

Chat Reynders

Chairman and CEO

Reynders, McVeigh Capital Management

www.reyndersmcveigh.com

Patrick McVeigh

President and Chief Investment Officer

Reynders, McVeigh Capital Management

www.reyndersmcveigh.com



FINDING SAFETY IN INTELLIGENT DIVERSIFICATION: MAINTAINING THE MARRIAGE BETWEEN RISK AND INVESTMENT QUALITY

When analysts assess the lessons of this economy, they routinely attribute the downturn to an unfortunate convergence of negative events. The mortgage industry stumbled, the U.S. auto market was in decline, overseas labor became too competitive, consumers were overleveraged...the list is extensive. And it does little to point us in the direction of long term security.

To regain trust in investment strategy, investors need to isolate the root causes of the global collapse and build a better approach. Ironically, one of the main culprits in this case is diversification: a crucial investment tool which over the course of a decade transformed from a fundamentally sound, central element of portfolio construction into a dangerous sales pitch for unstable product.

Intelligent diversification is still central to success, and when employed with appropriate due diligence it provides great benefits to investors. But diversification as commonly practiced today will only lead back to over-engineering of financial vehicles sold under the guise of distributing risk.

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The warping of diversification was slow and undetected. Well-intentioned managers allocated investments to suit a range of risk profiles, and bit by bit the extended bull market offered creative ways to present high-yield opportunities as “low-risk.” Being safe, smart and improving risk profiles began to mean over-diversifying as investors moved into vehicles like hedge funds, commodity futures, and other high-margin product driven by institutions. Providers could skip due diligence and lean on the theory of diversification to justify expansion into new and unproven areas.

In this way, diversification became the sales driver of Wall Street, and the system became unmoored amidst seemingly unrestrained growth. It became acceptable to extend risk in place of carefully apportioning it. And eventually, the strategy was no longer about understanding risk and quality of investments, it was about having a number of different risk elements and trusting that they were not correlated.

Unfortunately, it turns out that risky investments spread across a dozen areas are still risky investments.

Even in light of this history, intelligent diversification is by no means dead. Indeed, if based on sound investments and treated as a part of stewardship it may well provide the path to stabilization and recovery. This requires the tactical work of investigating each income statement, balance sheet, and gauging the sustainability of revenues for an investment. Intelligent diversification then determines appropriate exposures, ensuring that revenue flows are varied enough to provide high yield opportunities without ever sacrificing the sturdy fundamentals that help to weather a widespread economic downturn.

A common theme

More than one reputable advisory firm was guilty of diversifying assets into mediocrity (at best) and high risk (at worst). Consider, for example, a traditionally conservative and well-regarded firm that slowly migrated its balanced portfolio to a dangerously exposed position.

On the fixed income side, the firm managed two buckets, one comprised of low risk, conservative investments and one of more aggressive selections. In the fixed income bucket, it moved half from bond holdings to high yield vehicles in order to stretch returns. The other half was moved to a multi-alpha hedge fund that was compared against cash, with a target of cash yield + 9 percent.

For these “low risk” positions, the firm’s index was the Merrill Lynch three-month Treasury Bill. At the end of 2008, that index was up 1.7 percent, while the formerly safe bucket was down 37 percent. The desire to outperform steadily drew these managers away from the strategy of intelligent diversification and into a pattern of unbalanced risk.

Re-learning intelligent diversification

In late 2008 and early 2009, investors reacted to the collapsed market with understandable caution. A conservative approach emerged briefly as fixed income positions and careful due diligence became fashionable.

But it didn't take long to fall back into old habits. When the market improved in March 2009 and the S&P climbed back above 800 from its low of 676, investors immediately reverted to a wider view of diversification, re-opening the same dangerous doors that crippled the market in the first place. As the economy slowly stabilizes, accountability is again being deflected and losses explained away as the result of an unforeseeable convergence of downward momentum.

As noted in a recent Barron's article, "The chain of events that led to the fourth-quarter market debacle produced a statistical anomaly too far outside the probability distribution to be anticipated," says Financial Engines Chief Investment Officer Christopher Jones, 'and is similarly unlikely to be repeated...If that debacle taught us nothing else, wasn't it that there is no such thing as a safe investment?'"ⁱ

Indeed, all investments carry risk. The lesson of the debacle is not that investments are unsafe, however; it is that knowing those risks goes a long way to mitigating them.

Equally telling is the perspective from an April 2009 Wall Street Journal entry, as "David Kreinices, a portfolio manager with ETF Portfolio Management..., believes investors will be tentative on stocks for years to come, making ETFs a more likely avenue for large pools of retail cash. 'Core, multi-asset class diversification is incredibly hard to beat,' said Mr. Kreinices. 'The big question is what percentage should be in gold, commodities or absolute return strategies. Really focusing on minute details of stocks isn't worth the time or energy.'"ⁱⁱ

And yet, focusing on "the minute details of stocks" is the work that safeguards investors from risk. Portfolio strength is developed on themes, opportunities in the marketplace and underlying quality, and it is – and always has been – critical to have a full understanding of the composition of and rationale behind each investment. That requires investigating elements such as:

- ***Disruption opportunities.*** Economies are made up of shifting plates of industry, and those who identify undervalued areas that are poised for significant momentum – and individual companies that are positioned to benefit – will see enduring upside that thrives when the general investing population weakens.
- ***Debt/asset ratio.*** A low debt/asset ratio is a fundamental sign of a strong balance sheet, and in a deleveraging environment (such as that of 2009) it is a critical component to sustainability. There is a true competitive advantage to having actual liquidity at hand; it provides management with the flexibility to keep their options open, to pursue opportunities that may benefit shareholders, and to grow market share when overleveraged competitors are weakened by a lack of accessible capital.
- ***Dividend growth.*** Management that gives back to its investors with consistent increases in dividend returns demonstrates a long term commitment to the enterprise, and invites shareholders to remain as dedicated as they are.

Emerging mentality

Emerging markets make a fascinating case study of diversification that could and should be intelligent, but that is already headed in a troubling direction. As investment values begin to rise, investors are engaging in the same practice of 2006 and 2007, when emerging markets like China and Latin America were generating 50 percent returns and the high risk involved was shakily justified by diversification.

These risks inevitably manifested in a painful crash that saw average emerging market fund losses of 64.6% in 2008. Yet here the market stands just a few months later, and “emerging markets are the world's best performers. A Morgan Stanley index tracking emerging-market stocks is up 12% in dollar terms. By contrast, its index following stocks in developed markets outside the U.S. and Canada is down 9%.”ⁱⁱⁱ

Investors are therefore moving back into immature marketplaces that are dominated by consumers and not institutions, are without reliable regulatory structures and are reliant on the

inflow of capital for returns. Political upheaval, shifts in industry, healthcare concerns – any number of elements can destabilize the investment.

The lesson is not that emerging markets are a bad investment; indeed, one of the most compelling growth stories of the next two decades will be the evolution of the middle class in developing nations. But allocation to broad based opportunities invites tremendous risk, and investments must be highly selective. Intelligent diversification calls for in-depth scrutiny of individual companies poised to post gains in these markets – it is not the mass market trend that brings sustainable returns, but the fundamental strength of players that are active in the regions.

Safety in discipline

In this environment, the risks remain real even as the world anticipates the next wave of growth. Some industries will return faster than others, regulations and policies will shift, and the global economy will present enticing opportunities. Amidst this financial renaissance, it will be paramount to remember the fine line between intelligent diversification and overexposure. Investors should avoid heightened risk brought about by broad, untested diversification, and instead focus on gaining clarity about the quality of individual investments.

The market is already showing encouraging signs of retrenching, which will lead to the painfully slow recovery that lies ahead. With that in mind, the time is right to begin examining strategy and considering risk allocation – adhering to the lesson that intelligent diversification and investment quality should never again be separated. That slope, we know, is a slippery one.

About the Authors

Charlton Reynders, III, is Chairman and Chief Executive Officer of Reynders, McVeigh Capital Management, a rapidly growing investment management firm with a strong emphasis on building portfolios around ethically managed, sustainable investments. Chat has compiled more than fifteen years of experience in investment management and social venture investing. He has structured and funded public/private partnerships that have brought more than \$150 million in revenues to leading cultural institutions around the world, projects that have won numerous awards. The IMAX film, *Dolphins*, produced in conjunction with the National Wildlife Federation, garnered an Academy Award nomination in 2000; another IMAX film, *Coral Reef Adventure*, received the largest grant in the history of the Informal Science Division of the National Science Foundation.

Patrick McVeigh, President and Chief Investment Officer of Reynders, McVeigh Capital Management, has 23 years of experience in the investment management industry. A recognized leader in the field of socially responsible investing, Patrick has served as Managing Editor of *Investing for a Better World*, authored numerous articles on ethics and ecology, and contributed chapters to *The Social Investment Almanac* (New York: Henry Holt, 1992) and *Working Capital: The Power of Labor's Pensions* (Cornell University Press, 2001). Since 1995, he has been project manager for a series of groundbreaking studies conducted by the Social Investment Forum, tracking the growth of socially responsible investing and its implications in the investment markets. Patrick has served on the boards of SEED: The Haitian Community Loan Fund, directing approximately \$1 million to peasant cooperatives in Haiti to create businesses; the Social Investment Forum; and the San Jose Food Co-operative.

Endnotes

ⁱ *Modern Portfolio Theory Ages Badly*, Mike Hogan, Barron's, February 16, 2009
[<http://online.barrons.com/article/SB123456977248286211.html>]

ⁱⁱ *ETF Share Shrinks as Managers Opt to Pick Stocks*, Geoffrey Rogow, Wall Street Journal, April 8, 2009
[<http://blogs.wsj.com/marketbeat/2009/04/08/etf-share-shrinks-as-managers-opt-to-pick-stocks/>]

ⁱⁱⁱ *Emerging Markets Go on a Tear*, Joanna Slater, Wall Street Journal, April 13, 2009
[<http://online.wsj.com/article/SB123957006660511755.html>]