

## 3) Building robust portfolios



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## 1. Building robust portfolios

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In this document, we dive into *how* we build portfolios. The first thing to remember is that there is no absolute best way to construct a portfolio, but there are certainly some portfolio structures that are more sensible and more robust than others. The second thing to remember is that few decisions – like most in life – are black or white, but shades of grey. We believe that it makes good sense to base our portfolio construction process on the academic theory and empirical evidence that exists and to think deeply about each of the key decisions that need to be made, on your behalf.

## 2. Deciding on the asset class menu

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The first step is to decide what you *possibly should* invest in, from what you *could* invest in. Asset classes are investments with distinct attributes such as the economic source of their returns, the risks they exhibit, the level of expected reward they offer as a consequence, and how different their returns sequences are to other asset classes (i.e. how correlated they are). The spectrum of choice is wide, from cash to global equities, gold, vintage cars, and cryptocurrencies. Not all of them deserve a place in your portfolio.

There are three major asset types: equities (sometimes called ‘stocks’), which provide regular cash payments in the form of dividends and the possibility of price appreciation; commercial property, where income is derived from rents on office, retail, warehousing, data centers, etc.; and bonds, which are IOUs from corporate or government borrowers who promise to pay interest (coupons) and return the principal amount borrowed at a specified date in the future (maturity date). Cash is simply the short-dated end of the bond universe.

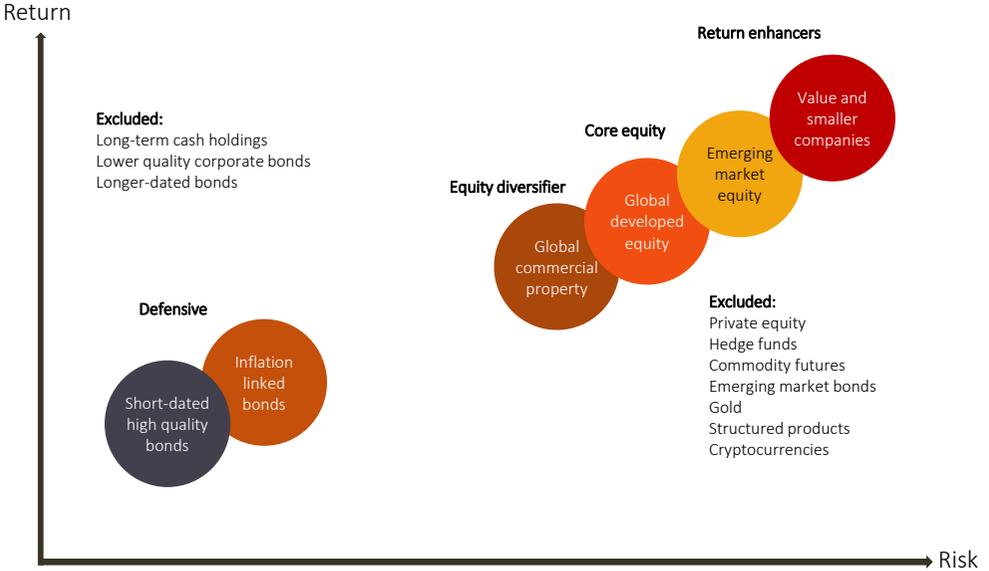
To make matters more complicated, these asset classes are often broken down further. Within equities this might be by geography, company size, or relative valuation (where companies may be more or less expensive relative to a balance sheet metric like book value). In bonds, this subdivision may relate to the quality of the borrower, how long you lend for and whether foreign currency effects impact returns (unhedged) or not (hedged). Beyond this there are many strategies that use combinations of assets classes, or derivatives of these asset classes, or other asset classes, such as commodities.

We base our choices on each asset class’ ability to meet our pre-determined selection criteria. The discipline of this framework allows us to review any asset class or investment strategy that crosses our desks, in a systematic way. It forces us to engage our reflective minds, which defuses much of the emotion that might exist, of something that superficially seems to be a good investment, usually following a burst of strong performance.

These criteria include being able to make an economic case for returns in excess of cash; how good the data set is that we have to hand; whether investors are likely to be adequately compensated for the risks involved; how the asset class contributes at a portfolio level; whether robust products exist in the marketplace to capture these attributes; and that we have adequate skills and resources to understand and manage the risks involved.

The list is separated into those assets we will include, those that we will keep a close eye on until we can make a definitive decision either to include or exclude them, and those that we will not use. The latter are often the seemingly more sophisticated and more esoteric products like hedge funds and structured notes.

**Figure 1: A big difference exists between *could* and *possibly should* investments**



Note: this is a broad representation of where on the risk/return spectrum such assets might sit. It is not based on specific periods of market data.

Being entirely comfortable with the assets held in your portfolios – including how they interact with one another – ensures that when markets get tough, as they will from time to time, you are better placed to remain disciplined and stick with the strategic decisions that were made in calmer waters.

### 3. The growth and defensive components

Your portfolio will comprise two components; the first is what we call ‘growth’ assets, which are higher returning, equity-like investments. To own an entire portfolio made up of these higher risk investments – however well-diversified – would take some staying power when markets are in turmoil. In the past, portfolios of growth assets have fallen by as much as a half or more, before recovering over time.

As a consequence, most investors require a balancing allocation to ‘defensive’ assets that perform a strongly defensive role, which tends to be predominantly high-quality, shorter-dated bonds. Let us look at each of these portfolio components in turn.

► **Growth Assets – The engine of portfolio returns**

The growth assets component of your portfolio represents a logically constructed, globally diversified mix of risk assets that seeks to deliver strong mid-single digit, after-inflation returns over medium to longer-term investment horizons. Different assets play different roles in the growth component, as illustrated in figure 2.

**Figure 2: The primary roles of growth asset classes**



Source: Albion Strategic Consulting

Developed market equities (e.g. the US, UK, Germany, and Japan) sit at the core of the growth assets component. We also include – in moderation – return enhancing assets such as emerging market equities (e.g. China, Taiwan, Brazil, and South Korea), smaller companies and cheaper (value) companies, which, on account of their higher risk, should deliver a return premium to the broad market over time. We also seek out other asset classes that can diversify some of this equity risk, but without giving up too much return, as tends to happen in the case of bonds. Global commercial property – being offices, retail, and industrial buildings such as warehouses and data centers – is one such asset class that potentially offers this role.

As a result, the growth assets component of your portfolio will be highly diversified at the asset class, geographic, sector and company levels, as the charts below clearly demonstrate. Note that these charts reflect the make-up of the developed and emerging markets in their market capitalisation weights and your portfolio may vary a little depending on its final structure. Today, the US market with its mega cap stocks represents more than half of all global markets, and the UK represents around a mere 3%. It is perhaps evident that having a large overweight to a small home market makes little sense. It is worth noting that many companies are large multi-nationals operating globally with diversified revenue streams themselves, such as Apple, Amazon and Microsoft.

Figure 3: Global developed and emerging markets by market capitalisation



Source: Morningstar Direct © All rights reserved. Fund: SPDR® MSCI ACWI IMI UCITS ETF as at 31/12/2024.

These markets and sectors are made up of several thousand individual companies, that by definition in aggregate deliver the return of the markets.

Figure 4: Global developed and emerging markets by company



Source: Morningstar Direct © All rights reserved. Fund: SPDR® MSCI ACWI IMI UCITS ETF as at 31/12/2024.

This growth assets component of your portfolio will be volatile, with negative returns likely in around one-in-three annual periods. That is the nature of equity markets. Yet, it is this very uncertainty of shorter-term outcomes that delivers a longer-term premium compared to holding cash. Large falls in value may well be experienced at times of market turmoil, as occurred during the technology crash (2000-02), Global Financial Crisis (2007-09) and COVID-19 pandemic (2020). **Remember that a fall only becomes a loss if you sell, which is something that patient and disciplined investors should avoid. Remember, too, that your holding in defensive assets is expected to mitigate to some extent the fall in the value of your portfolio at these times.** We explore briefly how we get this balance right for you a little later.

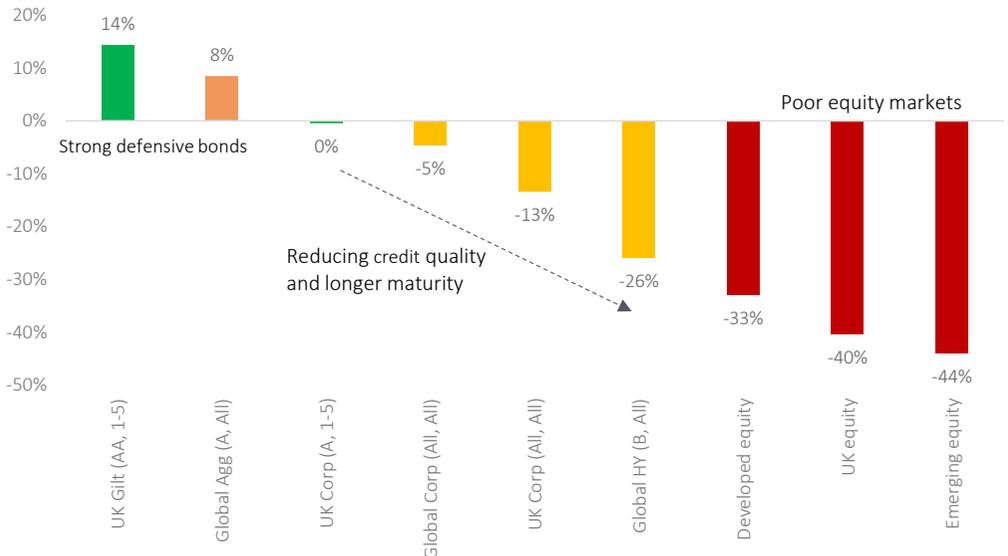
## ▶ Defensive assets – balancing your portfolio

Defensive assets, for longer-term investors, play an important role in all portfolios. For more cautious investors they provide downside protection by delivering lower levels of potential falls than equity markets and should preserve purchasing power over the long term, although this is not guaranteed. For more risk tolerant investors they provide a crucial balance against equity market trauma, delivering solid returns to offset equity market losses.

Short-dated, high-credit-quality bonds provide useful defensive properties. Their short-dated nature, i.e. the amount of time until the bond matures and capital is repaid, leads to lower volatility than longer-dated bonds, all else equal. High-credit-quality bonds tend to attract money fleeing from riskier assets at times of equity market trauma, driving prices of these bonds up. This generally is the case, although 2022 and 1994 before it, provide exceptions to the rule. That is the nature of investing!

Figure 5 explores this relationship, by looking at how different types of bonds performed during the equity market crash from 11/2007 to 2/2009 over the period now known as the Global Financial Crisis. It is evident that the riskier bonds (highlighted in yellow) tend to act more like equities at times of market trauma, particularly if this is accompanied by an economic downturn.

**Figure 5: Balancing growth assets with solid defensive assets, 11/2007 to 2/2009**



Source: Morningstar Direct ©. All rights reserved. Indices used: Markit iBoxx GBP Gilts 1-5 TR, BBgBarc Global Aggregate TR Hdg GBP, Markit iBoxx GBP Corp 1-5, BBgBarc Gbl Agg Corp TR Hdg GBP, Markit iBoxx GBP Corp, BBgBarc Global High Yield, MSCI World NR USD in GBP, MSCI United Kingdom, MSCI EM NR USD in GBP.

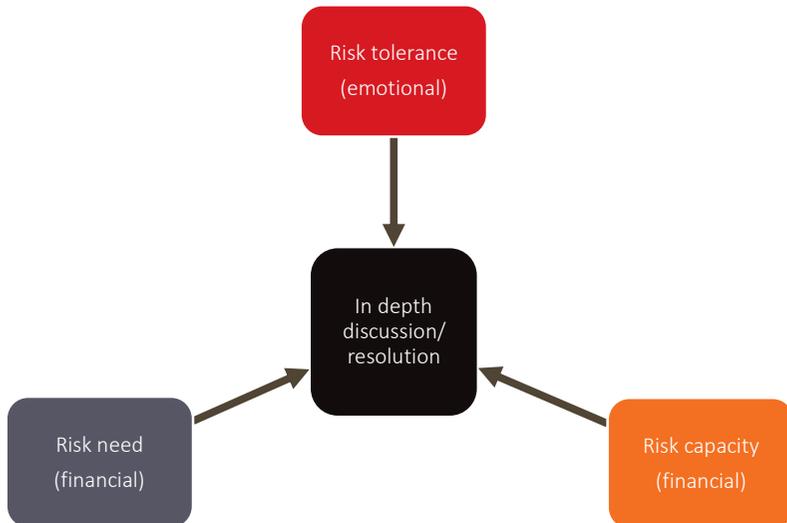
If bonds are denominated in currencies other than your base currency, then all of the currency risk will be hedged out (i.e. avoided), as the volatility associated with exchange rate movements is similar to that of equities.

## 4. Identifying the portfolio that is right for you

Finding the balance between growth assets and defensive assets that is most suitable for you is one of the most important decisions that we will make together. At the end of the day, you need to be able to sleep at night knowing that your portfolio will not cause you emotional or financial pain that you cannot handle. You also need to know that the investments that you own will provide you with a good chance of meeting your financial – and thus lifestyle – goals. There is no easy way to work this out. It requires a deep discussion around what risk means to you both financially and emotionally, supported by some useful financial analysis that facilitates this discussion.

There are three distinct areas that need to be understood, discussed and addressed: first, we need to understand **your emotional tolerance for taking on investment risk** i.e. the point at which you feel most comfortable when balancing the trade-off between upside and downside outcomes; second, we need to understand **the worst magnitude of any falls in the value of your portfolio that you can survive financially**; and finally, we need to establish **how much risk you need to take in order to achieve your goals**.

Figure 6: Identifying a suitable level of risk for you to take



Source: Albion Strategic Consulting

The first element of risk, i.e. your ability to tolerate investment risk, can be assessed using a robust risk tolerance questionnaire. This independently assesses the emotional trade-off between upside gain and downside pain that you feel comfortable with, which improves the likelihood that you will be able to stick with the investment journey on which you embark. This acts as a starting point in our discussion with you, without slavishly relying on its output.

The financial side of the equation revolves around exploring the financial impact of risk. We use lifetime cash-flow planning models to help us to understand the impact on your future of different portfolio outcomes. We model your financial capacity to suffer losses, given your level of wealth, the flexibility of your goals, and your investment horizon, and work out what rate of return you need – and therefore how much risk you need to take – to achieve the goals you have set.

Defining the right level of risk to take is not simply the prescriptive output of the tools we use but requires careful discussion, and the resolution of the trade-offs that you may need to make. Your experience in, and understanding of, investing needs to be taken into account. This ensures that you end up owning a portfolio that has a good chance of delivering on your unique emotional and financial objectives and one that you can live with along the way.

## 5. Using funds that deliver market returns

We describe the way we invest as being systematic. What we mean is that we do things according to a disciplined system that is efficient, methodical, and objective. Whilst, inevitably, we have to hold long-term views on the characteristics of asset classes that we use to build portfolios, we do not make short-term forecasts on the direction of markets or the value of individual securities e.g. preferring BP over Shell. We put in place a sensible long-term strategy, live with it, and refine it over time if new products and evidence allow us to improve its structure. Low cost – which also means low activity – is important. This approach is sometimes referred to, wrongly, as ‘passive’ investing or index tracking.

The opposite to a systematic approach is a judgmental approach, which can be described as where a fund manager has the ability to act according to his or her own discretion or judgment to make subjective forecasts of short-term market or security prices in order to try to beat the market. This is commonly referred to as ‘active’ investing.

When it comes to selecting our best-in-class funds, we are also looking for funds that are systematic in their approach to identifying market risks (e.g. smaller company stocks) and which implement a rules based system for capturing the market returns that these risks deliver. These funds need not be following a market index (index tracking) but seek to capture the specific risk characteristics being sought. Such strategies tend to be highly diversified in the stocks that they hold. We dislike the word ‘passive’ as it dumbs down the highly skilled work that systematic managers undertake. Charles Ellis – a legendary investment sage in the US – highlighted the issue most succinctly:

***All is fair in love and war and marketing. So, active investors can take great pride in their PR masterstroke of hanging on index funds the dreaded albatross “passive.” Would any among us ever want to be called passive? (Try it. “This is my husband. He’s passive.” Or: “Our team captain is passive.”) Of course not! Throughout our society, passive has a major negative connotation while active has a major positive connotation.’***

*Charles Ellis – investment sage, consultant and author<sup>1</sup>*

The label ‘passive’ hangs like an albatross around the necks of those who see the effectiveness of using passive investing to capture asset class returns. It is annoying to read in the newspapers that passive funds are supposedly simply run by computers. Nothing could be further from the truth. Systematically managed funds employ fund managers who are highly focused on, and experienced at, making portfolio structuring decisions to capture the market characteristics sought, and minimising costs throughout the portfolio management and trading process, in order to capture as much of the market return on offer for investors. Whatever label is used, systematic strategies provide you with a highly effective and, serendipitously, a simpler way to invest. We will explore why, below.

► **The power of understanding that the markets are a zero sum game**

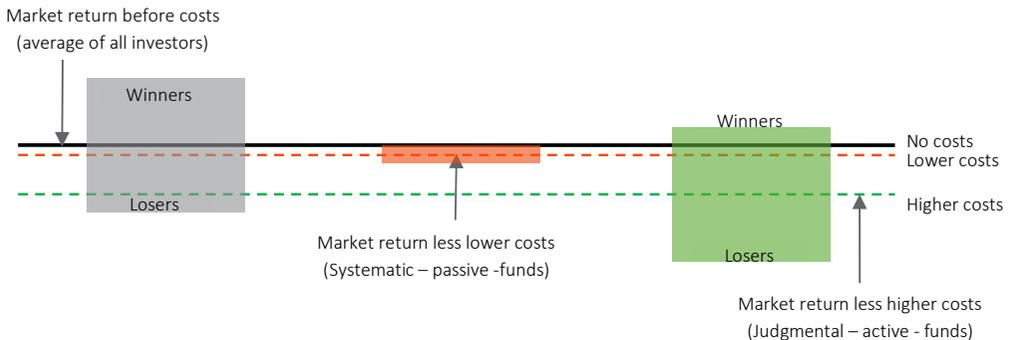
An important concept that is often overlooked by investors is that for every investor who beats the market, there has to be an investor who loses to it. This is often referred to as a zero-sum game. Understanding that markets are a zero-sum game, in aggregate, provides the very elegant, yet powerful, insight that simple maths dictates that low cost funds, in aggregate, will deliver better performance than a majority of higher cost, usually judgmental, funds.

***‘What becomes a zero-sum game is trading back and forth because all of us together are, of course, average. If I make a smart trade, believe me, somebody out there has made a dumb one. I mean, that’s the other side of the trade, so beating the market becomes a zero-sum game’***

John C. Bogle, Founder – Vanguard Group

By definition, as a group, investors will achieve the market return before costs. After costs, there will be more losers than winners. Average costs for judgmental (active) funds trying to beat the market return are generally materially higher than systematic (passive) funds aiming to deliver the return of the market. Figure 7 illustrates the concept.

**Figure 7: The zero-sum-game-less-costs that investors play**



Source: Albion Strategic Consulting

The simple maths of a less-than-zero-sum-game-after-costs mean that the average investor in low cost funds will beat a majority of investors invested in higher costs funds. That is a galling conclusion for the clever and hardworking active fund management community. The table below looks at the zero-sum game at work. It illustrates the percentage of active managers beaten by a market benchmark that they should be aiming to beat. As you can see, it does not make pretty reading for active managers.

**Table 1: GBP-denominated active funds beaten by their benchmarks over 10 years to December 2024**

UK equity	UK large-/Mid-cap eq.	UK Small-cap equity	Europe ex-UK equity	US equity	Global equity	Emerging market eq.
82%	88%	67%	87%	93%	97%	91%

*Source: S&P Dow Jones Indices. SPIVA Europe Year End 2024 Scorecard*

This table indicates the less-than-zero-sum-game is at work. It is this, rather than the degree of efficiency of underlying markets, that is a major driver of judgmental manager underperformance. Market efficiency – offering few low hanging profit opportunities – just makes the game even harder.

What is interesting is that in markets where one might expect judgmental fund managers to be able to find incorrectly priced companies and extract market beating returns as a result – such as emerging market equity – they perform just as badly. This is because the transactional costs of trying to extract the identified pricing anomalies are high and negate the profit opportunity. Another shocking statistic is that in the GBP fund data above, between 40% and 60% of funds (depending on the category) in existence at the start of the period failed to survive. Looking at the opportunity set of active funds today, it is worth bearing in mind that a good proportion of them are likely to disappear in the next 10 years. Good funds do not tend to disappear, as you can imagine!

**► *Discerning between luck and skill is difficult***

None of the above would matter if we could identify a few managers who are truly skilled and demonstrate the ability for their good performance to persist across time. Unfortunately fund rankings in the Sunday papers are entirely useless in this task. To be able to discern skill from luck with any confidence, you need a track record of 15 to 20 years to analyse depending on your assumptions (how statistically certain you want to be). Short-term rankings based on performance are meaningless, yet most investors still pick funds that have performed well over the past three to five years, which is akin to coin flipping. Again, let’s go back to the wise words of Charles Ellis:

***In addition, some overzealous fund companies dedicated to active investing have made matters worse by their extensive advertising of those few funds that have recently had great results. Although all professionals know it takes many years of superior performance to prove that skill, not luck, is causal, the vast investing public is unwilling to wait. And most are so unsophisticated when it comes to statistics that they don't realize how dangerous selective sampling can be. So, performance envy runs rampant and investors mutter, "I'll have what she's having!"***

Charles Ellis – investment sage, consultant and author<sup>2</sup>

If you are in any doubt as to the challenge of trying to find a judgmental manager worth their fees, ponder on an academic study by the respected, UK-based, Pension Institute. It set out to decide whether or not UK fund managers exhibit skill – and therefore the ability to outperform the market consistently – both before and after costs. Cutting to their conclusions provides a clear answer:

***The vast majority of fund managers in our dataset were not simply unlucky, they were genuinely unskilled. However, a small group of "star" fund managers are genuinely skilled and hence able to generate superior performance (in excess of operating and trading costs), but they extract the whole of this superior performance for themselves via their fees, leaving nothing for investors.***

### ▶ ***Why we prefer systematically managed funds***

We hold a deep conviction that by selecting well-managed, low-cost, systematically managed funds, we will be providing you with the best chance of capturing the bulk of the market returns that are on offer. Trying to identify judgmental managers, who can persistently overcome their fees and costs to deliver market beating returns is extremely difficult and requires long track records to discern skill from luck. Picking funds that will even be around is a tough starting point, given the poor survivorship record of the industry. Living with the inevitable underperformance that will occur from time to time when employing judgmental fund managers is not for the faint hearted and may well lead to impatience and ill-discipline; and we know where that leads. Our view is perhaps best summed up below:

***The significance of the evidence is not that passive investing will always outperform active investing, but that when an investor has to make a decision about which way to invest, the probability of success always lies in favour of passive investment.***

Professor Simon Keane, Glasgow University

## 6. Conclusion

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We hope that this detailed note has provided you with a good insight into the key principles and investment practices that guide our systematic approach to investing. We are confident that our approach will provide you with every chance of having a successful investment experience. We cannot guarantee what returns the markets will deliver in the future, but we can guarantee that you will capture most of what is available through our systematically managed, best-in-class funds. By owning a well-diversified portfolio for all seasons, having faith in capitalism, allowing the markets to do the heavy lifting, being patient and remaining disciplined, you give yourself – with our continued help and guidance – every chance of success.

If you have any questions on anything in this document, or you would like to talk through our investment approach in more detail, please contact us and we can arrange a time to talk. ■

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### References

1) *In Defence of Active Investing*, by Charles Ellis, CFA, 23 June 2015. This is a good, easily digestible piece, which is a somewhat back-handed compliment to the members of the CFA Institute comprised of many active investment managers.

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