

Constructing an All-Weather Mutual Fund Portfolio

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*Equity mutual funds perform differently in different time periods. There is more to constructing an **all-weather** portfolio than just screening for the top funds.*

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INDUSTRY INSIGHT

Equity mutual funds perform differently in different time periods as investment styles and sectors come in and go out of favor. While screening tools readily provide performance data and make the task of identifying top mutual funds relatively easy, there is more to constructing an all-weather portfolio than screening for the top funds.

This article describes methods of constructing an all-weather portfolio. Before getting into the nitty-gritty of constructing an all-weather portfolio, it helps to know how equity mutual funds are classified and how their performance is impacted by market conditions.

Classification by Market Capitalization & Style

Equity funds are commonly classified based on market capitalization of the companies in which they invest their assets and investment style.

Market capitalization is divided into three categories: large, medium, and small. Investment style likewise is divided into three categories: value, growth, and blend.

Combining both types of classifications, equity mutual funds typically fall into one of nine boxes on a 3 x 3 matrix. This classification system works well in analyzing diversified funds.

Classification by Sector & Industry Group

Instead of dividing the equity market by market capitalization and investment characteristics such as value or growth, an alternative way is to slice it by sectors. The Global Industry Classification System jointly developed by Standard & Poor's and Morgan Stanley Capital International, for example, classifies the equity market into ten sectors, such as financials and information technology. Each sector in turn is divided into several industry groups. This classification system is

particularly useful for analyzing sector funds that invest their assets in a given sector like information technology or industry group like computer hardware.

Impact of Business Cycle

The net asset value per share of a fund changes in response to the prices of stocks held in its portfolio. Generally speaking, stock prices are impacted by business conditions. The business cycle has various phases to it: Recovery, Boom, Slowdown, and Recession. Different parts of the stock market as seen from market capitalization, style, or sector perspectives perform differently in different phases of the business cycle.

Impact on Diversified Funds

Growth style funds, in general, fare well during expansion phases such as recovery and boom, and value style funds during contraction phases such as slowdown and recession. Likewise, from a capitalization perspective, small cap funds tend to perform better during expansion and large cap funds during contraction.

Looking at the most recent boom-bust cycle, Spectra Fund, a large cap-growth fund, was among the star performers during the 1997-1999 boom. Spectra gained 141% during the three-year period ending October 31, 1999. However, Spectra fared poorly during the 2000-2002 slowdown and lost 52% during the two-year period ending October 31, 2002.

In complete contrast, Hotchkis & Wiley Small Cap Value Fund, which failed to participate in the 1997-1999 boom, was among the top funds during the 2000-2002 slowdown. Following the 30% loss for the two-year period ending June 30, 2000, Hotchkis gained 88% during the two-year period ending June 30, 2002. ▶



Impact on Sector Funds

Like diversified funds, certain sector funds tend to perform better during some phases of the business cycle. Sector funds that invest in economically sensitive sectors such as technology typically tend to perform better during expansion phases. Sector funds that invest in economically less sensitive sectors like consumer staples typically tend to perform better during contraction phases. As a result, a sector fund that performs best in one time-period may not perform as well in another time-period.

Among the 41 Fidelity sector funds, Fidelity Select Energy Services was the top fund in 2005 with a 54% gain. However in 2003, the same fund gained just 8% to be the worst performer.

Constructing an All-Weather Portfolio

Can one select the top fund by knowing what stage the business cycle is in? Unfortunately, things do not get that easy.

Getting the turning points of the business cycle right is less than a science. Although certain styles and sectors are expected to do better during particular stages of the business cycle, there is no certainty they will do so each time. Additionally, stock prices tend to anticipate and lead the business cycle. The performance of a fund therefore usually varies from one economic cycle to another.

So, rather than chase the top funds, a prudent course is to construct a robust, all-weather portfolio.

A) Constructing with Diversified Funds

One way to construct an all-weather portfolio is to use diversified funds that emphasize different types of market capitalizations and investment styles. To simplify the task, one may construct a portfolio using a large cap-growth fund, a large cap-value fund, a small cap-growth fund, and a small cap-value fund.

In evaluating funds in each category, focus on the long-term track record and see how the funds have fared in different market environments. Complement this by evaluating each fund on non-performance-based metrics such as manager tenure, price volatility or risk, mutual fund fees, and mutual fund fiduciary grade. Choose the best available fund in each category and build your portfolio with managers of a 'dream team' caliber.

Alternatively, if you want to restrict yourself to only one fund to start with, you may consider a total market index fund which spans all capitalizations and styles.

B) Constructing with Sector Funds

Sector funds can also be used to construct an all-weather portfolio. This approach offers the advantage of creating customized diversified portfolios by including sectors and industry groups which are likely to outperform the market indexes and excluding those which are likely to under-perform.

The reward potential can be enhanced by concentrating in a few sectors or industry groups. Diversification across several sectors and industry groups serves to mitigate risk. By

optimizing the balance between concentration and diversification, one can achieve superior nominal and risk-adjusted returns.

The AlphaProfit Core model portfolio exemplifies this approach. Over the 33 month period from September 30, 2003 to June 30, 2006, the AlphaProfit Core model portfolio gained 57% compared to 39% for Dow Jones Wilshire 5000 Total Market Index. ■

Key Points

1. There are no top mutual funds for all times and climates.
2. A prudent course is to build a robust, all-weather portfolio.
3. Diversified funds as well as sector funds can be used to construct an all-weather portfolio.

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