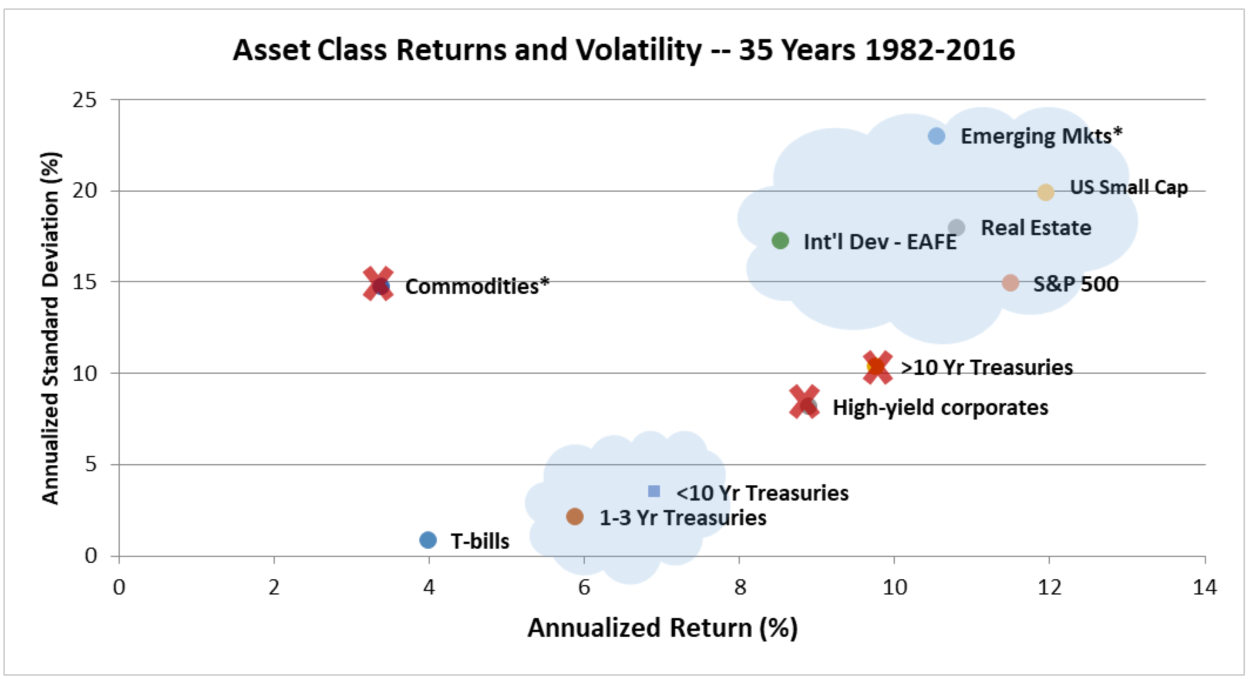
Passive Capital Management

Building A Passive Portfolio

The mass media of late has given full coverage to the benefits of using low-fee passive investment vehicles – ones that do not try to pick individual positions, but rather represent broad asset classes. The next logical step, building a passive portfolio, is a much more difficult proposition. Which asset classes to choose? Which vehicles to buy? What allocations?

Which asset classes? At PCM, we choose asset classes based on their historical risk/return profiles and their correlations to each other. The table below shows annualized returns for various asset classes (x-axis) and a corresponding measure of risk as measured by volatility (y-axis). In our client portfolios, we use all the assets in the upper right "cloud" of the chart. These are equity asset classes. This is where portfolios take on risk, and where we expect portfolios to generate returns over long investment time horizons. We also use the asset classes in the lower left cloud of the chart. These are short-duration, high quality fixed income asset classes that give a portfolio stability. The particular circumstances of the investor -- time horizon, risk tolerance, and return desires – will determine the relative size of the two clouds.



Asset class data as follows: Int'l Developed and Emerging Markets Indices from MSCI, Real Estate Index from Dow Jones, Small Cap Index is CRSP 6-10, Commodities Index from Bloomberg and Fixed income indices from BofAMerrill and Bloomberg. Data provided by DFA Returns database.
*Emerging markets since 1988. Commodities since 1991.

You can also see asset classes we do not use at Passive Capital, as noted by the red X's in the chart. Commodities have a poor long term track record of risk adjusted returns. They do not represent investments in future cash flow streams. We do not use commodities in any portfolios at PCM. We also do not use long-dated bonds or high yield bonds. These asset classes have higher correlations to equities. They have a nasty habit of acting too much like stocks exactly when you need them to play their role of stability, and be available for portfolio rebalancing.

Which investment vehicles? For all asset classes, we choose our passive investment vehicles based on four critical criteria: 1) They must be broadly representative of the underlying asset class. Diversification is core to all our portfolios. Even where we try to capture a factor attribute, like size or value, we simply "tilt" the holdings, we still want to own the whole asset class. 2) Investment vehicles must have reasonable fees. The investment vehicles we choose do not always have the lowest fees, but we always look for the best representation of an asset class at a reasonable fee. 3) Investment vehicles must be marked-to-market daily and have daily liquidity. 4) Lastly, we like all our investment vehicles to have low turnover, this is especially relevant for mutual funds that distribute gains to taxable portfolios.

This is a good time to point out that ETFs and hedge funds are investment vehicles, not asset classes. Many ETFs meet all of the four criteria above – broad diversification, reasonable fees, daily liquidity, low turnover – and most PCM portfolio include some ETFs. The majority of hedge funds don't meet any of these critical criteria. We do not own hedge funds in any PCM portfolios.

What allocation? Asset class allocations are the trickiest part of portfolio construction. We know that asset allocation is the largest contributor to portfolio performance. We also know that asset class performance can vary widely, particularly over shorter time periods. Unfortunately, we do not know, in advance, which asset classes will be the winners and which ones will be the losers over any specific period. Our asset allocations will never be "the best", or "optimal", as we only know this after the fact. We own a mix of risky and stable asset classes appropriate for the individual investor's circumstance, and we own equity asset classes in roughly the weightings of global equity markets. We adhere to these strategic asset allocations through market ups and downs, maintaining discipline in the portfolio by always rebalancing toward the targets. We never attempt to make a market timing call, or try to predict which asset class or which global market will be the best or worst performer over a given time frame.

At Passive Capital, we strongly believe that the best long-term investment experience comes from controlling things that can be controlled: appropriate asset allocation with disciplined rebalancing, diversification, low fees, tax efficiency and daily liquidity. This prepares us all for the things we cannot control … including the short-term gyrations of the market.

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