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Fortune, Entrepreneur & TIME

PITTSBURGH FINANCIAL

Modern Portfolio Theory: Good or Bad?

Guardian Capital is committed to protecting its clients' investments, regardless of the market's ups and downs.

"In 1952, famed economist Harry Markowitz developed a system for balancing investor risk," explains Greg Miller, CEP, RFC®, principal of Guardian Capital, LLC. "This system is called modern portfolio theory (MPT), and the original version of it is investing in a 60/40 mix of equities and bonds."

Using this approach, investors see potentially more growth from their equity portfolio, which consists of positions of individual stocks. The stock market can be volatile, and to protect against this, investors would hold direct-issue bonds from corporations, municipalities, and government agencies.

"Bonds are a debt instrument, essentially a loan, for which the issuer pays a constant annual interest rate," Miller says. "Since the 1950s, most investors followed Markowitz's advice and stuck to that 60/40 mix of individual stocks and bonds. Then, somewhere along the way, MPT morphed, as a majority of advisors recommended mutual funds in hopes of lowering risk."

Many investors and advisors preferred mutual funds due to their blended exposure to market volatility as opposed to individual stocks. By combining a variety of securities into a single investment pool, mutual funds aim to reduce the impact of losses from any individual security. Does this mean that using mutual funds has an advantage in MPT?

THE ANSWER

"Not necessarily, not in my opinion, because the bond mutual funds and exchange-traded bond funds can still lose value, just like equity funds and exchange-traded funds (ETFs)," Miller says. "From an MPT perspective, bond mutual funds are not going to provide a positive interest rate in a down market to offset equity declines. The original concept was to offset losses and risk. If there's a serious downturn in the stock market, investors could still count on the positive interest rates from their direct issue bonds, CDs, and/or fixed annuities to offset some of those losses in the portfolio."

Mutual funds are also subject to internal fund expenses, Miller notes, and their internal fees make the investment less efficient. When an investor directly owns stocks and bonds, however, there are no internal fund expenses.

"When we talk about efficiency, a portfolio consisting of a 60/40 mix of individual stocks and bonds can be more efficient than a mutual fund portfolio," Miller says. "The most efficient method of investing is direct ownership. Clients like the ability to see the names of companies they own stock in listed on their statements, which gives them greater transparency."

Why the switch to mutual funds? What about risk? Mutual funds are designed to reduce the impact of market volatility by being a pooled investment containing anywhere from 10 to 200 stocks. Does this outweigh the efficiency advantages of direct ownership? Miller doesn't believe so, "although there are times where we would use some mutual funds and exchange-traded funds in building a portfolio.

"There are many ways of managing market risk in a portfolio other than using all mutual funds and ETFs," Miller states. "Owning stock in blue-chip companies like Waste Management, The Home Depot, or AT&T is one way to reduce risk as these stocks are more defensive in nature compared to a growth stock like Apple or many other stocks in the tech sector. In a mutual fund, you need to do some investigating to even know what securities the fund holds. Investors should always know what they're investing in."

Miller notes that many mutual funds are less efficient because of their mix of stocks that contain high-performing, mediocre, and low-performing positions. From Guardian Capital's perspective, clients are better served using MPT with efficient investment strategies such as individual stocks and bonds to realize the original benefits of MPT.

"Our suggestion would be for investors to address risks using direct-issue bonds, CDs, and/or fixed annuities," Miller says. "These all provide a higher degree of principal protection. If the market goes down, the constant interest rate will offset declines in the portfolio's value. Never subject your entire portfolio to market loss. You're never putting all of your eggs in one basket, the risk basket."

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