ASSET ALLOCATION: THE ACHILLES' HEEL OF MOST INVESTMENT PROGRAMMES

Asset allocation decisions have great impact on an investor's wealth. And yet the highly compartmentalised world of institutional investing means that key asset allocation decisions have little diversity of insight that is typically obtained for security selection through the use of multiple investment managers in each sector. And to make matters worse, most asset allocations decisions are made by committees or boards that meet infrequently, are comprised of members with other day jobs, and are advised by asset consultants who do not implement the decisions. These bodies are generally ill-suited to the challenges of dynamic asset allocation. I explore the possibility of diversifying both the insight and the process of asset allocation.

This essay is based on a speech Chris Condon delivered to the CFA Society of Sydney on 29 March 2012.

THE CHALLENGE

Recently David Neal, the CIO of the Future Fund, was reported[1] to have said:

> *"Once you let go (of the benchmark) you do feel adrift for a while and that is when you have to think very carefully about an investment philosophy - how you run your portfolio and think about markets or you will get tossed in the storm," Neal said.*

The article went on to say:

> *The Future Fund operates as a single portfolio according to Neal rather than breaking allocation into various sectors as is traditionally done.*
>
> *"If you give a property team a set capital allocation they'll go off and spend it whether those property ideas are a good thing or not," Neal said.*
>
> *Every idea should instead be evaluated against every other idea with strategies directly compared to assess the marginal benefit of where each dollar goes, according to Neal.*

I think you will agree that David has thrown some interesting challenges to the industry. But unfortunately most of us do not have the luxuries of the Future Fund:

- we don't have one client, but rather service the disparate needs of thousands of mums and dads
- we don't have a well known investment objective with a time horizon many years into the future; and
- most of us don't have a well resourced internal investment team financed by the scale of a huge investment portfolio with a single focus.

So we do need to perform some sort of asset allocation. But are we doing the right sort?

Here are some questions:

1) Why do asset allocation at all?

2) What exactly are these "assets" we are allocating?

3) What skills do we need? And over what time horizons?

4) How do our behavioural biases distort our understanding of skill?

5) What is the impact of agency risk?

6) What if we do not have sufficient skill?

7) Should we be diversifying skill and insight when conducting asset allocation?

DEDUCTIVE REASONING

This article uses deductive reasoning to explore this issue. This inspiration came as I read Woody Brock's wonderful new book "American Gridlock". He bemoans the "Dialogue of the Deaf" in American politics in which virtually all players have bifurcated into either the left or the right, each with its own trenchant views that are not open to development through reasoning.

Woody proposes a way out of this gridlock by having all participants leave their preconceptions and political interests at the door, and enter into a dialogue using deductive, rather than inductive principles.

This starts with all parties agreeing to a set of axioms; self-evident propositions that are not controversial. The dialogue then progresses on a step by step basis, with each party agreeing to the logic that leads from axioms and previously agreed statements to points of agreement that would not be reached without the prior logical stepping stones.

I thought that this approach may be useful in thinking about asset allocation. I do not believe that investment professionals involved in asset allocation have the overt prejudices that seem to be endemic in politics. But much of the debate on this issue does not build from agreed axioms, and worse, is often heavily influenced by vested interests, often without the awareness of the conflicted party.

AXIOMS AND CONJECTURES

I start with two obvious axioms and work through seven conjectures, building on each step by step. The initial conjectures are downright obvious to the point of being boring. But bear with me; they build to more interesting propositions.

AXIOM 1:
THERE IS A HUGE NUMBER OF ULTIMATE INVESTORS

The ultimate owners of capital are generally mums and dads who need, or wish, to defer consumption today for a number of years, often decades. There are literally millions of them needing help to do this.

AXIOM 2:
THERE IS A HUGE NUMBER OF INVESTMENT OPPORTUNITIES

There exist organisations that require capital for various purposes. The obvious set of such organisation is firms that undertake productive enterprise such as making widgets or providing services. This includes providing real estate and other assets for rent. Another set of organisations are governments that need to fund intergenerational wealth transfers. I believe that this covers most valid users of capital. It deliberately excludes investment managers as I define them as intermediaries, and not the ultimate users of capital.

Not only is there a huge number of users of capital, but many users engage with the capital markets in a variety of forms (e.g. shares, bonds, bank loans, convertible securities, syndicates, mezzanine finance ... and more), each representing a different type of investment opportunity.

The consequence: there is a huge number of investment opportunities.

CONJECTURE 1:
INTERMEDIARIES ARE NEEDED TO MATCH OWNERS OF CAPITAL TO USERS OF CAPITAL

My first conjecture is obvious: intermediaries are needed to match the multitude of investors to this vast array of investment opportunities.

For these purposes, I define intermediaries to include superannuation fund trustees, internal investment teams, investment managers, asset consultants and financial planners.

SCOPE

In order to keep this topic manageable, I have elected to consider just individual ("mum and dad") investors. Moreover, I am only interested in those individuals/families that do not have the interest, time or skill to manage all or part of their wealth without external assistance.

I deliberately exclude individual investors who invest directly into investment opportunities without the assistance of an external adviser or manager. They include angel investors and entrepreneurs who self-invest. I also exclude from my scope those individuals (and their DIY superannuation funds) who for whatever reason have elected to eschew the entire investment industry.

I also exclude institutional investors that that do not pass investment risk directly to their underlying stakeholders. These include defined benefit funds, insurance companies, sovereign wealth funds and other institutional investors. Despite David Neal's comments, most of these investors do undertake some form of asset allocation. But I believe that as they have fewer moving parts their asset allocation challenges are more tractable and as such tend to get more attention by academics. In any event, defined benefit funds in Australia are dwarfed by the defined contribution funds.

MORE CONJECTURES

CONJECTURE 2: NO ONE INTERMEDIARY CAN OFFER A COMPLETE SERVICE

What if an intermediary offered a one stop shop, i.e. a "complete investment service"? Such a service may eliminate many of the well known frictions, agency issues, gaps and confusion that we all know are endemic in the investment industry. What would such a "complete investment service" look like? I suggest it would need to have an integrated capability that has all of the following features:

- Assess the individual investor's circumstances, aspirations and attitudes
- Assess all relevant investment opportunities
- Identify the portfolio of individual investment opportunities that best meets the investor's needs
- Continuously reassess the portfolio in light of changing conditions that affect:
  - many assets (e.g. interest rates, inflation, market sentiment)
  - specific assets (e.g. earnings, corporate events, credit risk)
- Transact in both the primary and secondary markets

This is impossible. The task is simply too massive. Even if an organisation attempted to provide all of these services, I suggest could not do so in an integrated form. The different functions would operate as a set of internal intermediaries that operated as independent silos.

This leads me to refine my definition of "intermediary". In what follows I define an intermediary as being a unit that undertakes a service in a form that is internally integrated. The unit may be a separate organisation, such as a boutique investment manager or a small firm of financial planners. But most units will be separate functions within larger organisations. For example, the internal investment team of a superannuation fund may be an integrated unit, but will not integrate with the team of internal financial planners (if there was such a team) that advises the individual members.

In other words, no one intermediary can offer a complete service. (Conjecture 2)

CONJECTURE 3: INTERMEDIARIES NEED TO FOCUS

Now for something that may be a little less obvious. My third conjecture is that each intermediary needs to focus on one of three things:

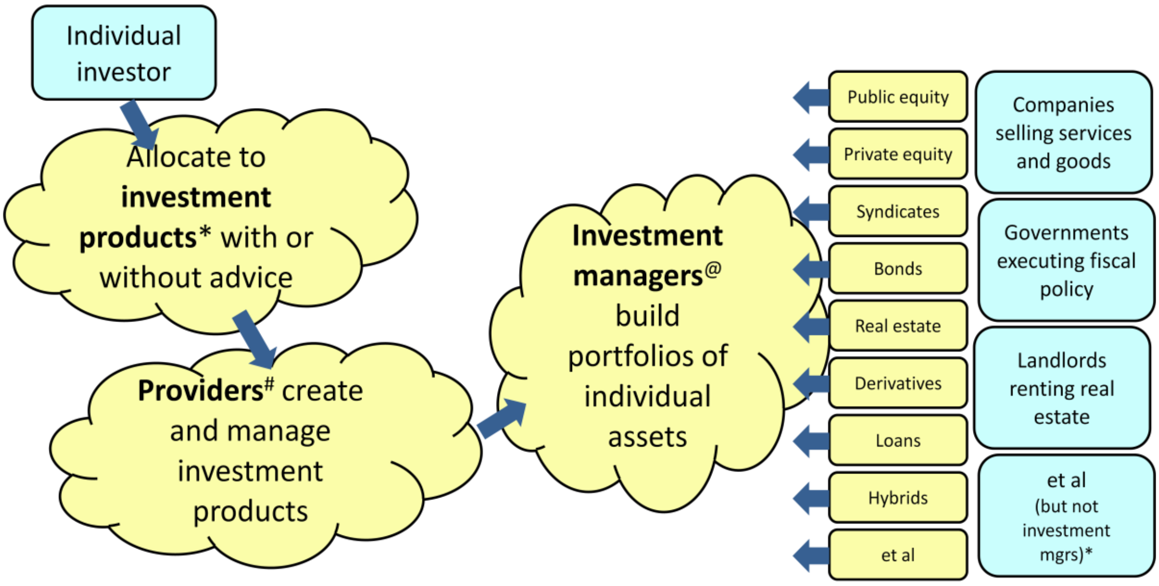
1) assisting individual investors;

2) packaging investment products; or

3) assessing individual investment opportunities.

First some important definitions:

- "Investment products" are defined to include super fund investment options, managed retail funds, ETFs et al. In other words, vehicles containing and managing aggregated investment opportunities that are made available for retail investors.
- "Providers" are those intermediaries that construct and manage investment products. They include DC super funds, retail fund managers and issuers of ETFs.
- "Investment managers" are those intermediaries that focus their attention on direct investment opportunities. They include external and internal teams with focused mandates. For these purposes, I define each "investment manager" as a distinct unit that assesses and manages its portfolio of direct investments in an internally integrated manner. For this reason, investment firms housing several separate investment teams would not be defined as being a single investment manager for these purposes. Instead, each investment team would be an investment manager. Once again, the firm would house several separate intermediaries (by my definition).



* "**Investment products**" defined to include super fund investment options, managed retail funds, ETFs et al
\# "**Providers**" include DC super funds, retail fund managers, issuers of ETFs et al
@ "**Investment managers**" include external and internal teams with focused mandates

Figure 1

Of course, some individual investors allocate some of their wealth to direct investment opportunities. But most will invest much of their wealth via investment products. In any event, they will use some sort of advice in the selection and allocation of investment products and/or direct opportunities. (Note, I earlier ruled out of scope those investors who had eschewed investment advice.)

Moreover, some providers do build and manage products of direct investments. But these products generally have narrow sector objectives and are rarely complete solutions for an investor.

CONJECTURE 4: SOME SORT OF AGGREGATION IS NEEDED TO CREATE COMPLETE PORTFOLIOS

My next conjecture is that some sort of aggregation is needed to create complete portfolios.

In the first cloud in Figure 1 we see the allocation problem faced by individual investors. With or without help from a financial planner or some other form of advice, these individuals need to assess which investment products (and direct investments) they will select, and how much. This can be a very difficult task. It inevitably involves some sort of simplification by aggregation. A typical strategy would involve identifying an allocation defined by traditional asset classes that, according to various assumptions, best suits the proclivities and circumstances of the individual investor.

Of course, the investor (with or without the help of a financial planner) could elect to outsource the whole allocation problem to a product provider by selecting just one product that is "complete" and matches the investor's needs. Plenty of such products are available to retail investors, including the set of diversified investment options offered by many retail investment houses and industry funds. (Default investment options that superannuation funds are required to provide are examples of "complete products".) In such cases the challenge of asset allocation is not eliminated, just outsourced to the product provider.

And again, in the second cloud Figure 1 (populated by providers) some sort of aggregation is required to develop strategies that encompass the huge set of investment opportunities (and other investment products) that are available to construct the providers' investment products.

In a few rare cases, some investment managers have the skills and processes to build portfolios of eclectic investment opportunities from the bottom up. The resulting portfolio may well be suitable as a complete investment product for individual investors. In such cases an investment manager (in my definition) is also a product provider, thus violating Conjecture 3. But such instances are rare and most investors would consider the product too concentrated in terms of either the number of investments in the portfolio, or skill used to build the portfolio. If used at all by individual investors, such products would be combined with other investment products, and the investor's allocation challenge remains.

At this point it is worth reflecting on David Neal's remarks quoted at start of this essay. I interpret these remarks as suggesting aggregated asset allocation is dead. Investors should simply select portfolios of direct investment opportunities that, when assessed from the bottom up, result in a portfolio that suits the investor's needs. This is an alluring proposition, but I believe it is a red herring for much of the investment industry and its clients. My Conjecture 4 is that some sort of aggregation is required by both individual investors (and their advisers) and by product providers. This is hardly controversial, but does, I believe, put to rest the notion that the practice of asset allocation is obsolete.

CONJECTURE 5: CURRENT ASSET ALLOCATION PARADIGM IS FLAWED

While some sort of aggregation is generally required to create portfolios (Conjecture 4), there is no doubt that many of today's approaches to asset allocation are flawed. This is my Conjecture 5.

ASSET ALLOCATION BY PRACTICES BY FINANCIAL PLANNERS

Why? First consider the allocation practices of individual investors advised by financial planners (i.e. the first cloud in Figure 1).

The challenges faced by financial planners are:

- Many unique client circumstances to be assessed.
- There is huge number of investment products to select from. (Let alone direct investment opportunities.)
- Planners are typically small businesses with very limited research capabilities and portfolio construction tools.

- It is administratively cumbersome to change asset allocation in real time for all clients.

The typical response often includes:

- Planners belonging to dealer groups that provide approved lists of investment products and model portfolios.
- Using research houses for rating investment products.
- Setting asset allocation infrequently.

These are generally fair responses, but issues remain:

- Model portfolios and static asset allocations are often naive with little diversification of insight.
- Asset allocations typically use the simplistic asset class paradigm.
- Asset allocations often dominated by peer and agency risk.
- Rating agencies have limited resources, and can be conflicted.

Some planners avoid the challenges of asset allocation by identifying a single, highly diversified, investment product that is suitable for the investor. In essence, they are outsourcing the asset allocation challenge to the product provider. But as I will now contend, the asset allocation embedded in most of those products have issues; it is just that the issues surface in the practices of the product provider, not the financial planner.

ASSET ALLOCATION PRACTICES OF PRODUCT PROVIDERS

Product providers face a different set of challenges when conducting asset allocation, but agency and behavioural biases are also significant issues in this realm. Their challenges include:

- They do not have deeply informed relationships with individual investors and cannot offer individual solutions based on such this knowledge.
- There is a huge number of investment opportunities to select from.
- Many have limited research capability.
- Asset allocation is seen as a key strategic investment decision, one that boards and investment committees are loath to delegate. The resulting governance practices applied to asset allocation are generally slow, require broad consensus, and many participants have limited investment skill and nous.

Most investment product providers, be they retail investment houses or industry superannuation funds, will generally approach these challenges in the following manner:

- A set of investment products (aka investment options) will be designed to meet the perceived needs of their customer base. They will often include a number of diversified funds intended as complete products for investors with different risk appetites. Sometimes they will include a set of sector products, typically based on traditional asset class sectors (or a narrower subset thereof). These products are almost always designed and described in terms of their strategic allocations to traditional asset classes. In some cases the products are described as having an absolute return investment objectives (e.g. CPI+4%). But even then this "objective" is rarely the driver of asset allocation; rather it is an expected outcome from an asset allocation that has already been determined.
- In determining the asset allocation, the decision making body (e.g. superannuation trustee board or investment committee) will generally use an asset consultant and/or an internal investment team.
- Those advisers will also recommend or determine asset class strategies that deal with sector specialist manager related issues such as active/passive, style and manager diversification and then go on to populate each asset class sector by selecting one or more sector specialist investment managers.

There are numerous issues that almost all product providers face in this process:

- Asset allocations are typically based on the simplistic asset class paradigm.
- Strategic asset allocations are often naive with little diversification of insight.
- Agency risk drives investment strategy. For example, the obsession with

underperforming competitors over short periods of time, even when longer term client outcomes are being achieved. This issue is rife in both the for-profit and not-for-profit sectors.

- Those involved in asset allocation will often jealously guard their involvement. Boards and investment committee will rarely delegate asset allocation to a small team of investment practitioners, often reasoning that it is too important to delegate, and their interpretation of their fiduciary duties would not allow such delegation. And the advisors to the process, i.e. the asset consultant and/or internal investment team see asset allocation as part of the *raison d'etre*.

BOTH TYPES OF ASSET ALLOCATORS TEND TO USE A FLAWED ASSET ALLOCATION PARADIGM

In summary, the typical response by both financial planners and products provides has serious flaws, including:

- use of simplistic asset classes
- naive processes
- no diversification of insight
- peer and agency risk
- vested interest jealously guard control
- slow governance
- illusion that retaining control will result in better outcomes

In short, my Conjecture 5 is that the current asset allocation paradigm is flawed.

DIGRESSION: THINGS WE DO NOT NEED TO AGREE UPON

Nothing I have said to date is controversial, although some asset allocators may take affront at Conjecture 5. My final two conjectures are a little more interesting. But before I move to them, it is worthwhile listing a bunch of concepts that are often in dispute, but which are irrelevant to this discussion.

This is important as much of the debate about asset allocation goes around in circles... the protagonists have not established a solid foundation for developing their concepts. By listing those issues that do not need to settled, different protagonists should be able to put aside their differences and agree to the list of conjectures I make in this note. In other words, I hope this approach allows the industry to move forward on the asset allocation debate.

Here is a grab bag some issues that people in our industry love to argue about:

- Market returns are knowable and cheap to obtain. (Or not.)
- Alpha should be separated from beta. (Or not.)
- Investment managers need to specialise in an asset class.
- Markets are efficient. (Or not.)
- That asset allocation is responsible for 90% of [pick your favourite metric]

None of these are relevant to the conjectures I propose. Taking an extreme side of any of the above issues should not put you at odds with any of the five conjectures I have already stated, and (more importantly) you should not inhibit you from agreeing to the logic of the final two conjectures.

MY FINAL TWO CONJECTURES

This is where received wisdom and practice deviates from my conjectures.

CONJECTURE 6: THERE ARE LOTS OF WAY TO SKIN THE ASSET ALLOCATION CAT

There are at least five different dimensions in which an asset allocation practitioner can vary:

- What is allocated
- Type of skill
- Portfolio construction
- Time horizon
- Process and governance

I illustrate each with some examples, but there is insufficient space here to do justice to diversification that should be possible in conducting asset allocation.

WHAT IS ALLOCATED

Examples of what gets allocated:

- Most asset allocators allocate to traditional asset class portfolios. These asset class portfolios are then typically invested in one or more traditional sector mandates, which can involve active stock pickers, index trackers, or both.
- A rare breed of managers don't bother with aggregation, but jump straight to selecting individual investments, regardless of how most in the industry would categorise the asset. I believe that this is what David Neal was referring to. It is challenging and requires a very sophisticated approach to portfolio construction, which I discuss later.
- Some asset allocators think in terms of return drivers, such as productivity, inflation, economic growth, interest rates, risk premia, commodity prices and volatility. They then look for derivatives that reflecting these return drivers (e.g. equity index futures, VIX, currency forwards, interest rate derivatives, options) and allocate accordingly.

TYPE OF SKILL

As in all investment practices, you should know your competitive edge and stick to it. As Warren Buffett said: *"If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."*

An honest assessment of your skill can lead you to different approaches. The spectrum of asset allocation approaches we typically think about range from strategic to tactical:

- If you do not have superior insights relating to market moves, then a well constructed "strategic asset allocation" that assumes mean reversion over decades, with no attempt to finesse the path is a perfectly valid approach. However, it should recognise the dearness or cheapness of current asset classes when estimating the prospective returns available over the next decade or so. You could do a lot worse.
- At the other extreme, some investment managers believe that they can exploit short lived market mispricing. This is sometimes called "tactical asset allocation".
- If you believe that prospective returns on different asset classes are forecastable over the medium term, say 5-7 years, then you could use a more dynamic approach to changing asset allocation. This is sometimes called "dynamic asset allocation", but is really just a midpoint on the time-horizon spectrum.

But this focus on the skill of the fund's own decision making (typically some combination of investment committee, internal investment team and asset consultant) ignores the fact that serious insight into asset allocation can exist in investment managers that look at the world from the bottom up. After all, returns on markets, are no more than the aggregation of returns of the individual assets that make up the market. Bottom up managers with mandates that do not limit them to a specific asset class can be effective asset allocators if they:

- Focus on a region, industry or theme but invest across the capital structure in that focus.
- Focus on identifying individual assets from eclectic sources.

PORTFOLIO CONSTRUCTION

Asset allocation is essentially a form of portfolio construction that seeks to achieve the best risk/return outcome. Here are some approaches:

- Asset allocation using traditional asset classes generally involves some sort of risk/return modelling in which assumptions for risk and return are made for the "market return" of each asset class, estimated by available index proxies.
- Focus on return drivers rather than asset classes. Practitioners form views as to the return and risk associated with drivers such as productivity, inflation, economic growth, interest rates, risk premia, commodity prices and volatility.
- Focus on risk, to ensure that each asset or asset class has contribution to the overall

volatility of the portfolio commensurate with its anticipated return.

- Examine each individual investment in terms of its idiosyncratic risks and seek other individual assets or derivatives that hedge those that are undesired. This is a challenging approach that is rarely seen, but it does allow bottom up managers to construct eclectic portfolios of individual assets with an eye to absolute risk and return.

TIME HORIZON

Examples of different time horizons:

- Strategic asset allocation: decades
- Dynamic asset allocation: 3-7 years
- Market mispricing. Varies:
  - some approaches have very high turnover
  - some approaches look for strategies to resolve over 3 years

PROCESS AND GOVERNANCE

As I indicated in Conjecture 4, most asset allocators today are either (a) financial planners guiding their individual clients into a portfolio of investment products, or (b) product providers (such as defined contribution superannuation funds) setting strategy for a set of diversified products.

Each has process and governance issues, as previously discussed. Common themes include:

- slowness
- decision makers are not close to markets
- governance process designed around compliance and business risk, not investment nous
- need for consensus makes "brave" decisions difficult

On the other hand, investment managers typically have governance processes that should be more suitable for successful asset allocation. In particular, developing investment insight and making investment decisions is part of their day job. And they can make decisions in real time. While investment managers can worry too much about their own business risk, this can be mitigated by awarding carefully designed mandates.

SUMMARY

Conjecture 6 states that there are many dimensions along which asset allocation practices can vary, including:

- What is allocated
- Type of skill
- Portfolio construction
- Time horizon
- Process and governance

The full diversity of insight and process is rarely explored by most asset allocators.

CONJECTURE 7:
IMPROVE DIVERSIFICATION BY ALLOCATING TO OTHER PROCESSES AND INSIGHTS

All of which leads me to my final conjecture that asset allocation can be improved by allocating to other asset allocation processes and insights.

The typical approach to asset allocation can be thought of as cutting up a cheesecake.

Each piece represents a traditional asset class and generally consists of several layers, representing different sector specialist investment managers in that asset class. There is a huge degree of diversification within the slice.

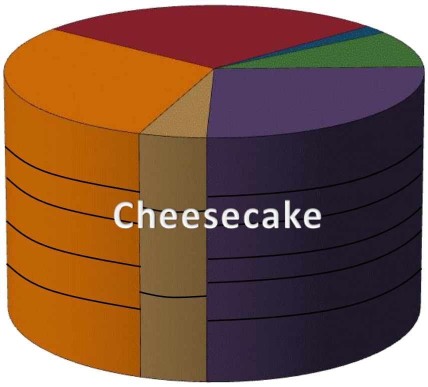


Figure 2

But consider the processes and skill that go into deciding how big each slice should be. This is typically concentrated on the decisions of non-experts with slow process and obsession with agency risk.

But as Conjecture 6 has demonstrated, there are many ways to skin the asset allocation cat. In my view these are not exploited by most asset allocators. Which leads me to my final conjecture: It is possible to improve diversification of the critical asset allocation activity by allocating to other processes and insights.

How? Back to the cheesecake. Why not slice some "pizzas" off the cheesecake? (Please excuse the ugly mixed metaphor.)

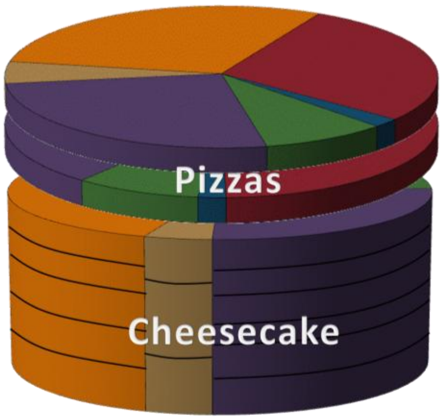


Figure 3

In the diagram I show two pizzas which each account for 15% of the total, leaving 70% subject to current asset allocation practices. But these are just stylised. I would suggest that smaller allocations to the "pizza" managers may be appropriate as a first step. And over time it may be possible to identify several such managers.

A key point to remember in this approach: each pizza manager should be awarded an independent mandate with no attempt by the client to influence the manager's approach to asset allocation. This probably argues against setting a benchmark based on the return of a static allocation to traditional index proxies. This can be challenging and is beyond the scope of this note.

Also, it is vital to use managers with genuine skill. There is simply no point in diversifying into mediocrity. Of course, identifying true skill in this area is also challenging. There is no substitute for deep immersion into the managers processes and resources.

ROAD BUMPS

I believe that these seven conjectures are logical. But the final conjecture does not reflect common practice. There are a number of reasons for this, which I list below. In the first group, the enemy is us... how our industry has let behavioural biases and agency effects fashion the way in which asset allocation is performed. But there are some technical challenges, which I list at at the end.

The enemy is us. To change we need to:

- Wrest power from current asset allocation decision makers and advisers who are driven by self interest and the illusion that having control will lead to better outcomes.
- Change the naive disclosures requirements that insist on allocating into asset classes.
- Take peer and career risk.
- Think about genuine sources of risk and return, without the security blanket of the benchmark.
- Live with the outcomes of independent processes.
- Find managers who can genuinely offer asset allocation diversification.

The open technical challenges include:

- Designing products to meet true investment objectives rather than simply reflecting the investment approach used.
- Measuring performance in terms of meeting objectives, rather than beating some index or peer group.

LOOKING FORWARD

I would love for readers to identify any holes in my logic. It is my view that diversifying the process and insights of asset allocation should lead to better outcomes for our ultimate clients, the mums and dads who need to defer their consumption for decades.

No doubt many readers may remain uncomfortable at moving in this direction. Indeed, the dearth of investment managers offering truly integrated alternatives to asset allocation is largely due to the absence of demand for such products. While there are some technical issues that require resolution, the dominant roadblocks are the behavioural biases and agency effects that permeate our industry.

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