

Investment Redux

Strategies

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Portfolio Management Strategies

Passive vs Active Management

- Passive Mgt – long term; designed to track a specific index
- Active Mgt – attempt to outperform a specific index

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Three ways of constructing a passive index portfolio

- Replication
- Sampling
- Quadratic optimization

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Quadratic Optimization

Historical information on price changes and correlations between securities are input into a computer program that minimizes tracking error with the benchmark.

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Quadratic Optimization cont.

The problem with QO is that it relies on historical price changes and correlations. If these factors change the technique is subject to large tracking errors.

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Active Manager

- Goal of an active manager is to outperform a passive benchmark portfolio, net of transaction costs, on a risk adjusted basis.
- Active manager fees and transaction costs generally run around 1.5%

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Two key factors for active managers

- Keep transaction costs to a minimum with low turnover
- Keep a consistent investment style

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Three generic themes in active management

- Market timing – shifting funds in and out of stocks, bonds and T-bills
- Shift funds among different equity sectors
- Stock picking

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Additional sub-strategies

- Sector rotation
- Earnings momentum
- Price momentum

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Value versus Growth Investing

- $P/E = \text{price per share} / \text{Earnings per share}$
- Growth and Value investors view this equation differently

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Growth Investing

- A growth investor focuses on the EPS part of the equation, the denominator
- Rapid EPS growth
- Assumes P/E will remain constant – meaning price will rise

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Value Investing

- A value investor focuses on the price part or the numerator
- Price must be “cheap”
- Current earnings less important
- P/E is below its “natural” level

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Summary (focus)

- A growth investor - current and future economic story of a company
- A value investor - share price in anticipation of a market correction and improving company fundamentals

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Style Analysis

- An attempt to explain the variability in observed returns to that of a specific benchmark
- Style Grid – classifies a portfolio manager's performance in two dimensions, firm size and value-growth
- Style drift

Economic Fundamentals

How the market moves “generally”

- Strengthening economy – bearish for bonds, bullish for stocks
- Slow growth weak economy – bullish for bonds, bearish for stocks
- Federal Reserve reports can dramatize the effect
- Amplified in the commodities markets