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Rethink Risk

By: Jerry C. Wagner

Passive asset allocation simply isn't enough these days. Advisers should also consider dynamic diversification strate-

The bear market of the last three years has clearly shown the weakness of the primary tool used by the investment advisory industry to manage risk — passive asset allocation. While it has its place as one method of risk control within an investor's portfolio, it is not the only method.



Financial advisers owe it to their clients to understand alternative methods of risk reduction and to be prepared to implement those tools when appropriate. They should now broaden their horizons and also consider market timing, dynamic asset allocation, and strategic diversification.

Many planners may be using a passive asset allocation portfolio because it's the only method they know to manage risk. Basically, they use historical statistics of return, risk, and correlation to allocate a portfolio among different asset classes or funds representing those asset classes. Once they make the initial allocation, these planners review the portfolio quarterly, yearly or whenever they can drag the client back in for an appointment. They then reconsider the allocations based on the investor's circumstances and risk tolerance, make small changes and rebalance the portfolio to the proper percentage allocations.

Passive asset allocation is risk management based on combining non-correlated asset classes to create a portfolio with risk lower than the average risk of its component parts. Because it's passive, it cannot respond to evolving market conditions. By definition, it can only deliver mediocre returns (the average return of its component holdings). It takes almost superhuman discipline, requiring proponents not only to hold on to investments that have already taken serious losses but also to sell portions of the top performers in order to buy more of the losing

investments. Last, it subscribes to the almost un-American ethic that if you work less at your investing, you'll do better.

In real-life experience over the last five years, financial professionals using passive asset allocation have become somewhat disillusioned. Returns seriously lagged during the bull market, and then adding insult to injury, losses were deeper than expected during the market crash. Previously non-correlated asset classes were suddenly moving in lockstep as prices collapsed. The financial press responded with front-page stories speculating loudly about the "asset allocation hoax." But there was no hoax, only a failure to understand that there is no holy grail approach to investing.

There are other options, and market timing, despite being one of the most criticized terms in the lexicon of investing, is one of them. Many mutual funds and variable annuities, consistent with their obvious conflict of interest on the subject, denounce it. Yet it seems to be forever winning over converts. In a recent comprehensive study of the advisory industry, Financial Research Corp. of Boston found that active management was the fastest growing segment of the financial adviser industry. The industry's trade association, the Society of Asset Allocators and Fund Timers (SAAFTI), has grown from five firms in 1989 to hundreds today.

The promise of market timing is, of course, to buy low and sell high. (Will Rogers, professing to know the secret of market timing, said, "If it don't go up, don't buy it.") It differs dramatically from passive asset allocation in that it is not diversified and usually involves a 100% in – 100% out investment in the asset class with the highest probability of advancing based on the market timer's system or skill.

Still, the conventional wisdom on the Street is that "studies show market timing doesn't work."

Yet in the 1990s, academia produced a stream of papers demonstrating tradable inefficiencies in the market. In addition, the first American Nobel Laureate economist, Paul Samuelson, reversed his random-walk-based negativism to market timing, allowing that it might succeed for investors with limited time horizons. Recently, major studies of the results of large groups of market-timing firms over various time periods have demonstrated that market timers deliver real risk-adjusted returns after fees.

All this authority is not meant to imply that market timing is without faults and that every adviser should abandon passive asset allocation and invest solely using market timing. Market timing, too, has its flaws.

All market timing approaches go out of sync with the market, some for relatively short periods, some for long periods, and some never return to profitability. In addition, the translation of the buy decision into action has plagued many timers, as the chosen instrument may not mirror the market being modeled. In volatile or trendless markets, market timing is vulnerable to whipsaws. Studies show that market timing works best the more actively securities are traded. This, plus the 100% in – 100% out trading, can lead to strained relations with fund companies.

Fund company concerns may not be valid, however. They fail to consider netting of opposing trades; cash positions of funds; asset levels; today's lower commission costs; the fact that the addition of days necessary to avoid redemption fees does not address the supposed costs of the eventual trade to other shareholders; and, finally, that the fund family industry was built on the back of the very exchange feature that the fund companies now seek to limit. Still, there is little argument that it can be a daunting task to find sufficient shelf space to trade market timing strategies. Fortunately, the development of the actively tradable fund families (Rydex, ProFunds,

Potomac), as well as exchange-traded funds and basket trading, have lessened this issue for active managers.

Early in the 1990s, a few investment firms began to offer a new risk management strategy — dynamic asset allocation. It mixed much of what is best in passive asset allocation and market timing strategies. The approach is simple: A universe of funds composed of all of the domestic style boxes, international funds, bond funds, and money market funds is assembled. Based on academic studies that identify one

of the best tradable market inefficiencies as the tendency for a rising trend to continue, the funds from the diverse universe are ranked daily, weekly or monthly, and the best performers are chosen. These funds are held until something else supplants them for the top leadership. Since money market funds are also ranked, they can cushion the blow of a declining market.

This uncomplicated strategy accomplishes a lot. Like passive allocation, it draws on a universe of asset class funds and is diversified into a number of fund positions, but

dynamic asset allocation is actively managed and can respond to market conditions. Its focus on the best performing funds helps to prevent it from falling prey to the shortcomings of the passive strategy. It doesn't have to, by definition, achieve mediocre returns, and it doesn't take money from profitable positions to fund losing ones.

At the same time, dynamic asset allocation avoids the principal downfall of market timing systems: It does not interpose a set of market-related trading rules between the investor and the returns he or she hopes to achieve from a specific investment. Each fund's return — and only that return — drives the investment, retention, and sale decision. Macro factors cannot get in the way. While it requires much more effort than



passive asset allocation, dynamic asset allocation tends to have better risk-adjusted returns.

This strategy does have a downside, though. Many of the problematic fund relations issues remain. Also, momentum investing tends to go through trendless, whipsaw periods where small, short-term losses can add up. The practitioner must remember that the strategy simply puts the odds of success on the investor's side. It does not guarantee profits on every trade.

Another technique, strategic diversification, works by combining strategies into a portfolio of strategies. It works much the same way as traditional asset allocation does. Diversifying client investments not only along asset class lines, but also based on the strategic techniques used, further reduces risk. For example, a financial planner can maintain a passive portfolio together with a timed or tactically managed investment and a dynamically allocated investment service.

As with traditional asset allocation, it is important that clients really diversify. In other words, advisers can't combine five similar strategies and



expect to reduce risk significantly. That would be like fielding a football team with eleven quarterbacks playing all of the positions. They could be the eleven finest quarterbacks, but as a team trying to fill all the roles, they probably would not be too successful.

Diversification, then, is more than simply owning lots of strategies; they must be different, non-correlated strategies. Advisers need to find approaches that work with different asset classes

— U.S. equities and their subcategory styles, global investments, bonds, and alternative or defensive investments like precious metals and real estate. They should not shy away from asset classes or strategies that have underperformed in the short run if they have a good long-term record.

To avoid the problems associated with passive asset allocation, active strategies must account for a substantial portion of the strategic portfolio. Active management's value results from the inherent advantage of active over passive strategies — the ability to capitalize on short-term trading opportunities to avoid risk and seek profits. By diversifying among these actively managed strategies, investors will have already captured passive asset allocation's singular benefit — lower risk through diversification.

In addition, combining different styles of active management is important. A strategically diversified portfolio should include some tactical (market timing) strategies, as well as the dynamic asset allocation approaches. Different techniques (fundamental, technical, top-down, bottom-up, cyclical, predictive, seasonal, neural net) further the diversification cause. Keep in mind that diversification works to reduce risk only if it is among non-correlated strategies.

Another practical consideration is the management of different strategies. While a client can separately contract with many advisers, it is easy to drown in the resulting paperwork. Fortunately, a few advisers are now offering multiple strategies on one investment platform. Non-manager planners can find these offerings on retail platforms in the separate accounts arena for large stock accounts managed by traditional fund providers; they are also available from active advisers utilizing mutual funds and variable annuities. The investment management fees charged to the client, a percentage of assets under management, are split with the referring planner.

The mutual fund and variable annuity product environment is especially appealing. In a stock portfolio, active trading can generate high transaction costs, but active managers working with no-load funds or variable annuity subaccounts have

few or no transaction costs (although these costs do exist within the funds or the subaccounts).

On the other hand, separate account managers can better handle the tax costs of their efforts within taxable accounts. Active managers prefer to work in the deferred tax environment provided by IRAs, retirement plans and variable life and annuity products. Finally, to achieve adequate diversification, investors need to own a number of strategies, so a low minimum account size per strategy may also be an important consideration.

Although they face an increasingly challenging market, investors and their financial advisers have more tools available than before. Employing them all in a single portfolio can achieve a new level of risk reduction. Strategic diversification means today's investor is like a football coach in a close contest. He's not going to use just his defense to win the game. He's going to use every weapon at his disposal — his offensive unit, his defense, his special teams, and all the talents of a well-stocked bench — to bring home a winner. ♦

WAITING GAME

It takes longer than most investors think to recover from bear markets. There were 14 bear markets, defined as those periods when the S&P 500 has fallen at least 20%) between 1929 and 2003. Omitting the 1929 crash, it took 3.5 years on average to break even after a crash.

Bear Market	Duration in Months	% Decline	Time Needed to Break Even in Years
Sept. '29 – June '32	33	86.7	25.2
July '33 – Mar '35	20	33.9	2.3
Mar '37 – Mar '38	12	54.5	8.8
Nov '38 – Apr '42	41	45.8	6.4
May '46 – Mar '48	22	28.1	4.1
Aug '56 – Oct '57	14	21.6	2.1
Dec '61 – June '62	6	28.0	1.8
Feb '66 – Oct '66	8	22.2	1.4
Nov '68 – May '70	18	36.1	3.3
Jan '73 – Oct '74	21	48.2	7.6
Nov '80 – Aug '82	21	27.1	2.1
Aug '87 – Dec '87	4	33.5	1.9
July '90 – Oct '90	3	19.9	0.6
Mar '00 – Oct '02	31	49.1	?

Source: Flexible Plan Investments

Jerry C. Wagner is the president and founder of Flexible Plan Investments, a leading provider of investment risk management services. Founded in Bloomfield Hills, Mich., in 1981, at the end of 2004's first quarter, with a staff of over 80 dedicated service professionals, Flexible Plan and its subsidiary actively manage more than \$1 billion in strategically diversified mutual fund, variable annuity and variable universal life accounts, for thousands of clients around the country*. Flexible Plan is one of the industry's largest and oldest active money managers and a founding member of SAAFTI.

*Flexible Plan and subsidiary.



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S&P 500 INDEX BEAR MARKET STUDY

SEPTEMBER 1929 THROUGH DECEMBER 2006 (77 YEARS)

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Source: Telephone Switch Newsletter, summer 1992. Updated by Flexible Plan Investments, Ltd. through 2006.

Bear Market Facts:

Between 1929 and 2006 there have been 14 bear markets, defined as those periods when the S&P 500 has fallen at least 20%.

The average bear market slashed almost 38.2% from stock prices. Omit the '29 crash, when values declined 87%, and the result is still an average loss of 34.5%.

During the 77-year period, a new bear market began on the average every 5.5 years, with an average duration of 18.1 months.

Omitting the distortion of the 1929 crash, the average time lost making up bear markets (zero earnings): **3.5 years.**

Source: FPI 2007.

Mathematics of Declines and Advances:

If the decline is It takes the following to break even

-5%	5.3%
-10%	11.1%
-25%	+33.3%
-33.3%	+50%
-50%	+100%
-75%	+300%
-90%	+900%



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Growth — Why You Need Balance!

Consider the investor with \$100,000 invested for five years.

Year 1 investment return – 15% – **\$115,000**

Year 2 investment return – 15% – **\$132,250**

Year 3 investment return – 15% – **\$152,088**

Year 4 investment return – (-15%) – **\$129,274**

Average annual return – **6.6% per year!**

Year five will require... _____% to return to a 15% average total return.

The Buy-and-Hold Argument

S&P Average Annual Return (1980-2006) 13.09%

What if you missed the good days?

If you missed the best Your average annual return fell to

10 Days	10.9%
20 Days	9.2%
30 Days	7.8%
40 Days	6.5%

What if you missed the bad days?

If you missed the worst Your average annual return rose to

10 Days	16.5%
20 Days	18.2%
30 Days	19.8%
40 Days	21.1%

What if you missed both?

If you missed the best & worst Your average annual return was

10 Days	14.2%
20 Days	14.2%
30 Days	14.1%
40 Days	14.0%

SOURCE: Ned Davis Research, Inc. 1980-90, Updated FPI Ltd. 1990-2007.

Answer: 56%



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