

PARAMETRIC PERSPECTIVES

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“The investor’s chief problem—and even his worst enemy—is likely to be himself.”

– Benjamin Graham



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► WHY MOST INVESTORS ARE SET UP TO FAIL

The market collapse has been a crucible that has pushed investor tolerance for pain to the limit and shaken the fundamental beliefs of advisors. “Is modern portfolio theory dead?” was a heated topic of discussion at the recent IMCA conference, with many new converts to market timing showing disdain for diversification and passive investing approaches; and even staunch advocates of modern portfolio theory asking themselves, “If correlations go to one during a crisis, how can I diversify my portfolio?” The experiences of Q4 2008 are a serious test of faith.

Over short periods the market can behave strangely and a crisis will cause people to sharpen their focus on the short term. However, I submit that over the long term there are two reasons investors fail to meet their investment objectives:

1. Their efforts to beat the market, chase performance, and time the market lead to higher levels of risk and/or lower returns.
2. Even if they do beat the market, the majority of their returns are drained away by the four horsemen of investing: fees, trading costs, taxes, and inflation.

To achieve their financial goals, most people will need to expose their assets to risk in order to earn an investment return that is higher than cash. Risk, by definition, is exposure to loss. Investors should structure their portfolios to control costs and avoid behavioral mistakes, but there

is no escaping risk completely. In this article, I try to dispel some of the common myths that lead investors astray.

MYTH: Beating the market is easy.

On average, we should expect active managers as a group to underperform by the amount of fees and trading costs they consume.¹ A study by Standard and Poors supports this theory by showing that the benchmark outperforms more than 50% of active managers in every fund category over a five-year horizon ending December 2008 (see figure 1).² Beating the market is difficult.

MYTH: Combining specialist managers from each of the style boxes is the best way to structure your portfolio.

The style-box argument goes something like this: styles of investing come in and out of favor—with some styles doing well at the beginning of the cycle and other styles at the end of the cycle—therefore, fill up the style buckets with active managers to get a full representation of the market. Scott Welch in his paper “Hitchhikers Guide to Core/Satellite Investing” summarizes the problems with this approach:

The investment consultant community, in particular, largely remains anchored to the idea of “style box” investing (e.g., large cap growth, small cap value, etc.), the result of

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which is that the managers that gather the most assets and, therefore, are "successful", are those managers that do not deviate too far from their benchmarks or from their style box.

This is an expensive and tax inefficient way to get a return very similar to the market. The alternative to style box investing is a core/satellite approach. The core of the portfolio should be passive and tax-managed. The active "satellite" part of the portfolio should be very active, with managers that are free to be different from the index, and with return patterns that are less correlated to the market.

MYTH: High return = skillful management.

Chasing performance is a common pastime for investors and is difficult to avoid. However, past performance is a terrible metric for predicting future results, for two reasons: (1) There is an incredible amount of volatility in the data which makes distinguishing skill from luck nearly impossible—the statistical test to detect the signal within noisy returns typically requires a twenty- or thirty-year track record; (2) Even if the manager has a 30-year track record and the statistics "prove" they have skill, the results are invalid because their people, process, assets under management, and the underlying markets have changed significantly over that horizon. It's better to choose managers based on more qualitative metrics—smart people, stable organization, disciplined investment process, etc.—than to pick the one with the best performance last year.

MYTH: Active managers have the advantage during bear markets due to their ability to tactically shift into cash or defensive stocks.

The same S&P study cited above shows that the percentage of active funds outperformed by the benchmark in 2008 and in 2000 to 2002 was well above 50% for all categories except Large Value.³ Even hedge funds had a difficult time posting positive returns in 2008, dropping 21% in value (HFR Institute HFOF Composite Index). Active managers don't appear to have a bear-market edge.

MYTH: Timing the market is necessary to grow and preserve wealth.

I predict that for the next couple years market timing programs and other strategies that outperformed through the

recent market crash will enjoy a sudden popularity. The theme of these products are that full market exposure is dangerous and that timing bear and bull markets is prudent and possible.

My father-in-law, an attorney, came to me recently with some questions about a case he was working on. His client was wrongfully terminated and after winning the case (over the course of eleven years of litigation) they were contemplating damages.

The primary issue was determining how much the client's \$100,000 of retirement assets in his 401k would now be worth at the end of eleven years. Figure 2 shows the investment options available and their annual returns.⁴

The client was a molecular scientist and quickly mastered the calculations for compounding wealth to come up with the figure \$1.97 million in damages (31% annualized return). He assumed that—given his success in science—he would have been able to invest in the best performing asset each year, switching tactically between large cap growth, emerging markets, REITs, and bonds.

A more likely scenario: he invests in the asset with the best performance over the prior year. This strategy has the same pattern of switching, but lagged by a year, and results in an ending wealth of \$101,300, an essentially flat return. After accounting for 2.3% annualized inflation, the portfolio will have lost 28% of its purchasing power.

So like most questions involving compounding over many years, the correct answer was somewhere between \$100,000 and \$2 million. In the end, we settled on an equal-weighted portfolio as a choice easily defended in court. If you have no timing skill or special information about these funds, diversifying equally across them is a reasonable default choice. If you were to buy equal weights at the beginning and hold them over the period you would end up with \$144,000. Rebalancing annually

improved your ending wealth to \$163,000, or 4.5% annualized return. Too bad he didn't finish the law suit a year earlier.

It is unusual, for periods longer than 10 years, to have equities underperform bonds. It was difficult to appreciate in 2007 that this was about to be the case. In 2007, we had only one investor express to us their concern about a potential financial crisis. In 2009, after the crash, everyone is talking about the

Figure 1:

		PERCENT OF EQUITY FUNDS OUTPERFORMED BY BENCHMARKS		
Fund Category	Comparison Index	Bear Markets		Current 5yr Period
		2000-2002	2008	2003-2008
All Large Cap Funds	S&P 500	54	54	72
All Mid Cap Funds	S&P MidCap 400	75	75	79
All Small Cap Funds	S&P SmallCap 600	84	84	85
Large Cap Growth Funds	S&P 500 Growth	90	49	81
Large Cap Core Funds	S&P 500	52	53	78
Large Cap Value Funds	S&P 500 Value	22	37	53
Mid Cap Growth Funds	S&P MidCap 400 Growth	89	82	77
Mid Cap Core Funds	S&P MidCap 400	62	70	76
Mid Cap Value Funds	S&P MidCap 400 Value	67	83	79
Small Cap Growth Funds	S&P SmallCap 600 Growth	96	88	96
Small Cap Core Funds	S&P SmallCap 600	82	71	81
Small Cap Value Funds	S&PSmallCap 600 Value	73	58	70

Figure 2:

ANNUAL RETURNS												
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Annualized
Large Cap Growth	42	28	-22	-13	-24	26	6	4	11	9	-35	0.2%
Large Cap Value	15	13	6	-12	-21	32	16	6	21	2	-39	1.4%
Small Cap	-3	21	-3	2	-20	47	18	5	18	-2	-34	2.4%
REIT	-17	-3	31	12	4	36	33	14	36	-18	-39	5.1%
International Equity	20	27	-14	-21	-16	39	20	14	26	11	-43	2.5%
Emerging Markets	-28	64	-32	-5	-8	52	22	30	29	36	-54	2.9%
Bonds	9	-1	12	8	10	4	4	2	4	7	5	5.8%
Short-term Govt Bonds	8	2	9	9	8	2	2	1	4	8	8	5.5%
Perfect Timing	42	64	31	12	10	52	33	30	36	36	8	31.1%
Chasing Last Year	42	28	-32	12	4	4	22	14	29	-18	-54	0.1%
Equal Weighted, Rebal	6	19	-2	-3	-8	30	15	10	19	7	-29	4.5%

financial crisis and there are many investors pulling their money out of the markets. Trying to time the market usually destroys wealth.

MYTH: Taxes and fees are secondary considerations.

The excess returns (positive or negative) for a manager are usually large relative to the fees, but fees are known with certainty and can be controlled by the investor. By mixing together low cost passive management with higher fee active management, an investor can create the fee structure they are comfortable with. The decision on how much active and passive management to include in the portfolio is a primary one—and often dictated by the investor’s desired level of fees.

A recent study of active manager performance demonstrated that for the typical manager, taxes reduce investment returns by 1% to 2% due primarily to the short-term capital gains taxes caused by frequent trading.⁵ Whether or not they realize or accept it, investors hoping to reach specific wealth or return goals have to acknowledge the role that fees and taxes play in eroding returns.

An investor who pays a 1% advisory fee, a 1% expense ratio, 1% in trading costs, and 1% to 2% in tax costs will need to take a lot of risk in order to have a hope of beating inflation.

INVESTING TRUTHS:

- **You must take risk.** Unfortunately, in order to earn returns above the rate of inflation, investors must take risk. Whether the risk comes from equity beta, market timing, default risk, or counterparty exposure—it exists. If you find an investment with double digit returns and single digit risk, then either you are measuring risk incorrectly (think Long-Term Capital Management) or something is very wrong (think Madoff).
- **Diversify.** Correlations rise during a market crisis, but over longer periods investing in different asset classes, countries, and sectors will benefit investors.
- **Rebalance.** The only market timing system that appears to work over the long-term is systematic rebalancing. If you can adhere to a rebalancing rule—whether at the asset class, country, sector, or stock-level—that forces you to sell high and buy low (against your natural instincts), then you will tend to outperform a buy and hold strategy.
- **Pay attention to costs.** Using a core and satellite approach, investors can significantly reduce the cost structure of their portfolio in terms of fees, trading costs, and taxes. These savings may seem small—only a few percent per year—but they compound over time.

¹ William Sharpe “The Arithmetic of Active Management,” *Financial Analysts Journal* (Jan/Feb 1991).

² “Standard and Poor’s Indices Versus Active Funds Scorecard, Year End 2008” includes the performance of mutual funds (not separate accounts or limited partnerships). Outperformance is based upon equal weighted fund counts.

³ Managers tend to outperform a style index when it does poorly relative to the market due to the fact that the index is more “style pure.”

⁴ For this article I’ve substituted the fund returns with index returns (gross of fees): S&P 500 Growth, S&P 500 Value, Russell 2000, DJ/Wiltshire REIT, MSCI EAFE, MSCI EM, BC Aggregate Bond, and BC 1-5yr Gov’t Bond.

⁵ Wotherspoon and Longmeier, “The Value of Tax Efficient Investments,” *Journal of Wealth Management* (Summer 2006).



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About Parametric

Parametric is an industry-leading provider of structured portfolio management, headquartered in Seattle, Washington. Parametric and its affiliate, Parametric Risk Advisors, offer a variety of structured portfolio solutions, including customized core equity portfolios (U.S., Non-U.S., global Tax-Managed Core™), options strategies (DeltaShift™), emerging markets (Structured Emerging Markets™), and overlay portfolio management (OverlayOne™).

Total AUM (03/31/2009):

\$19.2 Billion*

*This figure represents the combined AUM of Parametric and its affiliate Parametric Risk Advisors.

Established:

1987

WHAT'S NEW?

PARAHEDGE

Many advisors have contacted us with a desire to get back into the market, while mitigating downside risk. We have experienced significant interest in Parametric's custom portfolio solution—ParaHedge. ParaHedge utilizes transparent professional management of listed index options to provide continued upside participation while offering targeted downside protection.

Parametric Risk Advisors (PRA), our Westport, CT affiliate specializing in option and derivative solutions, developed ParaHedge to meet the needs of family offices and institutions. ParaHedge combines the sale of short-dated covered call options with the purchase of medium-term put spreads and employs a systematic, disciplined options management methodology to select and trade the option positions and monitor individual portfolios.

Strategy:

Option specialists employ put and call strategies on a long equity portfolio to provide upside participation while limiting downside exposure. This can be done with a funding from cash or existing active or passive portfolios.

- **Protective Put Spread:** medium term (3-6 month) put spreads. A purchase of a near-the-money put option - typically 5% out-of-the-money - and a sale of a further out-of-the-money put - typically 15% - 20% out-of-the-money. These provide partial protection against market declines. The put spreads may constitute a straddle (consult your tax advisor).
- **Systematic Call Selling:** short term (1-2 month) out-of-the-money call options. This helps pay for the put spread in exchange for limiting a portion of the potential appreciation.

Key Benefits:

PRA's proprietary risk management system can be an attractive alternative to "go-it alone" put buying, because it provides dynamic portfolio management, real time risk reports, valuation and institutional trading. Additionally, ParaHedge avoids the cost, lack of transparency and counterparty risk issues associated with over-the-counter solutions and structured note offerings.

Disclosures

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