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The Portfolio

Finding Your Client's Place on the Efficient Frontier

Billion-dollar boutique API Funds seeks to put modern portfolio theory into investment practice

By Gil Weinreich

Modern Portfolio Theory plays a role in academic finance, but for Dave Basten, CEO of API Funds, MPT plays a unique role in investment practice.

The founder of the billion-dollar boutique fund company believes API Funds is the only fund company that "conquers" the efficient frontier with six funds that lie on key points of Harry Markowitz' famous upward-sloping curve linking the highest expected return for any given level of risk.

So on the low-risk, low-return bottom left corner of the axis investors can find API's Core Income Fund, then follow the curve upward toward its Income Fund, then Capital Income Fund, Master Allocation Fund, Value Fund and Growth Fund.

And as MPT theory might suggest, at least in steadily rising markets, each of these funds have progressively generated increasingly higher annualized returns compared to their lower-risk siblings over the past five years through Dec. 31, from 2.73% to 11.60%. (The past 10 years, which saw dizzying highs and lows, reshuffled the performance deck, however.)

"Our funds are what Markowitz called 'the balanced whole,'" Basten tells ThinkAdvisor in an interview. "You can adjust your risk by overweighting or underweighting our five funds." (Note that a sixth fund, API's Master Allocation Fund, builds a balanced allocation using the other five core funds.)

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So how is that different from an investor in any other broadly diversified fund — say, an investor in a broad-market-based passively managed index fund?

Answers Basten:

"Someone who is extremely conservative could come in and buy 60% Core Income and 20% Income fund and put the remainder in three equity funds, and their risk exposure would be inclusive of emerging markets all the way down to short-term Treasury markets," he says.

Widows and orphans, in conventional investment industry thinking, don't go long emerging markets, but correctly implementing efficient markets theory, according to Basten, means that "even our most conservative investor earns a piece of the far end of the efficient frontier."

The essential argument of Markowitz and efficient markets theorists is that investors can minimize risk and maximize return by not owning too much of anything nor too little of anything.

It's easy to see how this approach differs from active fund management. As Basten puts it, "most active managers [inherently] exclude large swaths of the market."

But how again, besides giving Grandma some emerging markets exposure, does API differ from a passively managed index fund?

“We’re very much like a passive index fund except we’re actively managed,” Basten explains. “If you look at the individual holdings, you would see as much diversification or more than the most diverse passive index funds.”

“The difference is that active managers for the most part are trying to beat the market,” he continues. “What we are trying to do is to try to get as much of the market into your portfolio as we can to diversify risk down to zero while expanding opportunities, because more is a lot better [than less from an MPT point of view].”

That’s straightforward enough. But Basten’s key insight goes to why an investor might want an actively managed broad-market fund rather than an index fund.

“All passively managed funds are actively managed to some extent,” Basten says. “They delete funds that get bought out or [otherwise no longer meet their index standards]; passive is always updating their portfolios; we supercharge that update one [security] at a time, as best we can. We would be always open to that next best idea that comes into our research.”

The API Funds CEO came into this through hard personal and practical investing experience. It started with his newspaper route money, which he invested for the first time at the age of 13 in Pan American Gulf Sulphur Co., whose rapid rise and quick implosion became an early lesson in the value of diversification.

When at age 21 Basten joined the Navy, turning over an inherited trust fund to a local stockbroker with a good reputation, the Virginia native found he lost 85% of the account value in just two years’ time.

Those formative experiences sent the young investor on a quest for a methodology that could generate superior risk-adjusted returns, a quest that became a day-to-day affair when at age 27 he joined his father-in-law Aubrey Mason’s brokerage firm, Mason and Lee, a predecessor firm to what later became Legg Mason.

Basten’s son, a principal at API Funds, is now the fourth generation in the Mason family to work in the investment industry, a point of pride for the Lynchburg, Virginia-based fund family.

While Basten cut his teeth at Legg Mason, the firm’s storied value-investing approach bothered the loss-averse investor, who worried that the firm would necessarily perform poorly when value was performing poorly.

So he started API Funds in 1985, growing quickly to $30 million in assets until the market crash of 1987 quickly wiped away a third of that. Aubrey Mason happened to be in the office on that infamous Black Monday, when even blue chips were melting down.

Basten recalls that Mason called his father to get his take on the situation, whereupon Mr. Mason Sr., a veteran of Wall Street since the 1930s, said: “I am placing orders as soon as I can get to the office today. This is a buying opportunity.”

Basten did likewise, putting into practice his active-management cum MPT approach of buying as many good companies as opportunity presented, and the firm had recovered from the October 1987 crash by the following May.

Three decades later, API Funds manages assets north of $1 billion, sold through advisors, primarily those affiliated through broker-dealers though increasingly, he says, through RIAs.

Basten says a key draw apart from the unique MPT investment philosophy is the fund company’s active marketing and sales support for advisors.

“We have a very open shop as far as our relationship with our selling reps and broker-dealers is concerned,” he says. “They can call into any of the portfolio managers if they have questions; our products are designed to be very friendly for their clients.”

It goes back to that highly conservative investor with emerging markets exposure, or an investor with an opposite risk profile.

“We’ll assist [advisors] if they have comparisons they’d like to have run. We want to help in structuring the risk/reward [dimensions] of their clients’ portfolios. We have different services that help them design portfolios and get clients in the right spot,” he says.

Though, as the standard investment disclosures put it, all investing involves risk, API Funds’ goal is to remove as much of it as possible for shareholders.

“Market risk is something we have to prepare for,” Basten says. “We’ve diversified away all of the individual security risk and most sector risk; the total market risk we have is the only risk we’ve accepted. We’re updating our portfolios on a constant basis so when we do go through a bad period like 2008-’09, we do our best to add things we find that are good.”