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The Future is Never Like the Past

An article by Innovest's Richard Todd, Managing Principal, from the Innovest 2nd Quarter 2010 Newsletter, "The Research Report."

How would you have built a portfolio in 2009? For the majority of the first quarter of 2009, you would have stayed very defensive with lots of cash. However, beginning in mid-March 2009, you would have become aggressive by focusing on equities, especially non-U.S. equities with a healthy concentration in emerging markets. Forget Treasuries and munis, and invest in junk bonds and bank loans. Voila! You just made over 50% in 2009! Hindsight is easy, isn't it?

Technology has made it simple for investment firms to produce fantastic historical results in an instant. By combining investments with different characteristics, these track records "beat the markets," seldom lose money, do well in up markets, and give investors the peace of mind that they crave—especially after the last 10 brutal years of investing. Frequently, these track records are presented as series of diversified portfolios, from conservative to aggressive and often feature some of the hottest investments. Hedge funds, private equity, "absolute return" products, managed futures, commodities, low-cost ETFs, and passive management may be key components of these "bullet proof" portfolios.

The problem, however, is that these portfolios do not have real track records. They are concocted with a rearview mirror, and they almost never work on a forward-looking basis. The future is never like the past.

Looking forward, how should a portfolio be designed today? Credit spreads have narrowed and interest rates are low. With the mountain of government debt to be scaled, interest rates will likely move higher. Inflation is likely to come down the pike, as well. Gold and stocks have already climbed dramatically from multi-year lows. The economy is still sputtering, and unemployment levels are still very high. Taxes are on the rise.

It's complicated, isn't it? One thing is for certain: what worked in 2009 probably won't work in 2010 or 2011. This insight helps to explain why backtesting is bogus. Anyone can build a great track record with hindsight. Beware of firms that treat clients like guinea pigs, creating one quantitative product after another, only to close the products in a few years when they don't perform as the backtest anticipated. These firms just tee up the next idea for their next group of "clients."

How does one choose the right investment advisor? Here is a summary of suggestions from WebCPA.com on selecting an investment advisor:

- Make certain that your advisor acts in a fiduciary capacity. Your best interests should always be foremost.
- Use "fee only" advisors. Understand that commissions are conflicts of interest.
- Get references and check reputations. The professional community should vouch for them.
- Check for disciplinary actions and look into an advisor's background. It's amazing what can be found through Google.
- Verify that an independent custodian is utilized. The lack of an independent custodian was a huge red flag with Madoff.
- Understand the ratio of clients to investment advisors. The more clients an advisor has, the less the customization and service you will receive.
- Review both Part 1 and Part 2 of an advisor's Form ADV. Understand their hidden agendas, relationships and conflicts of interest.
- Inquire as to their personal investing. Many advisors sell asset allocation, but invest in the "deal of the day."
- Understand all fees and costs. Mutual fund expenses are a real cost that many investors overlook.

Some of the world's best sales people are in the investment business. Be thorough in your evaluation and selection of an investment advisor. If a portfolio backtest is a primary tool in the sales process, be highly skeptical.

Rich may be reached at 303.694.1900 x305 or richt@innovestinc.com.