Part 1 of 2: A Simple, All-You-Need Portfolio

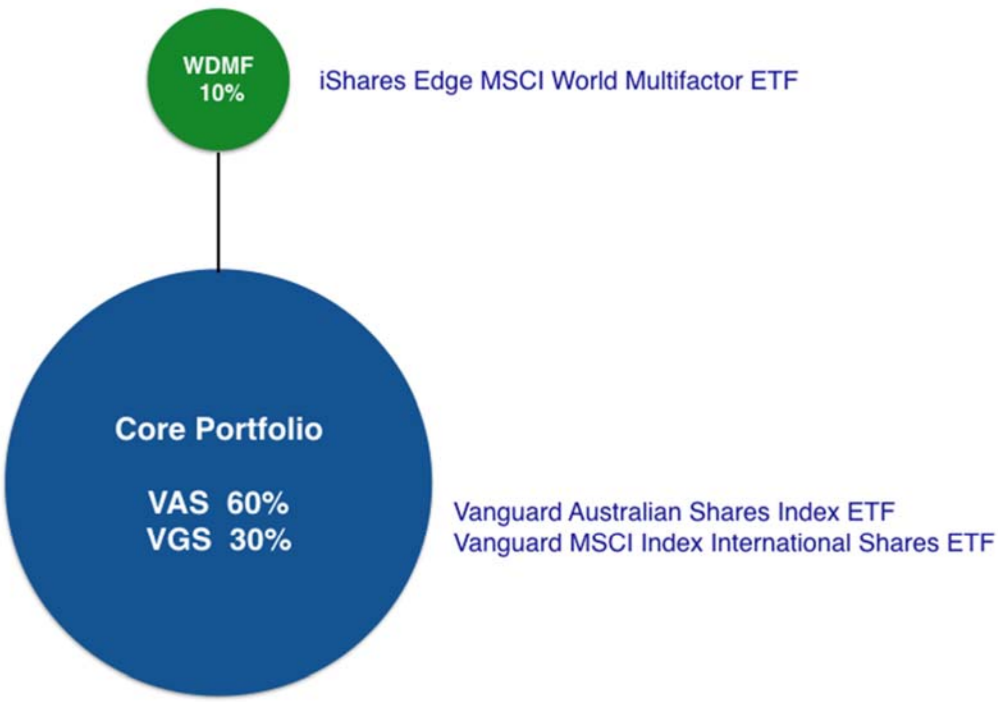
I thought I should formalise Post #53072 in the "Investing in LICs, ETFS and Fund Management Cos" thread. It's important I do this because if I was a beginner Australian investor starting today with a multi-decade time horizon, this is how I would invest … applying the hindsight benefit of my 30+ years of investing.

Consider a young person about to embark on their investment journey. With multiple decades until retirement and limited spare time to research the markets, this investor wants to construct a simple, minimal-effort portfolio with a high likelihood of achieving a great long-term outcome.

With the multi-decade time horizon, it's perfectly acceptable for this investor to have a 100% allocation to stocks. The higher long-term reward will come at the expense of having to endure painful periods of paper drawdowns, but a bond allocation to dampen volatility only serves to also dampen total returns over the long term. The challenge is to synthesise a stock portfolio that possesses the following attributes:

- Simple strategy, but not simplistic
- Easy to implement and easy to maintain
- Diversified across sectors and geographies
- Strong empirical evidence of at least capturing the returns of the market
- A right-sized opportunity to beat the market without risking it all

This simple portfolio satisfies this criteria for Australian investors.



Core-Satellite Portfolio
"Tilted" for Long-Term Outperformance

90% of investment funds are allocated to a core portfolio composed of 2 exchange traded funds: VAS which tracks the S&P/ASX 300 index and VGS which tracks the MSCI World ex-Australia Index. The result is a globally diversified core portfolio with 300 Australian companies and over 1,500 overseas companies. Both exchange traded funds are listed on the ASX and both are low fee at 0.14% per annum for VAS and 0.18% for VGS.

10% is allocated to WDMF, an exchange traded fund that tracks the MSCI World Diversified Multiple-Factor (AUD) Index. This fund is expected to outperform the standard MSCI World Index by holding a portfolio of stocks that possess the 4 attributes of small-size, value, price momentum and quality. These 4 factors have historically produced higher returns than the market on a risk-adjusted basis over the long term. The fund contains over 350 stocks and charges an annual fee of 0.35%, which is still reasonable for a quant-based fund like this.

A 10% allocation to the WDMF smart-beta fund provides a right-sized opportunity for the investment portfolio as a whole to outperform the ASX market index. If WDMF outperforms and the core portfolio of VAS and VGS track close to the returns of their benchmark index (less the small annual fee), there is an opportunity to outperform the vanilla market index.

This portfolio has been deliberately designed with an additional 20% home country bias to Australia (60% compared to 40% international). This is justifiable because not only do most of us live and hope to retire in Australia, but according to the Credit Suisse Global Investment Returns Yearbook 2019, the Australian stock exchange delivered the highest annualised total return between the period 1900 to 2018 in the world, after adjusting for inflation and converting to the world's reserve currency USD. The United States came in as the second best performer.

You could keep this portfolio structure unaltered all through your entire wealth accumulation years. No more funds or individual stocks need to be added.

Part 2 of 2: Challenging the Simple, All-You-Need Portfolio

Given we're dealing with risk and uncertainly, no portfolio structure is ever perfect. A good yardstick to apply is to ask yourself if the portfolio would survive scrutiny from a Financial Advisor with a Certified Financial Planner (CFP®) credential. I imagine if a CFP® credentialed advisor was to critique this portfolio, they could make the following remarks below in italics. These remarks have been sourced from investment articles I've read over the last few years from Advisor/Columnists with the CFP® credential.

Index funds relegate investors to settling for average returns each and every year.

The Standard and Poors SPIVA scorecard comparing active managed funds to their benchmarks consistently show the vast majority of active funds underperform their index benchmarks over a multitude of time frames. Over a 15 year period to Dec 2016, 92% of large-cap, 95% of mid-cap and 93% of small cap active managers underperformed their respective benchmarks.

Over the most recent 5 year period to Dec 2018, 82% of active funds underperformed the S&P 500 index. 64% underperformed over the course of 1 year. Fewer active managers are able to sustain their performance over longer time frames. This is the persistence problem. Out of the 550 active funds that were in the top quartile of performance as of Sep 2016, only 2.3% managed to stay in the top quartile by Mar 2018. The persistence scorecard shows that year in year out, relatively few funds can stay at the top.

The empirical results are in. Index funds aren't average performers. Held over a 15 year period, an index fund is likely to end up in the top decile of fund performers. The debate is not about active versus passive funds, it's more about high cost versus low cost. Passive index funds enjoy a low fee edge that active management can't seem to overcome.

Index funds are effective during bull markets, but you will suffer the full brunt of the downside in a bear market. Index funds capture 100% of every market downturn, whereas active fund managers can provide downside protection by selling out of positions before capturing the entire market crash.

Index funds capturing 100% of every market downturn is fact. This is the contractual agreement that must be accepted by every index fund investor. However, the claim that an active fund manager can insulate investors from the worst of a market decline is not supported by the empirical evidence. Corroborating research from Vanguard, Morningstar and a whole host of other institutions collectively dispel this myth.

During the 2000 to 2003 bear market, 65% of active managed funds beat the benchmark. Beating the benchmark only required an active fund to be **less negative** than the market index. This performance wasn't replicated during the next downturn in 2008 where only 45% of funds beat the market index. During that year, the S&P 500 index declined 37.0% while the average large-cap blend fund fell 37.4%. Active fund underperformance wasn't limited to large capitalisation stocks. During the same period, the Russell 2000 index of small-cap stocks was down 34.8% while the average small-cap blend fund declined by 36.6 percent.

If we go back further in history, there were 11 bear markets between 1973 and 2003. More than 50% of active fund managers beat the index in only 5 out of those 11 bear markets. Funds that did beat the index during a bear market had no statistical relationship that they could beat the market index during the next bear market. This persistence problem is prevalent in both bull and bear markets. High performing active funds don't stay high performing. The underlying reason is luck can be a significant contributor to the outcome of active stock picking and market timing.

The ability of an active manager to protect investors from a market downside is no better than a flip of a coin. One must also consider that a market timing strategy requires 2 consecutively correct timing decisions: when to get out of the market and when to get back in.

The increasing popularity of passive funds creates price distortions and market inefficiencies, creating lucrative opportunities for active managers to outperform.

The rise of index funds has been the result of increasing numbers of retail investors opting for a passive, low fee strategy. This passive buy and hold strategy removes increasing numbers of low to moderately skilled "Mum and Dad" investors out of the market. As the stock market becomes dense with highly skilled professional investors, the **paradox of skill** phenomenon emerges

As the remaining active market participants become more knowledgeable and skilled at investing, the difference between the best and the worst becomes much narrower. The skill level rises for all, making luck a much more important element that separates the highest performers from the average ones.

This is one of the reasons why persistence problem impacts top performing funds. It's the relative level of investing skill that counts. **If the dispersion of skill shrinks, luck becomes a greater determinant in the outcome of investing performance**.

Contrary to myth, the increasing popularity of passive index funds actually increases the price efficiency of the markets because lesser skilled participants are removed from the playing field.

The increasing popularity of multi-factor smart-beta funds will eliminate, or at least dampen, the excess returns previously available from the small-size, price momentum and value factors.

If your Financial Advisor is making a remark like this, then you know you're probably dealing with a very competent advisor. The "crowding effect" is always a legitimate concern and the pricing behaviour that results from crowding will arbitrage away any previous return edge.

The risk-adjusted excess return from the small-size, price momentum and value factors have been well publicised since at least back in 1992. The excess return advantage from these factors have not been fully arbitraged away because active factor strategies don't work all the time, and often underperform the market for extended periods. For example, the value factor has currently been a poor performer for almost 10 years now. This makes it very difficult for active fund managers to exploit these factors, they're judged on short-term performance while these factors require multi-decade holding periods. Fund manager career risk ensues.

A satellite investment in WDMF is an evidence-based, empirically supported opportunity to outperform the benchmark index. Basing an investment strategy of what worked well in the past may not be the sure-fire way to beat the market, but it's one of the very few rational prediction paradigms we have in investing. It sure beats relying on lady luck.