A Theoretical Basis for How I Manage Your Portfolio

A portfolio of perfectly diversified financial securities, also known as a Market Portfolio (M), is a theoretical concept. The academic literature describes M as a portfolio of all available financial securities in the market, each weighted according to its market value. Suffice to say that M involves diversification at two levels. The first level is diversification across all different asset classes such as stocks, bonds, real estate, commodities, and metals. The second level occurs within each asset class. For example, the stock asset class would include all equities traded on listed exchanges throughout the entire world. In theory, such broad-level diversification eliminates as much market risk as possible. As a practical matter, Exchange Traded Funds (ETFs) provide an acceptable mechanism for achieving this type of broad-level diversification.

While the theory is solid, putting it into practical use is not so easy. One practical way of constructing a proxy for the stock asset class of M is to invest in large-cap, mid-cap, and small-cap index ETFs in order to gain as much diversification as practically possible. Crucial judgments are needed at this step especially when assigning weights to each ETF. The end result is that these three ETFs form a reasonable base for creating the stock asset class. Although these ETFs do not specifically identify certain other types of stocks such as high-dividend paying stocks, low-P/E stocks, and fast-growing technology stocks, they are included within the indices. Consequently, these three ETFs capture a large portion of the exposure I want for the stock asset class. Other types of ETFs give me exposure to the additional asset classes I want represented in the portfolio such as bonds and RE. Combining all of these ETFs each weighted according to my assessment of your risk tolerance gives me a basic foundation for forming your portfolio.

Let me expand somewhat on this step in the portfolio management process--your risk tolerance. This is a crucial step because each client is different and, as a consequence, each has a unique tolerance for risk. Age, health, employment status, potential inheritance, life-style, amount of available resources, retirement aspirations all play an important role in that risk assessment. For example, a young, healthy client who is building his/her portfolio for retirement is most likely more willing and able to tilt the portfolio's weighting scheme more toward stocks as opposed to the other asset classes. Still, if diversification is the desired strategy, tilting toward stocks would not necessarily mean ignoring the other asset classes. This is where my judgment becomes incredibly important. Once I make this final risk assessment, I purchase a combination of ETFs that I believe meet your level of risk tolerance. Even then, however, the process is not finished. I rebalance each portfolio during the quarter in order to keep it within the boundaries of your unique risk tolerance.

In closing, the new year invariably brings a host of market predictions from various market gurus who each claims they have a crystal ball. These predictions are no more than pure guesses. I highly recommend that you not take these guesses seriously. Nobody has a crystal ball! My hope is that this brief essay not only describes the theoretical foundation for how I manage your portfolio, but that it also clearly depicts a disciplined, thoughtful methodology that focuses on your risk tolerance.

I have developed this unique model over many years of study. In the process I reviewed a multitude of other approaches to portfolio management such as market-timing, stock selection, and sector rotation. All of these approaches may sound attractive, but are generally not supported by sound financial theory. As a consequence, they greatly depend on luck for whatever success they may achieve. The academic literature strongly supports the theory of broad-level diversification, a strategy I have been steadfast in using for many years. I am so pleased to have a junior business partner, Justin Burgess, who also strongly believes in this approach. I welcome your comments and questions. Please feel free to call anytime. Happy New Year, Ron (M: 910-431-6308)