

Anatomy of Portfolio Trading

(April, 19, 2019)

No matter how carefully a portfolio coordinates with an investor's objectives and risk tolerance, poorly conceived and executed trades can undercut its long-term success. Although intelligent trading is critical, most investors find it opaque.

Confusion arises, in part, because the popular term 'trader' connotes someone who trades to maximize short-term profit and loss [P&L]. P&L-oriented strategies put a premium on speed and order type (market, limit, etc.) – not to mention the choice of trading venue (open market, crossing network, 'dark pool,' and so forth). An order type tells the market how you wish your order to be treated, whether to hide your order, execute immediately at the market price, execute only if the price moves in a favorable direction, execute only if the trade can be filled within the next few milliseconds, and so forth. There are dozens of order types that traders use to try to beat their counterparties. Such trading tactics often go hand-in-hand with attempts to time markets – i.e., to predict market movements over short periods.

Let's be honest: if you are a short-term P&L-oriented investor, you are almost certainly not a client of this firm. First of all, as a matter of firm policy, Schultz Collins does not accept trading accounts. Second, our clients invest to meet long-term objectives – education funding, retirement income, bequest objectives, and the like. Third, and of utmost importance: Schultz Collins acts as a fiduciary with respect to everything we do for each client engagement. And fiduciary acts are seldom hasty. On the contrary, the hallmarks of prudent fiduciary conduct are care, skill, and caution.

The fiduciary standard of caution utterly precludes hasty trade execution.

In the complex context of portfolio trading, haste truly does make waste.

The central question we ask then is not: how much money can we make on this trade? Nor is it, ever: how soon can we get this trade done? It is, rather: does this trade comport with our client's unique long-term financial objectives and risk tolerance?

Let's take a closer look.

Recently a client needed to withdraw \$40,000 from his portfolio and approximately \$25,000 of that amount needed to be in the form of a Required Minimum Distribution from his IRA. His Schultz Collins advisors wanted to mitigate any resulting tax liabilities in the trust, and to preserve the portfolio's intended asset allocation. The portfolio had a target allocation of 70% to stocks and 30% to bonds; and,

roughly 60% of the portfolio assets were in taxable accounts, and 40% in IRAs. The \$40,000 withdrawal target required an additional \$15,000 from the taxable trust account.

This combination of factors can make planning an appropriate set of trades rather tricky. We often call the exercise “three-dimensional chess,” because it requires simultaneous consideration of asset allocation, tax implications, and asset location (whether a particular investment is better held in a taxable account than in a tax deferred account), the existence of multiple accounts, and both current and future distribution needs. We use a sophisticated rebalancing tool that enables us to view most of this information on two computer screens. The first screen displays data downloaded to us by custodians; the second provides an overlay of portfolio management tools. A screen capture below highlights one of the sell transactions (Emerging Markets) for this particular client’s request:

Total buying power	\$1,649,545.50	Total cash	\$40,614.16	Model	Case Study Model: 70/30
Household value	\$1,674,545.50	Excluded cash	\$25,000.00	Cash outside tolerance band	\$6,985.05
Cash available for trading	\$15,614.16	Simulated cash	\$0.00	Cash outside rebalance band	\$7,644.87

Overview	Positions - Horizontal	Positions - Vertical	Rebalance - Horizontal	Rebalance - Vertical	Taxes	Restrictions	Equivalents	Orders	Charts	Tasks	Notes	Other Details	Audit Trail
One or more accounts will have a negative cash balance post rebalance. Other messages require your attention. Review the Messages box.													
Action: Rebalance the household to its assigned model													
Code	Description 1	Description 2	Current (\$)	Trade (\$)	Current (%)	Model (%)	LTR-Gain (\$)	Post (%)	R-Gain (%)	U-Gain (\$)			
41163GAF8	41163GAF8	Harcourt Gener...	394.22	0.00	0.02 %	0.00 %	0.00	0.02 %	0.00 %	394.22			
EQ: EM	Equity: Emerging Mark...	EQ: EM	109,305.93	-40,010.80	6.63 %	4.06 %	8,994.47	4.20 %	29.00 %	20,147.87			
ODMAX	ODMAX	Oppenheimer D...	0.00	0.00	0.00 %	0.00 %	0.00	0.00 %	0.00 %	0.00			
VEJEX	VEJEX	Vanguard Emer...	0.00	0.00	0.00 %	0.00 %	0.00	0.00 %	0.00 %	0.00			
VERSX	VERSX	Vanguard Emer...	0.00	0.00	0.00 %	0.00 %	0.00	0.00 %	0.00 %	0.00			
PREPLACE	PREPLACE	Nwide Adv Solu...	0.00	0.00	0.00 %	0.04 %	0.00	0.00 %	0.00 %	0.00			
DFCEX	DFCEX	DFA Emerging ...	44,505.83	0.00	2.70 %	0.58 %	0.00	2.70 %	0.00 %	5,580.73			
DFEMX	DFEMX	DFA Emerging ...	0.00	0.00	0.00 %	0.58 %	0.00	0.00 %	0.00 %	0.00			
SPEM	SPEM	SPDR Portfolo ...	0.00	0.00	0.00 %	0.58 %	0.00	0.00 %	0.00 %	0.00			
EEM	EEM	iShares MSCI E...	64,800.10	-40,010.80	3.93 %	0.58 %	8,994.47	1.50 %	29.00 %	14,567.13			
0829 i	rman Trust		64,800.10	-40,010.80	3.93 %	0.58 %	8,994.47	1.50 %	29.00 %	14,567.13			
0869 i	Roth IRA		0.00	0.00	0.00 %	0.00 %	0.00	0.00 %	0.00 %	0.00			
0870 i	Trad IRA		0.00	0.00	0.00 %	0.00 %	0.00	0.00 %	0.00 %	0.00			
0872 i	Roth IRA		0.00	0.00	0.00 %	0.00 %	0.00	0.00 %	0.00 %	0.00			
VWO	VWO	Vanguard FTSE...	0.00	0.00	0.00 %	0.58 %	0.00	0.00 %	0.00 %	0.00			

Note that we track—highlighted in yellow—several variations on the allocation to Emerging Markets: (1) the allocation target of the Investment Policy Statement “Model (%)”, (2) the current allocation, and (3) the post-trade allocation. We also track (again, in yellow) the estimated recognized gain from the proposed sale. The sale changes the portfolio’s allocation to Emerging Markets from 6.63% to 4.20%, much closer to the target model allocation of 4.06%.

Tax considerations also come into play: although we needed only an additional \$15,000 from the taxable trust account, we recommended a sale of \$40,000 from the Emerging Markets position. \$15,000 was sent to the client; the remaining \$25,000 was used in a rebalancing trade to preserve the overall asset allocation. Estimated long term capital gains are \$8,994. In this case, maintaining a constant asset allocation outweighed the relatively small, added tax liability.

A second set of trades is outlined below. It shows the parallel and concurrent use of cash for a rebalancing trade in the underweighted fixed income asset class. The portfolio requires a 3% allocation to short term bonds. You can see the sale of \$24,669.54 (a full liquidation of the short-term bond position) in the IRA would expose the client to added risk because it would strip these short-term bonds from the asset mix. However, by using \$25,000 from the Emerging Markets sales in the trust account,

we managed to “shore up” the shortfall in the short-term bond allocation per the risk/return guidelines in the client’s Investment Policy Statement.

Total buying power	\$1,649,545.50	Total cash	\$40,614.16	Model	Case Study Model: 70/30	...	X
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Action: Rebalance the household to its assigned model

Code	Description 1	Description 2	Current (\$)	Trade (\$)	Current (%)	Model (%) ▲	LT R-Gain (\$)	Post (%)	R-Gain (%)	U-Gain (\$)
DFIHX	DFIHX	DFA One Year ...	76,654.58	0.00	4.65 %	2.84 %	0.00	4.65 %	0.00 %	-178.76
SHY	SHY	iShares 1-3 Yea...	24,669.54	25,340.82	1.50 %	3.00 %	-315.58	3.03 %	-1.26 %	-315.58
0829 Ca	an Trust	..	0.00	50,010.36	0.00 %		0.00	3.03 %	0.00 %	0.00
0869 Jol	th IRA	..	0.00	0.00	0.00 %			0.00 %	0.00 %	0.00
0870 Ca	ad IRA	..	24,669.54	-24,669.54	1.50 %		-315.58	0.00 %	-1.26 %	-315.58
0872 Ca	th IRA	..	0.00	0.00	0.00 %			0.00 %	0.00 %	0.00
PTLDX	PTLDX	PIMCO Low Dur...	0.00	0.00	0.00 %	3.00 %	0.00	0.00 %	0.00 %	0.00

Our careful and comprehensive fiduciary approach to trade planning, evaluation and execution is possible only because we have invested thousands of hours to set up and track individualized client portfolio models, asset allocations, trade restrictions, trading costs at various custodians, drift variances, asset redemption fees, availability of low-cost institutional share classes, and other important parameters – including, of course, and most importantly, client preferences and constraints. Our database updates market values, transaction histories, and tax bases every morning, so that we can see what we might best do for each client, given his policy decisions.

It is important to stress that, however great their embedded intelligence, our computer systems are no more than aids to trade evaluation. They set the table for our work, and no more. The entire process requires active, alert, and informed involvement by your team of advisors at Schultz Collins, who evaluate the benefits and costs associated with every trade.

No matter how detailed and comprehensive it may be, a computer trading platform is no substitute for intelligent, careful judgement.