

# Investment Choices

## Protecting the value of advice

### STANDUP ADVISOR

BY JOHN DE GOEY



Risk and return are related; any informed investment decision, then, requires a clear consideration of both factors. This means there are essentially three alternatives: market type risk with market type return, less than market risk with less than market return and above market risk with above market return. The extent to which one mixes and matches is primarily a question of risk preference.

Similarly, there are three primary product types available for investors who want to use diversified investment products as portfolio building blocks: actively managed mutual funds, exchange-traded funds (ETFs) and “enhanced” index funds. Actively managed funds involve technical and fundamental analysis where the stock-pick-

ing managers buy those securities that they believe will outperform the market as a whole. ETFs aim to replicate the market – both as to risk and reward. However, since these products have a cost (albeit a small one), they are certain to lag their benchmarks over time. Enhanced index funds are like ETFs in that they believe in market efficiency, but differ because they are not concerned about tracking error. Enhanced indexers believe risk and return are related – the enhancement, therefore, is to willingly take on more risk in the expectation of increasing returns by an equal or greater amount. (There is a fourth product type – hedge funds – but they tend to have the highest fees and the most opaque reporting of all the product paradigms. For those reasons, I do not believe they merit serious consideration as a primary investment paradigm.)

To many, the three primary product lines offer a logical con-

tinuum of choice. Depending on one’s views, any or all could be used in portfolio construction in varying proportions. In practice, active funds typically get below market returns in the long run with wildly divergent risk levels. While some active managers have performance records that look better than their benchmark, two points remain crucial:

1. **Outperformers over statistically significant time horizons are rare.**
2. **No one has figured out how to reliably identify outperformers in advance.**

If people could identify outperforming managers in advance, those managers would most certainly be worth hiring. Sadly for investors, mutual fund outperformers cannot be reliably identified in advance and past performance is not a reliable indicator of what the future might hold. Every mutual fund prospectus says so.

In contrast, ETFs get market returns (minus a modest cost) while taking on market levels of risk. Because they are concerned with tracking error as a primary definition of risk, ETFs are required to buy and sell stocks when

they are added to or removed from the index in question. If you define risk as “the extent to which my investments deviate from the market as a whole,” then ETFs are for you.

Finally, enhanced index funds typically (but not always) offer above market returns in the long run precisely because they seek out securities with above market risk. It is noteworthy that this enhancement strategy does not involve a one-to-one relationship – the products typically involve modest increases in risk relative to a market level, while simultaneously aiming for moderate to strong improvements in long-term returns. It sometimes takes decades for this risk/return attribute to play out. Enhanced indexers buy the asset class, but are smart about how they do it. They are not slaves to tracking error.

This brings us to the question of how one might define risk – through standard deviation or by tracking error? Again, actively managed funds have all manner of standard deviations relative to the asset classes they invest in. The easiest products to understand are traditional market-capitaliza-

tion weighted ETFs. They essentially define “risk” as tracking error. To traditional ETF investors and product manufacturers, risk is defined by how much the investment deviates from the index it is mandated to track. Enhanced indexers are far more concerned with standard deviation than tracking error. As such, it might also be said that enhanced indexers view risk in absolute terms while traditional indexers view risk in relative terms (i.e. relative to a benchmark). Neither is necessarily right or wrong, but advisors need to ensure that clients understand the difference so that they use products that reflect their own views.

Investors should consider their own views regarding risk, reward and the probability of outperformance when making investment decisions. And advisors need to offer reliable evidence for all possible investment choices and let their clients make the final decision.

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