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WORLDSOURCE FINANCIAL MANAGEMENT INC.
Sponsoring Mutual Fund Dealer

Client Information Summary

Getting More from the Power of Diversification

The first investment advice many of us received may have come on the knees of our parents, who told us, "Don't put all your eggs in one basket!" It is sound advice that has stood the test of time and which is practiced, almost universally, by prudent investors. A good example of how this concept has taken hold can be seen in the explosive popularity of mutual funds. It is estimated that half of all investors now own mutual funds. The appeal, of course, is the immediate diversification that can be achieved with a single investment. The average equity mutual fund, for example, holds 70 to 100 stocks, providing a level of risk reduction through diversification that would be extremely difficult to achieve on an individual basis.

The concept of diversification can be further extended, beyond mutual fund ownership, to achieve even greater risk reduction. The way to do this is by including in your portfolio varying approaches not only to the market, but to fund management styles as well.

There are essentially three opportunities to diversify by approach or style:

- Active vs. Passive Management
- Strategic vs. Tactical Asset Allocation
- Growth vs. Value

The following exploration of each topic will give you with a better idea of how you can maximize the benefits of diversification.

Active vs Passive Management

The choice between active and passive management is the foundation of the diversification model, so it may be helpful to start by defining these two approaches.

Advocates of *Active Management* believe:

- There is an art and a science to security selection.
- Professional money managers can make better choices and decisions than individual investors, due to the knowledge, skill, expertise, and technology they possess.

Supporters of *Passive Management*, on the other hand, contend that:

- Investment markets are so efficient that prices reflect all available information and adjustments occur too quickly for active security selection to add value.
- After deducting the costs associated with making trades, active managers cannot beat the market, relative to returns.

In simpler terms, *active* management takes a hands-on approach, with the manager attempting to gain advantage by buying and selling the correct securities, rotating the portfolio from one sector to another, or shifting the asset mix.

Marketing timing, in which an investor directs all or most of their money to the asset class they feel will outperform the others, would be considered an extreme form of active management.

In contrast, *passive* managers are often perceived as simply going along for the ride, in an attempt to mimic the returns of an individual index. That isn't entirely accurate, because passive managers often do make active trading decisions. However, they do so in response to widely known information about individual securities and market or economic conditions, rather than trying to outguess the markets.

Index funds are the most extreme form of *passive* management, which is the practice of mirroring the composition of a major market index, like the S&P/TSX Composite Index or the Dow Jones Industrial Index. There is neither active security trading involved nor its associated costs, so indexers should have returns very close to those of the markets themselves (although, of course, there are some management expenses that must be covered in any circumstance).

The popularity of index mutual funds tends to increase when market indices are rising, particularly if the increases are substantial. In such circumstances, a strong case can be made for using lower cost index funds to participate in the upswing. However, the real test for these funds comes when markets decline for some extended period, as they inevitably do. Then the index funds experience a parallel fall, and true indexers have to be psychologically prepared to stand back and watch that happen.

So which form of management is better? The debate over which management style is better will never end, simply because the investment world is too dynamic. When markets are climbing, the argument shifts in favour of *passive* management. After all, why pay the extra costs of *active* management when so many managers fail to outperform their respective indices? When markets start to tumble, however, many investors want the expertise of a professional *active* manager to cushion the fall. In fact, this is the most frequently cited argument in favour of active management — managing risk — and isn't that what it's all about?

Generally, we believe in *active* management because:

- It offers the potential of better downside risk management (by estimating and compensating for the potential decline in the price of a security if market conditions turn bad).
- There is a legion of good money managers who have consistently outperformed their respective indices, and their expertise is only available through actively managed products.

Finally, but perhaps just as important as anything else, there is the human factor. Since, as human beings, we naturally bring emotions into the investment arena with us, there are psychological rewards that come from utilizing *active* management services:

- We feel more involved in the process.
- We feel more comfortable knowing that someone is doing something when things go awry.
- We enjoy a sense of hope and optimism that they will sometimes beat the market.

Here, then, is our summary advice on how to deal with the *active/passive* debate: Take an active role in manager selection, then a passive role in security selection, by putting your manager's expertise to work for you. This will give you the best of both worlds!

Strategic vs. Tactical Asset Allocation

The comparison between *strategic* and *tactical* allocation is very similar to the debate over passive vs. active management. In this instance, however, we are more concerned with the portfolio mix across various asset classes than diversification among individual securities.

Strategic Asset Allocation

At its purest level, *strategic asset allocation* is the process of calculating the optimal percentage of each asset class (typically among stocks, fixed income and cash) to be included in a portfolio, in order to yield the maximum expected return for any given level of risk. Conversely, we could be trying to achieve the least amount of risk for a targeted rate of return. In other words, we can approach the asset allocation decision from either side of the risk/reward trade-off — by attempting to either maximize the expected return or minimize the risk.

The calculations to optimize a portfolio, or determine the most efficient trade-off between risk and reward, involve several variables, including the historical return and volatility for each asset class (the statistical measure of which is referred to as standard deviation) and the degree to which the asset classes fluctuate compared to each other (correlation). We get a sense of the importance and complexity of the computations to determine the best mix when we realize that a gentleman named Harry Markowitz was awarded the Nobel Prize in Economics in 1990 for his work in this field. Fortunately, today the power of modern computers allows us to use these same advanced techniques for individual investors that in the past were only available to multi-million dollar portfolios.

The outcome of the optimization process is an asset mix that can be used as a long-term guide for investing — the portfolio's *strategic asset allocation* plan. The target weightings or percentages assigned to each asset class remain fairly consistent throughout the lifetime of the plan, unless the underlying assumptions change or the investor's objectives or risk tolerance are altered. In that case, the portfolio would be optimized again, based on the revised input.

Once optimized, the portfolio must be periodically rebalanced to restore it to its original mix, since actual performance over time will cause at least one of the asset classes to grow at a greater or lesser rate than expected, thereby distorting the portfolio's optimal allocation. However, once the portfolio mix is established, the entire process is really more passive than active.

Tactical Asset Allocation

Tactical asset allocation is a deviation from the long-term strategic asset allocation in an attempt to capitalize on shorter-term market trends. The most extreme example of *tactical asset allocation* is market timing. As previously explained, this is where an investor directs all or most of their money to the asset class they feel will outperform the others. For example, if they forecast that bonds will yield the best return over the next few months, they will sell their stocks to buy bonds. Conversely, when they feel bond prices have peaked and are about to give way to stocks, they will sell their bonds to repurchase stocks. When market timers prefer neither stocks nor bonds, they will revert to cash holdings. Again, this is an extreme example. In practice, few investors are so bold as to attempt a 100% market timing strategy. Furthermore, there is no empirical evidence to prove that investors have been sufficiently accurate in predicting market movements to produce consistent results. Remember, to be successful as a market timer, you have to make two accurate predictions in a row – when to get in and when to get out!

That being said, with the higher volatility of investment markets today, more and more investors are being emotionally challenged to maintain their traditional buy and hold strategy as they watch certain market segments or asset classes rise and fall in dramatic fashion. Consequently, a less aggressive version of *tactical asset allocation* is gaining favour. With this approach, investors set ranges for the various asset classes in their portfolios and adjust within those ranges when they feel it is appropriate. For example, if the *strategic* asset allocation suggested a 60% stock weighting, the investor may choose to consider that as falling within a *tactical* range of, say, 50% to 70%. Then, if stock markets are appealing, he or she could increase their stock weighting up to as much as 70%. If stocks are less promising, they may reduce the proportion down to as low as 50%, with such tactical adjustments being repeated for each asset class. In this way, the original portfolio mix is more or less maintained, which is important because it reflects the investor's risk profile and long-term return objectives. At the same time, however, assuming that the market forecast is accurate, the investor can participate, at least to a certain extent, in the better performance of one asset class over another.

Growth vs. Value

Growth and *value* are labels that are often applied to the investment style of mutual fund managers, although the terms more accurately describe the type of securities they tend to favour in their portfolios. While not perfectly accurate, the analogy that comes to mind when comparing value and growth is the age-old tale of the tortoise and the hare. Essentially, it is the quick and fleet of foot against the slow but steady.

Value managers look for stocks that they feel are, in fact, under-valued, because they are out of favour with investors in general. Such undervaluing may come about for a number of reasons, such as a temporary decline in an industry's profitability, bad publicity, a misunderstood corporate story, or a short-term setback in the firm itself. A trained analyst, however, may determine that the underlying core value of the firm is strong, though not currently being recognized by investors, with the result that the stock price underestimates the future potential of the firm. All other things being equal, *value* managers will purchase these stocks because they feel they are cheap, in comparison to what they should be. They will then hold these stocks until the market catches onto the real picture and pushes the stock price up to its actual value. In essence, they believe that good security selection will overpower the noise of market movement, in the long term. This is the tortoise in the analogy.

Another reason that stocks are undervalued may be that everyone's attention is focused on the fast-rising stars. When great short-term gains are being made by companies that sharply outpace all the others, there may be less demand for the slow and steady options. Such fast-rising or G*rowth* stocks are generally described as those that are increasing in price faster than the market itself.

The best and most recent example of *growth* and *value* jockeying for position is the rise and fall of the high tech industry worldwide and, in particular, the dot.com boom/bust. When technology firms were growing at a furious pace (often with no profitability in sight) *growth* was the place to be. The mantra was, "Get on board the bullet train and enjoy the ride!" (however wild that ride might be). The plodders– the traditional low tech industries–couldn't get investors' attention and, consequently, their stock prices often languished at very low levels. However, like the hare, many of the hi-tech firms eventually ran out of steam as the investing world came to realize how extraordinarily out of whack their share prices had become as compared to their longer-term potential and real value. Thus *growth* became less attractive and there was a return to *value*.

This does not, however, mean that *value* is inherently the better option, which is why it helps to have an active manager working for you, who can assess the market and make the wisest investment decisions at any given time, by choosing the best combination of approaches and styles in order to achieve the best results.

Summary

Asset allocation and diversification are the cornerstones of successful investing. The options outlined above provide an overview of the ways in which diversification by investment management style can play a part in your overall wealth-building strategy.

Smart investors create a triple safety net by diversifying among all three of the following:

- Securities
- Asset classes
- Management styles

Such an approach truly harnesses the full power of investment markets and works intelligently with them to move towards long-term objectives with the least amount of risk.

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