Overview of Investment Strategies

Developing a purposeful investment strategy requires you to evaluate your financial circumstances and define goals which fit your life plan. Consider things like the purpose of each pool of assets and your risk tolerances.

Investors have their own investing preferences, so the development of a strategy becomes an educational journey for you. You may or may not have a tour guide to help you along this journey. We'll discuss tour guides in another session. There is a generalization that wants to categorize investor sentiment into one of three broad categories: conservative, moderate, or aggressive. It's probably not a bad place to start, going from the general to the specific, but it is NOT the end point. There are many subsets of these broad categories, some of which we will discuss in this session.

You may fashion yourself as a risk taker by nature, and believe you would be willing to gamble large amounts of money on highly speculative investments, in return for the potential for substantial gain. On the other hand, you may prefer to keep cash in the bank for security reasons even if it means that the actual buying power of your money is slowly eroding because of inflation. In 2010 you would have to make more that 2% just to keep pace with inflation. Most people fall somewhere in between these extremes, and are willing to assume some risk, with the expectation that they'll be rewarded with reasonable returns, while keeping some safety valve. Finding this balancing point between risk and safety is one purpose of investment education-- to be able to evaluate the impact and characteristics of various investment styles, specifically as they affect YOU. You may be older, closer to retirement and hence a more risk-averse, conservative, investor. Alternatively you may be still in your peak-earning phase and might be inclined to take more risk.

An investment strategy is a specific plan tailored to **your** investment objectives that identifies the type of securities or other investments that will be purchased, what style of investing is appropriate, how long securities are to be kept and when they are to be sold. You need a plan that guides your choice. Much of the long-term success of any investment strategy depends on the way its assets are allocated, among the major asset classes (some analysts say more than 90% of a portfolio's return may be attributed to its asset allocation). Most financial professionals agree that the first step in implementing an investment strategy is asset allocation. Before you go there, however, the place to begin developing an investment strategy is the process of setting investment objectives (see our session on "Setting Investment Objectives").

While some investors may choose to "Go it alone " by investing via web-based providers, others will look to their financial adviser to develop an appropriate investment strategy for them. Among some of the more common investment styles and strategies are those we will discuss in this session, and include the following:

-Long/Short-   -Market Timing-   -Core-   -Value-   -Growth-   -International-

Buying Long vs. Selling Short

Simply stated, if you buy a security long, you purchase it, you own it. If you sell a security short, you sell something you do not own, but will have to buy later to “cover” the transaction.

Buying Long

Long buyers are basically optimists who purchase stocks outright in the belief that they will go up. If you own a stock in the portfolio, it is said to be a "Long" position. At some point in the future, if the stock price goes up, the stock will be sold, generating a profit for the investor. If the price goes down and does not recover, eventually the stock will be sold, generating a loss for the investor.

Selling Short

Just as long buyers are optimists, expecting prices to go up, short sellers are pessimists, expecting prices to go down. To profit from this anticipated drop as a short seller, shares of stock are "borrowed" from a broker, and sold, (short sale) with profits from the sale going to the investor. The client's statement will indicate a "short" position, which means a security that must be purchased by the investor (hopefully at a price lower that what was paid for it) so that it can be "Repaid " to the broker. If the price goes down the stock is purchased back at the lower price and the shares borrowed from the broker are repaid. After interest and commissions, the expectation is that the client will have made more on the initial sale of the borrowed stock than it cost to sell and repurchase the shares. The strategy can backfire, however, if the stock price goes up, rather than down, or even if the price is stable for an extended period, since interest charges will mount. At a point in time, the client may cover their short position by buying shares at a higher price than their sale, leaving the client with a loss.

Active vs. Passive Management

Many factors go into the classifying of the portfolio management of accounts. All Managers and Funds have specific investment philosophies and employ styles to suit their philosophy. In the arena of managed accounts, the skill of a money manager is crucial to the success of the investment philosophy, as is the adherence to that philosophy. We will discuss managed accounts in more detail below. However, there are two general philosophies of portfolio management, which apply to the level of the activity and involvement of the money manager—active and passive. The merits of one approach over the other have been and will continue to be debated for some time.

Active account management simply means that a portfolio of securities overseen by a portfolio manager, typically a money manager, is actively traded. Securities are bought and sold according to the investment philosophy of the money manager. Typically there are set target prices for the purchase and sale of each security under consideration, and securities are bought and sold according to those criteria. Some “active” managers can be very active, generating buys and sells every day. Others can be “active”, yet only generate slight activity. The less active can even have a “buy and hold” philosophy, with the theory that what they buy is good enough to hang onto for quite a while (unless the security’s fundamental financial condition changes dramatically). The theory behind active management is that the active manager will take advantage of pricing movements in securities so as to maximize potential return, and minimize loss. Most regular mutual funds and separate account managers employ an active philosophy. Therefore, **in theory**, the skill of the manager will enhance return over a passive methodology such as "Buy and Hold.”

The Passive Strategy of Index Funds and ETFs

ETFs are examples of passive management philosophy. A basket or group of stocks, which meet predetermined criteria, are purchased and kept. For instance in an index fund, which would be based on the Dow Jones Industrials, there would be no buying or selling unless stocks were added or removed from the index (which happened recently when stocks like AT&T and Kodak were taken out of the index, and stocks like AIG and Berkshire Hathaway were added). Passively managed funds may be rebalanced annually to keep the proportions level with the predetermined criteria or index.

Inherent in the theory behind passive management is the goal to replicate the performance of the basket or the index. Passive managers believe that there is no value added by active management. The debate continues to rage.

The obvious place to begin looking when evaluating active vs. passive management is to start with performance. A recent study of management philosophies showed that out of 17 identified active management strategies, seven out-performed a “buy and hold” strategy over 15 years. Ten did not. This evidence is, if anything, inconclusive. What about results over time?

Leave it to Vanguard—the king of indexing—to throw gasoline onto the fire. As reported in Investment News, March 15, 2004, in a study by the Journal of Portfolio Management, from 1977 to 2003, investors in actively managed funds run by Vanguard, "would have earned higher returns—and taken less risk—than those who put their money into the company's famed index funds." One conclusion the study reaches is that active managers may be able to react to the often-irrational behavior of the markets to protect their investors. Whether they will or not depends on the skill of the manager.

There are hundreds of studies and statistics, which claim to "Prove" that most active managers do not beat the market. The stock market indices did well in 2010, with the S&P 500 index ending up more than 12%. Among mutual fund managers that target the S&P 500 as their benchmark index to beat, not many beat that index. Vanguard and those who favor indexing are quick to point out that once costs (fees) are factored in, index funds win the battle.

In all likelihood the debate will continue to rage, and the result will continue to be inconclusive. The lesson to be learned is that each philosophy may be appropriate for you at a point in time, or for a portion of your assets, depending on your risk tolerance and investment objectives.