Insights

Why the portfolio review is a critical part of your investment strategy.

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We often speak with investors who are concerned about short term market fluctuations and how the value of their investment portfolios have been, or may be, affected as a result. Smaller movements happen on a daily basis and monitoring your portfolio as often as this will not give you a fair indication of how your portfolio might perform in the long-run.

After all, investing is a long term activity and should be viewed as such. A better way to assess your portfolio is to have an in-depth review once or twice a year under the guidance of a professional Investment Manager such as Psigma.

Psigma
Investment Management

Think of the portfolio review as a health-check for your investments.

Conducting a portfolio review means undertaking a full examination of your investments and assessing whether their composition, performance and risk profile still support your future goals. It is not just about examining each asset in turn, but also taking a holistic view including whether you are taking on too much or too little risk and of what type.

The review is not just an opportunity to get an update on whether your portfolio is behaving in line with your expectations but also for you and your Investment Manager to check in with each other, evaluate your current personal and financial circumstances, and assess whether anything major has happened in your life. If anything has changed, it is important to pass this information on to your Investment Manager so that any necessary changes can be made to your investment strategy. Even small things in your life, that may seem irrelevant to your investment portfolio, are worth mentioning because sometimes changes do not happen overnight, but are more incremental and add up over a longer period of time.

When first constructing a portfolio, you should determine your attitude to risk, your long term investment goals, and what your financial circumstances look like. Together, these factors will help determine which investment strategy might be suitable for you, and what asset allocation should make up the portfolio.

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Market movements will affect your portfolio's risk.

What determines your portfolio's risk level and absolute value, is the weight of each asset and, by extension, the asset class you are invested in. A portfolio invested in 100% equities will perform very differently to a portfolio invested 100% in bonds, both in terms of the value of the portfolio, and the volatility it will exhibit.

Equity investments generally refer to the investor buying, holding and selling company shares on the stock market. Fixed interest investments (bonds) refer to the investor lending money to a company or government for a fixed period of time, and generally experience smaller fluctuations in value. Fixed Interest investments generally pay a fixed regular interest payment (hence the name) together with the initial loan amount when they mature assuming that the company or government does not go bankrupt. Thus, while there are different types of bonds with different risk levels, they are generally seen as a less risky investment option compared to equities.

When markets fluctuate, the different asset classes in your portfolio will be affected differently. Some asset classes will increase in value, and some will decrease. This in turn will affect their composition in your portfolio, and hence its overall risk level.

For example, imagine that the first time you construct a portfolio, your overall situation suits a portfolio made up of 40% equities and 60% bonds (we are sticking to two asset classes in this example, for explanatory purposes and simplicity's sake. However, an investment portfolio is often made up of more than this).

After a period of six months you meet with your Investment Manager for a portfolio review. When you look at how markets performed, it turns out that equities did very well, and bonds did not. Thus, the value of the equities in your portfolio has increased and the value of bonds has decreased. As equities have increased in value, their weighting has also increased; conversely as bonds have decreased in value, their weighting has decreased. Your portfolio's new asset class composition is made up of 60% equities and 40% bonds.

With this change of asset allocation, the risk profile of the portfolio has now also changed. Therefore if your attitude to risk has not, your portfolio is likely to be misaligned with your objectives. When this happens, your Investment Manager should rebalance your portfolio by buying or selling various assets to return the portfolio to the agreed and desired level of risk.

In our example, your Investment Manager would sell equities and buy bonds so that the portfolio goes back to a suitable asset allocation. It could be that the portfolio is taken back to the original weighting of 40% equities and 60% bonds but it could also be that your Investment Manager changes the desired allocation somewhat.

If equities have done better than bonds, they are likely to have become more expensive compared to bonds and hence less attractive. Thus, your Investment Manager may take you to a weighting of, say, 30% equities and 70% bonds.

It is therefore important to highlight that the main focus of the portfolio review should always be to align the portfolio with a weighting that suits your risk appetite, not necessarily maximise the absolute value of your portfolio.

Why should you review your portfolio for the long term?

Most industry experts would recommend reviewing your portfolio every 6-12 months. As mentioned above, investing is for the long term, not a daily, weekly, monthly or even quarterly basis. Having a review once or twice a year allows enough time to assess the underlying performance indicators.

This is also why the general recommendation is to invest for a minimum of five to seven years: to allow the performance of your portfolio to reflect the long term drivers behind the investments' returns, rather than the markets' more random day-to-day movements.

If you employ an Investment Manager their job is to monitor your entire portfolio continually and make changes where necessary to keep it in line with its risk strategy and your investment objectives.

Long term macroeconomic drivers of investment returns include factors like economic cycles, interest rate and inflation changes, political upheavals, the development of new technologies and the passing of old ones; while microeconomic factors include company specific ones like the coming to fruition of investments in operations, new discoveries, changes in management or simply the market recognising value in some part of the business that it had discounted before.

Summary.

Many of the daily fluctuations seen in asset markets normalise quickly. What is important is the cumulative impact these movements may have on your investment portfolio and whether this remains commensurate to your appetite for risk and desired return. Having regular six-monthly or annual reviews with an Investment Manager is an important part of keeping the strategy of your portfolio aligned with your objectives but the priority should always be to ensure that the risks inherent in your portfolio are appropriate for you.

If you would like to have a complimentary portfolio review please contact Psigma.

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