Building Better Investment Portfolios

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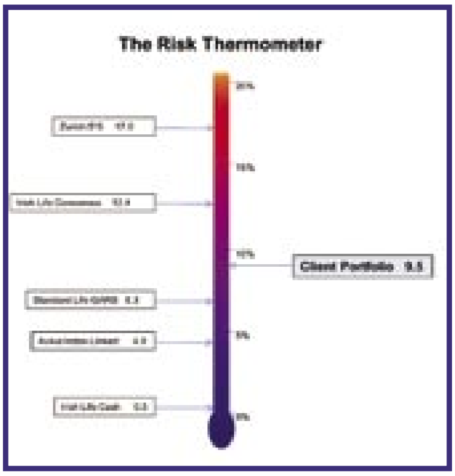
Establishing where a client sits on the risk spectrum is the first, crucial step in providing investment advice. This need not be a daunting task, particularly where judgment is supported by the use of more objective tools! Building a suitable investment portfolio presents a much greater challenge.

Most advisers used to rely substantially on 'packaged' solutions such as Managed/ Consensus /UWP funds but now realise that they are fundamentally flawed. Providers are beavering away to find new alternatives in what might be described as the "diversified assets" area - however it will be some time before new alternatives gain acceptance and prove their worth. In the meantime advisers may be forced to build their own portfolios, whether they like to or not. Many advisers prefer this option anyway, but it presents its own challenges:

- **What mix of assets?**
- **Active or passive?**
- **Which provider?**
- **Re-balancing?**

The main driver of both return and risk will be the broad allocation across asset classes. However the choices within asset classes can make a real difference -'regular' equities or high yield ? Eurozone/non Eurozone ? What about emerging markets? Small cap equities have been shown to add performance too. Boring old bonds have some interesting sub-categories with very different characteristics, notably corporate and index-linked. The field of Absolute Return is a broad church where funds are complex, often coming from unfamiliar providers with short track records.

The level of risk associated with the asset mix obviously needs to be appropriate and a measure of science can and should be brought to bear. The historical volatility and maximum drawdown (the loss which would have been suffered by buying and selling at the worst possible times expressed as a percentage) are extremely useful statistics in relating portfolios to the risk categorisation of the client .A client provided with this data is quite well-informed about the risk they are taking on, particularly when provided with a comparator(s) to which they can relate. This can be presented in a client-friendly way using a graphic such as a 'risk thermometer 'which shows the fund or portfolio in question against some popular alternatives :



The active/passive debate is pretty well over unless you choose to ignore the evidence - this is especially so where passive is cheaper. Unfortunately the main providers in Ireland do not offer any reduction for passive making the case less clear-cut. The particular passive component you need may not be on the shelf of the provider(s) you want to use anyway and some are not available at all.

Anyone opting for active management will be aware of how divergent the outcomes can be and selecting providers is not easy. It is not just the Financial Regulator who thinks past performance is not a good guide to the future – the evidence is overwhelming.

Re-balancing is often overlooked in terms of its impact on risk and return. In the real world many portfolios drift along without intervention for years and can get significantly out of kilter from the risk profile set at the start. That aside, re-balancing can be a source of return in so far as it forces sales of components which have outperformed and vice versa (Buy Low/Sell High).

Make no mistake, addressing the issues set out above to a good standard presents a challenge likely to stretch the resources of many advisers. Some who are well capable of tackling this agenda will conclude that their time and talents are better deployed acquiring and looking after clients. Just as people are happy to 'contract-in' expertise in areas such as compliance or IT why should this not extend to investment?

My own firm works closely with a number of brokerages some of whom have embedded our assistance into their service. However it is achieved, a robust and refined investment process can be invaluable in retaining clients and winning new ones. People of means normally have more than one adviser and there may be an opportunity to replace some of your competitors– if they have disappointed and you present a highly credible alternative, why not?

A structured and well-grounded approach to investment is likely to become a necessity from a defensive/compliance perspective – why not get ahead of the game and embrace it as a source of competitive advantage?