Implementing the Asset Allocation (Selecting investments) ©

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Virtually all the asset classes that we should consider for investment can be accessed directly by purchasing individual securities or through pooled investment vehicles such as mutual funds, exchanged traded funds (ETFs), partnerships and trusts. The types of securities used will vary depending on the advisor's expertise, client desires/needs and the size of the investment portfolio. Generally, pooled investment vehicles offer greater diversification opportunities and are appropriate for most investors. Selecting individual securities such as individual stocks and bonds require additional expertise and monitoring by the investment manager. This can provide more flexibility, however including the ability to engage in more tax loss harvesting. Mixes of the two approaches are also available through separately managed accounts and direct indexing.

Active Versus Passive Investing

An important consideration whether to choose securities or funds using an active versus a passive approach. An active approach involves the fund manager or portfolio manager performing a great deal of due diligence and analysis on potential investments such as individual stocks. For example, looking at past, current and future earnings and cash flow growth versus the current price and typically computing the intrinsic value of the investment, buying if intrinsic value is higher than the current price. A passive approach involves the fund manager mimicking an index, buying all or most companies in the index. If the index is market capitalization weighted, then the fund manager does virtually no trading except when a company or security is added or deleted from the index. Active management on the other hand typically involves more trading.

Active versus passive is a personal choice. If you select an active manager a great deal of due diligence is required. Many studies look at aggregate performance of investment managers such as mutual funds. The data shows that the average return of these investment managers is equal to or less than the return of the relevant index/indices. They then conclude that active management does not work and that investors should invest passively.

What's wrong with this picture? Let's look at a simple world. The world consists of $100 billion of investable assets in several asset classes. In this world there are only two investment managers each managing 50% of the world's investable assets. Both investment managers invest in the same asset classes in the same proportion to the market but actively select the proportion of each security within each asset class. Further let's initially make the very strong assumption that there are no fees or expenses. Over a recent multi-year period the performance of the managers and the world portfolio is:

Manager A: 8%

Manager B: 12%

Average Performance/World Portfolio/Index 10%

Note that the average performance of the two managers is equal to the world portfolio which is also the world index, since there are no fees and expenses. What can we conclude from this example? We can conclude that on average all (in this case both) investment managers do not outperform the world/index.

What can we NOT conclude? We cannot conclude that active management does not work. Clearly in this example one manager has outperformed the other and active management did matter in this example.

The key here is that when we look at large populations of managers we should expect that on average they will not outperform the market. In fact, if there were no fees or expenses then the aggregate average performance of all managers, passive and active, will equal the index. With the existence of fees and expenses, the aggregate average performance of all managers, active and passive, SHOULD underperform the index by the average of fees and expenses. We do not need to do a study or perform any analysis to make this determination. The figure below demonstrates what we should expect:

Returns on Passively Managed Portfolios (Net of relatively smaller fees, expenses and/or time expended)

+

Returns on Actively Managed Portfolios (Net of relatively higher fees, expenses and/or time expended)

=

Market Index Returns (Computed without fees and expenses)

-

Aggregate Fees and Expenses for Management of all Portfolios

The keys questions to consider are “Can individual managers (not the average manager) sustainably outperform their index after all fees and expenses (including taxes), and how can we identify those managers?” What matters most is performance after expenses – if an active manager can outperform after expenses over a sustained period and if the risk of that investment matches the risk tolerance of the investor, then active management is worthwhile.

It is clear from the last decade that many investors are embracing passive management and indexing due to its ease and low cost. For the average investor who does not have the time or inclination to evaluate active managers, the best approach is indeed a passive low-cost index. For investment advisors, a passive approach is also a low-cost method of getting exposure to an asset class and some asset classes are best accessed in this manner.

Dollar Cost Averaging

When initially implementing an investment plan from all cash to a strategic asset allocation across asset classes, an important consideration is whether to make all of the investments at once or spread them out over time. Generally, once you have determined the appropriate asset allocation for a client you should implement as soon as possible. During more volatile market conditions, however such as during the 2022 invasion of Ukraine, some advisors prefer spreading the investment program out over time to engage in dollar cost averaging. In a dollar cost averaging approach, you buy a fixed dollar amount each time. When fund prices are down you buy more shares and when fund prices are up you buy fewer shares. This results in a lower average cost per share in choppy markets. If the market is in an uptrend your average cost would be higher and you would have been better off making the entire investment at one time. In a downtrend you are better off waiting – to the extent you can predict the continuation of the downtrend. Timing the market is extremely difficult if not impossible so take care with these approaches.

Pooled Investment Vehicles

The portfolios of securities (for example, stocks) within these vehicles is overseen by a portfolio manager(s). In some cases this involves a simple index portfolio designed to invest in all the securities in an index or may involve a more complex strategy such as purchasing securities the manager things are priced at an attractive value relative to the underlying fundamentals of the investments (value stocks for example). In selecting a manager there are three main things to look at:

- Performance: The advisor evaluates the past performance of the manager and whether that performance can be expected to continue. Performance includes returns, risk and the return relative to the risk of the managers fund compared to an appropriate benchmark. Expenses and taxes both detract from the long-term accumulation of wealth, so it is important to look at and examine these elements of performance as well.
- People: The advisor evaluates the individuals managing the fund as well as management of the firm that employees them. We consider their education, experience, past performance (including at other funds) and adherence to ethical codes of conduct. The tenure of the individuals managing the money is important. If new managers are put in place the prior performance cannot be

attributed to them and you may have to examine prior funds they managed to learn about their track record.

- Process: The advisor evaluates the fund manager's investment process and whether it makes sense relative to the asset class they are managing. This includes looking at controls to ensure the manager sticks to their mandate (for example, passively mimicking a particular index or adhering to their active strategy).

There are great databases available such as Morningstar to screen for attractive fund candidates within each asset class of interest. This screening is often based on performance and style metrics to narrow down funds for additional examination of the people and process. Some data is also available at no charge from Yahoo Finance.

Let's use Large Cap Growth as an example. Your client's asset allocation has a portion allocated to Large Cap Growth. I will use YCharts to screen which includes Morningstar Data (you can also screen directly in Morningstar products such as Morningstar Advisor Workstation). There are 1,955 Large Cap Growth Funds available in the database. We limit those that are available to new investors in most brokerage or IRA accounts and decide to focus on ETFs. Mutual funds versus ETFs is a personal decision. Today most management companies have mutual funds and ETFs that are clones of each other with the same individual managers. Both are effective for managing client assets. Sometimes mutual funds must be on a brokerage preferred list to avoid transaction fees. ETFs on the other hand on major platforms such as Schwab, Fidelity and TD Ameritrade are commission free. ETFs can also be bought and sold intraday whereas mutual funds trade at the close of the trading day.

For performance we screen for the top 30% of funds on

- 3 Year Total Returns
- 5 Year Total Returns
- 10 Year Total Returns

We could also screen on expenses, however there are embedded in the fund returns so we choose not to screen for low expense ratio funds initially. We will however examine the expense ratio when we do our further due diligence. Similar we will examine risk metrics in the further due diligence stage. If the above screen does not narrow the field enough, we may include risk metrics in the initial screen. Based on this screen there are 7 ETFs with at least 10 years of data that are in the top 30% of funds in each of these time periods. This is a manageable number for additional due diligence including risk.

Note also in this case we are screening specifically for Large Cap Growth so screening only on returns is appropriate. If however, we are screening on large cap in general to include value and growth we would want to screen differently if during the period we were looking at there was a difference between performance of value and growth that we do not expect will persist. Otherwise, we bias ourselves with continuing with the prior top performers. I personally like to ensure that all portfolios capture both value and growth opportunities, so I screen and allocate separately to value and growth categories. Another approach is to incorporate vale and growth aspects into the screen (screen on returns and characteristics of fund holdings such as value metrics such as P/E).

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We can make a few observations from this data. The first two funds follow the technology heavy NASDAQ index and as a result had the higher performance over the trailing period.   They also have the highest risk looking at the maximum drawdown. The Schwab ETF on the other hand provides large cap growth exposure that is broader at a very low expense ratio and very low tax impact (not much trading).

The fund prospectus provides valuable information on the funds intent, process and management.   Morningstar's database also provide information on the experience of the managers, the tracking error for the fund compared to the index, ratings and many other performance and risk metrics.

In the case of SCHG, morning star rates the fund 5 stars (the highest rating), notes that this fund has a one of the cheapest expense ratios available, that Schwab's equity index team is well resourced and the fund delivers tight index tracking (low tracking error).

A similar process would be used to select funds for the other asset classes in the portfolio.

Symbol	Name	Expense Ratio	Historical Sharpe Ratio (10Y)	Max Drawdown (All)	Annualized 1 Year Returns	Annualized 3 Year Returns	Annualized 5 Year Returns	Annualized 10 Year Returns	Distribution Yield	10 Year Tax Cost Ratio
QQQ	Invesco QQQ Trust	0.20%	1.23	83.0%	2.00%	22.91%	19.81%	17.44%	0.52%	0.35%
ONEQ	Fidelity Nasdaq Composite ETF	0.21%	1.12	55.1%	-3.46%	19.13%	16.79%	15.60%	0.66%	0.36%
IWY	iShares Russell Top 200 Growth ETF	0.20%	1.22	30.8%	7.04%	21.30%	18.42%	15.42%	0.61%	0.36%
SCHG	Schwab US Large-Cap Growth ETF	0.04%	1.11	32.4%	2.78%	19.89%	17.16%	14.84%	0.52%	0.33%
SPGP	Invesco S&P 500 GARP ETF	0.36%	1.03	42.1%	5.23%	18.34%	18.47%	14.73%	0.78%	0.45%
MGK	Vanguard Mega Cap Growth ETF	0.07%	1.12	48.4%	2.30%	20.36%	17.22%	14.65%	0.51%	0.34%
VONG	Vanguard Russell 1000 Growth ETF	0.08%	1.14	31.7%	3.57%	19.31%	17.21%	14.59%	0.71%	0.34%

Individual Securities

Managing a portfolio of individual securities requires a great deal of due diligence and it is rare that an individual advisor has the skills and experienced needed to select individual securities across all asset classes. If you are not using a pooled vehicle as above with an experienced manager, then you need to do all the due diligence/analysis the manager would have done. For individual bonds you need to evaluate credit risk, overall economic situation, interest rates and trends in rates, interest rate risk of the particular bond among many over factors. For individual stocks you would need to analyze fundamental ratios, management performance, the economy and industry situation, future earnings and cash flow prospects and valuation. If you have time and interest, there are quite a few books from CFA Institute on these subjects.

Fortunately, there is an alternative – separately managed accounts. In a separately managed account arrangement, you outsource each asset class to a professional manager to manage that part of the portfolio. For example, you might outsource all equities to an equity manager (or different subtypes of equities to different managers each with expertise in that subtype). This can provide more customization that mutual funds to account for practically client preferences. These accounts can also be tax managed to maximize the after-tax return (tax loss harvesting and similar strategies). The downside, however, is an additional layer of fees which can be higher than mutual fund or ETF alternatives.

Another recent variation is direct indexing. This involves buying all or most securities in an index and managing them directly rather than using a mutual fund or ETF. Similar to SMAs you can customize, and tax manage the holdings. Some investment firms are now offering this product through separately managed accounts.

