Diversifying Risk is the More Dependable Way to Increase Return

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Nobel Laureate Harry Markowitz, the father of Modern Portfolio Theory, identifies the fundamental problem all investors face: *decisions about portfolio selections are made under uncertainty*. This uncertainty results from the fact that there is really no way to know today which investments will be superior performers and which ones will be inferior performers.

Many investors - including stockbrokerage firms, banks, trust companies and other investment advisors – act as if this uncertainty doesn't exist. They believe that there *is* a way to know today which investments will be superior performers and which ones will be inferior performers. Such advisors believe that the best way to "know" this is through "active investing," the purpose of which is to "beat the market." Active investing takes a number of different forms.

One form of active investing - known as "track record investing" - focuses on the past. This involves attempts to assess which superior performing investments from the past will continue to be superior in the future.

Other forms of active investing - known as "stock picking" and "market timing" - focus on the future. They involve attempts to profitably forecast the future price movements of stocks (or bonds) so that an investor can predict which investments will be superior performers.

All such forms of active investing lead to the widespread belief that to be successful in maximizing investment performance, an investor must be able to "see" into the future or find a "skillful" money manager who can.

Attempts to find investment "winners" based on readings of the past or forecasts of the future do not, however, create ideal conditions for achieving investment success. After all, in order to be successful such attempts must be highly accurate in forecasting the random variable of movements in stock (or bond) prices. Since a random variable is (by definition) unpredictable, it is likely that most attempts to find investment winners based on readings of the past or forecasts of the future will be unsuccessful.

That is why many portfolios created as a result of attempts to find investment winners are often poorly diversified (e.g., heavily invested in high technology stocks or whatever other sector of the market is currently "hot") and saddled with high costs and taxes. Such portfolios generally are not regarded as successful portfolios.

Solving the Problem All Investors Face

In fact, the ideal conditions for achieving investment success are created by disciplined application of three major themes found in modern prudent fiduciary investing: broad diversification of risk, low costs and low taxes. These factors, upon which the Uniform Prudent Investor Act and the

Restatement 3rd of Trusts (Prudent Investor Rule) place such great emphasis, help give investors the best chance to be successful by reducing portfolio risk and enhancing long term wealth.

Broad Diversification to Reduce Risk and Increase Return

Dr. Markowitz observed, as noted, that decisions about portfolio selections are made under uncertainty. Not being able to know today which investments will be superior performers and which ones will be inferior performers is the cause of that uncertainty. Adding to this fundamental problem all investors face is the inherent uncertainty in the price movements of stocks (and bonds) that are held in investors' portfolios. This is illustrated by the up and down "volatility" in portfolio returns.

Whenever this volatility decreases the value of a portfolio, an investor understandably becomes concerned about how low the value will go and how long it will stay there. It is now wonder, then, that many investors define investment risk as not knowing whether their portfolio will be able to generate enough money to fund a desired standard of living.

Reducing the up and down volatility in their portfolio returns – in order to reduce the risk that a portfolio will not be able to generate enough money to fund a desired standard of living – should therefore be the goal of any investor. Efficient portfolio diversification, achieved by using the tools of Modern Portfolio Theory, is fundamental to reducing this volatility risk. The following example illustrates how a portfolio with lower up and down volatility in its returns can have a higher ending value than a portfolio with higher volatility, even though both portfolios have the same average return.

> Assume that Portfolio A has $100 and achieves a +10% return in year 1 and a -10% return in year 2. The portfolio's average return is 0% per year (10% - 10% = 0 ÷ 2 = 0). Assume that Portfolio B has $100 and achieves a +30% return in year 1 and a -30% return in year 2. The average return of this portfolio is also 0% per year (30% - 30% = 0 ÷ 2 = 0).
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> Both portfolios have the same beginning value ($100) and the same average annual return (0%). The compound returns of the portfolios are different, however, because Portfolio B has a larger volatility of returns (+30% and -30%) than Portfolio A (+10% and -10%). This means that the ending values of the portfolios will be very different.
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> The compound return of Portfolio A is -0.50% per year which results in an ending value of $99. The compound return of Portfolio B is -4.61% per year which results in an ending value of $91.

Both portfolios are penalized by the volatility of returns. But Portfolio A's series of returns has a lower volatility (1%) than Portfolio B's (9%). As a result, Portfolio A suffers a smaller penalty (an ending value of $99) than Portfolio B (an ending value of $91). This means that Portfolio B has an actual dollar loss that is *9 times greater* than Portfolio A (-$9 vs. -$1) - even though both portfolios have the same average return (0% per year).

The bottom line: lowering the volatility of a portfolio's returns is a more effective way of reducing risk and enhancing long term wealth than attempting to score big in the random game of trying to identify investment winners through stock picking and market timing. Volatility has a big impact on compound return, which measures the actual number of dollars that end up in a portfolio. Wealth is compounded by lowering portfolio volatility. In short, then, *diversifying risk (i.e., lowering volatility) is the more dependable way to increase return*.

Reduction of Costs and Taxes to Increase Return

In addition to employing broad diversification to reduce risk and increase return, prudent investing involves reducing costs and taxes to increase return. The Restatement suggests that the best way for investors to reduce portfolio risk and enhance long term wealth is through “passive investing.” That involves investing in broadly diversified, low cost and low tax index mutual funds and asset class mutual funds that efficiently and effectively capture the returns offered by financial markets while incurring market-level risk.

Reducing risk, and lowering costs and taxes therefore tend to promote prudent investing while attempting to pick stocks or time markets tend to encourage speculative investing. Apart from the fact that fiduciaries (who are responsible for managing other people’s money) should not be engaged in speculative investing, one of the many problems with speculative investing is that it requires fiduciaries to always be “right” in the sense of achieving consistent superior investment performance.

But fiduciaries cannot always be right when it comes to performance. They can, however, be prudent when it comes to their fiduciary conduct. Fiduciaries as well as attorneys, accountants and other professional advisors who are concerned with issues of legal liability and fiduciary obligation should understand this crucial distinction.