Our goal in this series of articles is to put the investment management process in the context of today's capital markets. A disciplined, well structured investment program includes five steps: identifying the investment objectives, establishing an asset allocation, building the portfolio through security selection, rebalancing the portfolio and managing the overall risk. With the myriad of challenges facing investors in today's capital markets, this article focuses on the role of security selection in the investment program.

Identify Objectives

Asset Allocation

Security Selection

Portfolio Rebalancing

Risk Management

In last month's issue of *Principles of Investing*, we emphasized that asset allocation is the single most important decision within a disciplined investment program. A proper asset allocation includes investment in securities that are not correlated. As valuations of securities and risk change in the market, it is important to adjust the portfolio through rebalancing over time. Proper asset allocation results in a diversified portfolio. The process of selecting the right securities corroborates the asset allocation and helps provide excess return above the performance benchmark.

The Role of Security Selection in the Investment Program

Security Selection is the process by which an investor chooses the individual securities, mutual funds, exchange traded funds, derivatives, and other assets to include in a portfolio once the asset allocation is established. In making the decision of which securities to invest in a portfolio, an investor should consider the risk, the potential return, the liquidity, and other factors that affect the other securities and the portfolio as a whole. The traditional stock selection approach is based on fundamental analysis of a company's financial statements and operations. This type of investor views each company as unique and does in-depth research searching through trade magazines, attending trade shows, and meeting with company managers and competitors trying to get an edge and find securities that are undervalued.

For example, if you had invested in Apple stock on December 31, 2005 at 71.89, you would have increased your investment by 366% as of May 31, 2011. Similarly, if you had invested in Microsoft over the same period, you would have earned 8.72% including dividends. The analysis of what causes one security to appreciate over time while the other dwindles is the disciplined study called security analysis. The same intensive research discipline process applies to the analysis of mutual funds, hedge funds and exchange traded funds.

The academic research supporting security selection underscores that it can play an important role in a comprehensive investment program. In the article, *The Importance of Asset Allocation*, Roger Ibbotson discusses the impact on performance of the long-term asset allocation policy relative to the impact of active management.[1] He concludes that most of the variation in time-series returns for a typical mutual fund comes from general market movement, while the remaining variation comes about equally from asset allocation policy and active management through security selection. Similarly, in the article *The Relative Importance of Asset Allocation and Security Selection*, the authors conclude that both asset allocation and security selection have important roles in determining performance and that one may not be deemed to be more important than the other[2].

[1] Roger G. Ibbotson, "*The Importance of Asset Allocation",* Financial Analysts Journal, March/April 2010, Vol. 66, No. 2: 18-20

[2] Kodjovi Assoé, CFA, Jean-François L'Her, Jean-François Plante, CFA, "*The Relative Importance of Asset Allocation and Security Selection"*, CFA Digest, May 2007, Vol. 37, No. 2, 1 page

The Process of Proprietary Research and Security Selection

Since all publicly traded securities (except for municipal bonds) are required to register with the Securities and Exchange Commission (SEC), undeniably, the United States offers the most transparent disclosure for investors of any financial market around the world. By way of example, corporate issuers release quarterly and annual financial statements which can be downloaded from the SEC's website www.edgar.sec.gov. Most other countries do not offer this level of disclosure. By analyzing a company's financial statements, investors can identify trends in financial information including sales, operating margins, leverage and cash flow which will be helpful in determining the relative value of the security in the market. There are many resources and publications to assist investors in fundamental analysis. One of the most important books for investors pursuing fundamental analysis is Security Analysis, by Graham & Dodd. First published in 1934 after the market crash, this book is still as relevant today as when it was first published as it provides details into standard calculations and ratios investors use for decision making.

As a discipline, with every investment it is important to recognize the underlying assumptions that are being made in the decision to purchase or sell. The biggest misconception in a well structured investment management program is that the asset allocation *will actually* reflect the expected risk and return profile of the underlying investments (and it will actually work the way we expect). That is to say that the asset allocation will reflect the expected returns, risk and correlation in a manner which we project. However, since we operate in an environment of uncertainty, this obviously is a flawed assumption. Many research firms including Zacks Investment Research, Morningstar, Value Line, and Standard & Poor's offer investment research for an annual fee. In addition, some brokerage firms such as Schwab and Fidelity allow clients to access investment research. In addition, there are several free websites that offer insights into security selection including www.gurufocus.com.

Does Security Selection Matter in Today's Financial Markets?

There are periods of time when security selection matters to the overall performance of the portfolio and there are periods where it simply does not. Our example of buying Apple stock relative to Microsoft is evidence that security selection still matters in today's financial markets. Yet, while the mechanics of the capital markets have remained the same over the years, there have been changes that affect the valuation of securities and the pricing of risk in the market. These changes include the growth in exchange traded funds and hedge funds, the growth in rapid trading systems, the role of banks in the market, as well as the growth in derivatives and structured securities. In the aggregate we believe these changes have diminished the role that security selection plays in the investment program in today's market as the premium for risk has compressed across asset classes. In particular, the growth in exchange traded funds requires that the fund buy the security in the index regardless of valuation. As a result, if a security is in the S&P 500, as long as money is flowing into S&P 500 ETFs (which also includes S&P 1000 and S&P 1500 funds) the fund has to buy the stock regardless of its valuation. Thus, a security's valuation can become distorted given the buying patterns and fund flows in today's capital markets. Whether you are a trustee of a foundation or an individual investor, as you review your portfolio's asset allocation, we encourage you to call your investment advisor or consultant with questions and request the information you need to better understand the role that a particular security serves in your portfolio.