Portfolio valuations in perspective

Summary

Today, many investors have online access to their portfolios and can obtain all sorts of information about them. In reality much of what they see is simply market noise. The danger is that they get distracted by it and risk missing the wood (the benefit of a robust long-term investment strategy) for the trees (market noise). This note summarises the *'do's and don'ts'* when looking at your portfolio valuation.

Newsletter September 2014

Portfolio valuations in perspective

From a Dilbert cartoon by Scott Adams

"I'm sitting in a box and checkin' my stocks...I must use all of my will power to resist checking every 10 seconds...I'm sitting in a box and checkin' my stocks..."

Portfolio valuations – a snapshot of where you are on your journey

It is important to remember that investing is about delivering yourself with a future ability to consume. A portfolio valuation tells you little about this goal; it is simply a single day on a long and bumpy journey. It is however a useful record of what you own in your portfolio, such as the number of units in a particular fund, the price(s) that you bought them at, and the transactions that have been undertaken during the period between one valuation date and another. It provides a single day's snap-shot of your wealth – in Sterling (or other base currency) - recording unrealised gains or losses on assets, and the impact of exchange rates.

Unfortunately for some, it can become a source of anxiety and create doubts when it reveals a total portfolio value lower than the previously reported level, or the disappointing performance of specific funds. This can manifest itself in questioning the strategy or even making unnecessary and costly knee-jerk reactions, such as selling the offending funds, chasing funds or markets that have recently performed well, or pointing the finger at your adviser.

Keeping things in perspective

Every time you look at a portfolio valuation, it is useful to remind yourself of a number of important points:

- Your valuation simply tells you how much money you would have if you liquidated your portfolio today, which you have no intention of doing.
- Don't feel too despondent when your portfolio is down or too elated when it has risen strongly. Markets go up and down.
- Your portfolio has a well-thought-out structure that has been designed to provide you with the best chance of a favourable long-term investment experience.
- It is made up of a number of different investments (asset classes) like developed market equities, emerging market equities and short-dated, high quality bonds. Each of these assets play a useful and well considered role in your portfolio.
- Some assets will be doing well at times and others less so. No-one knows which asset(s) it will be at any point in time. Markets work well enough to make jumping from one asset class to another a dangerous gambling strategy.
- Your adviser cannot control what markets do, nor can fund managers. Markets will do what they do.
- You only make actual losses if you sell assets. If you don't sell them, they remain in your portfolio to deliver future returns.
- Using low cost, passively managed, institutional quality funds allows you to capture as much of the return that each of the asset classes delivers as possible.

The do's and don'ts of looking at your portfolio valuation

Bearing these points in mind, here are some tips for getting the most out of your valuation with the least amount of emotional stress.

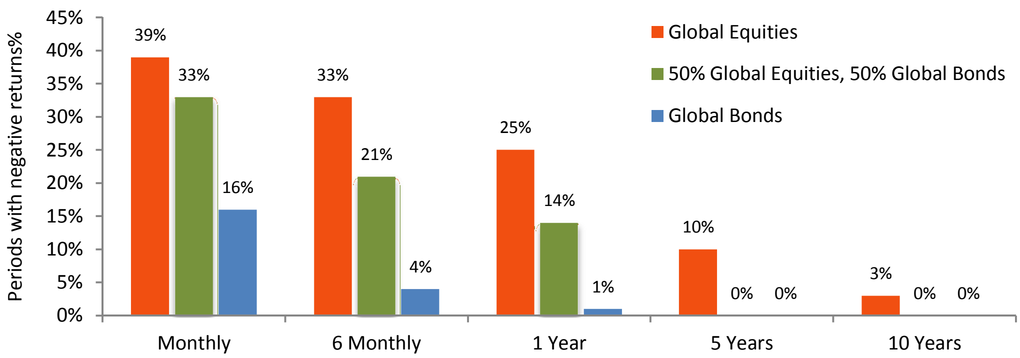
The don'ts

1) Don't expect to see positive returns every time you get a valuation

Although most investors intuitively know that investment returns do not come in straight lines, they can't seem to contain their disappointment when they see a negative number on the valuation statement. We also know that many investors like to check and see how much their portfolio is worth on a regular basis, sometimes daily if they have online access. Yet, the reality is that the shorter the time period, the more likely you are to see a fall in value, which just creates unnecessary and unwarranted anxiety.

Take a look at the figure below which simply takes two representative asset classes – global equities and global short-dated, high quality bonds – and illustrates the percentage of periods during which returns have been negative[1]. The outcome of a 50% blend of each has also been calculated. These numbers are before inflation and costs.

Figure 1: Percentage of periods exhibiting negative outcomes



Data source: DFA Returns Program. Jan-1973 to Jun-2014

On any one day your chances of seeing a loss on an equity portfolio is around 50% or one-in-two. Given the fact that most investors feel about twice the pain from losses as the elation they feel from gains, the longer the periods between looking at your portfolio the better. As the wise old saying goes:

> *'Look at your cash every day if you must, your bonds every five years and your equities every ten years.'*

2) Don't anchor your expectations to the 'Footsie' – you don't own it!

The 'Footsie' or FTSE 100 Index is an index that covers the top 100 companies listed in the UK. It gets lots of air time on the BBC news and in the newspapers and many investors, as a result, anchor their return expectations to it. However, it has a rather odd structure with the top 10 stocks representing around 45% of the index. It exhibits large sector biases compared to the global market with, for example, an overweight exposure to energy and an underweight exposure to technology. Add the fact that the UK market only captures 8% of global equity market capitalisation and the UK economy is less than 4% of global GDP and it is evident why it only plays a limited role in your portfolio.

In practice the returns of your portfolio will be quite different a) because you may well own some bonds to balance the equity risk and b) you will own international equities, smaller companies, value stocks and emerging market stocks, for example.

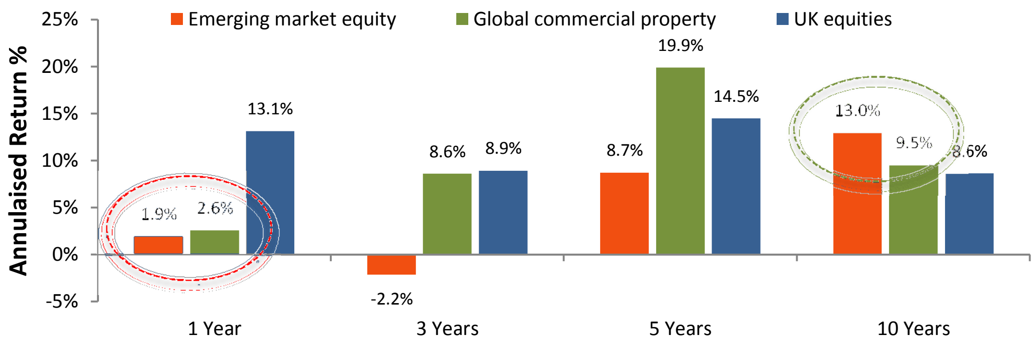
---

1 This uses the MSCI World Index (gross div.) and the Dimensional Global Short-dated Bond Index hedged to GBP as proxies for global equities and bonds in nominal (before inflation) terms. It uses monthly data, and calculates horizon returns rolling forward on a monthly basis. Data period January 1973 to June, 2014.

3) Don't get down on an asset class or fund just because recent performance is weak

Because no-one can be certain about what markets will do in the future, it is important to own a well-diversified portfolio to mitigate weak performance in any one market. Good advisers will help to structure robust portfolios to weather all investment seasons. Inevitably some parts of your portfolio will be doing better than others, but that is not a reason to give up on the poorer performers. Recent examples of 'poor' performers are emerging market equities and global commercial property, but this performance needs to be placed in context of longer-term returns. The figure below[2] provides some context.

Figure 2: Recent poor performance needs to be placed in context



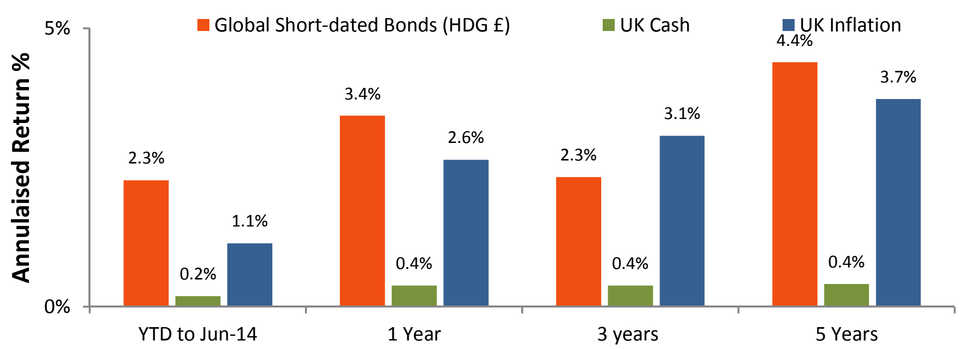
Data source: DFA Returns Program – data to Jun-2014, before inflation and costs

Over longer periods of time, both asset classes have had a material, beneficial effect on portfolios, and helped to drag portfolios up from the depths of the Credit Crisis. The logic for their inclusion in a portfolio has not changed. Don't panic!

4) Don't get despondent about the low returns from bonds

One asset class that in the past two to three years has come in for some unjustified criticism is short-dated, high quality bonds. Investors had got used to exceptionally high returns from bonds in the past, as falling bond yields delivered strong capital gains. That is not the norm, or the expectation, and returns have been lower of late. The risk of yield rises has been talked about for three years or so now, and while they have risen to some extent, this has not been to the level that the 'bears' expected. Sitting in cash - waiting in the wings for yields to rise - would have been a poor tactical decision. Short-dated bonds, which provide some yield pick-up relative to cash, have been a reasonable place to be invested. Take a look at the figure below. Cash has lost 15% of its purchasing power over the past five years, whilst short-dated bonds have protected purchasing power.

Figure 3: Short-dated bonds, cash and inflation[3] – annualised returns



Data source: DFA Returns Program – data to Jun-2014, before inflation and costs

[2] MSCI Emerging Market Index (gross div,), S&P Global REIT Index, FTSE All Share Index
[3] Data: Dimensional Global Short-dated Bond Index hedged to GBP, UK 1 month T-bills, UK RPI.

Try and remember why you own bonds in the first place. It is because you cannot take the market falls – either financially or emotionally – that you might experience in an all equity portfolio, or you don't need to take on so much risk to meet your goals. You need these high-quality, lower risk assets as a defence against traumatic times in the equity markets in the future. Some may be tempted to try and squeeze out a little more juice from their bonds by owning lower quality bonds, but this strategy will come home to roost in equity down markets as these bonds become increasingly correlated to equity markets, the lower the credit quality. Keep the faith; short-dated high quality bonds are doing their job.

5) Don't blame your adviser for how the markets have performed

Finally, your adviser can't control what the markets do. Neither can he or she hope to time the entry or exit from equities to cash and vice versa. Although some active fund managers claim to be able to do so, promises are easily made and broken and the empirical evidence does not support their claims[4]. What your adviser can do is to make sure that you have a robust portfolio strategy, executed using the best passive products they can find and to rebalance your portfolio on a regular basis back to its original structure. Doing this around once a year is fine.

The do's

1) Do think about the long-term strategy

Remember that you have a long-term strategy in place and what you are looking at is mainly noise. Each asset class has a role to play and some will be doing better than others. Keep the faith and stick to the strategy.

2) Do think about the returns in the context of expectations

Some simple back-testing of historical data can provide a good insight into the ranges of returns over different time horizons that you might expect from a portfolio with a certain mix between bonds and equities. As a rough guide, the table below illustrates the ranges of one-year returns that portfolios of global bonds and global equities would have experienced[5]. A useful insight that an annual portfolio valuation can provide is whether portfolio returns have fallen within expectations, given that some years will be good and some less so.

Table 1: Worst and best - ranges of 1 year returns

Nominal 1-year returns	100% bonds 0% equities	80% bonds 20% equities	60% bonds 40% equities	40% bonds 60% equities	20% bonds 80% equities	0% bonds 100% equities
Best	+37%	+41%	+47%	+54%	+61%	+68%
Worst	-3%	-4%	-8%	-18%	-27%	-37%

Data source: DFA Returns Program – data from Jan-1973 to Jul-2014, before inflation and costs

3) Do have patience and remain disciplined

Investing is a long-term game and requires both patience and discipline. Once you realise that you can't control the markets - and that nobody can - and that knee-jerk decisions almost always result in the wealth destruction strategy of buying high, selling low, then all you have left is structure, patience and discipline. Time heals most investment wounds. Discipline forces you to do what is actually right, not what feels right, such as rebalancing into equities when they have fallen dramatically.

4 In a recent study of the Local Government Pension Schemes in England and Wales, by Hymans Robertson, active mangers actually performed more poorly than the markets in all but one asset class categories reviewed during the Credit Crisis. Reference: Selman, L., Wright, J., (2014), LGPS structure analysis December 2013, Hymans Robertson.

5 Again, this uses the MSCI World Index (gross div.) and the Dimensional Global Short-dated Bond Index hedged to GBP for global equities and bonds in nominal (before inflation) terms. No costs of any kind have been deducted. Portfolios were rebalanced annually.

4) Do ask your adviser if you are still on track to meet your future goals

Sometimes investors erroneously feel that the fee that they pay to their financial planner is entirely linked to the investment performance that the portfolio earns. However, while the adviser can control portfolio structure, they cannot control the markets. What they can do is monitor the progress that the assets are making relative to the plan in place, raise concerns, and facilitate clients to make informed decisions about the lifestyle, expenditure and investment challenges they face, particularly if market returns have been disappointing over a sustained period of time. Good advisers are focused on long-term client goals. They are guides, facilitators, coaches and disciplinarians, encouraging their clients to stay the course and to maintain investment discipline.

In conclusion

Portfolio valuations are part and parcel of investing, but sometimes they raise both anxiety and doubt, neither of which are good bed fellows for the long-term investor. The key to successful investing is to believe in your portfolio strategy and have the discipline and fortitude to stick with it. Your adviser plays a key role in structuring your portfolio and monitoring the funds and other products used to make sure that they are doing what is asked of them. But most of all he or she is there to provide insight, progress reviews and to deal with the consequences of what the market throws at you, empowering you to make sensible decisions to meet the challenges ahead. Hopefully, with their guidance and discipline and your belief, you will be able to enjoy the ride and the rewards that you hope for.

Our next article:

5) Alpha? Beta? It's all Greek to me

The investment industry has a propensity for using Greek letters to describe different concepts. Whilst it is all a bit geeky, these are important concepts that deserve some insight. This note provides a primer on translating the 'Greeks' into plain, easy to understand language and how they can help in understanding how to invest sensibly.

The Georgian House
Park Lane
Stanmore
Middlesex
HA7 3HD