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# The Importance of Active Portfolio Management

## It's All About Finding the Right Balance

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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.

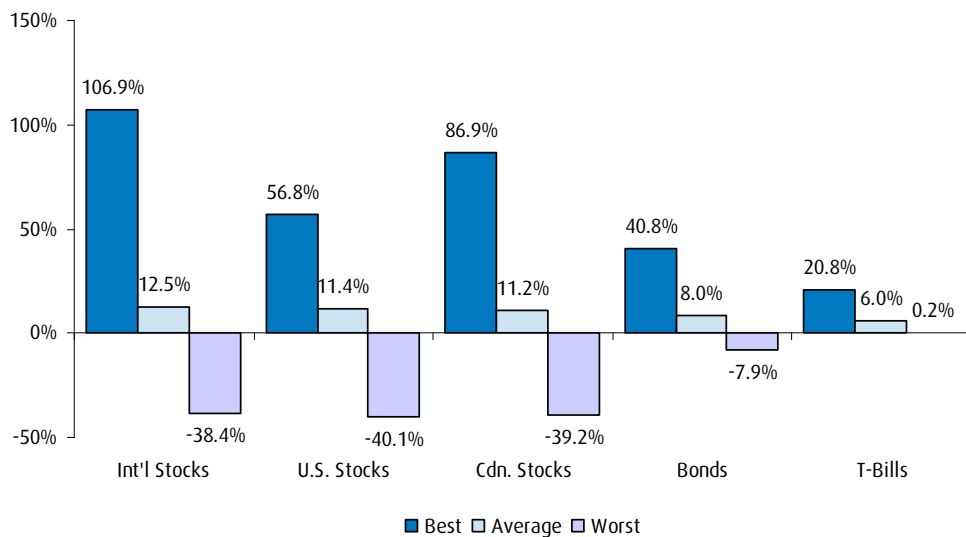


Some of the most important risks that investors must consider include:

- 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

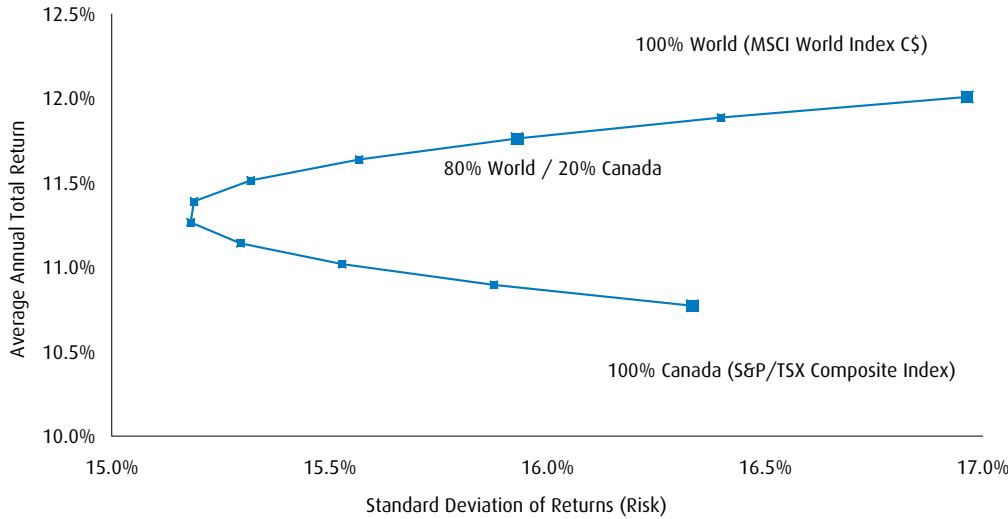
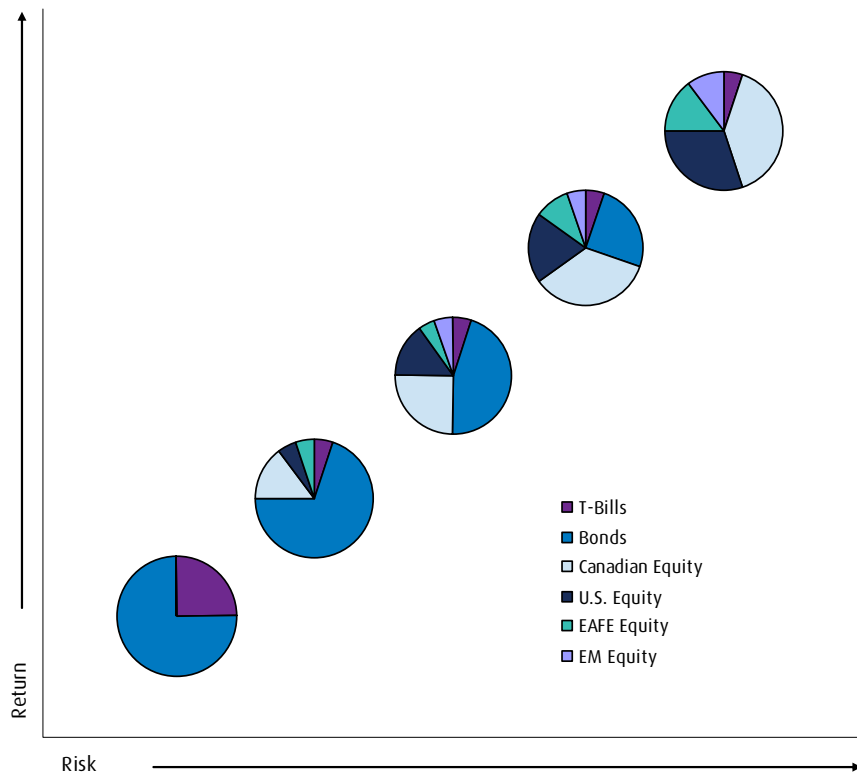


Figure 2 illustrates that a combination of roughly 80% of MSCI World Index and 20% of S&P/TSX Composite Index had a lower level of risk than a 100% investment in the S&P/TSX Composite Index, but provided a superior return. As such, including foreign investments in an equity portfolio can enhance returns and reduce risk.

Source: Bloomberg.

Putting these concepts together, 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



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.

Source: BMO Nesbitt Burns Private Client Research



### 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.

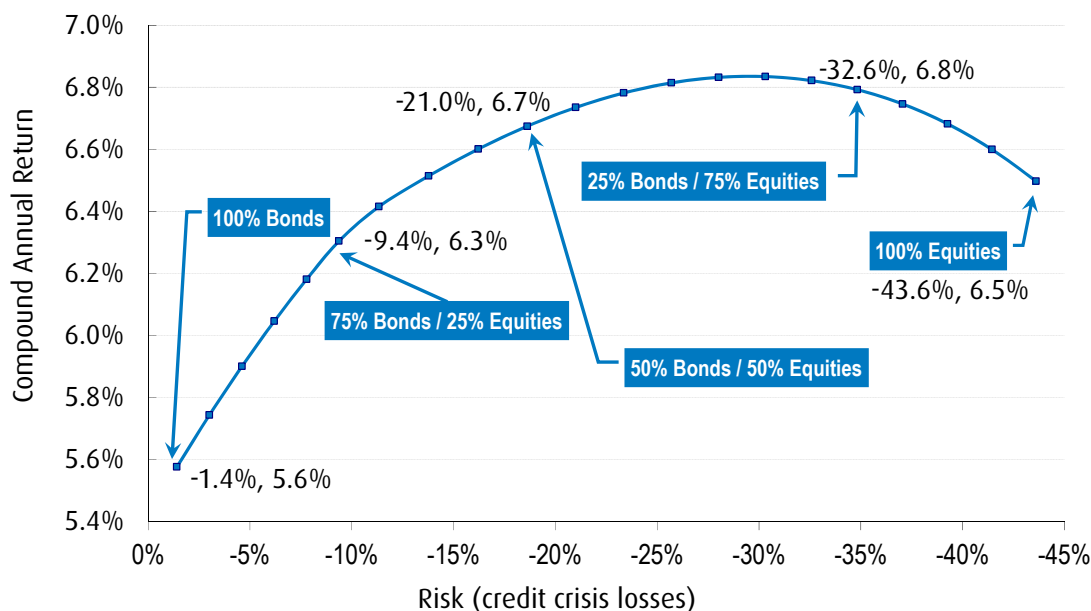
Notably, we concluded that cash and cash-like equivalents have a place in an investor’s portfolio; however, the bulk of one’s financial assets should be invested in long-term securities. We believe that an individual should keep his/her income requirements for a 3- to 12-month period in cash and cash-like 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 | Benchmark | Recommended | Benchmark | Recommended | Benchmark | Recommended       | Benchmark |
|                 | Asset Mix   | Weights   | Asset Mix   | Weights   | Asset Mix   | Weights   | Asset Mix         | 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.





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- (S) = speculative investment;
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