THE PORTFOLIO FOOD PYRAMID

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FRONT MATTER

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THE IMPORTANCE OF DISCIPLINE

Before you make any financial or investment decision, ask yourself whether it maintains a portfolio that is:

- Transparent
- Low-churn (hence, low-tcost and low-tax)
- Diversified
- Risk-managed (controlling volatility, skew, kurtosis, value-at-risk, and stress losses)

If the answer is “no”, DON’T DO IT!

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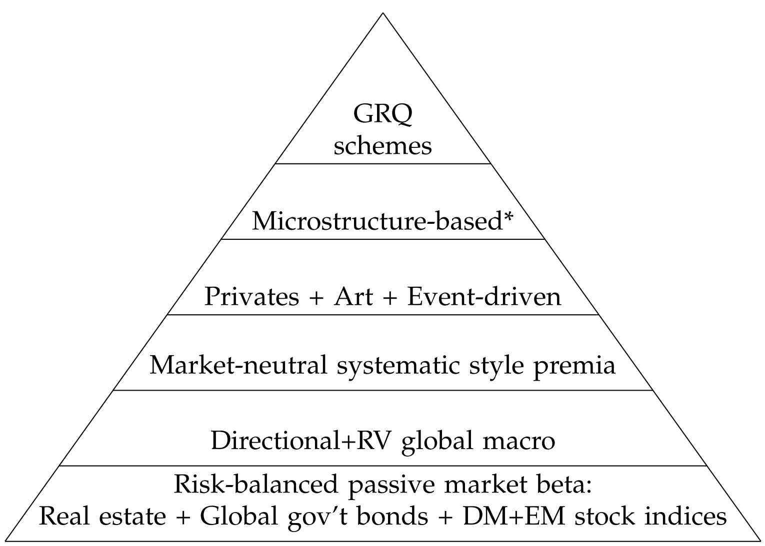

*Things like stat-arb and HFT

As you go rightwards and up the pyramid, asset classes become increasingly hard-to-access and low-capacity. Each layer of the pyramid should be long-term-uncorrelated with—or point-in-time-hedged against—moves in the layers below. Otherwise, all you’re doing is adding an illiquid, expensive, undiversifying version of the same stuff you could have gotten below! For example, a lot of corporate-bond funds mainly just load up on single-name default risk (which is highly-correlated with single-name equity risk, which is highly-correlated with global equity risk, which is easier and cheaper to get from liquid stock-index ETF’s or futures) and global yield-curve risk (which is easier and cheaper to get from liquid government bonds or interest-rate swaps). The flip side of this is that, if you can find a good and trustworthy manager, going upward offers more opportunities to generate true “alpha” (proprietary and reliable bets on idiosyncratic returns) rather than just scamming you with expensive blackboxes full of beta (well-known long-term-compensated global risk factors).