

Why SMAs Don't Deliver as Devised

By Robert Levitt



Robert Levitt

We can sum up our clients' risk tolerance very easily. When markets go up, they want to be in and when markets are moving down, they want to be out. Compare that to the usual retort from an advisor that they "can't time the market." To them it means either being fully invested or fully in cash. But the past few months highlight no matter how intelligent a long term investment policy you create, if clients won't stay in, it isn't very useful.

Our private clients have a similar *time horizon* to institutional clients, but they have very different *evaluation horizons*. They look at their returns frequently, not six weeks after the end of the quarter. And for individuals, if the returns are negative for too long, they won't stay, as they become consumed with fear. Even if they stay, their faith and confidence in their adviser will be reduced, unless the markets make an amazing recovery and new highs are quickly realized.

For this reason, we never recommend using separate accounts where private investors are in any way tied to institutional accounts. Institutional investors have the disadvantage of being large. They buy a position and have to hold it because in a declining market, there are simply no large buyers or perhaps no buyers, close to the current market price. This is also a disadvantage of an advisor getting too big. You gain the advantage of information and lose it by virtue of market impact.

Yet the private investor doesn't

have the disadvantages of the institutional investor. They are small and can move in and out without market impact. So in declining markets, being invested like an "institutional" investor means an investor is kept in a declining market unnecessarily. An investor can sell and move to cash, or as we do, reduce exposure to risk assets at each point in the market decline.

At the start of every year, we rebalance our client assets with respect to equity asset allocation, typically with 55% equities. The remainder falls into "cash flow," which are assets that produce income or the majority of the return from income, and "commodities" including ETFs like agricultural commodities or gold. Sometimes we add a category which includes absolute return assets. We track returns constantly, more than once a day, and as our returns increase, we increase our exposure to risk. This means that if our portfolios are up 5% or more by March, then we will have much more than 55% in equities. Depending on our performance versus the S&P 500, we may be as much as 70% equities during the year. Our portfolios can earn substantial returns during periods when markets are rising. Conversely, when they fall, we take the opposite action. If, after one month into the year, our portfolios are down by 3%, we reduce our equity exposure. We will reduce much faster when we are experiencing negative numbers than we increase in rising markets. Anytime our returns are falling, we think about reducing risk, taking profits, and harvesting taxes. As markets decline, our exposure is

falling as our clients' risk tolerance is falling.

Reinvesting after a significant market decline works the same way. As we rebuild positions, we will add slowly as our returns improve. After taking some equity exposure, we would also carefully add, usually 5% at a time, until we can build our exposure back. It takes a much shorter amount of time to go down then to build up returns, but our clients understand that we are taking action. As we add exposure, particularly after a serious decline, we typically hedge our portfolios using an 8% stop loss. So, a 5% position with an 8% peak to trough stop loss, means we limit our downside to a maximum 40 bps every time we add 5% exposure. In this way, we can meet our clients risk objectives without having to time the market.

Using an institutional approach to risk and an institutional investment approach is not an advantage to the private investor. It may work well for the pension funds that have a true long term evaluation horizon, but for our clients, we can provide a conservative approach without sacrificing the upside. **FA**

Robert Levitt, Chief Investment Officer of Levitt Capital Management LLC, manages over \$300 million for high net worth individuals and advisors with \$3m of investable assets. He invests thematically directly on foreign and domestic stock exchanges around the world. He can be reached through www.lcmadvisors.com.