An Interview with Edward Mitchell, portfolio manager, INVESCO Total Return Fund

A Conservative Stock/Bond Balance Using an Asset Allocation Approach

In this month's Mutual Fund Workshop, John Markese describes the characteristics of asset allocation funds. The category can be difficult to analyze because of the varying definitions attached to the term. For some funds, the term refers to a long-term diversification strategy among major asset classes, while for other funds the term implies a market timing approach, shifting between the various asset classes.

A perusal of the table on pages 4 and 5 illustrates the wide differences that exist among these funds—in their asset allocation strategies, the types of securities in which they invest, and, needless to say, in their performance.

Among the funds that have performed well over the long term relative to its peers is the INVESCO Total Return Fund. Over the past five years through year-end 1996, the fund had an average annual return of 12.8% compared to 11.0% for the average asset allocation fund; over the past three years it returned 13.9% annually compared to 10.7% for the average asset allocation fund; last year the fund returned 12.3% compared to 13.9% for the average asset allocation fund. (For more performance comparisons, see the table on pages 4 and 5). Currently, it has about $1.5 billion in total assets.

In early May, portfolio manager Edward Mitchell discussed the management of the fund with Maria Crawford Scott.

What are the investment objectives of the fund?

It's a balanced fund, and the objective is to earn a reasonable rate of return versus the appropriate benchmark, which we would normally consider to be 60% of the S&P 500 and 40% of the Shearson Lehman corporate government bond index. Basically, this is a relatively conservative fund that's designed to give some participation in the equity markets but with a reduced level of risk by including fixed-income securities in the portfolio.

We also classify it as an asset allocation fund.

It definitely has an asset allocation component since we vary the allocations somewhat. The allocation varies between 30% and 70% in equities and we have a model that we use to tell us where we need to be at any particular point in time. Only under highly unusual and rare circumstances would we exceed the maximum of 70% in stocks, although the prospectus does permit us to do so.

How much has the fund varied its stock commitment within the last five years or so?

Not a lot—our stock commitment has been as high as 70% and as low as 55%.

How does the model work?

It is pretty straightforward. First we calculate what we think is a reasonable expected return—what an investor might experience over a long period of time with a diversified portfolio of common stocks. Given where stocks are today, their historical profitability, their reinvestment range and so forth, we think stocks are priced on average to give you a return somewhere close to 10%, which coincidentally happens to be what the long-term historical average has been, or maybe slightly below it. Then we compare that expected return to the yield-to-maturity for an index of longer-term, high-quality corporate and government bonds. When the spreads [the difference between the expected returns and the yield-to-maturity] are narrow, we tend to lean more toward bonds relative toward stocks, and when they're wider, we'll tend to lean more toward stocks relative to bonds. That said, let me add that our neutral position is 60% stocks, 40% bonds.

So, we vary the mix depending on the relationship between stock returns and bond returns, and most of the time the spreads are between 0% and 5%. We've seen two very brief periods where they've fallen outside of that range, and the average over a longer period of time is about a 3% spread. So with our model, a 3% spread is equal to a 60/40 mix.

How do you come up with your long-term equity return estimates?

We use a modified dividend discount valuation model on a large universe of medium and large-sized companies, 800 to be exact. We calculate an expected rate of return for each company in that universe, and we use the

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The INVESCO Total Return Fund is part of the INVESCO family of funds, P.O. Box 173706, Denver, Colo. 80217; 800/525-8085; www.invesco.com.

median return as a proxy for the market.

I think what's unique about this approach is that we are not making any forecasts about the economy, interest rates, or anything else. Instead, we start with a universe of companies that have a fairly long and analyzable financial record. In valuing each company, we look at the company's assets per share, then what they earn on those assets now and what they have earned on them over a long period of time—we look back at least 10 years. This allows us to determine a reinvestment rate and, assuming the historical record is still representative of what the company might do in the future, this is the rate at which we assume the company would grow its earnings and dividends in the future. From this, and given the current price of the stock, we can determine an internal rate of return, or what we would call the expected return. And as I said, the average return for the 800 companies is our long-term equity estimate.

And you make your stock selections for the equity portion from this universe?

Yes. Of course, you need a cut-off, and we select the top one-third as the most attractively valued. The next step in the process, and the one that's more difficult, is to look at the data and determine whether the firm's record is meaningful going forward. In other words, since you are valuing these companies based on their record, is it reasonable to assume that the record is meaningful going forward or has something materially changed either in the company, its industry, or the environment in which it operates that would make the record less useful? If it has, the stock is eliminated from further consideration. So, we start with 800 companies, work our way down to maybe 100 companies we think are valued attractively and have records that are useful for valuation purposes, and these are the companies we use to construct the portfolio—we'll include maybe half of those.

The goal is to not only have stocks that we think are going to give us better than average returns, but to construct a portfolio that controls the risk as well. For that reason, we have highly diversified portfolios. The Total Return Fund has close to 70 stocks in it, primarily in the larger-cap area, and we tend to be fairly equally weighted across the board—we're not taking large sector bets or individual stock bets. Compaq, IBM, American Home Products—those are the kinds of stocks that are in the portfolio.

What about international stocks?

We do invest in international stocks in the sense that we have in our universe of 800 companies about 60 foreign corporations that are traded here (on U.S. exchanges) either in registered or ADR form. That includes stocks like Royal Dutch and Unilever—names that most people readily recognize. ADRs in the portfolio include Hanson and Telmex.

How do you manage the bond portion?

We start with the premise that in bonds, you really don't get paid for taking risk in the sense that the longest maturity bond only gives you a slight advantage in terms of total return compared to an intermediate bond, and yet it has a great deal more risk. So our neutral position is an intermediate-term maturity, but if we saw very high real yields we would extend the maturity somewhat. The way we monitor that is we take the nominal yield and adjust it for longer-term inflation, to determine the real yield. Normally, the real yield should be somewhere in the range of 3%. If we can find real yields significantly above 3%, then we may extend the maturity and go as far up as we can. But if it drops below 3%, then we reduce our maturity strategy. So, it's a risk-averse approach. And for the most part, we own only high-quality bonds—corporates, Treasuries and agencies—but again, based on historical relationships, we'll own a lower-quality bond when the yield spreads are decidedly in our favor to do so. Actually, right now we own mostly Treasuries because the spread between them and high-quality corporates is not very large, so you are not getting paid to take the risks, such as credit risk and call risk.

What about the cash position?

We minimize cash. We can control risk in so many other ways that we think that would be almost too risk-controlled. And besides, trying to time the market is very difficult—it actually tends to add more risk. To reduce risk, we stay pretty fully invested and control risk through the asset allocation process, through diversification and stock selection on the equity side, and through maturity and sector policy on the bond side.

What would prompt you to sell a stock, other than changing asset allocation decisions?

What creates a sale would be a stock's change in ranking. In our ranking system, with 1 being the best and 100 among the worst, if a stock's price has gone up relative to the rest of the stocks in the universe, its ranking will deteriorate. At that point, we might reduce it, or we'll actually eliminate it if it becomes so overvalued that it falls within the tail of the distribution—in the 85th percentile or higher. We have a control which says that when you weigh all the stocks in the portfolio by their relative percentages times their individual rankings, we want to maintain a 30% or better ranking. If we begin to drift beyond that, then that means we're going to have to sell some stocks that aren't as highly ranked and reinvest in ones that are better-ranked. It's kind of a refreshing process that goes on continuously, and it results in a relatively low turnover. We tend to buy stocks that may temporarily be down in price or out-of-favor and usually there's good reason for that, so that suggests we're going to have a longer-than-average holding period in order to capture the higher expected return we think conceivably exists. So with a 20% turnover, the average holding period might be something around five years for a company.

What tends to have a greater impact on stock transactions—allocation changes or changes in the rankings?

Well, that's a good question because up to this point we've had strong cash flows in the fund, so the model really hasn't had a chance to work like it normally would. We haven't had to make a lot of sales to achieve a target asset allocation target, plus we haven't had any significant swings in our target asset allocation that would prompt large sales in the portfolio. But that's something that concerns me because if we go from 70% to 60% in equities and we've got $1.5 billion in the fund, that means we're going to sell something like $50 million to $60 million in stocks, which I don't mind doing but we try to minimize transaction costs. So one of the things we are asking the fund directors to approve is the use of financial futures to help manage the asset allocation process. And if that's approved, I'll be much less concerned about the transaction costs involved with asset allocation shifts.

What kind of investor is best-suited for the fund?

The fund appeals most to those who are risk-averse. One way I think it could be used is as a core portion of your portfolio and then you can augment it with other strategies, where you may want to have an emerging market fund or a small-cap or a growth fund. So this would be your anchor and you could step out with some of these other strategies to provide a little greater return but still have a fairly well-diversified, risk-controlled investment approach.

Basically, the fund provides a combination of income and appreciation. In terms of returns, you have to be realistic. We have a normal position of 60% in stocks, and typically stocks on average return 10%, although with prudent management, maybe we can augment that a little bit. And bonds typically give you somewhere between 6% and 7%. So the fund should provide a longer-term return somewhere in between 8% and 10%, but with a low level of volatility, and a high degree of consistency and predictability.

What kind of risks would an investor be taking on?

Well, if the stock market and the bond market go down together in a substantial manner, that would result in returns being nominal or possibly negative. But I would think that would be a rare situation. It's important to realize that these corrections do occur from time to time, but they are simply that—corrections of the longer-term trends. Typically, the asset classes work in your favor, because they're positive.

What benchmarks do you compare the fund against?

Internally, we track the fund relative to a 60/40 benchmark [an index invested 60% stocks and 40% bonds] and then we compare the fund to other balanced and asset allocation funds to see how we're doing versus the competition. The problem with comparing against other funds is there is so much difference in how the funds are constructed and the types of securities that are in them. For example, our fixed-income component is primarily government bonds and high-quality securities, while some other fund may use convertibles and high-yield bonds.

How does the fund compare to your 60/40 benchmark? How much of the fund's return is due to asset allocation decisions versus security selection?

We've typically outperformed the benchmark by 1% or something along those lines.

Asset allocation would be the most important, and because we typically have had more in stocks, that has been a plus over the last several years. Last year, our stock portion and bond portions both underperformed their benchmarks. The stock portion only marginally underperformed the S&P, by around one-half percent. On the bond side, we underperformed that because we shortened our bond portfolio early in the first quarter of last year after interest rates had moved and we almost locked in the loss for the year, but we maintained the shorter duration and it is helping us this year. But the asset allocation helped us last year.

And right now, we're targeting about 64% in stocks. And that's just about where the fund is, so we're in pretty good shape.