Be a Barbell investor, Not a Dumbbell investor

Stockholm (HedgeNordic.com) – Modern Portfolio Theory (MPT) has become the standard method of asset allocation for investors in the last twenty years. Most investors have a tendency to structure their portfolio as a pyramid. The base is normally made up of low-risk, low-return like bonds, preferably governments. The middle layer is smaller and consists of blue chip dividend paying stocks, index funds or global equity funds. At the top of the pyramid are small-cap stocks, development-stage biotech, hedge funds, private equity etc. Some investors also apply some sort of portfolio hedging overlay using a combination of different options, futures, and forward strategies.

Most investor portfolios end up in the middle-of-the-road with two significant drawbacks. The first is that it is very hard to control your absolute risk this way. Sure, investors can control their relative risk by shifting some money at the margin back and forth, such as from bonds to stocks. However when large market events happen such as 2008, 2002 and 1929, which some investors refer to as "black swan events", investor portfolio losses are un-proportional and years of previous performance gets wiped out. The second problem is that the MPT pyramid isn't likely to generate enough returns to make up for those portfolio losses in the foreseeable future.

A barbell strategy in its simplest form focuses on the extreme ends of the risk spectrum. Typically it comprises a high alpha strategy that carries a higher level of risk and a lion's share in a low risk and low cost strategy. This is very different from the classical MPT pyramid approach. In other words, investors should have extremely safe investments that will give them a fighting chance against inflation, deflation or whatever comes – with very low risk of blowing up. That might be up to 80-95% of the entire investor portfolio, depending on the investor's portfolio time horizon. At the other end of the spectrum it should be higher risk investments that will pay off hugely if it works out. Not too many of them, with not much money invested in each one.

Investors know that the risk at the safe end of the portfolio is very, very low and they know that the risk in the other end of the portfolio is very, very high. However, investors can control risk by moving a little money from one end of the barbell to the other, because when investors are limited to very low or no risk in the middle, it will only take a small shift between the two ends of the barbell to make a big difference in investors' overall risk and hopefully contribution (performance).

While the average MPT investor's portfolios ends up with a middle-of-the-road portfolio return and risk with only some small variances, the barbell strategy allows an investor to take advantage of higher risk opportunities, especially those with an asymmetrical reward.

Investors and those relying on professional money managers can also save time and money, by depending on investments with more predictable returns for the majority of a portfolio. The time and resources which are freed up may instead be spent on fewer high conviction investment ideas, ie well understood investments with a greater expectation of return and alpha.

Applying the barbell concept of constructing portfolios could result in either a single portfolio or a span of different barbell investor portfolios. For instance, an investor could create equity, fixed income, geographic or a standalone single overall barbell portfolio.

Also unlike the classical MPT investors collecting mutual funds, blue-chips and ETFs, the barbell investors actually know how much risk he is taking, and where. This has become the major battle ground for investment survival in today’s market environment.

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