RETHINK THE WAY YOU INVEST

Core and Explore: A Slippery Slope

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One of the trends developing among investors is the belief that your portfolio can be divided into two components. The larger component consists of more conservative investments and is comprised of traditional asset classes. It may contain bonds, blue chip stocks, broadly diversified mutual funds, or exchange traded funds (ETFs)—and it is called the *core* of your portfolio. The smaller portion of the portfolio is used for aggressive investments and may include speculative positions, concentrated stock options of high risk equities, industry over-weightings, tactical asset shifts, or alternative investments—and this is called the *explore* portion of your portfolio.

This type of portfolio construction seems logical and prudent. And yes, limiting risk to one portion of your total assets is definitely better that having 100% of your investments tied up in exploratory options. Financial institutions claim that institutional pension plans have been successfully using a concept called "core and satellite" for quite a while now. You could also make the argument that this type of construction allows all the great investment ideas to come together in your portfolio. So wouldn't this be a viable—and possibly even the best—option for individual investors?

Before we jump to any conclusions, let's review how pension plans might be implementing their core-and-explore or "core-and-satellite" investment approaches. Institutional investors usually have a "core" of passive investments and "satellite" investments under active management. The satellite portion may also include a very small proportion of alternative assets; according to the Pension Investment Association of Canada, as of 31 December 2006 the average pension plan had 7.1% in alternative strategies. In fact, not so long ago, diversified investments in real estate could have been considered a satellite position. Typically, however, the most striking difference between pension plans and individual investors is that the pension plans have very stringent risk management processes in place to ensure that the overall pension fund asset mix is managed prudently. The costs paid by institutions for access to satellite investment positions is also significantly less than the costs for individual investors.

For individual investors, the problem with core-and-explore investing is that the "explore" portion all too often provides the mental justification for taking unnecessary—albeit sometimes thrilling—risks. It can serve as a psychological prop that encourages investors to make silly investment bets and to embark on strategies with a low probability of success. The explore portion of the portfolio can foster bad investment habits such as market timing, chasing hot manager performance, huge industry bets, aggressive tactical asset allocation, and speculative investments, to name a few.

The main challenge in executing the core-and-explore strategy is that we are all human—and our emotions *will* get in the way. All too often, the explore part of the portfolio leads us to buy high and sell low. We tend to buy investment concepts that are in vogue or hot today. Classic behavioural investing errors occur here. Biases towards recent investment trends, jumping in on the herd mentality and, above all, investor and advisor overconfidence can lead investors to take much larger gambles than they might have intended.

Like a rollercoaster, the explore section of the portfolio runs after perceived opportunities. Unfortunately, we could actually define much of the performance-chasing that we see in portfolios as speculation. Investors often simply do not have a clear understanding of the level of risk they are taking and do not truly understand the difference between investing and speculating. The problem with speculation is that, once you have lost your investment capital on a trade idea, it's gone forever. If losses are repeated frequently, the explore component of your portfolio can become not money in the bank but a chronic drain on your resources—always weighing down the performance of the core and holding you back from your personal and financial goals.

Investors are much better off building portfolios with a total investment strategy in place. Treat your entire portfolio as a core. If you want higher rates of return (and are prepared to take on higher levels of risk), then increase your exposure to diversified "out of favour" and "neglected" companies or very diversified positions in "small companies." The capital markets have shown that you will be rewarded over the long-term for using these strategies. This is a much better game plan than relying on hope.

SOURCES & DISCLAIMER:

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