COMING TO PORTFOLIOS NEAR YOU

Investment Ideas You Should Be Paying Attention to (The Sequel)

By Scott Welch, CIMA®
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Editor’s Note: The I&WM Editorial Advisory Board asked Scott Welch to revisit an earlier work and comment about how asset allocation and portfolio construction has evolved over the past decade. Welch provided an honest assessment of which themes played out and where he missed the mark.

In the fall of 2007, I published an article in the Journal of Wealth Management entitled, “Coming to Portfolios Near You: Investment Ideas You Should Be Paying More Attention To.” Now, almost 12 years later, how did those predictions hold up and, more importantly, where might we be heading over the next 10-12 years?

How Did I Do Back in 2007?

Here are my predictions from 2007, along with a self-evaluated “report card.” The focus of these predictions was for high-net-worth (HNW) and ultra HNW investors, not institutions (though some of them apply to both investor bases).

1. Post-modern portfolio theory will evolve and behavioral finance will continue to work its way into wealth management, as advisors increasingly adopt objectives-based portfolio construction and downside risk evaluation.

   Grade: A− / B+. I was absolutely right about behavioral finance and goals-based wealth management, but less right about the adoption of downside risk evaluation and post-modern portfolio theory.

2. More investors will dig out of the muddy middle of traditional active management and adopt a more core-satellite approach to constructing portfolios; the core of those portfolios largely will be passively managed, using index funds, exchange-traded funds (ETF), tax-enhanced index products, and derivatives based thereon.

   Grade: A−. I was correct in my prediction, but this was an easy call to make even back in 2007, so I took points off for a low degree of difficulty.

3. Additionally, we will see the continued development and use of designer index products that are not capitalization-weighted (though the more traditional index products will continue to dominate the landscape into the foreseeable future).

   Grade: A. Nailed this one—smart beta anyone? This call may seem obvious today, given the proliferation of factor-based products in the marketplace, but this field was still in its infancy in 2007.

   4. The satellite investments will include alpha-chasing active managers that have been freed of traditional investment constraints regarding use of leverage, shorting, style purity, and source of alpha as they seek a wider opportunity set with which to employ their skill.

   Grade: A. Nailed this one, too. Most investors and advisors have recognized the need to move away from traditional style-box investing and, if they are going to pay active management fees, seek out less-constrained alpha seekers.

   5. The use of hedge funds and alternative investments will increase, both for diversification and performance enhancement purposes. When talking about a 60/40 portfolio, investors will no longer be referring to the allocation between equity and fixed income,

   Grade: A.
but rather to the allocation between traditional and alternative investment strategies.

Grade: B−. I wrote my article in late 2007, and I did not see the events of 2008 coming (grade of F− on that front). Those events put a huge damper on the use of hedge funds, at least by individual investors. Specifically, investors didn’t turn away from the investment strategies associated with hedge funds, but rather the legal structure, fees, relative illiquidity, and relative lack of transparency. Also taking points off for not foreseeing the explosion in alternative investment mutual funds—the direct result of those investor dissatisfactions—that would begin less than 18 months after I wrote the article.

Because investors now can access multi-strategy funds in mutual fund form at lower prices, as well as single manager multi-strategy hedge funds, FoFs are withering (at least, as measured by assets under management growth).

6. Replication strategies attempting to deliver exotic beta will proliferate, and the same separation of alpha and beta that is putting fee pressure on traditional active managers will begin to exert fee pressure on “2 and 20” underlying managers (but skilled managers that truly deliver alpha will always be able to charge a premium price for doing so).

Grade: C. Although tax-efficiency is (I believe) a critical way that advisors can and should add value, investors overwhelmingly remain focused on pre-tax performance. Consider this prediction as one driven by wishful thinking on my part, rather than correctly interpreting market trends.

WHERE DO WE GO FROM HERE?

So, not a terrible report card, but that was then, this is now. As we near the end of a 10-year central-bank-fueled, fundamentals-be-damned global rally, where the only investment approach required was “be long beta,” what investment ideas and strategies in asset allocation and portfolio construction should we be paying more attention to now?

TRENDS ALREADY IN PLACE OR FAIRLY EASY TO ANTICIPATE

ESG and impact investing will grow in importance, with a caveat. When discussing environmental, social, and governance (ESG) and impact investing with HNW clients, the first observation is that, to date, it has been more widely discussed than actually implemented, even at the institutional level, at least in the United States (it is more widely deployed in Europe).

That is changing, however, as more individual investors seek purpose or impact with their investment portfolios, versus simply maximizing risk-adjusted returns.

That said, it still is not clear if (1) a majority of investors are willing to give up return in their portfolios in exchange for optimizing the impact or virtue signaling of those portfolios; and (2) it is still early days in determining whether ESG actually can improve performance, as some claim. I am not suggesting that it cannot, only that we need more time and much more data to verify those claims.

In the socially responsible investing (SRI) days, the investment process was more about excluding the issues or industries that investors didn’t want in their portfolios.

As part of the very positive evolution of SRI into ESG, however, that dynamic is changing. Investors are still free to eliminate or divest from things they don’t want, but they now have an increased ability to highlight positive investment themes in order to achieve their ESG goals.

Good governance, board and corporate diversity, women- and minority-owned businesses, clean water, newly established opportunity zone investments,
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and other similar investment spaces are all examples of ESG approaches to investing that focus more on positive outcomes than on simply eliminating perceived negative aspects of a given portfolio.

I think this pivot toward positive screening, combined with an increased ability to customize solutions to meet specific objectives (versus pre-packaged solutions that may or may not align with a given investors’ objectives), suggests a much wider adoption of an ESG investment approach. But that brings me to my caveat.

If, in fact, positive screening becomes the norm, then the logical result will be that the “E” and the “S” fade away (because, historically, these have been primarily exclusionary filters), and we are left primarily with “G”—good governance. Put differently, good governance should evolve toward incorporating positive environmental and social policies (because that, theoretically, is what shareholders want and reward).

In other words, the evolution of the space eventually will result in dropping the E and the S, and it will be all about the G.

The democratization of private investments will grow steadily. Historically, private investments—equity, credit, real estate, etc.—were the purview of large institutional investors (pension funds, sovereign wealth funds, endowments, etc.) and very wealthy investors and families. These were the investors who had the necessary sophistication, investable assets, access, and time horizons to benefit from the illiquidity and complexity premiums enjoyed by the private markets.¹¹

Two different but related market trends are changing this characteristic of private investing.

The first is that the public markets themselves are shrinking rapidly as the result of mergers and acquisitions, the delisting of previously public companies (to avoid the regulatory and quarterly reporting hassles of being publicly traded), and the delay or simple avoidance of private companies in going public (for the same reasons).¹² As a result, investors are far more interested in accessing private market investments.

The second is that the fund managers themselves are looking to diversify—democratize—their investor bases and target more individual investors.¹³ The JOBS Act of 2012 effectively eliminated the cap on the number of limited partners a private fund may include,¹⁴ and advances in technology have allowed for the ease of implementation and management for feeder or access vehicles into these funds, lowering the investment minimums to levels accessible by smaller investors (e.g., $100,000).

In addition, many of the most well-known private equity firms have launched or are in the process of launching a next-generation version of private funds that are available to accredited investors,¹⁵ which carries a far lower barrier to entry than the more stringent qualified purchaser requirement.¹⁶

Behavioral finance and goals-based investing will become the norm, not an outlier, in constructing and managing HNW portfolios.

The academic concepts behind behavioral finance have been around for decades,¹⁷ and the academic treatment eventually evolved into the practical applications of goals-based investing.¹⁸

The challenge in actual implementation of goals-based investing has been more of a technological obstacle than anything else. The concepts are fairly straightforward—you build portfolios to address specific investor objectives and goals or to avoid typical behavioral tendencies that can lead to investment mistakes.¹⁹ But how do you optimize, propose, implement, and report on goals-based portfolios on an enterprise-wide, scalable basis?

Fortunately, technology now has advanced to the point where building, managing, and monitoring goals-based investment portfolios has become a reality.²⁰ As investment management becomes increasingly commoditized (and investment alpha becomes correspondingly harder to generate consistently), more advisors will adopt a goals-based approach as a means of differentiating their client experiences.

Decumulation portfolio construction will overtake accumulation portfolio construction in importance as the population ages.

This one is kind of a no-brainer. Most of the developed world is aging, and this, combined with extended individual post-retirement longevity, means that wealth managers increasingly will need to pivot from building and managing accumulation strategies (portfolios designed to preserve and grow wealth during the working years) to decumulation strategies (portfolios designed to outlive the beneficiary while maintaining a desired standard of living). Although there is overlap in terms of how advisors should think about and construct these two respective types of portfolios, there can be profound differences in terms of growth, income generation, and risk management characteristics.²¹

The search for uncorrelated investments will grow dramatically.

It is more or less stating the obvious that when you equitize something, or as an asset class becomes more efficient, it becomes less effective as a diversifier within a client portfolio. Small-cap stocks are not as effective a diversifier as they used to be. Neither is differentiating between growth and value stocks. Neither, for that matter, is the distinction between U.S. and non-U.S. stocks. This is not to suggest that different markets and different styles don’t rotate in and out of favor over full market cycles. But if 2008 (or, more recently, the 4th quarter of 2018) taught us nothing else, it taught us that when serious market disruptions occur—those times when you
need diversification the most—most equity market correlations quickly approach +1.

Even Morningstar, the godfather of style-box investing, has recognized the need to evolve toward a more “total wealth” approach.22

Other investment strategies that historically were very effective diversifiers when they were available primarily in non-mutual fund form (e.g., direct investments or hedge funds), such as trend-following commodity trading advisors, global macro, real estate, and master limited partnerships, all have seen their diversification benefits decrease as they became widely available in mutual fund and ETF vehicles.

Once you equitize any investment strategy (i.e., make it available on a traded exchange and therefore, more liquid) you increase its correlation to the broader equity and income markets, you effectively give it an inherent “short volatility” risk profile and, therefore, you make it less effective as a portfolio diversifier (i.e., its price will go down when volatility spikes because investors can sell it more easily).23

But this does not diminish the need or desire for effective portfolio diversifiers. There are two challenges to this. First, the obvious solutions (e.g., option-based strategies that allow investors to be long in volatility) can be very expensive, especially when needed the most.

Second is an odd but fairly typical investor behavioral tendency. Most investors accept and don’t think twice about paying insurance premiums on other aspects of their financial lives—their home and property, health, auto, and so forth. Yet, after paying those premiums, they don’t actually wish for something bad to happen so they can take advantage of the insurance. But paying for insurance on the value of a portfolio (e.g., by paying put option premiums) remains anathema for most investors, and implementing it within a client portfolio and having the “bad outcome” not occur is a sure-fire way for an advisor to get fired.

So the search for uncorrelated diversifying strategies will continue and, I believe, intensify. Over the past 12-18 months, my firm has listened to pitches from managers promoting strategies including timber and farmland leases, catastrophe insurance bonds, micro-loans, life settlements, securitization of the pre-refunding of individual tax returns, the securitization of patent royalty payments, and other novel ideas. Some of these strategies have interesting investment and alpha-generation profiles, others less so, but they are all positioned as low-correlation portfolio diversifiers. I don’t see this trend slowing down, especially as we near the end of the current economic and market cycle.

There was a period of time four to five years ago when the industry feared that human advisors would be replaced by digital or robo-advice platforms.

ADDITIONAL TRENDS TO WATCH FOR

Now, some other ideas that may seem less obvious, or perhaps a little further down the path in terms of development and adoption:

Technology, fractional shares, and direct indexing will put a serious dent in the ETF and index mutual fund industries.

There was a period of time four to five years ago when the industry feared that human advisors would be replaced by digital or robo-advice platforms. That fear was always blown down, and now the general consensus is that, as with other technological advancements, digital platforms are simply tools that can help advisors run their practices more efficiently and more to scale.24

But the larger potential disruption from digital platforms, though written about less, comes on the portfolio construction and portfolio management side, specifically the growth and evolution of direct indexing.

Direct indexing is not a new idea—it has been around for decades.25 The concept is straightforward: Rather than accessing index-level exposure via an index mutual fund or ETF, investors actually purchase a representative sample of the actual individual securities within the index (e.g., the S&P 500) that delivers index-like performance with minimal tracking error. The benefits of this approach are a potentially lower cost and, especially, the ability to customize and tax-manage the portfolio.

The benefits of owning a tax-managed index strategy are well-known, but these types of strategies historically were available only in separately managed account (SMA) vehicles, and therefore were limited to HNW and institutional investors (because of high minimums compared to mutual funds or ETFs). This was because the manager had to purchase whole securities to build the direct index portfolio.

Enter fractional shares.26 Using fractional shares (which are exactly what they sound like), investors can build (or buy) an index-like portfolio at far lower investment minimums than previously required when only whole shares were available—minimums comparable to or lower than those for ETFs and mutual funds.

The evolution of fractional shares, combined with the technological capabilities of digital advice platforms, potentially will be a true disruptive advancement in portfolio construction and management, and this evolution will do to ETFs what ETFs themselves did to the actively managed mutual fund and SMA
The evolution of factor-based investing will continue, both in terms of product development and, perhaps more interestingly, in creating “factor allocated” rather than “asset allocated” portfolios. The call here is not focused on factor-based investing itself (remember that was one of my correct calls back in 2007)—that phenomenon is well-established and here to stay.27

But from a portfolio construction perspective, perhaps the more disruptive evolution will be with respect to the asset allocation framework. Historically and still today, investors and advisors built and build portfolios by allocating across various asset classes—primarily because that was and remains the only choice.

But asset classes—or more specifically the securities that fall within a given asset class—can be thought of (somewhat simplistically) as convenient little bundles of specific risk factors. This is why seemingly diversified asset class portfolios don’t always deliver the expected level of diversification during disruptive markets—they all are exposed to the same or comparable risk factors.

Consider the simple example of large-cap U.S. stocks, emerging markets stocks, and high yield bonds. These are all very different asset classes, but they all have highly correlated risk factor profiles (specifically, they are all heavily influenced by the equity risk factor). So when a disruptive market event occurs, they all tend to fall together.

The logical conclusion of this avenue of thought is that better diversification can be achieved by allocating across risk factors instead of across asset classes. Again, this is not an especially new idea,28 but thus far the commercial applications of factor-based investing have been primarily on the product side—specifically risk parity and factor-based ETF strategies.

Going forward, I expect that analytical and technological advances will drive the ability to build more robustly diversified factor-allocated portfolios, and this will become best practices in portfolio construction.

AND NOW FOR SOMETHING COMPLETELY DIFFERENT
I will close with three predictions that are not uninituitive to think about, and in some cases have even been discussed, but which are farther down the road (I think) in terms of implementation.

The confluence of big data, artificial intelligence (AI), high-frequency trading (HFT), global deficits, and a growth in populism will drive a transactions tax on trading. The notion of a transaction tax on trading is not new, and has now gained traction in the United States among more progressive politicians and constituents.29 The argument in favor of it is based on the (somewhat valid) belief that technology, in the form of big data, AI, and HFT, has minimized the value of fundamental analysis and discouraged long-term trading. Put differently, it has stacked the deck against individual investors in favor of institutional and wealthy investors who can access and take advantage of the technology.

If we combine this with increasing concern over global income inequality, exploding governmental deficits, and a growing global trend toward populism, it is not hard to envision the idea of a transactions tax on trading gaining traction.

As Ronald Reagan famously said when describing the governing philosophy of his political opponents: “If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.”

In a portfolio management context, what moves faster than HFT? I think a transaction tax on trading is a terrible idea fraught with potentially huge negative unintended consequences, but I will not be surprised to see it enacted in some form within the next 10 years.

“If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.”

But investment management is only one aspect of a wealth manager’s value proposition and, in an increasingly commoditized investment world, it may not even be the highest value add. As a simple example of this, consider the great financial collapse of 2008. Under a percent-of-AUA model, advisors may have seen their fees fall by 20–40 percent or more. But that in no way corresponded to a comparable decline in added value advisors were bringing to their panicked clients.

Retainer fees have different problems. Once negotiated, even with the best of intentions and the most honest of counterparts, the client is unconsciously
motivated to maximize the services provided for the fee paid and the advisor is unconsciously motivated to minimize the amount of service provided for that same level of fee.

This is not to suggest that either pricing model is fatally flawed and, in fact, both are widely used and accepted by advisors and clients, primarily because they are easy to explain, implement, and monitor. But the fact is that both have the potential for creating a misalignment of interests.

I believe that technological advances ultimately will allow us to actually monitor advisor alpha—the value of advice and the value of non-investment management services provided, and this will become the industry best-practice pricing model.30

Finally, here’s to you, Jules and Gene: “Beam me up, Scotty” becomes a portfolio construction reality. One of the reasons science fiction remains a popular genre in books and movies is that the technology, often futuristic and perhaps even fantastical, is believable enough. Consider Jules Verne’s Around the World in 80 Days and 20,000 Leagues Under the Sea. At the time they were written, they were considered absolutely unrealistic in terms of technological and human capabilities. Today, high-speed air travel and deep-sea underwater exploration, respectively, seem almost commonplace.

Or consider the Gene Roddenberry original TV series Star Trek. Although it aired for only three seasons and 79 episodes back in the late 1960s, it firmly installed in the American imagination the concepts of deep space travel, phasers, wireless communication, medi tricorders, and transporting.

Today, many of these at-the-time fantastical technologies and devices have become realities.31 And, of course, advances in 3D printing move us ever closer to the day when transporting will become a reality. But what does any of this have to do with the future of portfolio construction?

In a world of fractional shares, factor-based allocation, and 3D printing, I see a future where portfolio construction becomes completely customized—individual securities will be deconstructed into their composite risk factors and then re-aggregated into customized investment strategies that are customized to exact investor specifications.

I will note in closing that I did not even attempt to suggest portfolio construction advancements that will be brought about by blockchain technology—that is an entire subject all on its own.32

But I’ve created a fairly ambitious list nonetheless. I hope to check back in another 10 years and see how I’ve done.

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ENDNOTES


2. For more on post-modern portfolio theory, see, for example, Brian Rom and Kathleen Ferguson, “Post-Modern Portfolio Theory Comes of Age,” Journal of Investing 2, no. 4 (winter 1993): 27–33. In addition, the source that most influenced my call in 2007 was Pete Swisher and Gregory Kasten, “Post-Modern Portfolio Theory,” FPA Journal 18, no. 9 (September 2005): 74–83.


8. About the same as my actual academic one. Although he changed the gender to protect me, I’m pretty sure I am who Henry Wadsworth Longfellow had in mind when he wrote, “When she was good, she was very good indeed, but when she was bad she was horrid.”

9. Sorry, Professor Markowitz, it sounds crazy but it’s true.

10. See, for example, the white paper by Gordon Clark, Andreas Feiner, and Michael Vies, “From the Shareholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance,” University of Oxford and Arabesque Partners [March 2015], https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf.


14. The JOBS Act of 2012 increased the number of limited partner slots from 499 to 1,999 and jump-started the crowdfunding phenomenon.


16. An accredited investor must have, among other things, an adjusted gross income of at least $200,000 for each of the previous two years and a net worth (excluding primary residence) of at least...
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$1 million—a far lower hurdle than the qualified purchaser, who must have, among other things, a minimum of $5 million in investable assets.


This wealth management trend led to the launch of the Retirement Management Advisor® (RMA®) certification program by the Investments & Wealth Institute. Learn more about the RMA program at https://investmentsandwealth.org/rma.


