Step 4: Building a Global Core-Satellite Portfolio

This final report in our series discusses a systematic approach for putting the various investment elements together to build a global risk-balanced portfolio. Our focus is on the core-satellite approach to portfolio construction, a method used to combine a relatively stable core portfolio with a more actively managed satellite component. The appeal of core-satellite investing is that it combines the benefits of indexing – broad diversification, lower cost, tax-efficiency – with active management and the potential for outperformance and improved risk control.

Over fifty years ago, Nobel Laureate Harry Markowitz developed an innovative, math-based asset allocation approach to produce what he called "optimal portfolios." His method involved a number of simplifying assumptions combined with mathematical models that contributed greatly to our understanding of portfolio behavior. While his quantitative approach was important, his theoretical models rarely produced optimal portfolios for most real world situations. A core-satellite approach is a more qualitative and useful way of thinking about asset allocation strategies and building effective investment portfolios.

The core-satellite approach divides the portfolio into a core component, generally managed using index funds designed to track a benchmark, and an active component, which consists of one or more satellite strategies that attempt to outperform the benchmark through security selection, exposure to non-core assets, or by adding tactical overlays for risk control. It is best described by discussing both what it achieves and what it avoids.

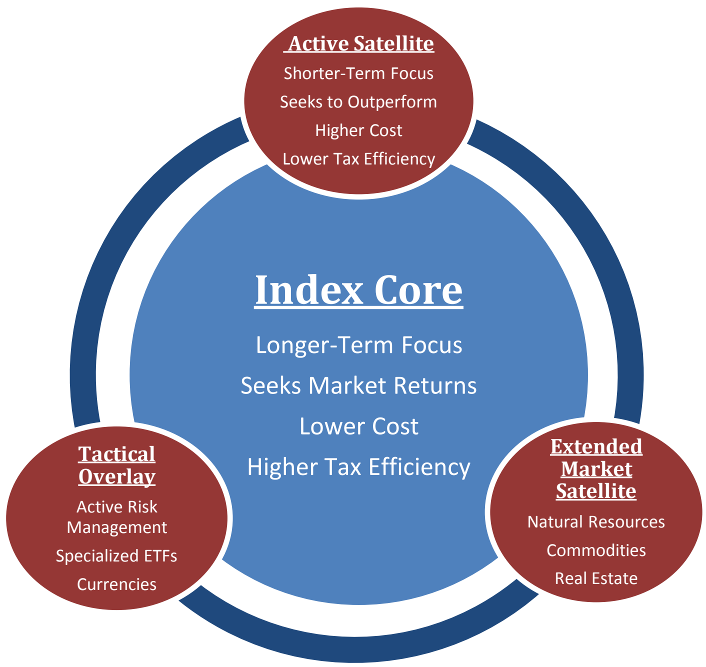
- **Core-satellite improves discipline and stability by reducing reliance on picking winners or chasing returns**. All investors intuitively want to win the game and hit the next home run – find the next "ten bagger"[i] in stock picking parlance. A core-satellite system can allow for riskier bets, but in a predetermined, risk-controlled way.

- **The indexed component, or core, provides broader, more consistent diversification than is possible with a 100% actively managed portfolio.** By definition, a broad market index contains all the stocks in an asset or sub-asset class, providing instant diversification and risk control.

- **Core-satellite reduces management and transaction costs and improves tax efficiency**. Active trading of stocks and bonds is expensive and results in higher tax bills. Limiting the active component to a predetermined percentage holds down costs and improves long-term returns.

- **Core-satellite builds on the fundamental importance of asset allocation, focusing attention on the most important decisions.** Market timing can provide short-term gains and active managers can sometimes outperform. However, the preponderance of independent empirically-based research studies (see our reports on asset allocation and diversification) proves that asset-allocation, or the relative amount invested in stocks, bonds, and other assets, is far and away the most important driver of long-term performance, accounting for as much as 94% of the variation in portfolio returns over time.[ii]

- **Core-Satellite provides a controlled, structured framework for using new investment products to enhance return and better manage risk.** The core-satellite process is not limited to index versus active investing, but can also help manage riskier asset classes, such as commodities, real estate or high-yield bonds.



Winning The Loser's Game[iii]

Over time, beating the market's performance is a zero-sum game. For every winner there must be an equal loser. The idea of a zero sum game suggests that when you consider the impact of costs and taxes on investment returns, active managers face a difficult hurdle in outperforming the market. The difficulty of consistently outperforming the market makes indexing a valuable starting point for all portfolios.

The primary goal for an index fund is to track broad market performance (beta) at a low cost. Index funds achieve this by holding broad spectrum of securities based on their weights in the index. Such a fund does not require the same level of analysis (and related cost) and will likely buy and hold securities with very little turnover. Lower turnover of positions results in much lower trading fees and generally more favorable tax treatment.

The primary goal of active management is to outperform the broad market (alpha) through security selection and/or market timing. Compared to index funds, active managers generally hold fewer securities and rely more on security analysis to pick stocks or bonds. As a result, there is more buying and selling, leading to higher realized gains and higher tax and trading and tax costs.

The core-satellite method acknowledges the fundamental differences between indexed and active management, combining the advantages of both approaches. Using core-satellite approach investors can choose how much security specific or unsystematic risk they are willing to take to try to "beat" the market. Investors who are more confident in their ability to pick stocks or managers, for example, can place more in the satellite allocation than a more risk adverse investor.

The mix of indexed to active exposure may vary from sector to sector. In some fixed income sectors, high-yield bonds for example, it may be appropriate to be 100% indexed. The financial markets continue to evolve and new products (ETFs) are being created that allow investors to access to segments of the market through low-cost indexes that previously could only be reached through active management. New methods of risk management using tactical portfolio overlays can also be considered to help dampen volatility. Applied in this manner, core-satellite becomes more than a division of indexed and active strategies; it is a method of managing exposure to riskier sectors, whether those sectors are accessed through active management or indexed products (ETFs).

What is the right overall index/active mix in a portfolio? Given cost considerations the difficulty and cost of consistently outperforming an index over time, we generally recommend no more than 50% of any portfolio be actively managed. The final answer depends on an individual investor's goals, tax situation, and the amount of risk compared to the market an investor is willing to accept. The right mix can also depend on the characteristics of a market regime, as well as the overall size of the portfolio. For some investors, a 100% indexed portfolio is the best solution.

Core-satellite investing is an old idea that is suddenly new again, enhanced with new low-cost investment vehicles and with the potential to deliver the best of both index and active styles of investing. It provides an effective, practical framework to manage risk and help you stay on the path to reaching your financial goals.

Contact us at info@proffittgoodson.com

---

[i] "Ten bagger" is a term coined by Peter Lynch in his book *One Up On Wall Street* (1990) and refers to an investment which is worth ten times its original purchase price

[ii] Brinson, G.P, L.R. Hood, and G.I. Beebower, "Determinants of Portfolio Performance", *Financial Analysts Journal*, July/August 1986

[iii] Ellis, Charles D., *Winning the Losers Game: Timeless Strategies for Successful Investing*, 5th Edition, 2010