How Do You Build an Optimal Investment Portfolio?

How should an investment advisor think about building a portfolio for clients? Or how should an investor think about building a portfolio for themselves? Many investors agree that a balance between stocks and bonds is fundamental to optimal portfolio construction. But there may be less agreement about other questions – passive vs. active, alternatives vs. traditional asset classes.

We at Counterpoint believe in a few principles that we think all advisors should consider when managing client assets.

Strategy	How helpful is this strategy?	Investors should want to track an index closely	Investors should expect expenses to be...	How much research is needed to find a suitable investment?
Passive Indexing[1]	Usually very helpful	Yes	Low	Not as much
Active Long-Only[1]	Sometimes helpful; often not	Not so much	Low to moderate	A lot more
Active Diversifier[1]	Usually helpful, with client education	No	Moderate to high (if truly active)	A lot more

Looking at the rubric above, we believe the optimal investment portfolio usually avoids actively managed long-only investment strategies, and instead combines passive/cheap beta[1] exposure with **actively managed diversifiers**.

Does buying cheap/passive indexes actually work?

It might seem a little surprising to hear a quantitative investment manager recommend holding passive index exposure, but the evidence for passive investing is substantial.

Passive strategies have come to dominate the investment world since legendary investor and Vanguard founder John Bogle (1929 – 2019) started his first index fund in the mid-1970s. Bogle believed that low cost and broad market exposure were the keys to success, not the high fees that often accompanied actively managed funds.

> **"Don't let the miracle of long-term compounding of return be overwhelmed by the tyranny of long-term compounding of costs."**
>
> **- John Bogle**

The inventor of the first S&P 500 index fund prophesied that investors would be better off investing in low-cost, highly diversified passive portfolios that make no effort to outperform ("cheap beta"). In the ensuing decades, this has been largely proven correct with **evidence** and **investment** piling up in support of this argument. Passive index funds offer broad market diversification and systematic exposure at a low enough cost that many investors find attractive.

We agree: Passive index exposure is a great way for investors to take advantage of ongoing technological progress, the tendency for economies to grow, and companies' habit of historically generating reasonable returns on capital in exchange for a certain amount of risk.

[1]*Definitions can be found on page 4.*

Be skeptical of long-only active management, especially discretionary management[1].

The rationale for passive investing hints at why we at Counterpoint mostly discourage "long-only" active investing that closely tracks an index. We believe it's very difficult to beat indexes simply by picking individual stocks or bonds whose returns are, on average, mostly dictated by the direction of the overall market.

Instead, long-only active management can generate greater expenses, which drag on long-term returns. The table below compares annualized returns to passive indexes and their actively managed counterparts, as represented by Morningstar categories.

Performance of Actively Managed vs. Passively Managed Long-Only Funds: 01/01/1987 to 8/31/2024

Investment	Annualized Return	Total Return	Annualized Return Active vs. Passive	Total Return Active vs. Passive
US Active Fund Intermediate Core Bond	4.78%	480.17%	-0.17%	-37.01%
US Passive Fund Intermediate Core Bond	4.95%	517.18%		
US Active Fund Large Blend	9.16%	2,618.49%	-1.15%	-1,310.34%
US Passive Fund Large Blend	10.31%	3,928.83%		

Source: Morningstar.

Basically, fixed income investors on average lost 17 bps of annualized return vs. passive. US active long-only stock investors gave up 1.15% annually vs. what they would have earned in comparable passive vehicles.

To get results that are different from those of the market, a manager should be doing something *really* different – running a very concentrated equal weight portfolio, **going "short" stocks alongside long investments**, or taking a **highly tactical approach** by shifting into and out of different asset classes.

Long-only active strategies have another potential weakness. Many long-only managers rely on discretionary processes that can be subject the same **cognitive biases and emotions that can lead to suboptimal investment outcomes**.

Get active, but when you do, get active for the right reason.

We said it already: Differentiated results require a differentiated investment approach. Passive investing is a great starting point for many investors.

Active investing should be aimed toward generating returns that behave differently from passive investing. In technical terms, active strategies should have high tracking error or active share, and low correlation. They should move differently.

Counterpoint was founded under the belief that investments (aka diversifier strategies) that move differently from the other asset classes held by a portfolio are a **key means to diversify and manage risk**. Indexes sometimes have down periods; investments that seek differentiated returns from indexes can create greater opportunities to be down less, be flat, or even sometimes be up when broad markets are suffering.

[1]*Definitions can be found on page 4.*

The indices shown above are for informational purposes only and are not reflective of any investment. It is not possible to invest an index. The data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Past performance is no guarantee of future results. Index definitions can be found on pages 3 and 4.

Here are examples of very active strategies we believe in:

- **Tactical asset allocation** that systematically seeks to manage downside risk.
- **Long-short equity investment** that seeks to identify mispricing in stocks and create portfolios of stocks with no correlation to the stock market.
- **Concentrated long equity investment** that creates a highly differentiated portfolio vs. market-weighted benchmarks.

It's important to note that investment strategies seeking this differentiated behavior can often be more expensive due to their unique approaches. The investor's job is to hold such managers accountable, and make sure they are getting what they pay for.

Conclusion

For many investors, we believe the optimal portfolio consists of a blend between low-cost passive investment and carefully vetted highly differentiated active alternatives. Counterpoint leverages this approach to portfolio management by managing highly differentiated active strategies and by advising clients on general portfolio construction. The key is to take broad market risk, and simultaneously manage that risk via a systematic approach to maximally active investment strategies.

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Important Risk Information

Investments cannot be made in an index. Unmanaged index returns do not reflect any fees, expenses, or sales charges. Past performance is no guarantee of future results. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses. The Adviser's reliance on its strategy and judgments about the attractiveness, value and potential appreciation of particular securities and the tactical allocation among investments may prove to be incorrect and may not produce the desired results. No level of diversification can ensure profits or guarantee against loss.

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Equity securities, such as common stocks, are subject to market, economic and business risks that may cause their prices to fluctuate. Fixed income investments are affected by a number of risks, including fluctuation in interest rates, credit risk, and prepayment risk. In general, as prevailing interest rates rise, fixed income prices will fall. Investing involves risk, including loss of principal. The value of the fund's shares, when redeemed, may be worth more or less than their original cost. There is no guarantee that any investment strategy will achieve its objectives, generate profits or avoid losses. Past performance is no guarantee of future results.

Index Definitions

US Active Fund Intermediate Core Bond refers to the Morningstar US Active Fund Intermediate Core Bond Category, which is a category of funds that aim to beat market returns by using a team or portfolio manager to select investment-grade US fixed-income securities, with a focus on intermediate-term debt.

US Passive Fund Intermediate Core Bond refers to the Morningstar US Passive Fund Intermediate Core Bond Category, which is a category of funds that track benchmark indices and aim to match the underlying index's performance by automatically investing in investment-grade US fixed-income securities with a focus on intermediate-term debt.

US Active Fund Large Blend refers to the Morningstar US Active Fund Large Blend Category, which is a category of funds that aim to beat market returns by using a team or portfolio manager to create a portfolio that is composed of U.S. large cap stocks, which occupy the top 70% of the capitalization of the U.S. equity market, and are fairly representative of the overall U.S. stock market in size, growth rates, and price. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

US Passive Fund Large Blend refers to the Morningstar US Passive Fund Large Blend Category, which is a category of funds that track benchmark indices and aim to match the underlying index's performance by automatically investing in a portfolio of U.S. large cap stocks, which occupy the top 70% of the capitalization of the U.S. equity market, and are fairly representative of the overall U.S. stock market in size, growth rates, and price. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

The **S&P 500 Total Return Index**, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

The **Bloomberg US Aggregate Bond Index** is made up of the Bloomberg US Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. As it is not possible to invest in the index the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Indexes do not include management fees.

Definitions

Return is the percentage change in the value of an investment, and/or cash flows which the investor receives from that investment, such as interest payments, coupons, cash dividends, stock dividends or the payoff from a derivative or structured product, over a specified time period.

Alpha (α) measures an investment strategy's ability to beat the market, or "excess return."

Beta (β) is a measure of the volatility—or systematic risk—of a security or portfolio compared to the market as a whole or index such as the Bloomberg Barclays US Aggregate Bond Index.

Correlation is a statistic (between or equal to 1 and 0) that measures the degree to which two securities move in relation to each other.

Passive Indexing refers to a passive buy-and-hold portfolio strategy with minimal trading in the market that typically seeks to replicate and hold a broad market index or indices and is often less expensive and can produce superior after-tax results over the medium to long time horizons.

Active Long-Only refers to actively managed buy-and-hold investment strategies that track the market (or an index) and is discretionary in nature using a team or portfolio manager to make investment decisions.

Active Diversifier refers to an actively managed quantitative investment strategy that does not move with the market, and instead offers performance that is low to uncorrelated to traditional stocks and bonds.

Discretionary Management, or Discretionary investment management refers to a form of investment management in which buy and sell decisions are made by a portfolio manager or investment counselor for the client's account. The term "discretionary" refers to the fact that investment decisions are made at the portfolio manager's discretion.