



Managing Risk Vs. Picking Investment Winners

By W. Scott Simon, CFP

Advisors who market their investment skill exclusively on the basis of return or track record can appear foolish and may be exhibiting imprudent fiduciary conduct.

They appear foolish because the return generated by an investment or a money manager is a random variable over which they have very little control. In fact, a wide variety of sources suggest any investment (or money manager) with a good track record from the past is just as likely to perform poorly in the future as it is to continue doing well.

When advisors place undue emphasis on return, they define investment prudence in terms of portfolio performance, not fiduciary conduct, directly opposite of how the Uniform Prudent Investor Act defines prudence. Advisors that engage in such activities may be exhibiting imprudent fiduciary conduct.

Although it seems counterintuitive, advisors can enhance portfolio wealth more effectively by consciously managing risk rather than trying to score big in the random game of identifying investment winners.

In short, the better way to increase return is to concentrate more on managing risk and less on trying to increase return via stock picking or market timing. This approach to investing and managing portfolios adheres to the principles of modern prudent fiduciary investing.

Variance drain shows advisors how emphasizing management of portfolio risk instead of attempting to pick investment winners can lead to enhanced portfolio return.

In addition, variance drain operates under the theory that between two portfolios with the same beginning value and the same average return, the one with the greater variance will have a lower compound return and less-ending wealth. Before providing an example of variance drain, it may be helpful to define the meaning of variance, average return and compound return.

Variance also measures the degree to which the period-by-period returns of a portfolio are expected to deviate from the statistically expected mean return of the portfolio for a given period of time. The more the returns are expected to deviate from the portfolio's expected return, the greater the variance and risk of the portfolio. As Nobel Laureate Harry Markowitz made clear in his seminal article on Modern Portfolio Theory in 1952, variance of return can be minimized for a given level of expected return.

When there are two portfolios with the same beginning value and the same average return.

the portfolio less diversified (by definition, since its manager seeks to maximize portfolio return by trying to find a relatively few concentrated winners that will beat the market) will have a larger variance and a lower compound return than the well-diversified portfolio with a smaller variance and a higher compound return. The well-diversified portfolio usually generates more ending wealth than the less diversified portfolio.

The mathematical rule of variance drain means that efforts to maximize percentage return in each time period with the goal of maximizing long-term dollar values increases the possibility that there will be a shortfall in expected dollar values. An advisor may fail to carry out its client's objectives not because he or she did not seek to maximize return, but because seeking maximum return is often inconsistent with maximizing the probability of a successful outcome in expected dollar values.

Given extreme volatility in percentage returns over extended time periods, variance drain can affect ending dollar values dramatically. For example, during the 1930s, when U. S. small-company stocks plunged in value and experienced equally dramatic rebounds, this asset class achieved an average return of 19.72 percent per year. However, compound return, which summarizes the accumulation of actual ending wealth in a portfolio, was just 1.38 percent per year.

Reducing portfolio variance of returns and keeping the size of fluctuations in portfolio values low are more effective ways of enhancing wealth.

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