

Portfolio Principles

This paper provides details on the rationale behind the methodology Veripax Financial Management uses to manage client portfolios.

Sector Diversification

Diversification based on industry sectors (Energy, Healthcare, Financials, etc) is not a new idea. In fact, portfolios using individual stocks have always been diversified this way. However, popular mutual funds tend to be categorized by company size (Large Cap, Small Cap), geographic location (U.S., foreign, emerging markets) and stock style (growth, value). When the mutual fund industry began rapidly expanding in the 1960's, mutual fund asset classes were much more independent than they are today. Over the 20-year period from 1989 to 2008, the average correlation between large-cap and small-cap U.S. stocks averaged 76%. In recent years, the correlation has risen to above 80%, and in 2008 the correlation was 96%. The correlation between U.S. stocks (S&P 500) and foreign stocks (MSCI EAFE) has risen from 49% in the 1990's to greater than 80% since 1999.

The correlation between Energy stocks and Financial stocks, on the other hand, is 22% over the last 3 years, and 40% between Utilities and Real Estate (as an example). Diversifying across industry sectors as opposed to mutual fund asset classes significantly improves the overall diversification of a portfolio. Sector diversification is rapidly expanding as advisors realize that traditional mutual fund asset classes are no longer sufficiently independent (non-correlated) to provide the desired diversification.

Exchange Traded Funds (ETFs)

ETFs are very similar to mutual funds in that each share represents a basket of underlying stocks (usually an index), but they have many qualities that make them more efficient and therefore less expensive. Shares of ETFs trade exactly like stocks, meaning they can be bought or sold at any time during market hours as opposed to only at the end of the trading day like mutual funds. When using Sector Diversification, ETFs are an improvement over individual stocks because a Sector ETF (e.g. Vanguard Financial ETF) represents many stocks in a particular sector. A Sector ETF provides broad exposure to an individual sector without the risk of picking individual stocks.

Fixed Allocation

Some advisors attempt to predict which sector or sectors will outperform others during a particular timeframe, and will then overweight or underweight certain sectors in order to improve returns (called "strategic asset allocation"). Almost all actively-managed mutual funds do this. Unfortunately, stock market behavior does not lend itself to consistently accurate prediction, and statistically, it takes an incredibly long time to differentiate between luck and skill. The alternative is to spread capital relatively equally across all sectors according to a client's risk profile, and rebalance occasionally to maintain this equal-weighted allocation. With a fixed, equal-weighted allocation, you are guaranteed to be invested in the best performing sectors, and avoid the risk of being over-weighted in the poorest performing sectors.

Active Management

The debate between active management and a buy-and-hold strategy is a long-running argument. There are many forms of active management, and very few investors who practice true "buy-and-hold", so arguments one way or the other can quickly become cloudy. Our philosophy is that losses should be kept small by moving individual sectors to cash when there are signs the sector is entering a downtrend. Emotion is the primary cause of many investors buying high and selling low. The rules we use for exiting and reentering individual sectors have been thoroughly back-tested and do not rely in any way on emotion or guessing.

