Six Questions with Professor Christopher Geczy, PhD

Wharton Professor Christopher Geczy will anchor IMCA’s 2015 Advanced Investment Strategist Program, September 28–30 in Bethesda, Maryland, with his in-depth session: “Portfolio Theory and Management: A New Perspective on Diversification and Portfolio Construction.”

His presentation will cover a host of relevant topics, ranging from how alternative investments are defined and deployed in portfolios to how advisors can differentiate themselves in today’s competitive advisory community.

Professor Geczy talked with IMCA recently and provided a sneak peek at his presentation.

IMCA: Please tell us about the presentation you will deliver at IMCA’s Advanced Investment Strategist Program.

Geczy: My session will start from the imperatives that often motivate investors to make financial investments. They face certain “laws of physics” such as inflation, taxes, spending, and a handful of things that are ineluctable if you want eventually to use the money. I’m going to focus on the resulting requirement that almost surely arises: the requirement for investors in some form to take risk. The question then ultimately becomes: How are you going to take risk?

I make that point because we stand on the shoulders of giants such as Harry Markowitz and many others who have contributed academically and in practice to frameworks for risk taking, which are reflected in thousands of potential investment products. Given that almost surely an investor will need to take risk in some measure, how should an advisor think about taking it? You’re going to aim to take it intelligently. You’re not going to take it naïvely or stupidly. You’re going try to take it in a way that seeks to optimize, depending on exactly what your objective function and your definition of risk are.

In my session, I’ll talk about different kinds of models, such as the traditional 60/40 model, liability-driven investing, risk-parity, and the endowment model, with special emphasis. I’ll also talk a bit about more factor-diversified models or what I would call the Norway model. I’ll do it in a way that helps advisors move along the spectrum ranging from traditional active and passive management through a window into smart beta, which is, in my view, a potentially more diversified, higher-residual risk approach to getting off-benchmark risk into an allocation.

Finally, I’ll talk about how I define alternative investments and look at their roles in portfolios. I’ll talk about the strengths and weaknesses of what you can find in the marketplace. I’ll also talk a bit about challenges and opportunities in the industry including robo-advisors and end with some thoughts about how to implement alternatives.

IMCA: How do you define alternative investments today?

Geczy: Defining alternative investments is a little bit like putting your finger on mercury, and it’s more challenging today than it ever has been.

There’s no question that it’s important to understand the investment characteristics of alternative investments to approach a definition. Of course the structure, the investor qualification, the ability to act within or outside ’40 Act activity in the United States or the UCITS regime in Europe, and so on, compensation schemes and other characteristics are important, but today a lot can and must be understood from the perspective of risk-based diversification to attempt to define and ultimately utilize alternatives effectively.

Understanding alternatives by way of diversification characteristics, including their factor-based qualities, gets to what investors are thinking about and should be thinking about when they’re thinking about portfolio construction. They should be thinking about the different sources of risks in a portfolio. And then, of course, not ignoring return but starting with risk.

The explosion in the number of potential ways to implement an alternatives strategy that we’ve seen in the industry has and will continue to have impacts on advisors and their practices as well as undoubtedly their investors. In my view, the signal-to-noise ratio that advisors and their clients face has in some sense declined as products have moved beyond the confines of the private
fund setting in which they often were available. For instance, we now are seeing exchange-traded funds and traditional hedge funds that are alternative in nature. One way to make sense of it all is to understand them as accessing some more fundamental underlying risks.

This definition of alternatives also provides investors and advisors potentially, although not necessarily, a kind of benchmark or comparator—because the last thing you probably want to do is to invest at a high-fee rate and get something that you can get really cheaply on the outside. It raises the bar in providing an approach to incorporating diversifiers in a portfolio.

**IMCA:** How can advisors strategically employ alternative investments in client portfolios?

**Gecey:** Starting with risk is one important way to think about it, partially because risk has its own challenges including its connection to the uncertainty of our expectations about returns. Risk is related to investor action and inaction especially in difficult times, it changes across time, it changes investment outcomes, and it is related directly to the effectiveness of diversification. Also, investors are often short the risk of assets in which they've invested. There's a strategic approach to dealing with these challenges that I think makes a lot of sense—being strategically diversified across classes of risk.

I would caution most advisors to be wary of using solely recent historical returns to forecast the future, by the way. We always say past performance is not indicative of future results and I think most advisors believe that up to a certain point. If you use recent returns only, without reference to other models or forecasting techniques or thoughts about the environment, you can end up having what I term environmentally un-robust portfolios or portfolios that have high levels of exposure to classes of assets that have done well only recently. That might feel good for a while—when the state of the world in which that particular bias does well continues to do well and you get the rewards. But at a certain point, as we have seen from hundreds of years of data, we have cycles. We have cycles in the small and the large, across individual investments at the asset and risk class level. Any given bias can end up leading to poor outcomes for investors.

Investors and their advisors need to think at the beginning about the risks that are in the portfolio and then potentially try to augment the risks if they'd like to be risk diversified. In other words, they need to make as good and efficient use as possible from a budget of volatility or a budget of risk. Unfortunately, I see a lot of duplication of risk taking in investor and advisor portfolios, and that ends up being potentially environmentally non-robust.

**IMCA:** With today's proliferation of robo-advisors, how do advisors compete more effectively and differentiate themselves?

**Gecey:** Advisors need to understand a number of dimensions about robo-advisors, including their application of technique and technology and their potential to appeal to the elusive millennial demographic that many robo-advisors have targeted and that represent in the most real sense the future. At Wharton we hear advisors talking about and questioning how they can get in touch with that next generation. After all, the lifetime value of a customer is often highest not with a single client, but with that client over time and generations—not just one investor, but progeny, kids, grandkids, and so on.

In addition, some robo-advisors are antithetical to the advisor experience of investors. One robo-advisor executive I heard recently said he wants to totally disintermediate all advisors. He doesn't want to work with advisors; he wants advisors to be gone. On the other hand, it's my view that 3 million years of human experience hasn't led us to an app alone. There's an ongoing important added value that a human advisor can provide. I think it's essentially primordial. It does require advisors to raise their game. For example, some robo-advisors report to be doing sophisticated tax-loss harvesting. Many advisors are doing it also. However, at least for the time being, a machine can't get to know a client as well as an advisor, so there's a chance for advisors to get to know their clients better as part of a service proposition for that technical activity as well as for the softer roles they play. But that's also a choice financial advisors make. If a financial advisor overloads his or her book of business, how different are they, in fact, from a robo-advisor? They run the risk of being just a human robo-advisor, which is reduction to an absurd extent. It's a reversal of the phrase. Robo-advisors aren't full-spectrum advisors. And yet humans are sometimes like poor robo-advisors.

To summarize, robo-advisors are here to stay, many will find value in them, and yet advisors can and should compete and actually may work synergistically with them. However, I also would be wary of assuming that all this means that asset allocation models are commodities. I vehemently disagree. Also, what advisors provide for their clients by getting to know them, understanding their needs, potentially doing or relating to financial plans, or bringing to bear all resources significant to the client that they can, amounts to a competitive advantage. In addition, advisors should focus on outcomes for investors and not just performance for a host of reasons.

But again, let's not kid ourselves. It's not as if financial planning software isn't available to individuals or that artificial intelligence technology doesn't exist. And it's likely going to get better over time. At the end of the day, I suspect that you're going to see a kind of hybrid model, where the technology allows an advisor to have leverage in serving the needs of clients. I hope it also ultimately ends up bettering those outcomes for investors.

**IMCA:** How else can advisors stand out in today's competitive advisory community and differentiate themselves from robo-advisors?
**Geczy:** Advisors must have a value proposition, signal it, and deliver on it. In that context, robo-advisors actually serve as a powerful baseline and as a powerful reminder that the machine is watching us.

The kind of human capital investment and practice management ideas that advisors might learn from IMCA, or at Wharton, and the notion of defining the market for advice, defining an advisor’s value proposition and brand, and then executing on it will be critical features of successful advisors. Plus, to be on the cutting edge: We don’t see robo-advisors, for example, doing a whole lot of risk-factor or risk-based investing. They seem very traditional today. That bias at least for the time being sustains another type of advisor advantage.

Advisors can stand out by signaling and delivering on a higher level of service. I don’t think they would want to compete with a robo-advisor on cost. That’s a tough one, because robo-advisors are in some sense the ultimate form of leverage. Advisors can provide intelligent planning, and that’s not just wealth planning or financial planning, but that would include specifically tax planning. Just because robo-advisors are doing tax-loss harvesting, that doesn’t mean it’s the right tax-loss harvesting for any given client.

Robo-advisors, from what I can tell, are sophisticated in some cases. But they’re not as sophisticated as some advisors. The other thing I’ve noticed is that the product spectrum is pretty simple and isn’t very sophisticated in terms of underlying investments. Again, though, that’s bound to change.

**IMCA:** Why should an advisor attend the Advanced Investment Strategist Program?

**Geczy:** It’s an exciting but challenging time to be an investor and an advisor, and I’m excited to be a part of the program.

This program is unique and helps advisors arm themselves and prepare for those challenges. As such, the program is a comprehensive, collected whole of sessions that have been thoughtfully assembled and linked. For my part, the notion of starting the program with the important topic of risk is the right way to do it. It fits into the curriculum in a way that sets considerations of risk up as the backbone of the program, which really is key.

Christopher C. Geczy, PhD, is adjunct professor of finance, The Wharton School, University of Pennsylvania; academic director, Wharton Wealth Management Initiative; and academic director, Jacobs Levy Equity Management Center. He earned a BA in economics from the University of Pennsylvania and a PhD in finance and econometrics from the Graduate School of Business at the University of Chicago. Contact him at geczy@wharton.upenn.edu.

---

**For more information about the IMCA 2015 Advanced Investment Strategist Program, visit http://www.imca.org/conferences/AIS.**

---

**Now Available! The Investment Advisor Body of Knowledge**

The **Investment Advisor Body of Knowledge: Readings for the CIMA® Certification + Test Bank** is designed to help candidates prepare for and pass the CIMA exams, and includes key information and preparation for those preparing to take the tests. The book offers readings to address the six domains covered on the Qualification and Certification exams: Governance, Fundamentals (statistics, finance, economics), Portfolio Performance and Risk Measurements, Traditional and Alternative Investments, Portfolio Theory and Behavioral Finance, and the Investment Consulting Process.

It’s also a great resource to add to your library!

Order today using code “imca” for a 40% discount + shipping at www.wiley.com

---

© 2015 Investment Management Consultants Association Inc. Reprinted with permission. All rights reserved.