

Staying in Style

- ▶ This article, when read in conjunction with "Managing Risk through Diversification," helps clarify the concepts of asset allocation, diversification, and style.
- ▶ COMPASS constructs portfolios for clients with an appropriate asset allocation and a diversified mix of assets. Mutual funds are then painstakingly selected that offer the best combination of reward for the risk undertaken.
- ▶ A fund's style purity is one of the key factors COMPASS considers in its due diligence process to control risk exposures in client portfolios.

Most financial professionals agree that the asset-allocation decision is one of the most important factors in determining both the risk and the return of an investment portfolio. Asset allocation is the process of combining asset classes such as stocks, bonds, and cash into a portfolio that will meet your goals. Taking this process a step further means selecting mutual funds to represent a certain segment or style for your overall portfolio (large stocks vs. small stocks, growth stocks vs. value stocks, etc.).

This can be a challenging task, and once the process is complete and the portfolio of mutual funds built, you'll need to consider something else: style drift. Style drift occurs when actively-managed mutual funds deviate from a particular investment style over time in an effort to potentially improve performance. While improved performance might not seem like a bad thing, a shift in style can be hazardous because it alters your risk exposure and return profile.

For example, let's say you held a large percentage of your portfolio in a large-cap stock fund. Now, at a certain point in time, this fund's manager got convinced that small stocks would benefit due to certain market conditions. Acting on this belief, he shifted the strategy of what was supposed to be a large-cap stock fund by buying an unusual amount of small stocks. This not only unnecessarily increased the risk of your overall portfolio, but also potentially set you up for large losses if small stocks were not going to behave the way this manager expected.

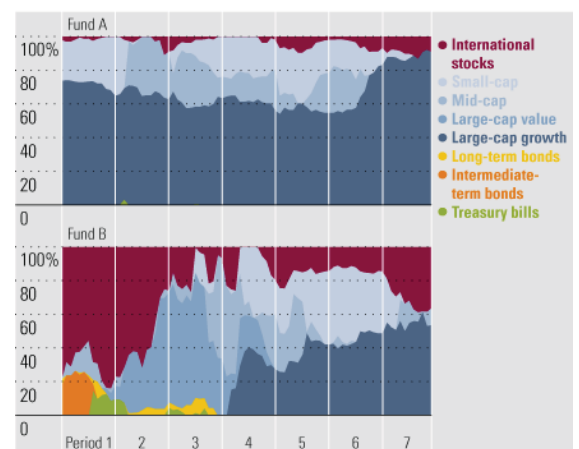
Style analysis is a technique used to understand investment style and identify the behavioral characteristics of a fund. It matches the returns of a fund to a mix of asset-class benchmarks that best describe the fund's behavior. This process can aid investors and advisors in the selection of funds to assemble a diversified portfolio.

The graph shows the rolling style analysis over time of two hypothetical mutual funds with the same stated objective. Although these two funds have the same objective, their style and

consistency differ greatly. Look at international stocks, for example: In Period 1 and Period 2, Fund B had a much higher exposure to international stocks than Fund A. Such style drift can indicate that your manager is not following the fund's stated objective.

If you notice your fund manager jumping on the bandwagon of past trends, he may be trying to save his own hide. Remember, the goal is to buy low and sell high, not jump in late and hope for the best. It takes real discipline to stick to a set of stated investment objectives. So always keep an eye on your investments and evaluate funds periodically to make sure they fit your asset allocation appropriately.

Understanding Fund Behavior: Some Funds Do Not Behave as Advertised



The percentages illustrated in the image are based on each hypothetical fund's returns-based style analysis results using 36-month rolling periods. Style analysis represents the best combination of benchmarks that match the variation in fund returns over the time period. It does not represent actual holdings.