The 4 Ds of Portfolio Management

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"A goal without a plan is just a wish"
- Antoine de Saint-Exupéry

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We are republishing this article because of its timeless nature, and its core position in our philosophy.

4 Ds <u>**The Fundamental Building Blocks**</u>

Any sound and successful portfolio management process requires four fundamental elements:

- **D**iversification
- **D**iscipline
- **D**etachment
- **D**edication

These "4-Ds" encapsulate the portfolio development process and form the very foundation of Quadrant's portfolio management process. No single one of the "Ds" is more important than the other. They are intertwined *making the whole more than the sum of its parts*.

Diversification

From an investment perspective, diversification is the process of allocating capital in a way that reduces the exposure to any one particular asset or risk. The primary objective is to reduce risk exposure in a portfolio in light of a particular return objective. Diversification is a key tool in maximizing the return/risk utility of a portfolio (maximizing returns for a given overall risk level).

i. <u>Diversification between Broad Asset Classes</u>

The broad asset class levels of equity, fixed income, and cash investments provide a starting point for diversifying a portfolio. The weighting of each of these components in a portfolio will depend on the time horizon, risk tolerance and investment objectives of the investor. Equity generally provides higher long-term returns but comes at a higher level of volatility, while fixed income provides a lower return but typically adds stability to a portfolio in the form of lower price deviations. Cash investments provide the lowest long-term return, but are the least volatile, and are used primarily to provide additional stability, manage cash flow needs and to act as a buffer to capitalize on attractive investment opportunities in the other broad asset classes.

ii. Sub-Asset Class - Diversification within each Broad Asset Class

Sub-asset classes are subsets of broad asset classes discussed above. Securities in each category can have differing characteristics beyond the fundamental characteristics associated with equities versus fixed income versus cash. Examples include:

- geographic location
- market capitalization (size) of companies
- industry
- credit quality

Often times Canadian investors view holding an assortment of Canadian stocks and bonds as being fully diversified, but in reality, the portfolio is overexposed to Canada and quite vulnerable to shocks in the Canadian economy. A more appropriate portfolio (in terms of maximizing risk/reward utility) would have the equity component (broad asset class) diversified amongst a number of sub asset classes –such as Canadian large cap equities, U.S. large cap equities, international equities, Canadian small cap equities, and real estate, while the fixed income component could be diversified amongst government, corporate bonds and preferred shares offered both within and outside Canada.

iii. Sub-Asset Class – Diversification of the number of Securities Within each Sub-Asset class:

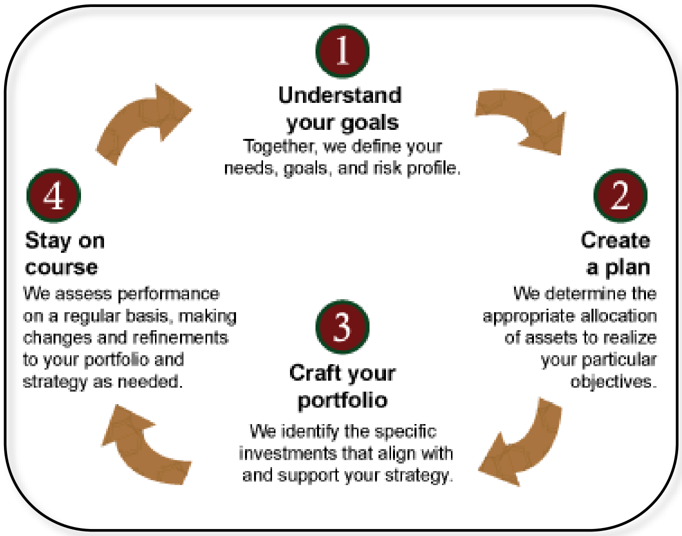
Each sub-asset class that makes up an investor portfolio should be composed of multiple individual and independent securities within that space. For example, owning a sufficient number of stocks within the Canadian small cap space is necessary to reduce unsystematic risk. Unsystematic risk is the uncertainty associated with a particular issuer of a security. For instance, by holding a diversified number of bonds issued by a broad range of corporations, the investor would be impacted far less by the failure of one of the companies in meeting its obligations.

Diversification within an investment portfolio goes far beyond the idiom of "not putting your eggs in one basket". It involves in-depth quantitative analysis coupled with a comprehensive and ongoing understanding of each client's circumstances. Diversification can sometimes be overdone, creating excess costs and a portfolio that does not meet a client's objectives over their investment time horizon.

Discipline

Every investor has different goals and different circumstances to take into consideration when planning for the future. By identifying these variables, a suitable portfolio can be created that is unique to each investor. However, creating the portfolio is only half the battle. In order for an investment plan to work there needs to be ongoing maintenance, periodic reassessment, and most importantly, the discipline to stay the course.

Take the portfolio management process in the context of a flower bed. Every gardener likely has their own unique vision of an ideal flower bed. Some might prefer one dominated by resilient and relatively low maintenance flowers like marigolds or daisies. Others might prefer to grow more fragile fare, such as orchids. While there is a difference in the skill and knowledge required to grow one versus the other, they both require the necessary discipline to ensure that the bed is properly planted, fertilized, watered and weeded – throughout the growing season.



Similarly, portfolio management requires a disciplined approach to design and ongoing maintenance. Beyond establishing the initial design, portfolios need ongoing and deliberate attention to maintain and reassess them to ensure that they still align with the current goals of the investor. The best investment plan in the world will fail to deliver the desired results without a disciplined approach to following it.

The need for discipline in investing is not limited to portfolio design and maintenance. It also extends to the management of all underlying asset classes by Quadrant's subadvisors. A well-designed and professionally constructed building using substandard materials is still a substandard building.

Beyond providing the necessary skill and knowledge in portfolio management, Quadrant's operational and governance processes ensure the necessary discipline to maintain your portfolio in concert with your personal circumstances.

Detachment

Behavioural finance deals with the psychology of investing and the human biases that are prevalent among many investors. In a recent presentation to an academic conference, Dr. Hersh Shefrin, an internationally noted pioneer of the field, outlined the importance of being able to emotionally detach oneself when making financial decisions.

The word “Detachment” may have a negative connotation to some, possibly inferring that one should separate themselves from their investments and not care about what happens. From a portfolio management perspective this is not the case. Rather, it is about not allowing base emotions (i.e. fear or greed) to influence investment decisions. Two common examples of decisions based on emotion are selling after the market goes down (fear) and buying after the market goes up (greed).

By engaging Quadrant as their portfolio manager, our clients create a structural detachment between decisions respecting their investment portfolio and their emotions. Quadrant has a fiduciary responsibility to each client to ensure that investment decisions are suitable to each client’s financial circumstances, investment objectives, time horizon and tolerance for risk. It is our duty to exclude behavioural biases from our decisions on behalf of clients.

Quadrant’s investment management processes are designed to ensure knowledgeable and rational decision making with each client’s circumstances in mind. Key to our approach is the structural detachment created by the provision of asset class management from external sources. As a result, Quadrant is not bound to any investment style or approach. We are able to assess the inclusion, implementation and replacement of asset classes or asset class managers based on individual merits (or demerits). The use of external asset class managers frees Quadrant from the tendency of portfolio managers with in-house asset class management to rationalize unsatisfactory performance (both to themselves and clients). This structural detachment limits Quadrant’s exposure to behavioural biases respecting asset class selection and execution and removes conflicts of interest with our clients’ investment needs and objectives.

Dedication

As with any relationship, the one between advisor and client needs to have a level of communication and commitment from both sides in order to be successful in the long term. It is the job of the advisor to help the client understand their goals, identify unique circumstances, and develop and maintain a suitable plan.

The fourth "D", dedication, is largely the job of the client. Portfolio management is a process that is intended to yield results over the long-term. Other than portfolios invested solely in cash, volatility will be a fact of life in the markets and, accordingly, progress is not always linear. Key to success is each investor's dedication to the portfolio process that is specifically designed to reach their goals.

Dedication requires trust of the advisor and the process. Trust, in and of itself, should not be blind or unconditional. Nor can it be established and solidified overnight. It develops through a combination of practical decisions, communication, consistency and transparency.

4 Ds A Summary

The 4Ds are key to the success of any portfolio management process. As an advisor to our clients, Quadrant is responsible for **Diversification** and creation of the portfolio, as well as for providing the **Discipline** and **Detachment** necessary to stay on track and make unbiased decisions. To ensure success the client must be prepared to **Dedicate** themselves to a long-term plan.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.