Stock Picking Service or Model Portfolios: Which Strategy Suits You?

For decades there has been a belief that stock brokers could pick some of the best untapped, undervalued stocks in the equity markets. Prior to the commercialization of the internet, it was not uncommon to "have a guy" who would pitch different stocks. Fast forward to 2017, stock brokers are becoming less mainstream and more of a one-off ideology. Movies like *The Wolf of Wall Street* make stock brokers out to be sleazy. However, investment firms have begun repackaging stock brokers into investment advisor representatives and having them pitch Turnkey Asset Management Portfolios, otherwise viewed as Target Asset Model Portfolios (TAMPs). Essentially, TAMPs are strategies that pool mutual fund managers, and exchange traded funds and indexes together in an attempt to manage a client's portfolio using some of the tenants taught in Modern Portfolio Theory (MPT). Unfortunately, these TAMPs have done little to further the belief that active management can outperform market indices over an extended period of time. Therefore a fundamental question arises, which is better: a stock picking service or model portfolio? This article will dive into each strategy to better answer this question.

Stock Picking Service

The art of picking stocks originated with the premise that information is the key to making money. Before the commercialization of the internet, information moved slower which made it easier to trade on public information. However, over the last 20 years technology has made significant strides

in bringing information to investors more efficiently. Through these technological advances, picking stocks has become more challenging as information is abundant, almost to an excessive point. With hundreds or thousands of pieces of content being written about a company, it can be difficult to wade through the material and decipher when or where to invest. This is why using a stock picking service like Motley Fool Stock Picks or Jim Cramer's television show Mad Money has been well received. While we do not endorse or support these services, many investors believe these services offer stock picking advice based on research, trend analysis, and technical or fundamental data points. Essentially, investors have outsourced their stock research (for a fee) to these services in an attempt to save time, and more importantly, rely on others to make bold predictions on the investor's behalf.

However, not all professionals are made equal. Under the Investment Advisors Act of 1940, there is an exemption outlining who is required to be licensed in order to provide advice on investments and who is exempt from the rigorous licensing requirements. The exemption states, "publishers are excluded from the Act if advice is provided impersonally, is "bona fide", and is of general and regular circulation." In other words, the authors of these stock picking publications may be providing a point of view without the securities licensing a financial advisor or investment advisor representative is required to undergo by regulatory bodies such as FINRA and the SEC. Make sure the person originating the content is a qualified licensed investment professional.

The Value Of A Model Portfolio

I believe the process of investing involves two elements: art and math. A well thought out investment plan is the intersection of those elements. More aptly stated, an

individual can conduct extensive technical and fundamental research to find appropriate investment opportunities. The research can indicate where to invest in a market, which companies to invest in, and when to invest. However, if investing was only about the math, then it would stand to reason that anyone could arrive at the same calculations. This in turn could translate into everyone buying the same, or similar investments. In order to stand out amongst a sea of the same, there needs to be something that differentiates one strategy over another. This is considered to be the ‘art’ of investing.

As new information is produced, changes to investment strategies may need to happen quickly, making access to real-time information a priority. Therefore, anyone who is not able to stay on top of stock picks or be actively involved in the day-to-day management of a portfolio, tends to turn to pooled investments like mutual funds and exchange traded funds. Under these investment structures, an investor no longer needs to worry about daily stock picks. The investor leaves daily management to the investment manager who operates the fund. So then why would an investor need a TAMP strategy to assist them when the investor can simply invest in a mutual fund or exchange traded fund?

TAMPs were built with the same premise of a stock picking service, to provide professional investment support for a fee. However, instead of investors wanting to invest in individual equities, this group of investors prefers to hire a company or person to diversify their investments amongst many fund managers. It is the fund managers who conduct research and make the stock picks based on a myriad of factors, such as market trends. TAMPs differentiate themselves from stock picking in three separate areas:

1. TAMPs leave active individual security selection to the money managers of the individual funds, allowing multiple strategists to co-exist within the same

portfolio.

2. TAMPs focus on finding value-added fund managers that compliment each other, thereby building an asset allocation model that meets an investor’s goal and risk preferences.
3. TAMPs are built on the bedrock of MPT, in which they use asset allocation and diversification to manage the risk return tradeoff.

Each of the above mentioned points highlights the desire of some investors to delegate direct oversight of their investment strategy to professionals. However, over the last fifteen years TAMPs have come under fire for not outperforming their benchmark indices. This underperformance has further supported the claim by passive investors that index based investing is better and less expensive. Why? Because it has to do with diversification and asset allocation.

Two of the tenants of Modern Portfolio Theory are asset allocation and diversification. In essence, these tenants posit that a portfolio’s overall performance is a product of the types of asset classes used and the percentage invested in those asset classes. Combining enough non-correlated asset classes together should produce a reduced and weighted standard deviation that can minimize a portfolio’s volatility. An example of this concept can be seen in combining three indexes of different asset classes. As an index is a representation of a basket of underlying investments, then combining (in equal proportions) a domestic equity index with an international index and a fixed income index, should produce a lower volatility as compared with a singular equity index. Unfortunately, these tenants create a problem as it relates to performance. The more “watered down” a strategy is through extensive diversification and asset allocation, the more likely the strategy’s performance will be impacted. This performance impact can be exaggerated when the TAMP’s fees are deducted from the gross performance, resulting

in an underperformance when compared to the TAMP’s benchmark.

Conclusion

When deciding to invest, it is always important to make sure you understand your financial goals, investment goals, and comfort with risk. If you are an investor who is very risk tolerant and is comfortable with singular equity risk, then the risk of stock picking may not be a concern for you. On the other hand, if you are not interested in a single security risk and would prefer to use pooled investments like mutual funds or exchange traded funds, then you will need to conduct your own research regarding which fund managers are best suited for your investment strategy. However, if you are an investor that does not want to perform the necessary research on various fund managers, then you may need to consider employing the services of an investment company. If you do employ an investment company to manage your funds then make sure you understand how their model portfolio(s) are constructed, what the performance history looks like, and whether their strategy is aligned with your financial objectives.

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