Rethinking Asset Allocation and Investment Selection
Principles for Making Informed Decisions

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A dvisors spend considerable time developing asset allocation programs designed to help their clients accumulate assets for retirement or other goals. Approaches to asset allocation continue to evolve in response to changes in markets, product innovations, and research that challenges conventional wisdom about investing (Ballentine 2013). After the financial crisis of 2007–2008, many advisors re-examined their approach to asset allocation and investment selection.

This article suggests a framework for advisors to consider when revisiting the asset allocation and investment selection process. The steps in the recommended process are asset class selection, capital market assumptions, investment strategy selection, and product selection.

Previously, diversified portfolios typically contained U.S. stocks, U.S. bonds (often Treasuries), and cash. Acting on academic research in the 1990s, institutional investors, endowments, and advisors began to add international equities (French and Poterba 1991) and other diversifying investments (Ankrim and Hensel 1993). Today, mainstream asset allocation structures for U.S. advisors include international developed markets and emerging markets stocks and bonds, significant exposure to smaller company equity holdings, and real assets such as commodities and real estate. The proliferation of alternative investments offered in mutual funds and exchange-traded funds (ETFs) has provided an easier mechanism for advisors to increase their use of alternative investments such as long-short equity, absolute return, and managed futures strategies. Following the same theme, the explosion of new ETF issuance has provided advisors with better hedging and tactical asset allocation tools.

Investments such as country funds, sector funds, and commodity funds allow advisors to express more nuanced positions within their portfolios and finely tune risk exposures in volatile environments.

Although we consider asset allocation to be of paramount importance, investment selection matters as well. Many advisors view the choice about whether to select an actively or passively managed investment as an absolute decision. Our view is that the optimal approach to investment selection for a diversified portfolio combines both active and passive investments.

We blend passive and active strategies to create a balance between passive investment strategies used in efficient asset classes and actively managed strategies used to gain exposure to less-efficient asset classes.

Asset Class Selection for Robust Asset Allocations

The classic balanced portfolio allocation of 60 percent stocks and 40 percent bonds, so common in decades past, has evolved in a number of deeper and broader directions. We believe that a potentially superior risk-return profile for advisors comes from asset allocation approaches that include exposures that are both deeper (extended capitalization and style representation) and broader (wider variety of asset classes; inclusion of non-U.S. investments). Newly popular asset classes with advisors such as leveraged loans, low-volatility equities, and managed futures can improve investor results. By adding less-correlated asset classes such as these, advisors can reduce the volatility of client portfolios, smoothing and possibly improving returns over the long term.

Investing in the latest industry innovation can be tempting, but we recommend caution when investing in less mature segments of the market. Due diligence is critical, starting with research into the role that the new asset class would serve in the portfolio’s asset allocation. Examining past performance of the asset class is a foundational exercise—identifying the effectiveness with which the asset class will contribute to portfolio performance. There are two persistent challenges in selecting an investment to represent an asset class. The first challenge is the extent to which the future performance of the asset class will—necessarily—differ from history. The second challenge lies in selecting an investment vehicle that will adequately capture the desired characteristics of the asset class. It is tempting to declare victory after reviewing historical results; however, a forward-looking view is necessary. Evaluating the vehicles available for investment is also important, because some asset classes are less investable than others.

Commodities provide a good example of the first challenge. Many institutional investors and advisors added commodities to their portfolios...
Commodities investments historically were used to hedge price risk for crops and raw materials, and the correlation studies that most frequently are used to justify inclusion of commodities reflect this historic market dynamic. Much as financial innovation changed the fundamental nature of the mortgage-backed security market in the years leading up to the financial crisis of 2007–2008, increasing interest in commodities and the proliferation of commodity-linked ETFs and exchange-traded notes has transformed commodity investing. Commodities are no longer just hedging instruments for a smaller community of market participants; they are used extensively for more speculative purposes. Consequently, correlations between commodities and equities have been increasing from the very low levels of 10 years ago, negating some of the theoretical and historical justification for including commodities as a diversifying investment.

Alternative investments illustrate the second challenge. Advisors increasingly have been using mutual funds and ETFs based on hedge funds and private equity funds, following the success of similar strategies popularized by Yale University’s endowment model. However, hedge fund and private equity strategies that thrived in private investment structures may not work as effectively when offered in a mutual fund or ETF. For example, arbitrage strategies that rely on leverage are constrained by leverage limitations placed on mutual funds and ETFs. Similar constraints may reduce the viability of strategies that focus on concentrated or illiquid positions, or require extensive use of derivatives. Mutual fund-based alternative products face the additional challenge of needing to accommodate daily cash flows, a very different investment consideration than that faced by hedge funds and private equity funds, which at best offer quarterly liquidity. Given the short track record of many highly regulated alternative products, advisors will need to evaluate the effectiveness of these products compared to less-regulated family members. Figure 1 shows the asset classes that we typically include in a globally diversified portfolio.

We recommend a predominantly quantitative approach for establishing a correlation matrix that reflects the relationship between different asset classes. We evaluate 10-year trailing correlations, and recently changed our process to give heavier weight to correlations within the past five years. We think this approach enables us to better capture the impact of correlations that trended upward during the financial crisis without losing the historical perspective that comes from evaluating a longer period of time.

Advisors typically use optimizers to build asset allocation models. Optimizers are helpful in evaluating a wide variety of potential asset class combinations; however, even the most sophisticated tool has limitations. Optimizers often assume certainty about return expectations, assume that returns are normally distributed, and assume that pair-wise correlations between asset classes are static. Making these assumptions allows for directional analysis of different alternatives but can be dangerous if the analyst presumes that the optimizer is providing the “correct” answer that will work regardless of what happens in the market. Returns are notoriously difficult to
predict, and small differences in expected returns can lead to major differences in optimal portfolios as identified by the optimizer. Modifying expected returns by as little as 0.50 percent for emerging-market equities can create a 40-percent difference in the allocation recommended by the optimizer. If investment returns have a tendency to revert to the mean, forecasts based on historical returns may have a systematic bias toward asset classes that may lag in future periods. Other assumptions made by optimizers can be equally problematic, because returns aren’t necessarily normally distributed and correlations were far from stationary during the financial crisis.

Advisors should use optimizers to identify the directional impact of different allocation strategies and thus inform the development of an asset allocation model. In our work, the optimizer helps us to understand how changes in asset classes, allocation weights, and return and risk assumptions will change the results of the optimization. We also identify how different asset allocation models perform in different market environments, determining whether the optimized results provide the experience we expect in a volatile market environment. With this approach, the optimizer becomes the source of a spectrum of asset allocation alternatives, with the final model selected through something of an iterative process.

**Investment Strategy Selection: Active versus Passive**

Although asset allocation may be the most important investment decision, advisors sometimes underestimate the importance of investment selection. Passive and active investments used together have potential benefits over clinging exclusively to one or the other. We often recommend passive investments to achieve broad market exposure, primarily using index ETFs for their inexpensive, tax-efficient, and transparent structure. Index ETFs are also desirable for their trading benefits, which make it easier to implement tactical changes to portfolios and to deploy or raise cash.

Actively managed strategies may be desirable in certain asset classes as a way to improve portfolio returns. Advisors may use active managers to seek superior returns in asset classes that are considered to be less efficient, such as small company equities, high-yield bonds, and emerging markets. Deciding whether asset classes are efficient or not often involves some level of subjective analysis, but it’s certainly possible to construct a systematic approach to making this determination. Examining the dispersion of performance between the top and bottom tier of performance may be helpful to identify the potential payoff for selecting actively managed funds rather than index funds or ETFs. Advisors also may examine the percentage of managers that outperform the index as a way to evaluate the viability of active management. Table 1 lists the asset classes we typically utilize and groups them according to our current preference for active or passive management.

Although many view index products as providing some inherent level of safety, that is not necessarily true. We are wary of the most-widely used fixed income indexes because they have systematic flaws that often create unrecognized risk. For example, conventional fixed income indexes reward issuers (companies and countries) that issue the most debt. The Barclays Global Treasury ex-U.S. Index in September 2009 had 22-percent exposure to borrowers that became severely troubled shortly thereafter, as shown in table 2. Consequently, it may be desirable to seek active management as a risk-management tool for certain credit-driven asset classes. In this scenario, active management would be as much about avoiding the losers as it is about selecting winners.

The Barclays U.S. Aggregate Bond Index has a different concentration of risk—nearly 80 percent of the benchmark is in U.S. Treasury and mortgage investments with a duration approaching five years. Although the “Agg” carries little or no default risk, the interest-rate risk is extremely high given the current level of interest rates. Investing in actively managed funds that can shorten duration or in bonds with lower levels of interest-rate risk may be appropriate as an alternative.

Of course, active management typically implies higher fees and less predictable patterns of performance. Advisors should establish a portfolio budget for risk and for fees, balancing the low-cost and predictable performance of passive products with the benefits provided by active management.

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<th>TABLE 1: PREFERENCE FOR ACTIVE VERSUS PASSIVE MANAGEMENT</th>
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<td><strong>Active</strong></td>
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<td>High-Yield Bonds</td>
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<td>International Developed-Market Bonds</td>
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| TABLE 2: TROUBLED BORROWERS IN THE BARCLAYS GLOBAL TREASURY EX-US INDEX, 2009 |
|-------------------------------|------------------|
| **Country** | **Index Weight** |
| Italy | 12% |
| Spain | 5% |
| Greece | 5% |
| Total | 22% |
Product Selection

Selecting index products—ETFs and mutual funds—is primarily a quantitative process. The process includes an evaluation of the benchmark that best fits the asset allocation need, followed by rigorous analysis of various products managed to track the desired benchmark.

In trying to identify the best-in-class index products, advisors should review a variety of return and cost factors. Advisors should evaluate tracking error relative to the benchmark, while examining the process used by the manager to control tracking error. Advisors also should consider the total cost of ownership, including the operating expense ratio, trading commissions to trade the ETF, and indirect trading costs such as bid-ask spread and market impact. The liquidity of the ETF and its underlying holdings are also important factors to consider.

Selecting actively managed products is a combination of art and science. Advisors should decide what role they want the active product to play in the asset allocation, identifying whether that role is tightly or loosely defined. Ultimately, a due diligence process must be designed to answer three important questions about an active manager:

**What is the manager’s edge?** In other words, what does the portfolio manager do that provides a competitive advantage?

**Is the manager’s edge sustainable?** Will the manager continue to have an advantage over the market? Identifying an historic advantage is of little use if the advantage won’t persist into the future.

**How will the manager perform in different investment environments?** No product does well in every environment. Understanding patterns of performance is critical to identifying whether the product will fulfill the portfolio role it is assigned.

We recommend that advisors use a 4 P’s framework to evaluating portfolio management teams:

**Philosophy.** What are the fundamental investment beliefs of the team? How do those beliefs shape the approach to managing money?

**People.** Who are the primary decision-makers for the product? How are they supported? What experience do they have managing money and working as a team?

**Process.** How does the team make investment decisions? How is information gathered and analyzed? What in the process provides a competitive edge?

**Performance.** How has the product performed over time? During what periods does the product underperform or outperform? How consistent has performance been? Does the performance pattern for the product line up with expectations based on the other three P’s?

Understanding the inner workings of the selected active strategy will help advisors ensure that they are getting what they pay for in fees and that the product is contributing appropriately to the overall portfolio. In a sense, product selection is the beginning of an advisor’s due diligence cycle. An advisor must continually monitor the selected investment products for changes in performance or any other characteristic that was used in the selection process. Changes in the management team or performance that differ from what was expected are common grounds for replacement in a portfolio.

In Conclusion

As the investment landscape evolves, so too do an advisor’s opportunities to build finely tuned portfolios to meet client needs. By starting with a sufficiently diverse group of asset classes, an advisor can use reasonable assumptions to design an asset class allocation and make informed choices about active or passive products. Revisiting and challenging these decisions—and staying up to date on the markets, portfolio construction techniques, and available investment products—will help to ensure that an advisor continually provides the best possible portfolio to clients.

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References


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