Performance Risk and the Investment Universe

It is impossible for the average investor to constantly outperform the stock market. The market is efficient at matching demand for shares and the supply of shares and the vast majority of information which investors use to make investment decisions is known by the market. The only way to outperform the market all the time is to be the first to buy and sell an investment or to be able to predict events that are yet to happen.

This does not mean that it is impossible to outperform the stock market over the long term and it does not mean that the only viable options open to investors are index funds.

What investors need to understand is this; individuals in general prefer more return to less return, more security to less security and more certainty of return to less certainty of return.

What this means is that the average investor prefers to be in areas of the stock market that are going up, that have been going up for a while and that have provided a better return than other investments. It also means that investors do not like being in investments that have been falling, have fallen or underperformed for a significant period of time and where there is less certainty of return than others.

If most people share these traits then most people will be looking to buy similar investments, will want to be in investments that are performing and will want to sell investments that are under performing.

What therefore happens is that there are areas of the market that are not efficiently priced. That is they are either under valued or over valued. This provides opportunities for the disciplined investor to buy areas that the market is neglecting or selling. The only problem is that you have to be able to stomach periods of under performance.

If you cannot accept the risks of periods of under performance, then you should not be taking an active investment stance, but should be buying the index. Investment advisors are not excluded from this rule. As a general rule, active management should only be entrusted to those with valuation and allocation expertise as investment discipline is directly related to the ability to value an investment or a market.

When you the investor are looking for asset managers, you need to understand the investment discipline of the asset manager and the performance risks that are relevant to their investment style. If you are averse to these risks and they are not able to adjust their portfolios to suit your preferences, then you should not be investing with them.

This also means that your advisors need to be able to educate you over their investment style and assess your aversion to their style.

If all investors were rationale, then it would not be possible for anyone to outperform the market. For further information on investment discipline and its importance please see the Technical section and Investment Discipline.

The investment universe

The following is not discussed in great depth here but is an advanced and relevant topic for developing and managing asset management solutions for the personal financial portfolio.

It is not a must know for investors, but it is a must do for advisors wishing to provide advanced personalised asset management services.

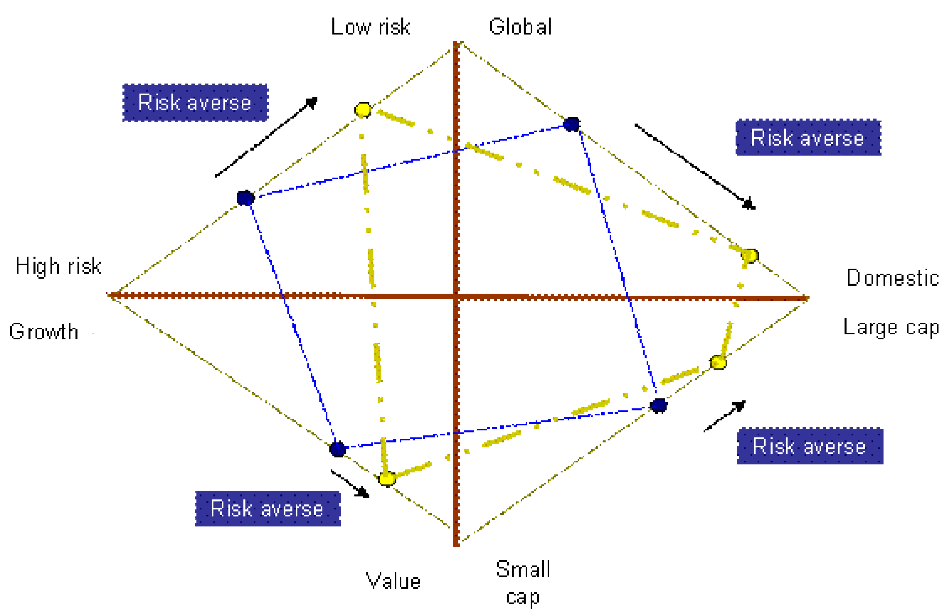
Every asset manager operates and every investor exists in the same value and risk universe, but they occupy different positions within it.

The investment universe is comprised of domestic and international markets, smaller companies as well as larger companies, growth stocks as well as value stocks. Every asset management company has a different investment style and will allocate to different areas of this universe for different reasons.

What each asset management company must understand is that different positions within the universe are more or less appropriate for investors with different financial and risk profiles. In other words, the amount that is allocated to each area of the universe can actually be determined by the relationship between financial needs, time frames, risk aversions and performance preferences.

The need for liquidity and the time frame of the liquidity will influence the market cap, global, yield/value and growth allocation of a portfolio. An organisation that manages total financial needs and assets needs to be able to structure its allocation universe relative to the universe of client liquidity requirements and time frames and to have disciplines to adjust allocation strategies for stock market risk aversion and performance risk aversion.

As noted below, the blue quadrant may represent an asset manager's preferred position, while the yellow quadrant represents the individual's preferred position. An organisation therefore needs to possess the expertise that allows their asset allocation stance to be directed towards the needs and preferences of the individual without having to compromise the organisation's own values.



Asset managers therefore need to be able to do the following.

- Define the performance risk of their style relative to the investment universe and allow investors to determine their position relative to theirs.

- Educate the client regarding their investment style, allocation, risk and return management.

- Allow investors to select appropriate performance risk profiles which will be used to determine and manage portfolio allocation over time.

As discussed in this document, managers who cannot adjust their allocation to suit client liability and risk profiles should not be in charge of the overall asset allocation and management decisions.