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Core and Explore: A Slippery Slope

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Core and Explore

A SLIPPERY SLOPE

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 overweightings, 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 than 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.

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SOURCES & DISCLAIMER:

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TULETT, MATTHEWS & ASSOC. INC.:

Keith Matthews is a partner and portfolio manager at Tulett, Matthews & Associates Inc. Tulett, Matthews & Associates specializes in discretionary portfolio management services and wealth management solutions designed for Canadian investors who are serious about achieving their long-term investment goals. Our unique consultative approach ensures that we only work with clients for whom we can add real value to their pursuit of a successful investment experience.

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Frank Danielson, BEd, CFP

Since 1994, Frank Danielson has built a reputation for attentive, client-focused service and valued advice. He currently serves as personal CFO for a number of high net-worth individuals, families, and professionals. Frank assumes responsibility for coordinating and managing the evolving needs of each of his clients, from portfolio strategy to risk management, estate and trust planning to financial planning and modeling.

Born and raised in Nanaimo, Frank attended the University of Victoria and obtained his Bachelor of Education in Biological Sciences. After two years in the teaching profession, Frank decided to focus on his passion for finance and embarked on his career as a financial planner. Since then, he has worked exclusively through referrals from his clients and a select group of CAs and lawyers. Frank, his wife Petra, and young son Dylan live in the UBC area. In addition to serving on several community boards, Frank is a strong supporter of the "Raise a Reader" literacy program. In his spare time, Frank enjoys golf, fitness, photography and expanding his personal knowledge.

Our Approach

At The F. Danielson Group we are passionate about providing our clients with the highest level of wealth planning services through the creation of a trusting, long-term relationship. Our commitment to your financial success and well-being is reflected in our unique consultative approach and client-centered process.

To ensure we are consistently adding value to our clients' overall financial plan we have developed our personal CFO process that continually aligns our ongoing advice and recommendations with your unique financial situation. Our consultative approach is based on a series of five meetings: discovery, planning review, portfolio design, opportunities, and implementation:

Discovery - discovery leads to clarity

The main objective of the Discovery Meeting is to learn more about your financial objectives, personal values, and key financial concerns. Together, we will also determine if there is a mutual fit and if we can add value.

We believe it is important to understand your financial personality, since human behaviour impacts every aspect of building your successful financial plan. We call this assessing your Financial DNA.



Plan Review - your financial roadmap

The main objective of our Plan Review phase is to confirm your financial objectives, then compare those objectives to your probability of achieving them. Most important, this meeting clearly reflects, in a written plan, your aspirations and creates the roadmap for achieving your goals.

Portfolio Design - implement

The main objective of our Portfolio Design phase is to review your unique investment objectives, liquidity needs, growth expectations, tolerance for risk, income requirements, investment time horizon, anticipated changes in lifestyle, tax considerations, and economic variables such as, inflation and market volatility.

These objectives will be reflected in your own Investment Policy Statement (IPS), which provides an account of your investment objectives and describes the strategies that we will employ to meet them.

Wealth Optimization - implementation leads to results

The main objective of the Wealth Optimization phase is to focus on wealth planning opportunities that will have the largest impact on your achieving your most important financial goals.

Using our Diagnostic Checklist (which covers nearly 100 tax, estate, corporate, and risk management opportunities), we ensure you are optimizing and protecting your overall wealth plan. Once the Checklist is complete, together we'll prioritize the results, then create an action plan that assigns realistic timelines for completion.

Financial Planning - implementation is not a "one time only" event

As your life evolves, so will your financial plan and investment portfolio. That is why we hold semi-annual meetings and conduct conference calls throughout the year to learn about the changes going on in your lives, monitor investment performance, and keep your overall wealth plan on track.

We would be pleased to discuss our process with you in person. Contact us at fdanielson@assante.com or by telephone at 604-638-0345.