

# Navigating Volatility by Combining Diverse Investment Approaches

Each investor has a unique profile formed by their time horizon, personal risk tolerance, current assets, beliefs about money, investment goals and market outlook—and all of these factors change through time. But for all investors, regardless of their personal profiles, understanding the drivers of investment performance and risk management provides a foundation for sound financial decision making. This knowledge inspires confidence in their investment strategy and a framework for repositioning that strategy as circumstances change.

Investors are particularly sensitive to the fact that markets have experienced two periods of high turmoil over the last decade—the dot-com crash and the global financial crisis. And they are now acutely aware that traditional asset class diversification has largely failed during bear markets, just when it was most needed.<sup>1</sup> As a result of these experiences, today many people question simple buy-and-hold stock and bond strategies that in the past were nearly universally accepted as the most sensible way to invest.

Some investors may respond to fear of another downturn by attempting to time the market; however, successful market timing by individual investors, who may make emotionally driven decisions, is widely recognized as exceedingly difficult at best. As evidence, a study by financial services market research firm Dalbar found that over the 20 years ending 2009, the average equity fund investor captured less than 40% of the returns of the S&P 500 Index due to poorly timed decisions about when to enter and exit the market. As shown in *Exhibit 1* on the following page, the average annual return of the index was 8.20%, while the typical investor captured only 3.17% per annum.

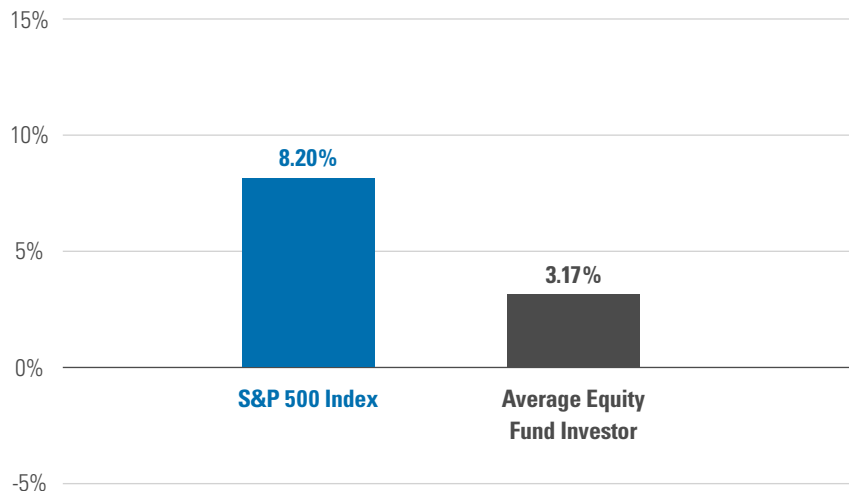
Starting from the premise that emotionally driven market timing is not an effective way to navigate volatile markets, in this paper we delve into the sources of volatility and its impact on portfolio results. Armed with this information, we then propose a method for improving the investor experience across bull and bear markets.

Today, many people question simple buy-and-hold stock and bond strategies that in the past were nearly universally accepted as the most sensible way to invest.

<sup>1</sup> For more details, see “Diversifying Portfolios for Early 21st Century Markets,” a Genworth Financial Wealth Management white paper. This paper highlights research indicating that asset class correlations have increased considerably over the past decade, and that diversification strategies based on allocations to a range of asset classes are likely to be largely ineffective during bear market declines—precisely when investors most need them. The paper also suggests that augmenting other diversification techniques by creating a mix of market-convergent and market-independent strategies may help investors better withstand stormy markets.

*Exhibit 1.***Average Annual Returns**

Equity Market Returns vs. Equity Mutual Fund Investor Returns (1988-2009)



Source: Dalbar, Inc., Quantitative Analysis of Investor Behavior – 2010. The graph depicts the average annually compounded returns of equity indices vs. equity mutual fund investors based on the length of time shareholders actually remain invested in a fund and the historic performance of the fund's appropriate index. Past performance is no guarantee of future results. Investors cannot invest directly in an index.

**Volatility's Impact on Investment Results**

Volatility not only tests the investor's resolve; it also can directly impact their returns. It is a basic principle of investing that long-term potential reward may be increased by exposure to higher levels of volatility. Examples of techniques for increasing exposure to volatility include investing in higher proportions of equities relative to bonds or higher proportions of riskier sub-sectors within equities.

However, while exposing a portfolio to higher levels of volatility may potentially improve results over the long run, the volatility of risky investments can also be damaging to the portfolio's performance, particularly over shorter periods of time. Consider *Exhibit 2* on the following page, which tracks two hypothetical portfolios invested over three years. Although simply summing the three annual returns gives the same result (+8%) for both portfolios, Portfolio A experiences much more volatility than Portfolio B. The impact of this volatility is significant. At the end of the period, Portfolio A has lost money, and has a balance that is 11% lower than Portfolio B's balance.

The unsettling experience of large market swings may also lead to ill-timed investor decisions that can result in missing the upside market capture as was shown by the Dalbar study: If Portfolio A in *Exhibit 2* had been liquidated at the end of Year 2, the investor would have lost nearly 20% of their original investment.

Clearly, high levels of volatility can adversely affect an investor's return experience, not to mention their comfort level with their investment strategy. So while exposure to volatility is necessary to generate returns, finding ways to minimize the impact of that volatility is also very desirable.

*Exhibit 2.***Illustration of the Impact of Volatility on Results**

	<b>Portfolio A High Volatility</b>	<b>Portfolio B Low Volatility</b>
<b>Beginning Balance</b>	\$100,000	\$100,000
Year 1 Return	26%	8%
End of Year 1 Balance	\$126,000	\$108,000
Year 2 Return	-35%	-10%
End of Year 2 Balance	\$81,900	\$97,200
Year 3 Return	17%	10%
<b>Ending Balance</b>	<b>\$95,823</b>	<b>\$106,920</b>

**Sources of Return Volatility**

To harness volatility for the investor's benefit, we first need to understand the sources of volatility in the portfolio. In search of returns, an investor may choose three strategies:

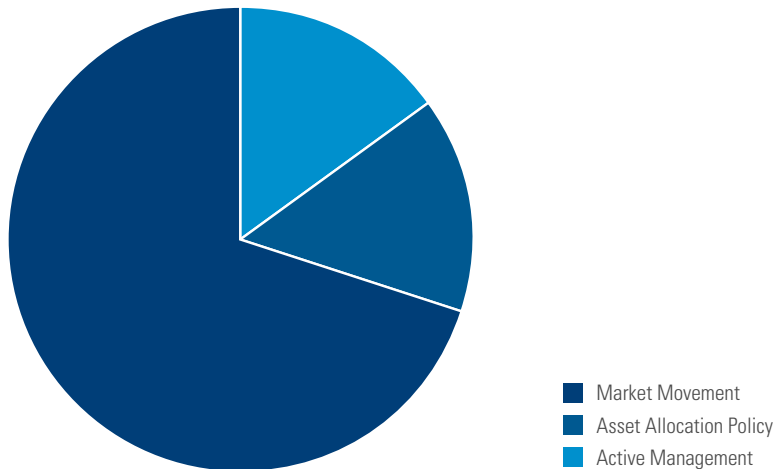
- 1** They may expose their portfolio to broad asset classes.
- 2** They may invest in sub-sectors of those broad asset classes.
- 3** They may select active management strategies that seek to add value beyond the first two sources.

The most commonly held asset classes are equities, bonds and cash. These broad asset classes can be subdivided in various ways. Within the asset class of equities, sub-sectors may be based on country selection, such as domestic versus international or developed versus emerging markets. Sub-sets of equities also include small, mid or large cap; growth, value or core; economic sectors; and the industries within economic sectors. Bonds can similarly be categorized according to average duration, maturity and credit quality. Investors may choose to passively expose their portfolios to virtually any of these asset classes or broader markets by choosing vehicles that mimic the category as a whole, for example indexed funds.

Looking beyond the decision to invest in markets or market segments, investors may attempt to garner returns by hiring investment managers to employ asset allocation, security selection or other active strategies as a means of harvesting risk-adjusted returns. The ability to realize extra return, above the results achieved by the broad market or particular asset classes, is dependent on the manager's unique insights, their ability to consistently implement those insights, and the current level of inefficiency in the marketplace.

Exhibit 3.

## Average Variance in Portfolio Returns



A study conducted by Roger Ibbotson and others using a universe of US equity, international equity and balanced mutual funds concluded that approximately 70% of return variation can be explained by market movement and the remaining 30% is, on average, divided between active management and asset allocation policy. Source: "The Equal Importance of Asset Allocation and Active Management," *Financial Analysts Journal*, Volume 66, Number 2. See Footnote 3.

Each of these three investment decisions—participating in broad markets, allocating to asset classes and engaging in active management—exposes the investor to risk. In *Exhibit 3* above, we see the average contributions of each of these decisions to the variability of portfolio returns. This exhibit is based on a conclusion from a study on return variability published in the *Financial Analysts Journal* by Roger Ibbotson and several others<sup>2</sup>

As shown, 70% of return variation over time can be attributed to general market volatility, with the remaining 30% split between asset allocation policy and active management decisions.<sup>3</sup> So while decisions related to asset allocation and manager selection are not trivial, nearly three-quarters of an investor's typical experience (positive and negative) can be traced to movements in the broad asset classes. Therefore, the decision regarding the amount of market exposure taken in a portfolio is the most important determinant of the investor's outcome.

This conclusion reinforces the pivotal role of the advisor in helping to shape market exposure decisions for each of their clients, depending on their particular circumstances. And it points to the idea that systematic approaches that aim to both capture market advances and cushion the portfolio from market declines may be particularly compelling.

The decision regarding the amount of market exposure taken in a portfolio is the most important determinant of the investor's outcome.

<sup>2</sup> James X. Xiong, CFA, Roger G. Ibbotson, Thomas M. Idzorek, CFA, and Peng Chen, CFA, "The Equal Importance of Asset Allocation and Active Management," *Financial Analysts Journal*, Vol. 66, No. 2 (2010): 18–20. The study's authors relied on return-based style analysis to measure volatility related to asset allocation policy (that is, investing in sub-sectors of the broad asset classes). For example, the proxies used to capture asset allocation policy for the US equity funds included indexes that reflect several combinations of market capitalization and style, such as the Russell 2000 Growth Index. The authors achieved similar results to those depicted in Exhibit 3 by experimenting with other groupings of asset sub-classes as well.

<sup>3</sup> Thomas M. Idzorek, "Asset Allocation is King," *Morningstar Advisor* (April/May 2010): 28–31. The study authors note that, within the 30% of variability that is not attributed to market movements, the relative contributions of active management and asset allocation policy can vary dramatically, depending on the sample and time period chosen for review.

## A Solution for Managing the Largest Source of Return Volatility

Based on the premise that harnessing the 70% of volatility that accompanies broad market exposure is one of the important decisions an investor can make, Genworth Financial Wealth Management offers a system of four asset allocation approaches, grouped by their primary strategies for actively managing exposure to broad asset classes. Two of these approaches—Strategic and Tactical Constrained<sup>SM</sup>—can be characterized as convergent with the market, and the other two—Tactical Unconstrained<sup>SM</sup> and Absolute Return—are independent from the market. (See sidebar below.)

Consistent exposure to the volatility of the broad markets through carefully managed Strategic or Tactical Constrained<sup>SM</sup> approaches is necessary to capture growth in the financial markets. At the same time, Tactical Unconstrained<sup>SM</sup> or Absolute Return strategies are well-positioned to provide effective diversification at times when other diversification strategies may be at their weakest, either by avoiding market exposure or by freely moving in and out of the markets at the direction of seasoned investment professionals. By choosing some investments that maintain persistent market exposure, for upside capture, and other investments that seek to avoid downside market exposure, the investor may benefit during both bull and bear market environments.

Diversifying across widely differing asset allocation approaches offers a new technique for not only meeting the challenges posed by today's highly unpredictable environment, but also potentially improving the risk-reward tradeoff across both bull and bear markets.

## Genworth Financial Wealth Management's Four Asset Allocation Approaches

GFWM seeks to bring a wide range of asset classes and investment approaches to the individual investor by drawing on the disciplined diversification strategies used by cutting-edge corporate pension and endowment funds. Our four asset allocation approaches are grouped into convergent ("sailing") strategies that target upside capture during bull markets and market-independent ("rowing") strategies that aim to protect the investor during bear markets.

### Sailing Strategies: Convergent with the Market

#### Strategic

The Strategic asset allocation approach creates a mix of equities, fixed income and cash designed to capture broad capital market returns while seeking to mitigate volatility at a targeted level based on the goals of the investor. The goal of this approach is to put the positive winds of "sailing" markets to work in the portfolio.

#### Tactical Constrained<sup>SM</sup>

The Tactical Constrained<sup>SM</sup> approach attempts to capture broad market returns while also seeking to take advantage of shorter-term opportunities and mitigate risks through moderate allocation shifts. This approach may put the positive winds of "sailing" markets to work in the portfolio, and at the same time create the potential to generate additional value through active near-term allocation decisions.

### Rowing Strategies: Independent from the Market

#### Tactical Unconstrained<sup>SM</sup>

The Tactical Unconstrained<sup>SM</sup> asset allocation approach removes all limits on the extent and frequency of allocation shifts, allowing the portfolio strategist to move more aggressively in response to changes in their outlook. This approach seeks to flexibly manage "rowing" markets during which headwinds place a premium on active asset class management.

#### Absolute Return

The Absolute Return asset allocation approach is designed for risk-averse investors who are comfortable targeting modest levels of expected returns while seeking highly active risk management that may include frequent allocation shifts, nontraditional asset classes or alternative strategies. This approach may be used for "rowing" toward the investor's goals regardless of the stock market's direction.

In *Exhibit 4* below, we see a sample of the results that may be obtained by combining convergent and independent approaches to financial markets. In this exhibit, a Relative Return asset allocation fully invested in global stocks serves as a proxy for the Strategic and Tactical Constrained<sup>SM</sup> asset allocation approaches. Although it must be remembered that past performance is no guarantee of future results, the combined portfolio employing distinctly different asset allocation approaches produced the best average annual return for the period shown. In addition, this combined strategy experienced markedly lower volatility (which, as we saw above, can have a bottom-line impact on the portfolio's assets and an investor's confidence in their strategy), as well as a more attractive Sharpe Ratio.<sup>4</sup>

*Exhibit 4.*

### Combining Asset Allocation Strategies Across Bull and Bear Markets

January 1990 - September 2010

Asset Allocation Approach	Relative Return	Relative Return Tactical Unconstrained <sup>SM</sup> Absolute Return
Relative Return	100%	55%
Tactical Unconstrained <sup>SM</sup>	0%	35%
Absolute Return	0%	10%

Annualized Performance Metrics	Relative Return	Relative Return Tactical Unconstrained <sup>SM</sup> Absolute Return
Return	6.85%	7.55%
Volatility (Standard Deviation)	14.96	8.75
Sharpe Ratio	0.20	0.43

This exhibit was created using the following proxies for the named strategies: Relative Return (proxy for Strategic and Tactical Constrained<sup>SM</sup>): 59% Russell 3000 Index, 39% MSCI EAFE Index and 2% Citigroup 3-Month T-Bill. Tactical Unconstrained<sup>SM</sup>: HFRI Fund of Funds Index, which includes funds that invest with multiple managers as a strategy for lowering the risk of investing with an individual manager. Absolute Return: HFRI Equity Market Neutral Index, which includes funds that aim to minimize or eliminate equity market exposure. Source: *Zephyr StyleADVISOR*

### Conclusion

Drawing on both market-convergent and market-independent strategies, skillfully implemented by institutional-quality asset management firms, offers a compelling approach to investing that aims to both augment traditional diversification strategies and smooth returns to improve the overall client experience. The flexible choices on the GFWM platform allow the advisor to choose multiple asset allocation approaches in proportions tailored to match each client's risk tolerance, objectives and personal circumstances. As well, the advisor can construct for each client a diversified strategy designed to fit a particular market outlook or a range of possible future market outcomes. In short, diversifying across widely differing asset allocation approaches offers a new technique for not only facing the challenges posed by today's highly unpredictable environment, but also potentially improving the risk-reward tradeoff across both bull and bear markets.

<sup>4</sup> The Sharpe ratio is a measure of risk-adjusted performance that compares a portfolio's return and the volatility of that return to a "risk-free rate" such as the return on 10-year US Treasuries. To calculate the Sharpe ratio, first subtract the risk-free return from the portfolio return. Then divide the result by the standard deviation of the portfolio's returns.

**Genworth Financial  
Wealth Management, Inc.**

Western US  
Consulting Office  
16501 Ventura Blvd.  
Suite 201  
Encino, CA 91436

800 664.5345  
GenworthWealth.com

Eastern US  
Consulting Office  
200 West Madison Street  
Suite 2860  
Chicago, IL 60606

Corporate Office  
2300 Contra Costa Blvd.  
Suite 600  
Pleasant Hill, CA 94523

For complete information on all of the advisory services offered through the Genworth Financial Wealth Management platform, including information on all applicable fees, please refer to the appropriate Disclosure Brochure (Form ADV Part II and/or Schedule H).

Genworth Financial Wealth Management, Inc., an investment advisor registered with the Securities and Exchange Commission, is a wholly owned subsidiary of Genworth Financial, Inc.

©2010 Genworth Financial Wealth Management, Inc. All rights reserved.  
Genworth, Genworth Financial and the Genworth logo are service marks of Genworth Financial, Inc.