Post ‘Groundhog Day’ Asset Allocation

By Theodore P. Enders, CFA®
Investors today face a problem hidden in plain sight—enormous pressure to overemphasize a handful of recently high-performing asset classes. In some respects, it’s like the Bill Murray film classic *Groundhog Day* (1993). Investors believe they are facing the same situation, over and over, as they eye relative performance charts. But unlike the behavior of the lead character in the film, the behavior of investors does not seem to improve with repetition. On the contrary, the deeper into this bull market we go, the greater the opportunity for asset allocation distortion, unnecessary risk, and behavioral biases to burrow into investors’ portfolios.

In evoking the repetition of *Groundhog Day*, I am referring chiefly to the dominance of U.S. large-cap equities, an asset class that has appeared at the top of performance charts for years. This happens to be a familiar, even comfortable place for many U.S. investors to be. Many professionally managed investment portfolios today are heavily overweight U.S. large-cap equities. Thousands of these portfolios examined by Goldman Sachs Asset Management (GSAM) show exactly this pattern: repeated overweightings to U.S. large-cap equities. We examine thousands of portfolios a year through our holdings-based asset allocation tool, called GSAM PRISM™, in the course of helping our clients identify unnecessary risks and overlooked investment opportunities.

Before describing these portfolios, though, we are faced with a question. Is a heavy emphasis on U.S. large-cap equities a problem in the first place? Certainly a U.S. large-cap overweight has not felt like a problem for many investors in recent years. On the contrary, performance has made this positioning seem like a benefit. The topic has become an easy one to ignore in the 10th year of an equity bull market.

Here are a few reasons to think that principles of asset allocation—diversification prominent among them—are not dead yet, and that, yes, investors should be prepared for the day when heavy allocations to recent high performers may prove problematic.

**No trend lasts forever.** It is difficult, if not impossible, to predict the outperformance of a given asset class in a given year. How long will U.S. large-cap equities continue to sit at or near the top of the charts? Could we return to environments like the 1990s or the first dozen years of the 2000s, when other asset classes showed relative strength? Eventually, trends reigning today will be exhausted, and investment portfolios premised on a continuation of the trend will face challenges. At a minimum, I believe prudent investors should be prepared for the possibility that markets may turn without warning.

**Investor behavior cuts both ways.** Realistic approaches to asset allocation and portfolio construction account for human nature. The behavioral tendencies that today encourage an overweight to recent high performers may lead to a pressure to sharply reduce equity allocations tomorrow. That, of course, would happen if equity market performance were disappointing, i.e., at the very moment such an allocation may become more attractive. At the extremes, this is a form of buying high, selling low, quite the opposite of what most regard as a prudent investment strategy.

**Eventually, risk concentrations can bite back.** Nearly all of the risk (98 percent) of a traditional 70/30 equity and fixed income portfolio historically has been driven by fluctuations in equity markets.1 Spreading a lopsided U.S. equity allocation across traditional Morningstar style box designations—for instance, separating growth versus value and small-cap stocks versus mid and large—does not move the risk needle appreciably. The risk concentration that today feels good may tomorrow be a source of woe.

**Asset allocation can reduce the possibility of damaging investment decisions.** A long-term, risk-managed

---

1. Morningstar, Inc.
an approach to portfolios accounts for the inevitability of challenging market environments. If we build a strategy with the goal of limiting risk concentration and overall levels of risk to levels deemed acceptable by the end investor, we increase the chances of sticking to the plan.

**HISTORICAL RISK AND RETURN: NOT ‘GROUNDHOG DAY’**

A more diversified approach may offer some surprising benefits. For one, portfolios deploying a wider range of assets often have been competitive from a performance standpoint. This is because more-diversified portfolios have taken advantage of relative performance variation over time—and variation is the historically normal state of markets over the long run. Consider an illustrative 70/30 portfolio that triples the number of risky asset classes contained in a simpler, U.S. equity-centric 70/30 portfolio. As described below, such a portfolio resists the stock–bond duality of classic asset allocation approaches.

The “70,” as per the GSAM definition, consists of a range of assets—equities from around the globe, a range of bonds besides investment-grade fixed income, and alternatives that are hedge fund-like. Each of these asset classes is deemed to offer attractive long-term return potential but also carries risk. The “30” consists solely of investment-grade bonds in the developed markets. Tripling the number of risky assets would simply be one way to expand the range of risk and return drivers beyond more conventional approaches.

The above illustrative portfolio outperformed a simpler, U.S. equity-centric illustrative portfolio in 53 percent of rolling monthly three-year periods during 1997–2018 (from the earliest common index inception through the latest full calendar year), 59 percent of rolling monthly five-year periods, and 58 percent of rolling monthly 10-year periods. The median margin of outperformance was an annualized 0.8 percent over the five-year horizons and 0.3 percent over the 10-year horizons. Importantly, in our view, the more diversified approach was less volatile—as measured by standard deviation—in 100 percent of the three-, five-, and 10-year observations. This improved risk reflects one main benefit of diversification aside from the somewhat academic concept of Sharpe ratios—the improvements in behavior that risk reduction can encourage (i.e., less temptation toward panic selling). Even in markets where correlations have risen and opportunities for differentiation have shrunk, investors may continue to find ways to improve portfolio efficiency by blending a diverse range of assets.

If these results are surprising, they perhaps should not be. **Relative performance patterns over long stretches of history have been more variable than the past several years.**

If these results are surprising, they perhaps should not be. Relative performance patterns over long stretches of history have been more variable than the past several years. The diversifying asset classes envisioned in our illustrative portfolio—emerging market equity and debt, developed market small caps, global infrastructure, master limited partnerships, and liquid alternatives, among others—have each had bad moments in the sun. Additionally, if risk reduction goes out of favor during bull markets, the behavioral effect of lower risk may still be compelling. Isn’t it easier for investors to stick to a plan when experiencing fewer frightening lurches in performance? Don’t professional investors advance their own business interests if they succeed in keeping clients on track with their individual financial plans?

Many financial advisors concede these points, but proceed to explain that their clients demand a different approach. Many argue that they feel compelled to overweight recent outperformers. The evidence from their portfolios shows they have acted on these views. The dominant trend in professionally managed investment portfolios that we have examined—portfolios managed by registered investment advisors, wirehouse financial advisors, private banks, and similar institutions around the country—are on average heavily dependent on relative strength in U.S. large-cap equities for their future returns.

Based on our reviews of these portfolios, we offer the following takeaways:

**The average portfolio featured a 51.5%-percent allocation to core equity.** In our framework, core equity consists of U.S. small-cap, mid-cap, and large-cap equities, plus developed country large caps—all areas that demonstrate similar levels of risk, return drivers (factors), and high correlations. This 51.5%-percent capital allocation has driven nearly 75 percent of the risk in the portfolios we reviewed. That is to say, three-quarters of the average portfolio’s volatility can be explained by core equity. In our view, the fourth quarter of 2018 was a vivid illustration of the danger of such a heavy emphasis on core equity. There is no guarantee that a bullish quarter will follow every bearish quarter, the way 1Q 2019 helped investors recoup from 4Q 2018. Investors should be prepared for market declines that are not followed by swift recoveries.

Many relatively conservative portfolios remain highly dependent on core equity risk. Portfolios with 50–80%-percent core fixed income—high-quality, investment-grade bonds—featured a 51%-percent core equity risk allocation. That is to say, even portfolios featuring a heavy allocation to bonds have risk that is dominated by equities. We view heavy risk concentrations in core equity as
problematic for a conservative investment philosophy.

**Home-country bias is prevalent in many portfolios.** Within the core equity allocation, industry portfolios we have examined are approximately 75-percent invested in U.S. equities but less than a quarter in equities benchmarked to the MSCI EAFE Index. By contrast, a market-weight approach would be closer to 60/40 U.S. versus EAFE.

We view this geographic imbalance as problematic. It creates a risk of missing out on potentially attractive returns in a range of investments outside the United States.

**Diversifying asset classes and alternatives are underrepresented compared to GSAM model portfolios.** Allocations to asset classes such as emerging market equities and debt, international small-cap equities, global infrastructure, and master limited partnerships were less than half those contained in our illustrative model portfolios. Portfolios with any alternative investment exposure were weighted a little over half of a model portfolio allocation with a 70/30 risk posture (~8 percent versus -15 percent).

**DIAGNOSIS: CHRONIC CORE EQUITY OVERWEIGHT**

After years of pronounced outperformance in U.S. large-cap equities, it must come as no surprise that many professional investors are heavily overweight this area of the portfolio. We nevertheless find the magnitude and degree of this overweight in industry portfolios striking.

The average U.S. large-cap equity weight as a proportion of U.S.-domiciled core equity in the industry portfolios we reviewed is 85.6 percent, versus 61.4 percent for an illustrative 70/30 GSAM model portfolio. Fully 17 percent of portfolios contained no U.S. small-cap allocation, and more than half (55.9 percent) contained no allocation to international small-cap equities.

The result is a noticeable skew in the risk allocation of these portfolios toward core equity, with the lion’s share of the risk of these portfolios tied up in a single equity sleeve or between a handful of types of closely related equities.

In our view, a heavy core equity overweight combined with a home-country tilt toward the United States implies a belief in the continuation of the remarkable relative outperformance of indexes such as the S&P 500 Index following the financial crisis. We think this view bears considerable risk, both for the investor as well as the financial advisor’s business.

**REMEDIES TO CHRONIC CORE EQUITY OVEREXPOSURE**

To start reducing overreliance on recent high performers, consider moving toward a more diversified approach. But avoiding large overweights to a single new asset class or handful of asset classes is key. Such an approach has been absent in many of the thousands of professionally managed portfolios we have examined (see figure 1). The following list describes attractive components for long-term asset allocation—and the percentage of portfolios that don’t contain them:

- 81 percent contained no specific allocation to international public real estate
- 67 percent contained no global infrastructure or master limited partnerships
- 57 percent contained no specific allocation to U.S. public real estate
- 55.7 percent contained neither type of public real estate
- 56 percent contained no international small-cap equity
- 52 percent contained no local emerging market debt
- 49 percent contained no alternative investments
- 34 percent contained no dollar-denominated emerging market debt (USD)
- 32 percent contained neither type of emerging market debt
- 18 percent contained no emerging market equity

**EVEN CONSERVATIVE PORTFOLIOS CAN BE HEAVILY DEPENDENT ON EQUITY RISK**

Dialing up “haven” exposures such as core fixed income generally does not remove a heavy reliance on core equity risk in situations where risky assets are concentrated in the core equity area. This result is largely attributable to the lack of diversifying asset classes in these portfolios, underscoring the potency of core equity risk even in relatively conservative portfolios.
HOME-COUNTRY BIAS IS PREVALENT IN MANY PORTFOLIOS

The tendency to favor familiar assets, especially those domiciled closer to home, has been well documented.\(^7\) Our findings among industry portfolios reflect the pattern. Within the core equity allocation, portfolios were approximately 75 percent invested in U.S. equities and less than a quarter in equities benchmarked to the MSCI EAFE Index.

Our fixed income results were even more skewed domestically (perhaps unsurprisingly in the context of low and in some cases negative rates for fixed income investors overseas). International bonds represented only a 14.1 percent average allocation, versus 60.8 percent for our illustrative models.

Nearly 20 percent of all industry portfolios contained no emerging market equities; more than half (55.9 percent) contained no international small-cap equity exposure.

DIVERSIFYING AND ALTERNATIVE ASSET CLASSES ARE SIGNIFICANTLY UNDERREPRESENTED

A heavy emphasis on U.S. equities and familiar assets comes at the expense of global opportunities and diversifying asset classes with potentially attractive returns. Among the industry portfolios we reviewed, allocations to diversifiers such as emerging market equities and debt, international small-cap equities, global infrastructure, and master limited partnerships were less than half of those suggested in our model portfolios.

A similar trend appeared in alternative investments, a group we define as including daily liquid alternative investments, hedge funds, and hedge fund–like strategies. Portfolios with alternatives contained a little more than half (~8 percent) the allocation of a 70/30 illustrative GSAM model portfolio (~15 percent). Including portfolios with no alternatives exposure whatsoever (48.5 percent of the total) leaves an average of 4.3 percent allocated to alternatives, or less than a third of our model allocation.\(^8\)

Among investors who deploy alternative investments, we note a heavy emphasis on one subcategory—equity long–short strategies, meaning those strategies that can go long a stock and short another. We view these strategies as the most equity–like of the alternatives universe, a factor worth noting in light of the core equity dominance seen in many portfolios.

‘GROUNDHOG DAY’ ALL OVER AGAIN?

As the saying goes, history repeats itself first as tragedy, then as farce. Investors today may enjoy an opportunity to avoid all that. They can build portfolios that refuse to repeat the mistakes of the past. They can reshape their risks and return potential to adapt to a range of potential market outcomes by building portfolios designed to persevere through a variety of scenarios.

ACKNOWLEDGMENTS

Brendan Conway and Olivia Zhang contributed to this article. \(^\star\)

Theodore P. Enders, CFA®, is global head of strategic advisory solutions for Goldman Sachs Asset Management. He earned a BS in operations research and an MEng in operations research and financial engineering, both from Cornell University. Contact him at theodore.enders@gss.com.

ENDNOTES

1. As of December 31, 2018, covering the period 2001–2018, the earliest common inception of indexes presented in this analysis. Risk is defined as the annualized standard deviation of historical returns over the full 16-year period. The 70/30 capital allocation is defined as: core equity 70% allocated to: 18% U.S. large-cap growth, 17% U.S. large-cap value, 10% U.S. small cap, 10% U.S. mid cap, 15% international, core fixed income: 30% U.S. aggregate fixed income. The performance results are based on historical performance of the indexes used. The result will vary based on market conditions and your allocation. The portfolio risk-management process includes an effort to monitor and manage risk, but does not imply low risk.

2. Referencing historical performance of the range of market segments listed in endnote 3 below. Also see the exhibit “Track Historical Asset Class Performance” at https://www.gsam.com/content/gsam/us/en/advisors/resources/portfolio-strategy.html.

3. Illustrative portfolios are as follows: Illustrative 70/30 portfolio consists of 17.5% U.S. large-cap growth equity (Russell Top 200 Growth Index); 17.5% U.S. large-cap value equity (Russell Top 200 Value Index); 10% U.S. mid-cap equity (Russell Midcap Index); 10% U.S. small-cap equity (Russell 2000 Index), and 15% developed market equity (MSCI EAFE Index); and 30% U.S. aggregate fixed income (Bloomberg Barclays Aggregate Bond Index). Illustrative GSAM 70/30 with 20% satellites and 10% liquid alternatives: 8.5% U.S. large-cap growth equity (Russell Top 200 Growth Index); 7.6% U.S. large-cap value equity (Russell Top 200 Value Index); 6% U.S. mid-cap equity (Russell Midcap Index); 4.1% U.S. small-cap equity (Russell 2000 Index), and 13.7% developed market equity (MSCI EAFE Index); 2.4% emerging market debt USD (J.P. Morgan Emerging Markets Bond Index (EMBI Global Index)); 2.4% emerging market debt local currency (J.P. Morgan Government Bond Index–Emerging Markets Global Diversified (GBI-EM Global Index)); 2.3% global high yield (Bloomberg Barclays Global High Yield Index), 1.5% high yield (J.P. Morgan Government Bond Index–Emerging Markets Global Diversified (GBI-EM Global Index)), 1.6% global ex-U.S. developed small cap (S&P Developed ex-US Small Cap Index); 1.1% U.S. public real estate (Dow Jones US Select Real Estate Securities Index), 1% global ex-U.S. public real estate (S&P Developed ex-US Property Index), 3% global infrastructure and master limited partnerships (S&P Global Infrastructure Index); 10% daily liquid alternatives (HFII Fund of Funds Composite Index); 11.8% U.S. aggregate fixed income (Bloomberg Barclays Aggregate Bond Index); and 18.2% global ex-U.S. aggregate fixed income USD (Bloomberg Barclays Global Aggregate Bond Index)

4. Portfolios examined through the GSAM PRISM™ analysis tool over the period 2016–2019

5. Source: GSAM Portfolio Strategy Group as of May 2018. Long-only Model: Illustrative 70/30 PRISM™ Strategic Asset Allocation Portfolio is composed of 70% (core equity and diversifiers) and 30% core fixed income. Model with alternatives: Illustrative 70/30 PRISM™ Strategic Asset Allocation Portfolio is composed of 70% (core equity, alternatives, and diversifiers) and 30% core fixed income. Diversifiers include EME, External EMD, Local EMD, global high yield, bank loans, global ex-U.S. developed small cap, global ex-U.S. public real estate, U.S. public real estate, and global infrastructure and MLPs. The illustrative models are two of various asset allocation models that are designed based on different return and risk expectations for clients. This information is provided for illustrative purposes only and does not constitute a recommendation of exposures for
any client account. GSAM PRISM™ is a trademark of GSAM.

6. Based on average weights of portfolios examined through GSAM PRISM™ portfolio analysis over the period 2016–2019.


8. Comparisons of industry portfolios to GSAM model portfolios require judgments regarding which portfolios are directly comparable and which are not. For example, many investment portfolios are constrained in their use of alternative investments. For that reason, in our analysis of alternatives weightings, we exclude portfolios containing no alternatives, which we believe enables a more directly relevant set of comparisons between portfolios including alternatives versus GSAM models also including alternatives. We also provide a statistic covering all portfolios under examination, including those with no alternatives, for context. In the case of satellite and fixed income weightings, we include all portfolios under examination, to reflect the greater flexibility many professional investors face when it comes to including these asset classes in portfolios.

Important disclosures
Past performance does not guarantee future results, which may vary. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur.

Views and opinions expressed are for informational purposes only and do not constitute a recommendation by GSAM to buy, sell, or hold any security. Views and opinions are current as of the date of this page and may be subject to change, they should not be construed as investment advice.

This material is for informational purposes only. It is not an offer or solicitation to buy or sell any securities. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. This material has been prepared by GSAM and is not financial research nor a product of Goldman Sachs Global Investment Research (GIR). It was not prepared in compliance with applicable provisions of law designed to promote the independence of financial analysis and is not subject to a prohibition on trading following the distribution of financial research. The views and opinions expressed may differ from those of Goldman Sachs Global Investment Research or other departments or divisions of Goldman Sachs and its affiliates. Investors are urged to consult with their financial advisors before buying or selling any securities. This information may not be current and GSAM has no obligation to provide any updates or changes.

Although certain information has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness, or fairness. We have relied upon and assumed without independent verification, the accuracy and completeness of all information available from public sources.

© 2019 Goldman Sachs. All rights reserved.

Date of first use: May 8, 2019. Compliance code: 166478-OTU-970499

CONTINUING EDUCATION
To take the CE quiz online, www.investmentsandwealth.org/IWMquiz