ADVISOR PERSPECTIVES

Our Interview with Phil DeMuth and Ben Stein

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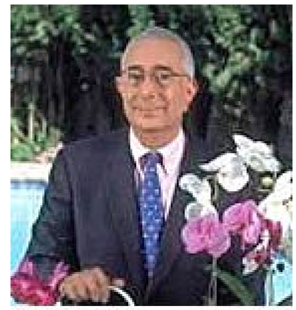
Phil DeMuth



Ben Stein

Phil DeMuth is an investment psychologist and a financial advisor. He has written for *The Wall Street Journal* and *Barron's,* as well as *Human Behavior* and *Psychology Today.* His opinions have been quoted on **theStreet.com** and *Fortune Magazine.* He is president of Conservative Wealth Management in Los Angeles. **Ben Stein** is a writer, actor, comedian, and game show host. He is a frequent contributor to *The New York Times, The Wall Street Journal, Barron's, and other financial publications.* DeMuth and Stein's most recent book is *Yes, You Can Supercharge Your Portfolio.*

You make some interesting observations about measuring risk in a retirement account, saying that "the securities industry and the government bodies that regulate it have this [measuring risk] backwards." Can you elaborate on this, and explain how advisors should think about risk when structuring portfolios?

DeMuth: It is posited that investors have an inner psychological state known as their "risk tolerance" – one that might be accurately self-reported, measured by a questionnaire or discerned through probing questions from a skilled advisor. As a psychologist, I am unaware that such a trait exists – I believe that research would show this construct to be situation-specific. However, even if this trait did exist, it would be a terrible guide to investment decisions. Investors should invest in whatever way has the greatest likelihood of meeting their financial objectives. A motorcycle daredevil might require a conservative allocation, and a librarian might require an aggressive allocation. The advisor's task is not to take the risk temperature and design the portfolio around that – this is sanctioned malpractice. A client should not be sleeping soundly at night if his low-risk portfolio is on track to under-fund his retirement. The advisor needs to create a portfolio to meet the client's goals and then educate the client about the need to endure whatever volatility is required to get there.

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Short-term volatility is precisely what clients are getting paid to endure for the sake of long-term returns that are better than T-bills, and this is a terrific trade-off for anyone with a long-term investment time horizon. I often find myself telling clients things like, “I’m not going to promise you that we’ll get these returns, but I will promise you that there’s going to be a year when your portfolio will be down 15 percent or even more. That part I will guarantee.”

Anyone can find investments (after enough trial-and-error) to meet his or her investment risk tolerance. The advisor can take the client to the next level and construct a portfolio that will meet his or her financial objectives. Then the advisor’s task is to keep the client in the chair during the promised market downturns. These are things that most investors cannot or will not do on their own.

Your central theme is to structure portfolios between the extremes of index funds and hand-picked individual securities. Can you describe the process you advocate, and how advisors can “supercharge” their portfolios?

DeMuth: The book describes a series of stages that investors might go through, starting with the usual portfolio of cats and dogs, going from there to a global portfolio of market index funds, to a portfolio of index funds with small additions to individual stocks and/or sector ETFs, and finally back to a portfolio of all individual stocks, but this time each chosen for its contribution to the total portfolio. If done correctly, each of these can represent a progression over the preceding stage. Our feeling is that most investors – including many professional investors – are not taking full advantage of Modern Portfolio Theory effects to increase risk-adjusted returns on a portfolio-wide basis. Since Modern Portfolio Theory is usually dated to Markowitz’s dissertation in 1952, we talk about bringing people’s portfolios into the rock’n’roll era.

One of the topics you discuss is that indexed investors are often not as diversified as they think. Can you give some examples of how this happens?

DeMuth: The book is about capturing the diversification benefit. This is a free lunch, and most people leave it on the table. Geoff Considine – a name I think advisors are going to get to know better – estimates that the diversification benefit is 2-3% annually on top of what is available even using market-wide index funds.

My epiphany came when I was looking at a number of highly-regarded investment portfolios through the lens of the QPP Monte Carlo simulator (www.quantext.com). This simulator lays out the inter-correlations among the component assets in a table. What jumped out at me was that these portfolios all sounded diversified – they held things like total stock market index funds, foreign market index funds, emerging market index funds, small cap funds, value funds, etc. – but that in the end all these asset classes had correlations in the 0.80 range or higher with the underlying portfolios. They held thousands of securities, but for all that – they were behaving as homogenous lumps. They were, in fact, significantly under-diversified. We called these the "glob" portfolios – shorthand for a great global glob of stocks.

With this as a starting point, we set out on a quest for assets that we could add that had much lower correlations, such that adding them in small quantities served to improve the portfolio's risk-adjusted returns. We didn't foresee that the book would come out in the middle of a major market downturn, but we were pleased at how the portfolios held up.

I have posted two articles documenting the process: A Practical Demonstration of the Value of Portfolio Theory and Global Giants and Diversifiers to Supercharge a Portfolio.

I should add that if advisors are going to get out in front of their clients in this regard, they will need to use a tool like QPP that offers forward-looking risk and return parameters. It's not going to happen by picking 5-star funds or stocks off some list.

Based on your experience in your investment advisory business, what are key risks with employing the supercharging strategy you advocate? What are some of the issues you encounter when presenting this to your clients?

DeMuth: Honestly, I think the main risk is that an advisor might not implement this strategy and thereby saddle his clients with sub-par risk-adjusted returns. I'm very fortunate in that my clients are a pretty sophisticated group so they got it right away. I suppose they took it on faith initially, based on my track record, and then the results started to speak for themselves. I core out my client's portfolios with Dimensional Funds, giving them a small/value tilt, and then add diversifiers to these. Certainly you would have to explain to clients how holding small quantities of riskier assets can actually lower the risk of a portfolio overall.

Another risk is, as Korzybski said, the map is not the territory. Monte Carlo models are not the same thing as getting next year's Wall Street Journal today. They can easily be over-tuned and used as magic number machines.

Common sense has to prevail at all times in deciding investment allocations.

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All of this has implications for the investment advisor profession. Instead of engaging in largely futile behaviors like judging risk tolerance, stock picking, frequent rebalancing, and market timing, advisors should focus their exertions where they add value: matching client investments to client goals, seeking low-expense investment solutions, maximizing diversification, and talking clients out of their own bad investment ideas (like selling out at a market bottom or chasing performance). Ben [Stein] once thought to start a company where, for a mere 10 percent of the amount you were going to invest, he would talk you out of whatever you were planning to do. Advisors who work in areas where they add utility will reward their clients many, many times over for the fees they have charged.

Your data shows that rebalancing leads to portfolios with lower risk and lower returns, and that the best way to avoid this effect is to set a tolerance that triggers the rebalancing. What is the underlying cause of this phenomenon? What is your bottom line on this – what rebalancing strategy do you use in your practice?

DeMuth: Our view is that frequent rebalancing does not rebalance risk vs. returns efficiently.

Let's say you rebalance daily. Over the past day, there have been movements in the market. Some of these movements reflect an accurate re-pricing of assets. But mixed in with this signal is also a lot of noise: some of these assets have been re-priced too far in one direction or another. If we rebalance every day, never mind transaction costs, we are going to be shuffling a lot of noise into the mix along with the signal.

Take the other extreme: let's say we never rebalance. Ten years out, it is pretty clear what the long-term secular trends have been. If we rebalance now, we are folding in almost all signal and very little noise. The problem is, our portfolio may have wandered far from its original specs and become riskier along the way.

Between these two points is an efficient frontier. For complex, multi-asset portfolios, we think that tolerance-based rebalancing adds value when a portfolio gets about 20 percent out of alignment. I take a fairly parsimonious approach to rebalancing, only rebalancing outliers as needed. But this is an empirical question and more research is needed.

One of the interesting topics you discuss is the role of fixed income in a portfolio. You suggest substituting low-volatility stocks for bonds as a way to reduce risk. Does fixed income have any role in the portfolios in your practice, and how do you choose the "right" stocks for this purpose?

DeMuth: Portfolio theory suggests that the role of fixed income – other than when it is used to provide, well, fixed income – is to dampen portfolio volatility. So I use a diversified bond portfolio to serve this purpose. The trade-off is that historically bond returns are much lower than equity returns.

One way out of this dilemma is to use low-volatility equities to give us the best of both worlds: more bond-like lower volatility but with more equity-like higher returns. We screen for stocks with a low 3-year standard deviation. The caveat is that whenever you are selecting for extreme scores on a criterion, you are going to get regression to the mean. A portfolio overweighted with low volatility stocks will almost certainly be higher in volatility going forward. Nevertheless, the solution is directionally correct. If you are running a standard 60/40 stock/bond portfolio, you won't be able to run a 100 percent low-volatility stock portfolio to the same effect. But you might be able to go 70/30 and get higher projected returns for roughly the same level of risk you had before. In general, the stocks that work best as market index portfolio diversifiers are those that are low beta, low r-squared, and/or low volatility.

You researched the holdings of Berkshire Hathaway to determine the level of diversification Warren Buffett has in his portfolio. Can you summarize your methodology and findings?

DeMuth: There is a division between academic advocates of Modern Portfolio Theory on the one hand, and seasoned

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value investors like Buffett and Munger on the other. Each side tends to be dismissive of the other. What we did was put Berkshire Hathaway's holdings into the Monte Carlo simulator – as best we could – and take a look at BRK through the lens of MPT. What emerged was a remarkable squaring of the circle. Buffett does not have a computer in his office, but he has intuitively managed to combine assets with a low inter-correlation just like a portfolio theorist would. We suspect that this comes naturally to him, since it brings into play precisely the same diversification skills needed to successfully underwrite Berkshire Hathaway's "big catastrophe" policies. One of the points of the book is that while owning 500 stocks in an index fund can indeed give you a diversified portfolio, it is also possible to have a well-diversified portfolio with a much smaller number of holdings.

Has the credit crisis and current market conditions changed your views on how advisors should diversify and the level of exposure one should have to the US equity markets?

DeMuth: Not in the slightest. The main benefit is that stocks are cheaper now than they were a year ago. Nothing makes me happier than buying stocks for clients on days when it looks like the world is coming off the rails. The "supercharged" portfolios have held up well in this troublesome environment, beating their benchmarks by a meaningful margin.

On the subject of the credit crisis, Ben's column in the New York Times on March 23, 2008 argued that the critical element in the credit crisis is hedge funds that control $1.5 trillion in capital and are changing "Wall Street from a financing entity to a market manipulation entity." As a solution, you argue for greater transparency in hedge fund reporting and more rigorous enforcement from the SEC against schemes to defraud. What troubles us about this theory is that it discounts the role of the collapse of the housing market. Given that, to our knowledge, there have been no allegations of illegal trading by hedge funds, what evidence is there that hedge fund activity precipitated the credit crisis?

Stein: It is a myth that the housing market has "collapsed." It is down, down very much indeed from its bubblicious peak, but not so far below a normalized rate pre bubble.

The trading does not need to be illegal to be incredibly disruptive and destructive. Immense short sales of the ABX and other mortgage related indices have destroyed that financing vehicle. The failures of buyers of homes have been vastly magnified by the manipulations of the short sellers. And it's not a theory. It is what happened.

[Ed. Note: The Markit ABX.HE indices track the prices of home equity asset backed securities.]

How does greater transparency solve the problem? Should a hedge fund that is restricted to accredited investors be forced to publicly disclose its holdings?

Stein: It does not solve the problem but it might make some rare people with a sense of shame refrain from disrupting markets.