 0.16
Canadian Equities 24.13	International Equities 26.80	Canadian Equities 9.83	Canadian T-Bills 3.11	Canadian Equities 35.05	Emerging Markets Equities 12.80	US Equities 4.41	International Equities 15.34	International Equities 31.81	Canadian Equities 10.55	Emerging Markets Equities 11.67	International Equities -0.56	Canadian Fixed Income 0.15
International Equities 10.59	Canadian Equities 17.26	Canadian T-Bills 4.22	US Equities -22.59	International Equities 14.30	US Equities 8.89	Canadian T-Bills 0.95	US Equities 13.48	Canadian Equities 12.99	Canadian Fixed Income 8.79	US Equities 10.22	Emerging Markets Equities -0.58	US Equities -0.03
Canadian Fixed Income 6.46	US Equities 15.74	Canadian Fixed Income 3.69	International Equities -30.04	US Equities 9.12	Canadian Fixed Income 6.74	Canadian Equities -8.71	Canadian Equities 7.19	Emerging Markets Equities 4.48	Emerging Markets Equities 7.09	Canadian Fixed Income 4.15	US Equities -1.12	International Equities -4.04
Canadian T-Bills 2.48	Canadian Fixed Income 4.06	International Equities -5.05	Canadian Equities -33.00	Canadian Fixed Income 5.41	International Equities 2.40	International Equities -9.75	Canadian Fixed Income 3.60	Canadian T-Bills 0.98	International Equities 4.18	Canadian Equities 2.58	Canadian Equities -1.63	Canadian Equities -7.86
US Equities 1.76	Canadian T-Bills 3.83	US Equities -10.27	Emerging Markets Equities -42.48	Canadian T-Bills 0.53	Canadian T-Bills 0.39	Emerging Markets Equities -16.33	Canadian T-Bills 0.92	Canadian Fixed Income -1.19	Canadian T-Bills 0.90	Canadian T-Bills 0.23	Canadian Fixed Income -1.71	Emerging Markets Equities -12.15

Source: FTSE TMX, MSCI, BMO Capital Markets

Investors must have a plan which includes an understanding of objectives and the risks we face in attaining them. This starts with understanding the investor's longer term income needs (to maintain a certain lifestyle) and then building sufficient assets to achieve these aims. It is very important to build a "safety cushion" which will allow us to handle longevity and health and long-term care risks (which are impossible to predict ahead of time).

We believe that above all else, investors should focus on adjusting the level of risk in their portfolios, and this requires decisive selling and buying when warranted (for example, selling a stock, even at a loss, when the risk / reward proposition becomes unfavorable). Not only will this approach help investors avoid catastrophic drawdowns in very difficult periods (i.e. the 2008 financial crisis), but also increase returns in healthier environments.

From an investment perspective, some of the most important risks to 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.

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 a quarterly portfolio review/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 the fluctuation risks and achieve returns that exceed the target benchmark. We believe there is some merit to this approach as controlling position sizes is, after all, a cornerstone of sound risk management but investors can do better.

Clearly, the first step remains to construct a portfolio that is aligned with each individual’s age, risk tolerance, capital growth objective and income needs. However, 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.

Looking at present market circumstances, we believe that fixed income investors are no longer being adequately compensated for both term and credit risk. There are growing risks of compounding losses of purchasing power by keeping excessive allocation to cash, a relatively expensive asset class in our opinion. Conversely, we believe that equities are by far the most attractively valued asset class—with a major preference for U.S. and international stocks (this is reflected in our recommended asset mix table below).

Figure 6: 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	15	25	20	35	20	40
U.S. Equity	15	5	35	15	40	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

We believe two of the most important secular trends facing investors are: 1) the bond bull market is coming to an end, and; 2) the commodity super cycle is now behind us. If we’re right on this, the investment implications are profound. This will mean

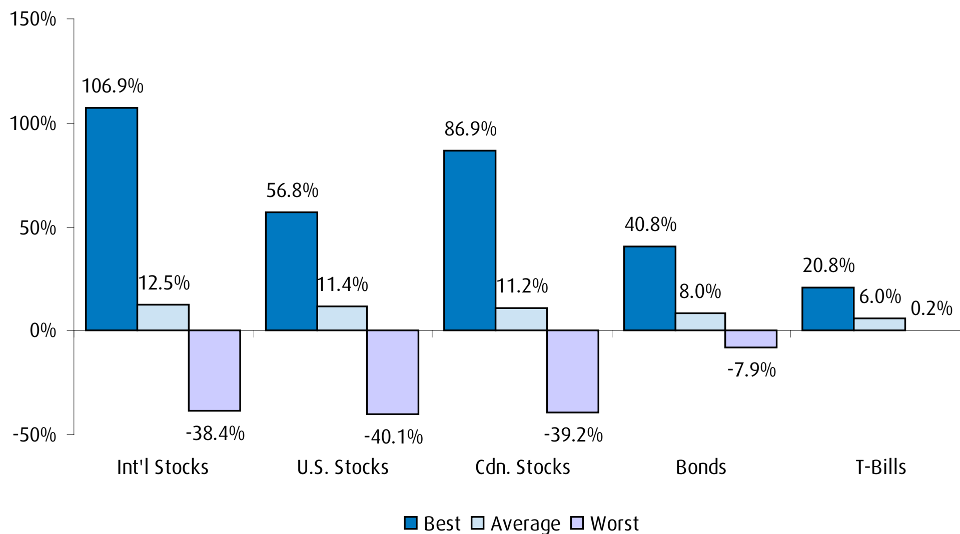
generally avoiding/underweighting interest rate sensitive securities such as long term bonds, perpetual preferreds along with stocks in the REIT and utility sectors. Our preferred current investment themes include: 1) The Coming Mergers & Acquisitions Wave; 2) the U.S. Housing and Auto Recovery; 3) the Re-Industrialization of America.

Please contact your BMO Nesbitt Burns Investment Advisor for our top stock and fund recommendations to gain exposure to these themes.

Portfolio Risks and Diversification Benefits to Consider

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



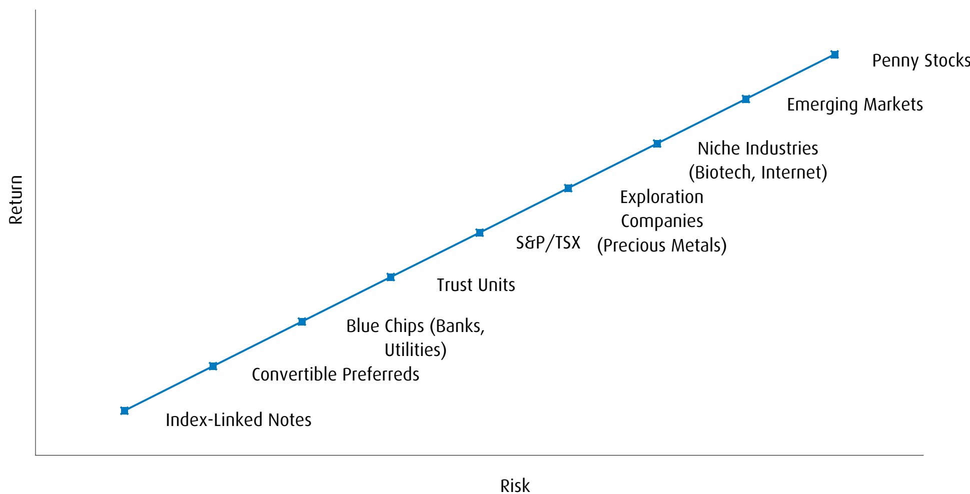
Stocks have experienced the most volatile returns and can present a risk of capital loss.

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, FTSE TMX, Bank of Canada

Not all equities are created equal and some are far riskier than others:

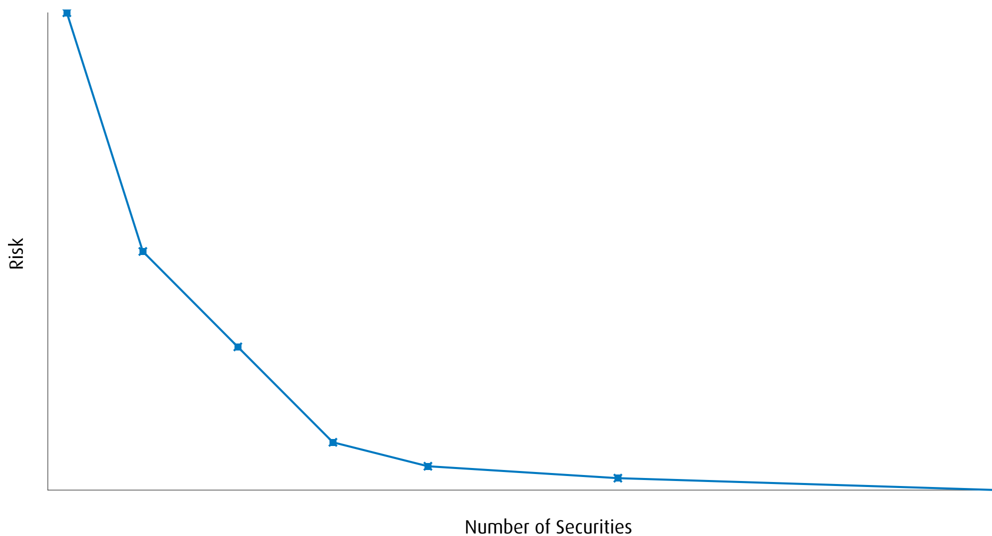
Figure 8: Some Equities are Riskier than Others



Source: BMO Private Client Research

Diversification clearly helps reduce an investor's risk. However, we think it is important to add that over-diversification (owning too many stocks) takes away a portfolio's ability to outperform the benchmark (e.g. the S&P/TSX Composite Index or the S&P 500 Index).

Figure 9: Security-Specific Risk Reduction through Portfolio Diversification



The volatility of a portfolio of stocks decreases as the number of stocks held increases. A well-diversified portfolio can help to reduce security-specific risk, i.e., the risk above that of the market.

For instance, a portfolio of 10 stocks from different industries or sectors will provide better diversification than a portfolio of 10 stocks from one sector of the market.

Source: BMO Private Client Research

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 10: Impact of International Equities for Canadian Investors 1960–2013

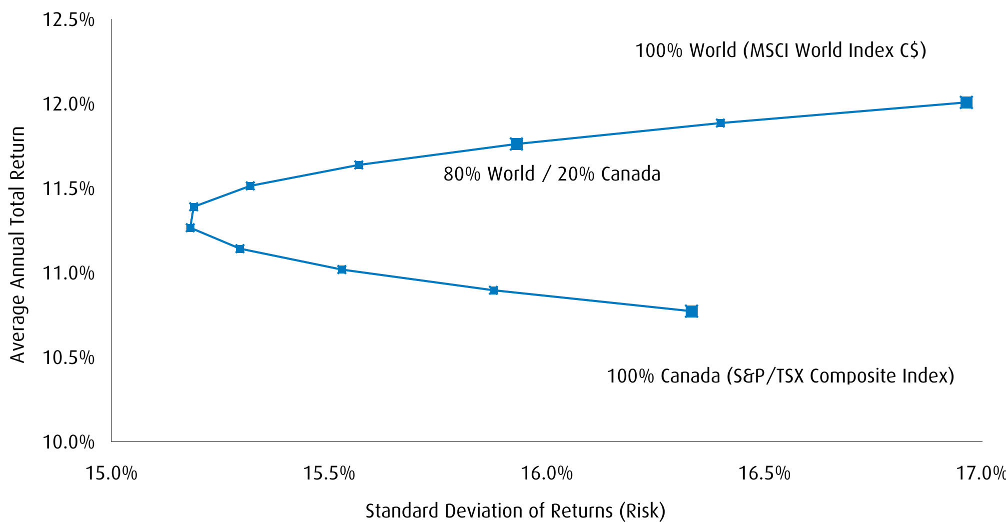


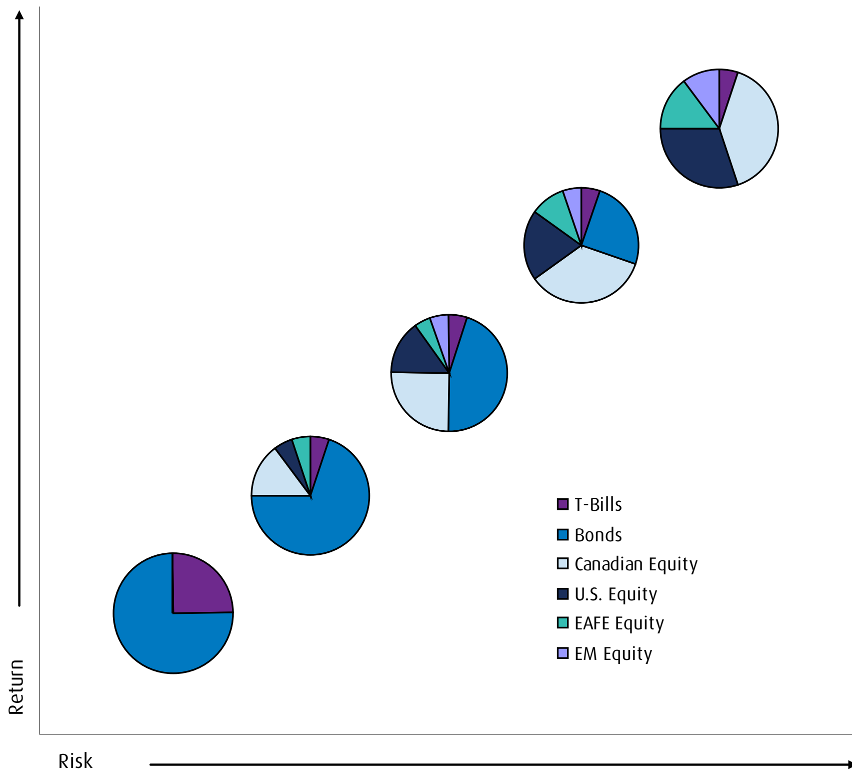
Figure 2 illustrates that a combination of roughly 80% of MSCI World Index and 20% of S&P/TSX Composite Index had a lower level of risk than a 100% investment in the S&P/TSX Composite Index, but provided a superior return.

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

Source: Bloomberg,

Putting these concepts together, Figure 11 shows that a superior risk/reward scenario can be achieved by combining asset classes and diversification.

Figure 11: 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.

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.

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