

Asset Allocation and Manager Selection

Adaptive Allocation

By Anthony B. Davidow, CIMA®

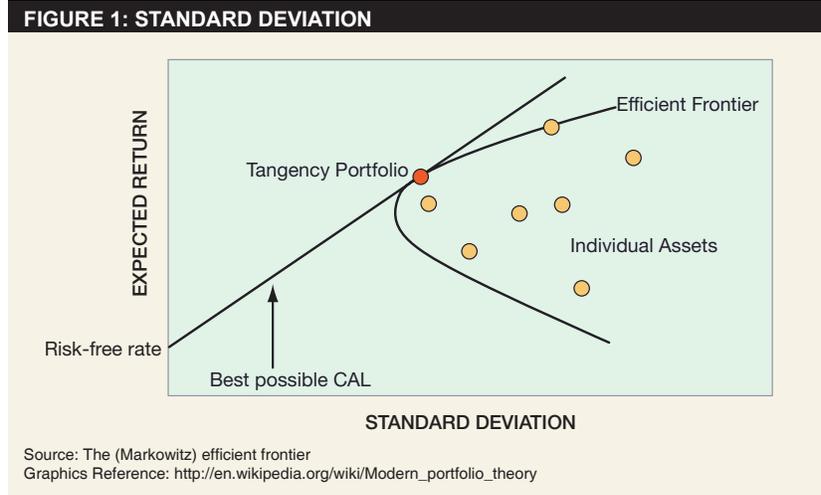
The market dislocation of 2008 has led to much debate about whether asset allocation is still a valid approach to investment. Some discount the merits of modern portfolio theory¹ because all correlations tend to go to 1.0 during times of extreme duress. Mohamed El-Erian, co-chief investment officer of PIMCO, argues that a “new normal”² exists and demands that investors spend more time evaluating tail risk.³ This paper considers the following:

- Is asset allocation still valid?
- Should investors be more tactical?
- What is the new normal?
- Is it active versus passive, or active and passive?
- What are the practical implications of these changes?

Historical Perspective

In June 1952, a 25-year-old graduate student named Harry Markowitz published a paper titled “Portfolio Selection” in the *Journal of Finance*. It received little notoriety at the time, but it is the root of modern portfolio theory (MPT) and it helped him win the Nobel Memorial Prize in Economics in 1990.

Markowitz (1952) discussed risk management through diversification. He suggested that by constructing a portfolio of two risky investments that have low historical correlation, an investor could reduce overall portfolio



risk. While this diversification seems very practical today, it was cutting-edge at the time. Building on Markowitz’s work, Sharpe (1964) took MPT to the next level and introduced the capital asset pricing model (CAPM), which describes the relationship between risk and expected return and introduces beta as a measure of market risk. CAPM prices risky securities taking into account the amount of risk taken and the time value of money.

Figure 1 shows the efficient frontier, which represents the optimal blend of asset classes (i.e., the optimal risk-return trade off). The capital allocation line (CAL) is a line created in a graph of the expected returns of all possible combinations of risky and risk-free

assets. The tangency portfolio is the portfolio on the efficient frontier with the highest Sharpe ratio that offers a greater return for a given amount of risk.

Brinson et al. (1986) evaluated the impact of asset allocation policy decisions. This is an often-cited (but often misunderstood) study that suggests that “. . . greater than 90% of a portfolio’s change in returns over time is attributable to asset allocation policy.” Interestingly, Brinson et al. (1986) studied the impact of stocks, bonds, and cash as the only assets available in allocation decisions.

Historical Asset Class Decisions

Asset allocation decisions have evolved beyond merely stocks, bonds, and cash (Brinson et al. 1986) to include distinc-

FIGURE 2: ASSET ALLOCATION—1986 AND 2010

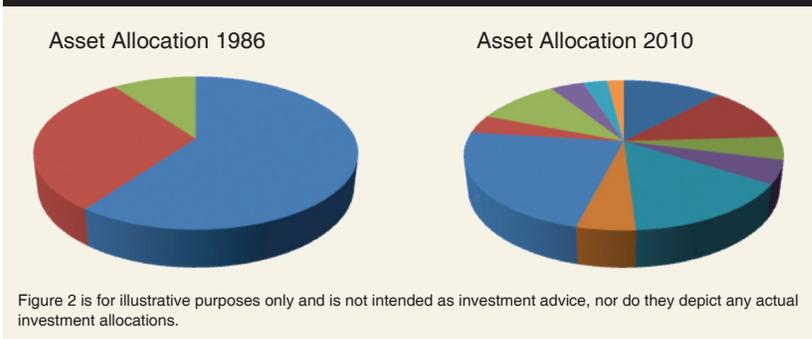


Figure 2 is for illustrative purposes only and is not intended as investment advice, nor do they depict any actual investment allocations.

TABLE 1: SAMPLE ASSET ALLOCATION FRAMEWORK

	Strategic	Tactical
Equity:	37	35
U.S.	25	22
International	10	10
Emerging Markets	2	3
Fixed:	37	35
Investment Grade	25	25
Global	10	5
High Yield	2	5
Alternatives:	20	24
Hedge Funds	10	12
Real Estate	3	2
Private Equity	2	2
Commodities	2	5
Inflation-Hedged	3	3
Cash:	6	6
TOTAL	100	100

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tions between large and small capitalization; value and growth; domestic and international; developed and emerging markets; and traditional and alternative investments (see figure 2).

As the array of asset classes has expanded, investors have struggled to determine appropriate weightings for each asset class. A number of commercial and proprietary asset allocation models are available, but they are driven largely by historical data that introduce biases. Most asset allocation models use mean-variance optimization as a

primary methodology. Mean-variance optimization exploits the risk, return, and correlation characteristics across multiple asset classes, and it generally assumes that future results will reflect historical norms.

Asset Allocation Today

In recent years, considerably more attention has been paid to tactical asset allocation, which overweights or underweights asset classes based on forward-looking views. This is not to be confused with market timing. Tactical asset allocation decisions can allow investors to respond more quickly to fundamental or technical factors driving the markets. Tactical calls allow investors to deploy capital more efficiently and can signal either the need for investors to gain/increase or reduce/avoid exposure to an asset class. Table 1 provides an illustration of strategic and tactical asset allocation frameworks. Strategic asset allocation guidelines are long term in nature, and tactical changes reflect short-term shifts in strategy.

The key to making good calls and appropriately deploying capital depends on one's access to and understanding of information. With the speed in which information is disseminated via the media, it is difficult for the average investor to process and respond to this information in a timely fashion, and more importantly, as quickly as needed.

During extreme events (like the 2008 financial meltdown), market correlations tend to go toward 1.0 (i.e., most markets move in unison). These events

remind us that markets aren't rational (even though over longer intervals they tend toward normalcy).

The New Normal

El-Erian's "new normal" suggests that asset allocation decisions need to be more adaptive or tactical. But are things really different now? Let's compare today's environment relative to the market in 1990, when Markowitz and Sharpe won their Nobel prizes.

Investment options have grown in the past two decades, and so has the complexity of investment instruments. Investing has gone global, companies now have global strategies, and many seek to capitalize on growth in less-developed markets. We have moved beyond basic stocks and bonds purchased by institutions and well-heeled investors to a global environment with participants of all sizes and all levels of sophistication.

Information flow also may be contributing to the changing investment landscape. In theory, the free flow of information should level the playing field and lead to more-efficient markets. The unintended consequence may be more panic and more rash behavior as information is readily available but not always properly analyzed. For example, the extraordinary growth of hedge funds has led to high-velocity trading that seeks to arbitrage away any pricing disparities.

So markets are different today. Investors need to adapt and asset allocation needs to evolve.

Manager Selection

Asset allocation has evolved over the years, and so have the ways investors gain exposure to markets. Investors used to merely seek a mutual fund that described itself in a particular manner. But many mutual funds have tended to drift as styles move in and out of favor.

Investment professionals also have often avoided investment managers who drift from value to growth, or up and down the capitalization spectrum. They seek "style pure" managers for as-

set allocation purposes. Unfortunately, many style-pure managers end up delivering market-like results because of limitations on the types of investments that fit their disciplines. Managers limited in where they can invest often look and perform much like the index. The growth of index-based strategies has spurred the debate over “active” and “passive” investments.

Figure 3 shows that it is very difficult to consistently outperform the benchmark. A manager may outperform one year then dramatically underperform the next.

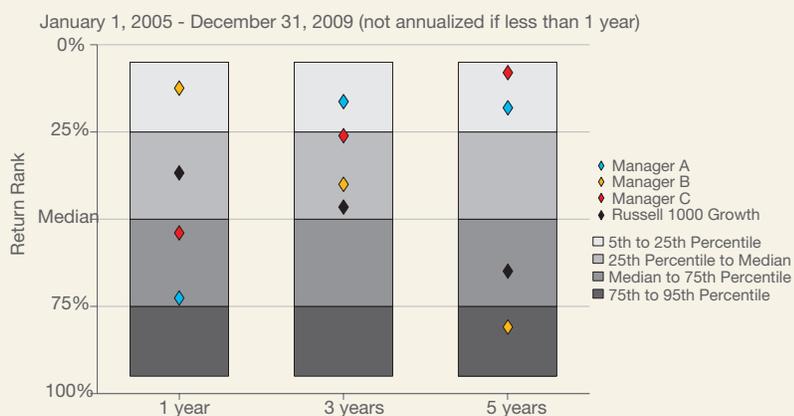
Investment professionals evaluate individual manager results, but—perhaps more importantly—they evaluate how multiple managers perform together. In other words, investment professionals emphasize the value of combining managers in such a way as to deliver favorable risk-return characteristics.⁴ Investment professionals will seek managers who exhibit low correlation to one another, i.e., who perform and react differently in various market conditions. To conduct this type of analysis effectively, an investment professional must analyze performance data and holdings of each manager.

Will the manager perform in the future as in the past? Clearly this is a judgment call. To further complicate matters, traditional manager search tools don't account for tax impacts, which should be a big consideration for taxable investors because taxes can dramatically erode gross returns.

Malkiel (1973) argues that the market is efficient and that the average investor likely will fail to beat the market with any consistency. Ironically, in 1973 an average investor seeking passive exposure was largely out of luck. Today, however, hundreds of exchange-traded funds (ETFs) offer exposure to virtually every slice of the market.

Investors need to consider how best to gain exposure to particular asset classes. They may consider separately managed accounts (SMAs), mutual funds, ETFs, or limited partnerships. Each has pros and cons.

FIGURE 3: MANAGER A, B, AND C VS. ZEPHYR LARGE-CAP GROWTH IN QUARTERLY UNIVERSE RANKING



Source: Zephyr
Figure 3 is for illustrative purposes only and is neither intended as investment advice nor a recommendation or offer of any specific security or strategy.

Asset allocation has evolved beyond merely stocks, bonds, and cash as addressed by Brinson et al. (1986). Investors now consider allocations into large and small cap, value and growth, domestic and international, developed and emerging markets, traditional and alternative investments. With such an array of investment strategies, investors need to consider asset allocation, manager selection, and vehicle selection. They need to determine the correct percentage allocation to each asset class. They need to evaluate the various strategies, and they need to determine whether to access actively or passively. Deploying capital intelligently is much more complex today than it was with MPT.

The Growth of ETFs

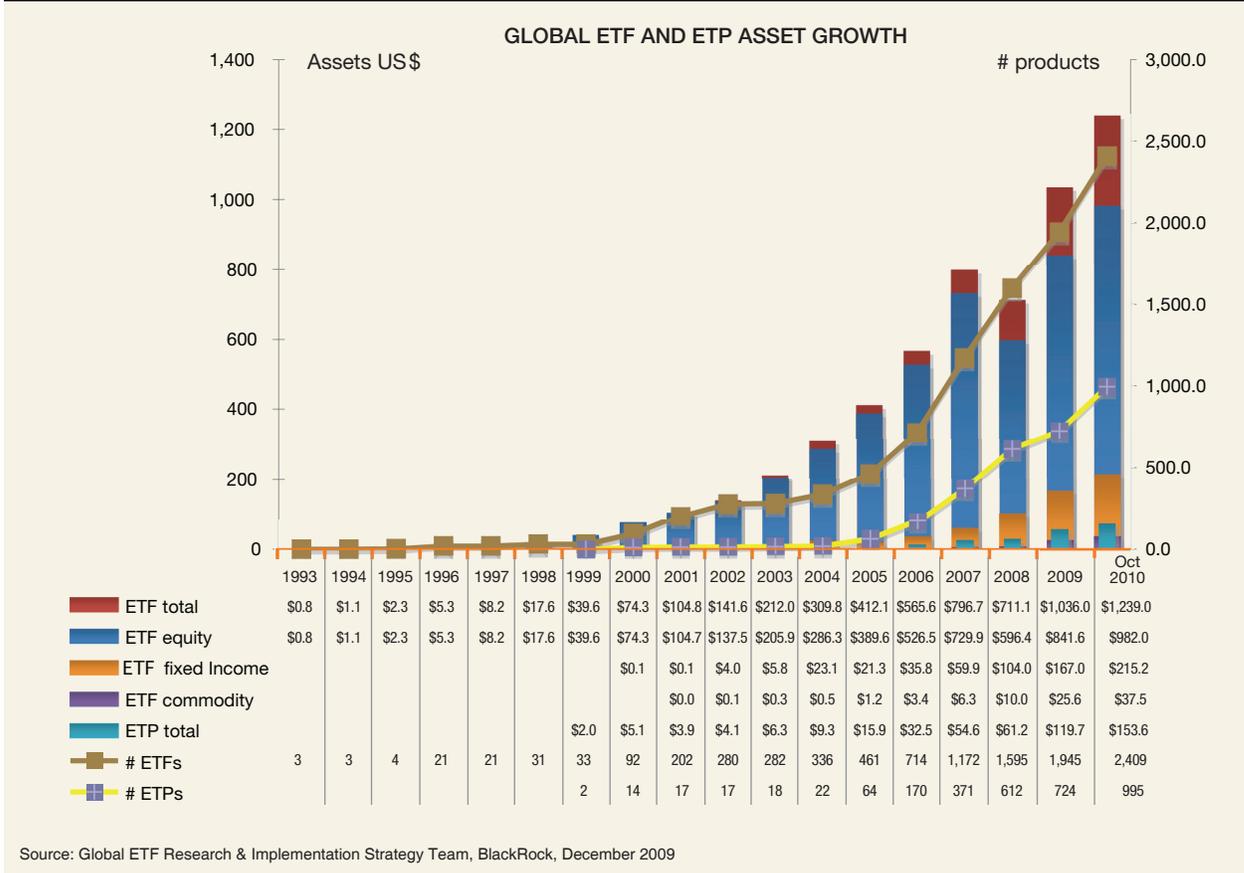
One significant development has been the extraordinary growth of exchange-traded products such as ETFs and exchange-traded notes (ETNs). Figure 4 shows the tremendous growth in the number of ETFs and the types of strategies packaged in ETF structures. The first ETF products were designed to offer passive exposure to the broad-based market sectors. Today, ETFs are designed to provide exposure to the broad-based equity markets, country

baskets, sectors, commodities, fixed income, and alternative investments. Institutions, family offices, and financial advisors have embraced ETFs as a way to gain exposure to myriad asset classes, including equities (large and small cap, growth and value, domestic and international, developed and emerging), fixed income (long and short duration, AAA, or high-yield, Treasuries, or Treasury inflation-protected securities or TIPS), commodities (gold, silver, oil, water, and combinations), and alternatives (hedge funds, merger arbitrage, and global macro).

ETF asset growth has been fueled by the fact that active managers have difficulty outperforming their passive benchmarks. ETF structure typically is designed to offer cost-effective and tax-efficient exposure to the underlying benchmarks. (There also is growing interest in active ETFs, which allow for active management within an ETF structure.)

ETFs are valuable asset allocation tools for implementing tactical decisions. More advisors are adopting ETFs as a primary way to gain asset class exposure. If asset allocation remains the most important investment decision, then ETFs are the tools for implementing those decisions.

FIGURE 4: U.S. EXCHANGE-TRADED FUNDS AND PRODUCTS GROWTH



But not all ETFs are created equal. Investors need to monitor each ETF to determine if it delivers. Ultra-short ETFs, which seek to achieve double the opposite return of the benchmark in a single day, were designed as a hedge for a falling market. Some were designed to provide two and three times the downside protection. But in practice many of these ETFs fail to mirror the downside, largely due to reset features. Many commodity ETFs don't perform as advertised, and they delivered K-1s rather than 1099s to boot.

ETNs snagged a lot of attention in 2008 due to counter-party risk.⁵ ETNs are an interesting structure, and in fact certain strategies fit better in an ETN than an ETF, making ETNs worthy of investors' consideration.

Core-Satellite

Perhaps the debate shouldn't be "active versus passive," but "active and passive."

FIGURE 5: TRADITIONAL CORE-SATELLITE MODEL



Core-satellite investing offers many variations of active-and-passive investment solutions. In the traditional context, an investor would seek passive/beta exposure to the most-efficient markets and active/alpha solutions to the less-efficient markets, as shown in figure 5.

FIGURE 6: ALTERNATIVE CORE-SATELLITE



Figure 5 shows exposure to hedge funds as alpha, because in theory hedge funds provide incremental return above and beyond the passive benchmark. But the extraordinary growth of hedge funds is making it increasingly difficult for hedge funds to deliver alpha. In



fact, many hedge funds deliver beta—alternative beta, but beta none the less. Alternative beta is the return derived from having exposure to common systematic risk factors in alternative asset classes such as hedge funds. Alternative beta is valuable, but it's not worth the excessive fees typically charged by hedge funds. In other words, don't pay alpha fees for beta results.

Academics have studied the separation of alpha and beta for years, and Sharpe (1992) was the first to bring the concept to the consulting community. Academics recently suggested that hedge fund results can be replicated through sophisticated regression analysis (Whitelaw et al. 2009). If alpha and beta can be separated, and hedge funds deliver alternative beta, then we have a more-evolved core-satellite model, shown in figure 6.

Figure 6 shows the alternative core-satellite model with the alternative exposures divided into sub-asset classes. Like traditional investments, some strategies are more prone than others to deliver alpha relative to the market. (Note that the hedge fund universe is the market for this example.)

Conclusion: Investment Implications

Investors need to evolve their views on asset allocation and manager selection. Rather than thinking about asset allocation, manager selection, and vehicle selection as separate decisions, investors need to consider them all as part of an integrated decision-making process. They need to evaluate asset allocation (strategic and tactical) and manager selection (active versus passive) as part of the same investment process. MPT has not become obsolete, but investors need to be more responsive to the change and complexity of the investment landscape.

Investors have a number of factors to consider in developing investment strategy. The following is a sample check list for investors and/or their advisors to consider:

- What is the appropriate long-term strategic asset allocation?
- Should you allow for tactical changes?
- Who is qualified, and who should make tactical changes?
- How frequently should portfolios be rebalanced or reallocated?
- Is the market efficient? Is the market always efficient?
- How should you evaluate investment options (individually and collectively)?
- Does active management perform better than passive management?
- Should you consider a core-satellite approach?
- Can you use core-satellite for alternative investments?
- How do you determine success or failure of your investment strategy?

Investors also must consider how best to gain exposure to a particular asset class. Investors need to evaluate individual

managers and managers in combination to build the optimal portfolio. Investors also need to evaluate which vehicle represents the best way of accessing a manager. They need to consider the value of a separately managed account structure versus a mutual fund structure. They need to evaluate attributes of an ETF structure and the limitations of a limited partnership structure.

MPT still offers valuable lessons, but investors need to evolve their views. With the increasing rate of change and flow of information, investors need to be more responsive to change. You can call that the new normal or call it being more tactical or adaptive.

Now more than ever, investors are seeking and may need professional help in developing long-term investment strategy. They need guidance in responding to the rapidly changing investment landscape. Investors need to develop strategy that is adaptive and responsive yet disciplined enough to keep them on the right path. Investors need help and guidance from trained professionals who have evolved their own views on the new investment paradigm. 

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Endnotes

- 1 Modern portfolio theory describes how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk that is emphasized as essential to achieve a higher reward.
- 2 See, for example, Adam Shell, "Pimco's El-Erian: 'New Normal' Argues for Investor Caution," *USA Today* (August 16, 2010), available at http://www.usatoday.com/money/companies/management/advice/2010-08-15-advice-el-erian_N.htm.
- 3 Tail risk is a form of portfolio risk that occurs when there is a high probability that an investment will shift more than three standard deviations from the mean.
- 4 A manager's past performance is not a guarantee of future results.
- 5 Counterparty risk is the risk to each party in a contract that the other won't honor its contractual obligations.

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