Core-satellite investing explained

Why a version of the 85-15 approach could work for you.

Summary: Core-satellite investing can provide the potential to outperform the market.

Key take-out: Active 'satellite' investments can have huge upsides, but are also subject to rapid downsides – often more severe than the market as a whole.

When it comes to investing, I am conservative by nature. I prefer the less glamorous side of strategic advice, that is, the interplay between superannuation, social security, investment and tax policy.

There are, however, many in the investment community who want advice for 'best performance' returns. In some cases, a core-satellite approach can be a sound investment strategy.

Core-satellite investing explained

For investors who are interested in following a core-satellite strategy, I generally recommend that 85 per cent of the portfolio is indexed to the market. This 'passive' component is the 'core' part of portfolio. It acts as the insurance policy to avert disaster for the medium- to long-term investor because of the level of diversification it provides. As the market moves, so does the core of the portfolio.

The remaining 15 per cent of available funds are the 'satellite' element of the portfolio. These funds take 'active' tilts and lean towards specialist asset classes. This strategy will give an investor exposure to the active side of investing, but not to the extent they are risking their entire portfolio and/or their retirement savings.

For the more risk averse, smaller satellite exposures will also keep total portfolio costs down. Active tilts are often much more expensive investments than passive investments.

Active satellite investments may have the potential for greater upside than the market, but also more severe downside.

If a satellite gets 'lift-off' – in other words, the sector booms – the overall portfolio could very well outperform the market. Obviously, the reverse is also true, hence the argument for a smaller tilt and not one that could risk blowing up the portfolio.

This is one of the reasons I would generally only recommend this approach to investors with larger portfolios who have the capacity to handle greater market volatility.

Examples of satellite investments

There are several satellite investments that could be worth considering, including infrastructure, small caps, and Asia as a market overall.

Infrastructure

Since the GFC, on a global level, governments have been investing heavily into growing infrastructure. In the latest Federal Budget, the Government allocated $24.5 billion for additional infrastructure projects, bringing the total infrastructure spend to $75 billion. And, considering interest rates are at historically low levels around the world, the potential for upside is attractive. Infrastructure also tends to have a complementary correlation to the sharemarket and therefore can reduce the volatility of a portfolio.

Small caps

These are companies that sit at the tail end of sharemarkets and are sometimes described as the ugly ducklings of investing. They might go unloved because they are smaller and/or newly listed companies, but sometimes, we see them grow into swans.

It is often forgotten that Apple, Facebook and Microsoft were all once small cap players, until their transformative business models started getting traction.

Small caps work well as an active tilt because more well-capitalised stocks are analysed to within an inch of their lives. Small caps often slip under analyst radars, and therefore, allow an enormous upside.

Having said that, last year most active small cap managers were beaten by the index. That can be the nature of speculation. This further reinforces why only small active tilts are recommended.

Asia

As a market, Asia remains very attractive as an active tilt. Within eight hours' flight time from Sydney, an unprecedented social change is occurring, and consumers in these countries are demanding goods and services not unlike those we currently enjoy in the west. The business opportunities in Asia have grown, and they continue to grow exponentially.

Potential for active fund managers to outperform the index in Asia remains relatively high. Research has time and again determined that Asian equity markets are less efficient than their developed country counterparts. Paying extra for an active manager to undertake the extra research for stock selection can be worthwhile.

The bottom line

Over the last five, 10 and 15 years, research has repeatedly shown that most active managers have not been able to beat index benchmarks.

Of course, no one can consistently beat the market, and as I often tell my clients, if I knew how to beat the index consistently I would not be selling that information. I would use these 'superpowers' for my benefit and never give my secrets away. Even Warren Buffett, 'the Oracle of Omaha', widely regarded as the world's greatest investor, says he would advise his family to follow a passive investment approach, unless they had developed his kind of 'oracle-like' insight into the markets (and deep pockets).

Hence, the 'solid core' of a core-satellite approach is based on low cost, fully diversified index investments, allocated in line with the investor's risk profile (the degree of willingness for exposure to greater market volatility in exchange for the prospect of higher long-term returns). The additional cost of a modest active tilt should also not blow out total portfolio investment costs.

In line with my conservative view, I believe that thirst for speculation in investing should be tempered. Human nature is such that we are often victims of irrational enthusiasm. If we get our speculative investments wrong and are at a stage of life where it would be difficult to recover, it could be very painful.

This is the primary difference between 'investing' in the sharemarket and 'betting' on the sharemarket, which is what many people do. If you want to bet on the market why not instead head to the casino and put your life savings on either black or red.

You will know the outcome much sooner and could retire in great comfort – or end up not retiring ever!

Theo Marinis