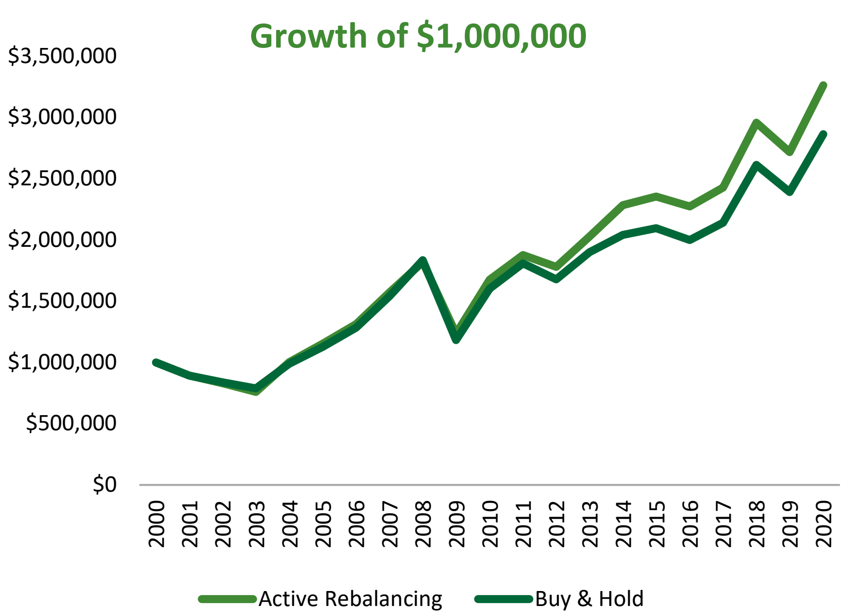
The Importance of Trading

The long-term rate of return for any diversified portfolio is the culmination of several distinct decisions in how a portfolio is constructed. We often focus on market fundamentals (i.e. earnings & valuations) because they are the key drivers of macro-level portfolio construction decisions. These macro issues such as how to allocate a portfolio amongst global asset classes, or which type of fund to use in a given asset class, are without question the primary drivers of long-term returns.

There is, however, another less obvious component of the portfolio construction process; the nuts and bolts of how a portfolio is functionally implemented & traded. While difficult to measure precisely, a portfolio's trading strategy has a very real impact on long-term returns.

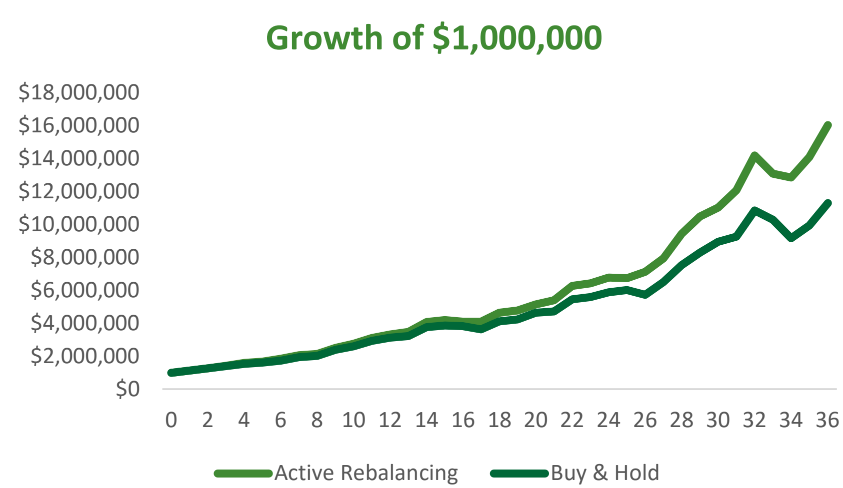
Let us start with an example to demonstrate the impact of basic rebalancing. This chart shows the performance of a portfolio divided equally amongst four major asset classes. The holdings are identical, but only one of the portfolios rebalances annually to maintain the original allocation percentages.



Rebalancing can be thought of as simply owning a specific percentage of a given investment, rather than a specific number of shares. Mechanically, this means selling whatever investments went up the most in order to buy those that went up the least. This results in "selling high" & "buying low", albeit in small increments. Over time, this allows the performance of a diversified portfolio to be greater than the sum of its parts. In the above example, simple annual rebalancing resulted in an additional 40% total return over 20 years (0.7% annualized).

The degree of excess return provided by professional trading strategies depends on several things such as the number of holdings and the rebalancing frequency. Mathematically, the most important factor is *correlation*: the extent to which the underlying investments mirror each other or move independently.

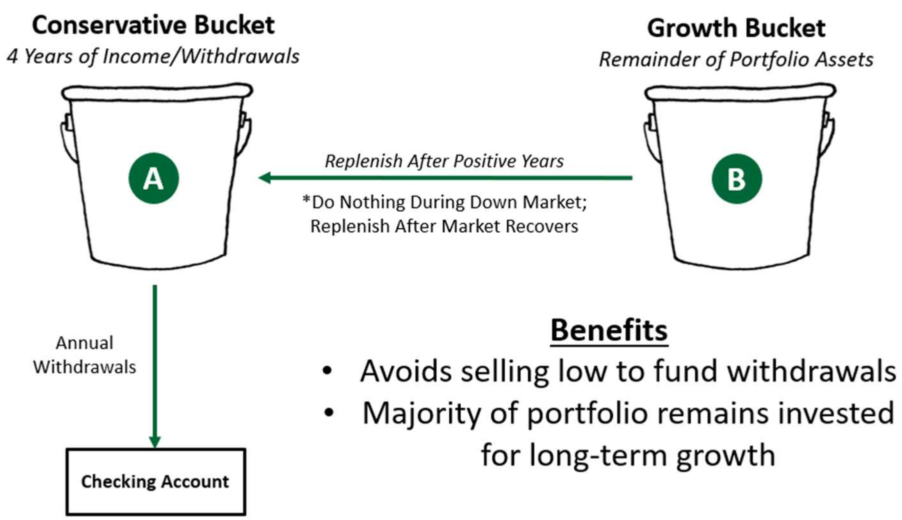
To demonstrate the impact of the correlation between two investments, we can use a stripped-down example. Let us take two stocks with identical annual returns – however, the order of those returns has been rearranged, so that when one stock is up, the other stock may be down. Please note that this results in both stocks finishing up with the exact same "total return". Then let us imagine a portfolio with a 50/50 split between these two stocks. In one scenario we will simply hold the stocks for the long term, in the other we will trade them back to a 50/50 split at the beginning of each year.



While the "Buy & Hold" portfolio provides the exact total return as its underlying holdings, the "Actively Rebalanced" portfolio outperforms significantly. Even with identical underlying holdings, this simple trading strategy boosted annual returns by just over 1%/year without taking on any additional risk.

Most investors are aware of the importance of diversification as a way of reducing risk in a portfolio – i.e. not keeping all your eggs in one basket. This is both important and true, but not the whole story. In addition to reducing downside risk, ***Modern Portfolio Theory demonstrates that by diversifying among non-correlated (or uncorrelated) assets, professional trading strategies & techniques can boost long-term portfolio returns.***

Both examples demonstrate the impact that trading strategies can have on long-term portfolio performance, regardless of an investor's personal financial circumstances. When combined with solid planning, there are also more personalized trading strategies that can significantly increase long-term spendable wealth. One of these is familiar to many of our clients, called the "Bucket Strategy".



Unlike the previous examples which aim to boost the returns of a diversified portfolio, the bucket strategy is a tailored trading solution to a specific dilemma: retirement. As we near retirement we still need to maximize long-term growth to ensure we do not deplete our portfolio, but now we also need to generate stable short-term income. The issue for retirees is how to re-structure their portfolio to best accomplish both of these conflicting goals. Going too far in either direction is inefficient and can erode portfolio value over time. By utilizing a bucket strategy to trade a portfolio we can have our cake and eat it too – reducing risk in the portion of the portfolio that is needed for withdrawals without limiting the long-term growth on the bulk of the portfolio.

There are a myriad of additional trading strategies and techniques that can impact portfolio performance, taxation, and long-term spendable wealth. Some, such as dollar-cost-averaging, are quite simple and easy to implement in most account types. Others, like tax-loss harvesting, are highly technical and situation-specific. While the impact is often difficult to measure precisely, the key to all these various techniques is their ability to increase performance and/or net spendable wealth, without adding risk to the portfolio.

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