ETF insight

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Adding discipline to your portfolio

Having a strategy is half the battle

According to BlackRock, the average investor underperforms virtually all other traditional asset classes and even inflation. When comparing 20-year annualized returns by asset class, the average investor rings in at 2.3% compared to the S&P 500 Index at 8.2%. This underperformance is largely attributed to behavioral finance.

Studies show that investor emotions are predictable and in sync with market cycles. During a bull market investor emotions have an upward trajectory from positive to confident, then thrilled, and peaking at euphoric. When markets fall, the emotions then track downward accompanied by surprise, nervousness, worry, and desperation. The descending emotional path ends in panic and defeat. As markets bottom out and start to regain some steam, investors cautiously re-enter the market as they become hopeful and encouraged.

Unfortunately, emotions rule and most investors exit their investments at the bottom. According to Fidelity Investments, when individual investors attempt to buy low and sell high, they tend to do the opposite. An investor who put $10,000 in the S&P/TSX Composite Index January 1, 1975 would now have $486,200, an annualized return of 10.7%, despite many market dips. If that investor was out of the market during the 10 best months, the annualized return would drop to 7.5%. If the 60 best months were missed, the annualized return would be -1.8%.

A first step in keeping emotions at bay is to create an Investment Policy Statement (IPS), setting parameters for making investment decisions and encouraging the discipline required to stick to the rules. Clear rules are important as they facilitate a calm assessment of hard facts and ensure proper reactions to new or changing information. Investors remain emotionally neutral, which ultimately makes them more likely to buy low and sell high.

The next step is to build a portfolio with investments that employ a rules-based approach. According to Barometer Capital Management, a disciplined strategy is half the battle. On the buy side, Barometer uses a number of systematized ranking systems and quantitative tests to determine whether a position should be added to a portfolio. A clearly defined selling strategy is equally important as it removes emotion and irrational decisions.

Similarly, factor-based strategies can help maintain portfolio discipline. According to MSCI Inc, long-term equity portfolio performance can be explained by certain key factors. Some are generic while others are premium-earning factors, which earn a risk premium relative to a capitalization-weighted market index. Such factors include value, low size, low volatility, high yield, quality, and momentum. According to MSCI, the strategy brings transparency to factor allocations, which ultimately helps alleviate

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manager 'style drift' and has positive implications for risk management.

One way to access factor-based strategies is to opt for exchange-traded funds (ETFs). First Asset recently launched four new exchange-traded funds (ETFs) built on the MSCI factor indexes, specifically, their risk weighted indexes. The ETFs are designed to provide liquidity, transparency, and low cost, together with strategies that aim to deliver better risk-adjusted returns.

The most successful investors are those who effectively remove emotion from their investment decisions. Such investors create rules, document them in a comprehensive IPS, and select investments based on those criteria.

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