

Second Quarter 2002 Investment View

Strategy Over Tactics

It now appears possible, if not likely, that the US stock market will finish its third consecutive calendar year in negative territory. The slide that began in early 2000 has caused many to make, or considering making, drastic changes to their investment philosophy and equity allocations. During times like these, investors feel overwhelming internal pressure to “do something.”

There is no question that a dramatic market decline creates strong pressure to react. Parametric has long advocated that one of the most important tenets in investing – particularly for taxable investors – is *strategy dominates tactics*. Portfolio structure should be designed to withstand inevitable tempests when emotions, competitive pressure, or the need for liquidity are at their height. Clearly, we are in one of those times.

What follows is our perspective on investing in the current markets. As you might expect, this commentary is not a prediction of the end of the current market decline, nor is it “hot stock” picks or a forecast of the Fed’s next move. As a diversified, buy-and-hold manager, we are often at a publicity disadvantage versus those who offer tactical advice, market predictions, security picks, and the like. Admittedly, we can sometimes seem indifferent to the current markets (at least relatively) because of our focus on adding value through risk control and tax management. However, there’s nothing indifferent about the “what do we do now” debates that currently wage in the media, between advisors and their clients, and most importantly, inside investors. We think it is crucial for us to speak up in support of *strategy over tactics*.

It is important, even fundamental, to remain continually aware that the industry and its constituents such as media, brokerage, and advisory, were built upon investors embracing tactics – not just a specific course of action, but a general tactical worldview. Support for tactics from these camps should be observed with appropriate skepticism.

Similarly, a possible contributor to the current pressures, and a certain exploitation, is a flood of investment theories and advice that represent shoddy thinking, at best, and irresponsible marketing, at worst. These messages are a constant call-to-arms, but do very little to equip investors for battle. We will examine some of these messages, but first, we should be clear about our perspective.

We submit, hopefully without much controversy, that the current bear market has NOT –

- **made investment forecasters any smarter,**
- **made the market less efficient (easier to beat),**
- **altered the destructive effect of fees and costs on investment return.**

With these observations in mind, we highlight some of the troubling arguments on the table today, and finish with a strategic recommendation for long-term equity investors.

Three Alarming Arguments

➤ **Argument #1: Trade the ranges**

Let's start with a particularly dramatic example of market pressures leading to dangerous conclusions – i.e. the increased interest in market timing. As one example, the July 1, 2002 cover of Barron's, under the title of "How to Invest Now" offered that now is the time to "maybe even engage in some market timing." A look inside the issue found an argument to "trade the ranges," a suggestion to exploit the market's trading ranges by selling stocks every time the S&P hits, say 1200, and buying stocks every time the market reaches its low (unclear where that is). Similarly, other pundits are arguing that buy and hold investing may not provide investors with the returns they seek. They predict that if the market is going to vacillate for an extended period, market-like strategies should be avoided, and returns can – or "should" – be enhanced through market timing.

Underpinning this argument is a dangerous logic: If the market, in a buy-and-hold broadly-diversified form, is not going to provide the return you need to reach your goals, then it becomes wise to embrace a tremendously risky investment strategy – market timing. Not so, we would argue. This approach creates risk, incurs substantial costs, and has been discredited by the academic and practitioner worlds alike. A dangerous "doubledown" indeed.

There are many studies that have dealt with the efficacy of market timing. One very recent example is the Dalbar research, released in June of 2002, and subtitled "More Proof that Market Timing Doesn't Work for the Majority of Investors." It found that, due to investor timing decisions from 1984 to 2000, "The average equity-fund investor realized an annualized return of 5.32%, compared to 16.29% for the S&P 500 Index."¹

Returning to our observations – if market forecasters, i.e., the establishers of "ranges," are still the same fallible humans, and the market they face is just as efficient, and the effect of fees, costs, and taxes remains just as damaging to wealth creation – then market timing is still a bad idea.

Opportunities for excess return do not mysteriously avail themselves just because the market, as a whole, offers less. Many investors may find that they indeed need to adjust their practices (e.g. save more, spend less) in response to market events, but for most, embracing market timing is desperate myopia.

➤ **Argument #2: Increase allocation to active management**

This argument states that in the current weak market and probable lower-return environment to come, passive or index-based strategies are easily bested by stock pickers and other active strategies. Two rationale seem to lie behind this thinking – (i) some investors want to believe that excess performance is now more readily available to mitigate poor market returns and (ii) an often repeated refrain that active management performs relatively better in weak markets. It is crucial to note that ***in every stock market environment, active management is a zero sum game. For every winner, there must necessarily be a loser.*** Or as Nobel laureate William Sharpe wrote, "the average actively managed dollar *must* equal the market return."² This is not altered by up markets, down markets, weak markets, or strong markets.

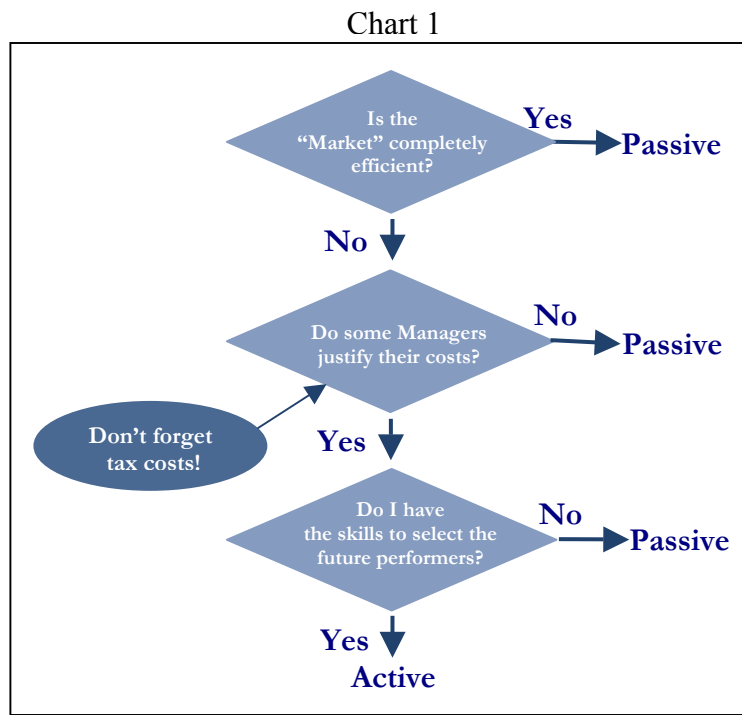
As we will discuss later in this paper, Parametric believes that many thoughtful investors allocate significantly to **both** active and passive approaches – often combined in a core and satellite

¹ For more information on this study and other conclusions of Dalbar's Quantitative Analysis of Investor Behavior see www.dalbarinc.com.

² The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991. pp. 7-9

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portfolio structure. Understanding the active/passive dilemma starts by considering that ultimately, an investor's active allocation is derived from conclusions about (i) the efficiency of the markets and (ii) one's ability to identify, a priori, managers or strategies that will add value. Consider the decision tree shown in Chart 1.



Accordingly, investors should increase their allocations to active only (i) if the market becomes less efficient and/or (ii) they have an increased ability to identify future outperformers. This decision is similar to other risk allocation decisions (such as broader asset allocation) in that it is closely related to an investor's market beliefs, risk tolerances, and time horizons.

So has anything really changed that compels an investor to take more active risk? From our perspective, the answer is no. Active investing is still very tough, markets are still efficient, and the collective value of active investing is still bound by the rules of logic and arithmetic. The pressure applied by a poor-return environment can cause an investor to inject tactics into a strategic decision and increase risk at the wrong time.

➤ **Argument #3: Don't worry about taxes**

There is no doubt that we are in a mild winter of cap gains taxes. In flat and declining markets, even managers who are typically tax-inefficient spin off fewer gains and realize some losses. This environment may cause investors to abandon tax-efficient strategies, believing the last thing they need now is loss harvesting and capital gain management – primary components of tax-managed portfolios. Some investors are “spending” existing realized losses as they allocate toward tax-inefficient strategies, rationalizing that capital gain taxes will not be a material issue in their investment situation. While the tax pain of changing strategies may be currently diminished, the vast majority of investors will find taxes re-emerge as a significant drag on performance. ***Many investors incorrectly assume that the only losses with value are those that can be used in the short run – a mistake that can have significant implications on long-term wealth creation.***

Parametric recently completed an analysis of a hypothetical case where an investor, after the last three years of weak market performance and many losses on the books, liquidated his tax-managed, core portfolio and moved to a tax-inefficient strategy, believing tax management was no longer needed. Even under assumptions of a slow market recovery, we found that, in the absence of continued focus on tax-efficiency, it takes only five to seven years to completely exhaust all his capital-loss carry forwards. ***The takeaway is that even though losses seem abundant now, only investors with short investment horizons should consider abandoning tax-efficiency.***

Tax cost, the largest investment cost for most investors, is an issue that deserves perpetual investor focus. The bear market raging in the summer of 2002 has not changed this. It is tempting, maybe even natural, to de-emphasize the issue of taxes in times when capital gains are scarce. However, many diversified investors have or will have gains from fixed income portfolios or hedge fund portfolios, and will face rebalancing decisions that involve tax consequences. Moreover, the market will eventually return to an upward trend, and when it does, tax-efficient investing will become more important – likely sooner than most realize. Losing focus during a “mild winter” can be damaging when the seasons return to normal.

Recommendations for Long-Term Equity Investors

➤ **So what, if anything, should investors do now?**

Put a long-term, diversified portfolio structure in place. It is not surprising that Parametric responds to this tactical question with a strategic answer. A “core-and-satellite” approach creates diversification in a long-term portfolio structure – particularly for taxable investors. In this structure, a significant portion of the assets is placed into a well-diversified, low-turnover, broad market portfolio. This ensures that a large part of the portfolio captures market performance with a low rate of capital gain realization. Around this core, aggressive alpha-seeking approaches are implemented.

While the full topic of core and satellite portfolio structure demands more space than we allot here, following are a few thoughts on how to think about core and satellite investments and how to combine them.

➤ **What is a good core?**

The first objective of a core allocation should be to provide the investor with broad exposure and risk control. Return rarely comes uniformly from the entire market. Rather, it comes in fits and starts and from different sectors at different times. The goal of the core is to ensure that no matter what happens with the market and with an investor’s chosen active allocations, the portfolio is assured participation in the broad market.

Index-based mutual funds, exchange-traded funds and separate accounts can all serve the purpose of providing broad market exposure³. However, the value of a core and satellite structure can be significantly enhanced if the core portfolio manager provides active tax management including opportunistic loss harvesting. The ability to pass through realized losses while staying fully invested is unique to a tax-efficient separate account.

Diversified separate accounts have the additional benefit of being highly customizable. An investor’s desire to implement social restrictions, for example, can be easily accommodated in a broadly based separate account without compromising the investment objective.

³ For more information, please click on materials@paraport.com and request the “Separate Account vs. ETF & Mutual Fund” study.

➤ **What are good satellites?**

The purpose of satellite investments is to introduce aggressive, alpha-seeking components into the overall portfolio. It is important to emphasize that the primary role of satellite investments is to enhance return, not to provide diversification. Along these lines, the satellite investments can be given broad mandates, should be relatively concentrated, and have low correlation to relevant benchmarks. A satellite strategy may involve tactical changes to the manager lineup.

➤ **What is the right core & satellite allocation?**

While, as is the case with traditional asset allocation, there are no unequivocal empirical solutions to this question, it is helpful to briefly consider some of the issues. Essentially the core reduces the risk of underperforming the desired asset class (active risk) and can enhance tax efficiency, while the satellites increase active risk in the search for excess return. In general, an investor will allocate more to satellites and less to core under the following assumptions, listed in order of importance:

- ✓ There is a high degree of confidence in the skill of the satellite managers (makes active risk more palatable)
- ✓ The investor's tax rate is lower (makes tax efficiency less important)
- ✓ The expected market return is lower
- ✓ The investment horizon is shorter

In this scenario, a tax-exempt investor who selects satellite managers that “never miss” has zero core allocation. As investors acknowledge uncertainty regarding active bets as well as the need for tax management, core allocations increase. Initial Parametric research indicates that nearly every taxable investor is wise to allocate at least 40% to a tax-managed, passive core. For many, the number approaches 60% and higher⁴.

The Bottom Line

To create a thoughtful portfolio for the long haul:

- ❑ Think strategically;
- ❑ Emphasize diversification;
- ❑ Focus on costs and take advantage of declining prices.

Parametric is convinced that the rules of investing have not changed and adherence to wise long-term strategy will serve investors well.

⁴ For more information, please click on materials@paraport.com and request the soon to be released “Core & Satellite” study.