

SOAPBOX



Are You Changing With the Times?

INVESTMENT ADVISORS TODAY are far too often competing on price, struggling in a commodity business where there is no differentiation between them and their competitors. That's because the investment industry was born in a time when information on companies was hard to come by, transaction costs were exorbitant, and liquidity was very limited.

This led to a widely accepted belief that the best way to manage risk in a portfolio was to use diversification. On the surface, this seems reasonable and prudent. Times have changed, however. The reality is that globalization of the world's markets in recent years has reduced the benefit of this type of diversification. Correlation among markets has not only increased, but the correlation increases even further exactly when we do not want it to—in times of crisis.

How has the world changed for portfolio managers in recent years? Since the middle of the last century when "diversification" became the mantra of portfolio managers, many tools and techniques have been created to aid in risk management.

The use of inverse funds, options, futures, and swaps has revolutionized portfolio management for sophisticated investors who find it unacceptable to experience the significant declines in portfolio value that are common in stock and bond bear markets. In fact, it is my belief that had the mutual fund industry implemented many of these risk control techniques, the hedge fund industry would never have grown anywhere near as large as it has, since there would have been no need for it to do so.

There is another overlooked and underutilized technique in controlling risk within a portfolio. I'm talking about having a strict sell discipline. Having a sell discipline will force out underperforming holdings in the portfolio and make room for new, better performing holdings. It is surprising how few indi-

viduals and professionals have implemented a sell discipline as part of their portfolio management process. Having a sell discipline is no "easy button" solution to risk control, but it does go a long way toward avoiding large, detrimental swings in portfolio values.

Let's go back to discussing how the investment advisory business can avoid becoming a commodity business. First and foremost, you must distinguish your firm from others, but that's exceedingly difficult to accomplish when you are doing what everyone else is. Therefore, you must provide a service clients value and then deliver it differently than your competition.

Having a strategy that calls for a fully invested portfolio but that only uses diversification to control the risk is like buying a car without brakes or fielding a football team without a defense. It doesn't only matter where a portfolio's value gets to at some point in the future—the path it takes to get to that value is also important.

We have found great value at our firm in differentiating ourself from our competition by employing risk management strategies that our clients find appealing, including the use of futures, options, swaps, and a clear sell discipline. As a result, we have the good fortune of not competing against our competition on just price.

It also allows our clients and their portfolios to experience a smoother, more pleasant journey on the road to investment success.

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Markets
have
changed—
so should
your
investment
process.

The IA Soapbox is reserved for Investment Advisor readers to sound off about an issue of importance to them. Please e-mail Jamie Green at jgreen@investmentadvisor.com.

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