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Maximizing Your Portfolio Benefits Via Asset Allocation

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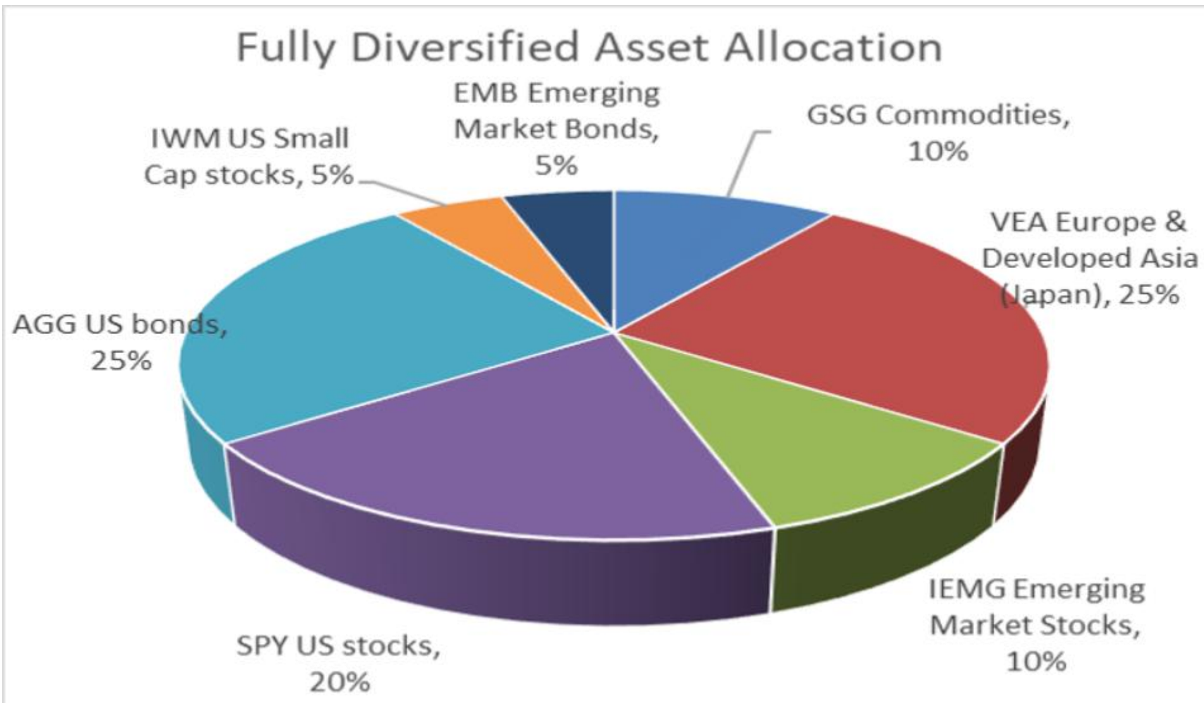


Are you truly diversified? WARREN FINANCIAL

Asset Allocation: Strategic Static, Endowment Style and Tactical Asset Allocation

Studies have touted that close to 90% of investment returns are determined by portfolio allocation. One of the often referred to studies was a paper by Gary Brinson and Gilbert Beeblower "*Determinants of a portfolio performance*" in 1986 which states that asset allocation strategy accounts for 94% of a portfolio's returns. This study points to a passive approach of a strategic allocation and that security selection will play less of a role in investment returns. Since the Financial Crisis in 2008 the strategic asset allocation model has come under scrutiny as asset classes have become more correlated.

Definition of the Types of Asset Allocation:

First a few definitions:

- **Asset Allocation -** simply, how you divide your money into various categories i.e.: stocks, bonds, cash.
- **Correlation** - a statistical measurement used to convey the strength and direction of a relationship between two variables, for instance, there is a very high correlation between the daily rise in temperature compared to the daily rising of the sun, and there is a very low correlation between the daily temperature and the day of the week.
- **Strategic Portfolio Allocation** - the traditional method aligned with **Modern Portfolio Theory** which was defined by Harry Markowitz in 1952. Strategic asset allocation involves setting targets for broad-based diversification across multiple asset classes. When creating the portfolio, the manager establishes an asset mix based on the expected long-term risk and return dynamics of each asset class.
- **Tactical Asset Allocation** - often poorly defined by many in the financial industry, implying that it is about timing the markets or active portfolio trading. It is driven by the prediction of underlying shifts in macro trends which occur over long periods of time (years) and then allocating assets accordingly. It similar to strategic allocation in that there is a target allocation for the major categories such as stocks, cash, and bonds but the target allocation is more flexible and can be adjusted given the economic and fundamental conditions. Some allocation categories may be completely avoided given the risk/return expectations.

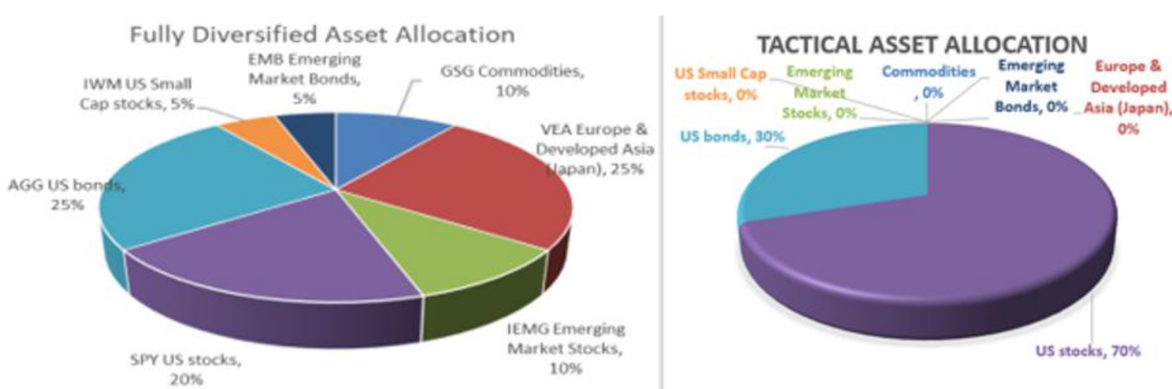
Are you truly Diversified?

Until the early 90's Strategic/Modern Portfolio Theory had a big influence on the allocations of pension funds and endowments and how their portfolios were structured. Today many Wall Street firms and advisors still use this theory to structure portfolios for individual investors. The rational is that this model is used by large institutions, it can be applied for the long-term, it is passive, disciplined, and eliminates the inclination for individual investors to overtrade or use market timing thus keeping investors in the market. The idea behind the theory is to allocate to asset classes that are less correlated or negatively correlated to each other with the expectation of enhanced returns and reduced risk to the portfolio. Key to Modern Portfolio Theory is to rebalance back to original weightings at set times with the idea being to purchase undervalued assets while trimming overpriced assets. The assumption is that asset classes will revert back to the long term average performance ("reversion-to-the-mean"). The Strategic model came into question as the correlation of most asset classes, outside of government bonds, became highly correlated during the large market declines and still have not started behaving statistically/predictability as in the past after the markets began to recover. This has led to the Modern Portfolio/Strategic theory models dramatically underperforming the major averages for the last 10 years. Over the past 10 years, the broad diversification to sub-categories such as International, Emerging Market stocks and bonds, and Commodities have worked against those portfolios. An important fact to keep in mind is that correlations change over time, sometimes quite dramatically.

The Strategic model is less sensitive to macro-economic and demographic shifts and heavily relies on the statistical reversion to the mean with the expectation that asset class will be driven accordingly. Some important demographic shifts include the pattern of savings by a retiring population (demand for fixed income), quantitative easing and low inflation that have reduced interest rates (bull market in bonds since the early 1980s), the increase in the level of debt by governments and its effects on secular slower economic growth that started with the financial crisis in 2008 (demand for US risk assets as US economy has been the strongest worldwide).

Tactical Asset allocations are generally implemented based on current and future analysis of market trends and are adjusted periodically. Like Strategic allocation there may be an overall allocation target such as 70% to equities and 30% to fixed income. The major difference from the MPT/Strategic models is that the Tactical models allow for flexibility in the allocations. The Tactical models may increase or reduce the weightings based on these long term fundamentals. Simply put, managers seek to create additional return by concentrating weightings in certain asset classes and securities that are expected to outperform the benchmark indices regardless of market direction. Warren Buffet was quoted saying, “ that if you lived in a growing town and you owned stock in three of the best enterprises in the town, isn’t that diversified enough?”

Using a 70/30 allocation the Strategic model can be broken down as shown in the chart below compared to a Tactical 70/30 allocation.



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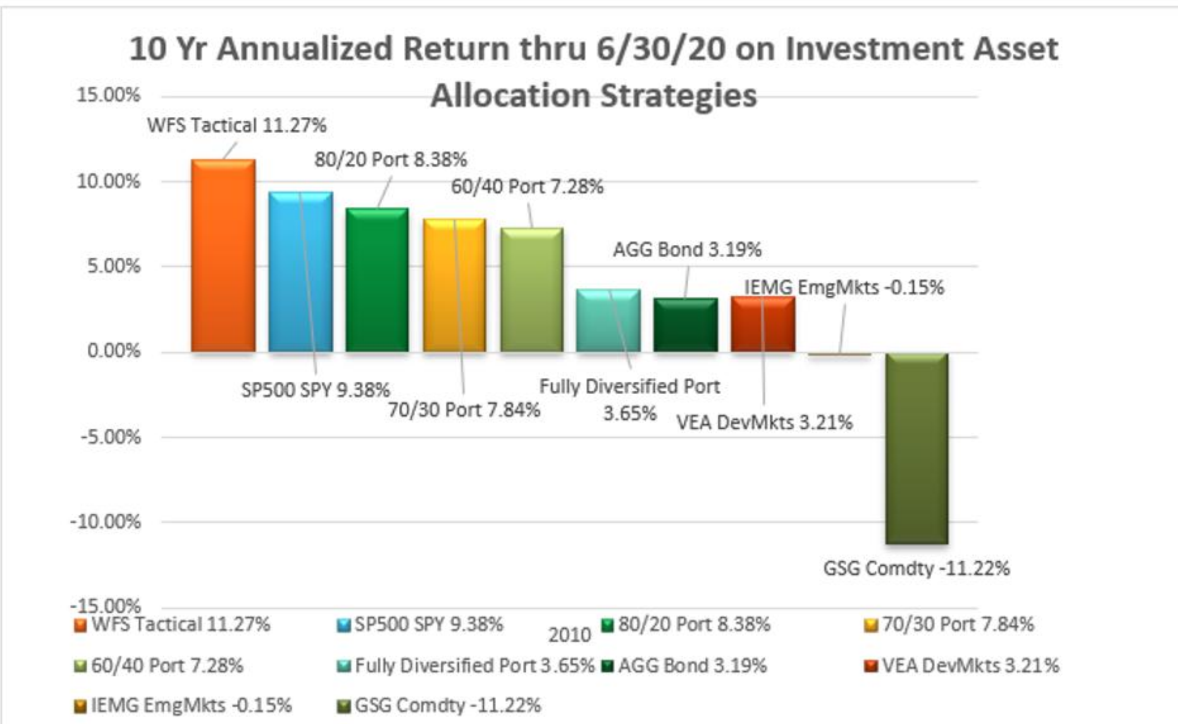
The return on a strategic 70/30 portfolio with allocation to international, emerging market stocks and bonds and commodities, as shown above, over the last 10 years (through 6/30/2020) was 3.65%. If the portfolio was tactically weighted to just the US 70% S&P and 30% AGG (benchmark for bonds) the return would have been 7.28%. The S&P index (SPY) SPY +0.1% was up 9.38%, and Bonds (AGG) AGG up +3.19% on an annualized basis during that time frame. Interestingly enough, the inclusion of weightings to developed international, emerging market stocks and commodities has worked against the strategic portfolio. International stocks (VEA) VEA were up +3.21%, Emerging markets (IEMG) IEMG down -0.15% and Commodities (GSC) were down -11.22% annualized over that 10-year period (ending June 30, 2020). A Tactical allocation weighting would have been a significantly more profitable allocation over the past decade.



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One explanation for the drag on the strategic portfolio (which includes diversification to international, emerging market stocks and bonds and commodities) is that correlations between allocations have tended to increase in negative markets, but not in positive markets. This "correlation problem" could be due to the fact that fundamentals become extremely more important in up markets whereas simple investor panic is the overwhelming characteristic in dramatic market downturns.

Correlation to the S&P Index			
Asset Class	**ETF**	**Long term average**	**2007-2009**
Investment grade bonds	AGG	-0.01%	4.10%
Commodities	GSG	50.10%	56.50%
International Equities	EFA	73.00%	91.50%
Emerging market	EMM	56.00%	85.30%
REITS	VNQ	73.50%	82.00%
High Yield Bonds	HGY	51.00%	73.80%

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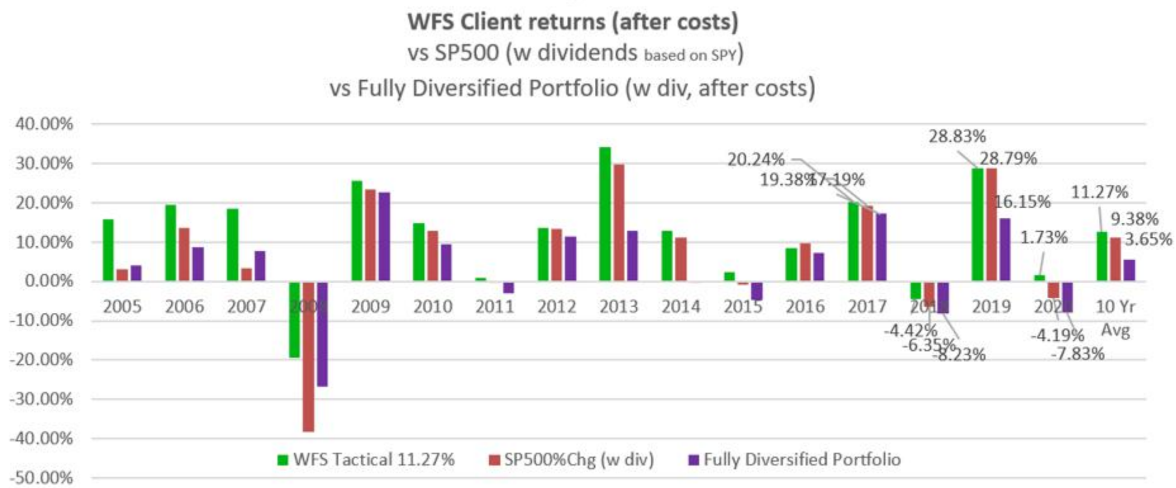
The real question is "Does allocation to riskier sub asset classes in a strategic portfolio truly provide diversification?". This seems to highlight an important distinction between risk diversification and return diversification. In general, bonds have lower volatility and add stability to a portfolio in times of market stress whereas risk premium sub asset classes provide some diversification but may have been added to provide higher returns.

As an example of Strategic versus Tactical allocation during the financial crisis, compare a 70/30 Strategic portfolio and a Tactical portfolio of 100% US equities. During the crisis, the Tactical manager adjusted the weightings to 50% equities and 50% bonds. The drawdown of the S&P 500 was nearly 40%, compared to the Strategic/diversified portfolio which was down 26%, but a Tactical portfolio that was flexible and reduced its equity weighting to 50% was down only 19%. This move allowed the Tactical investor to recover to pre-crisis levels much quicker than for the other investment styles. Anyone can back test a model and have the results come out to their own advantage, but this was an actual tactical move by Warren Financial during the 2008 crisis.



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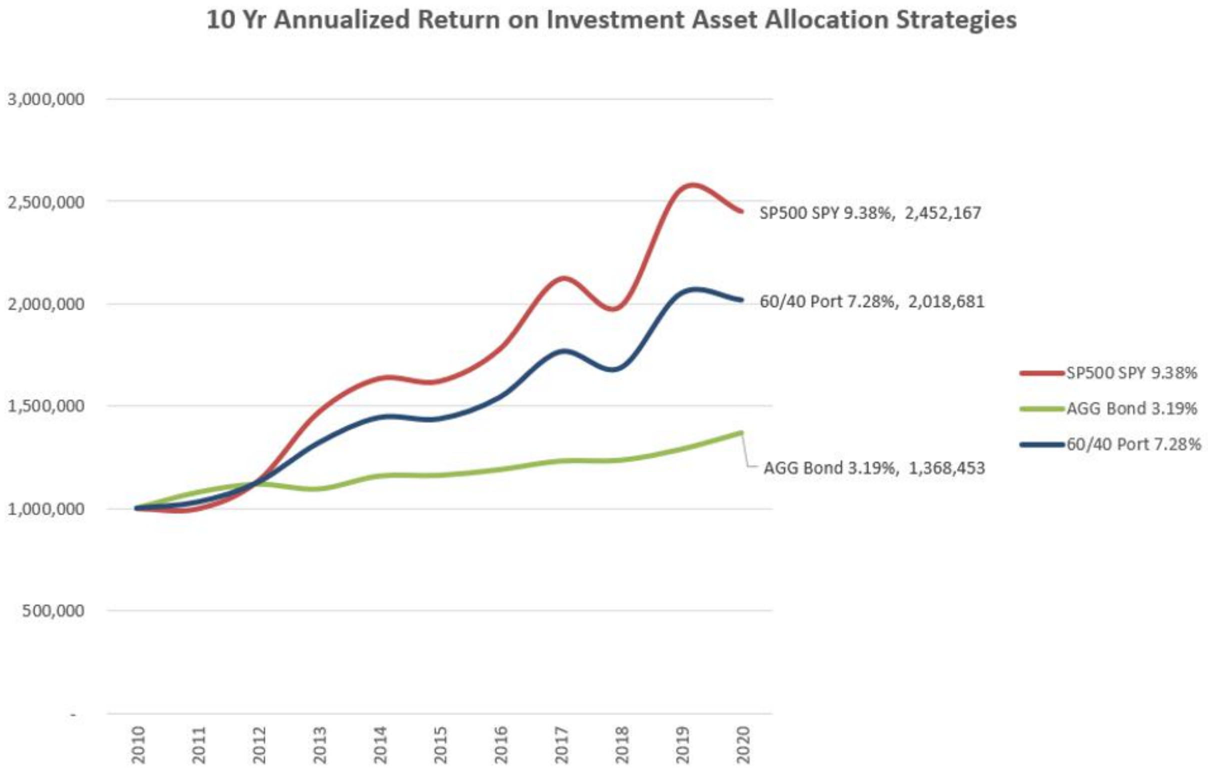
The Classic 60/40 Portfolio

One of the most commonly referred to asset allocation models has been the 60/40 portfolio. It has served as a benchmark for most moderate risk-taking investors and most investment managers. The chart below shows that this portfolio which is allocated to the US markets has kept pace with the indices. The 60/40 portfolio has returned close to 7.28%, with the S&P returning 9.38% and Bonds(AGG) 3.19% over the last 10 years through June 30, 2020. Note the correlation has been negative between stocks and bond and bonds provide low volatility, but the return on bonds has not kept up with equity returns even during the past 30 year bond bull market.



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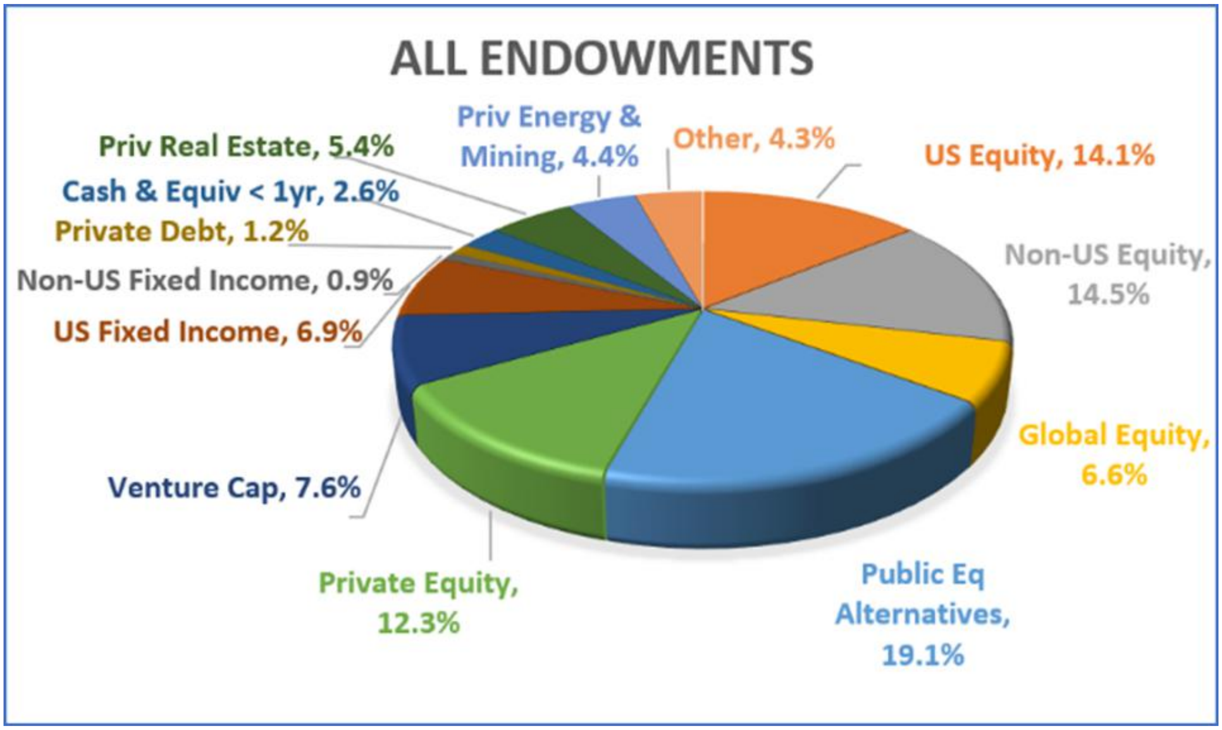
Rather than throwing his/her hands up and allocating assets all across the globe in hopes of a return-to-the-mean, a tactical manager may make a tactical decision and look at the fundamentals of the present situation (1) historically low interest rates - less than 0.6% on the Treasury 10-year; (2) notice the correlation of stocks to bonds has been negative for 20 years. This realization would then lead to a decision to underweight to US and international bonds thinking that a positive correlation could develop with the return of inflation. The resulting conclusion would be that bonds will likely dramatically underperform their returns over years past. Also, with central banks likely to keep rates low into future economic cycles, increasing an allocation to equities and alternative assets may prove to be appropriate.

A Shift in Styles for Endowments and Pension Funds

As discussed earlier, some investment firms have begun to mimic the institutional pension and endowment model. For the most part this strategic portfolio is still the model used today at many firms and with robo-advisors.

The year 1985 was the advent of the Endowment model moving away from the strategic model. This was dubbed the Yale Endowment model based on the Yale University endowment which diversified away from the traditional 60/40 portfolio mix using the long-term horizon of their endowment and investing in alternative investments. Endowments started to invest in alternative investments such as venture capital, private equity, real estate and hedge funds. The aim was to yield a risk-adjusted return above the 60/40 strategic asset allocation while simultaneously reducing the volatility. The graph below shows that the typical endowment portfolio does not look anything like the 60/40 portfolio!



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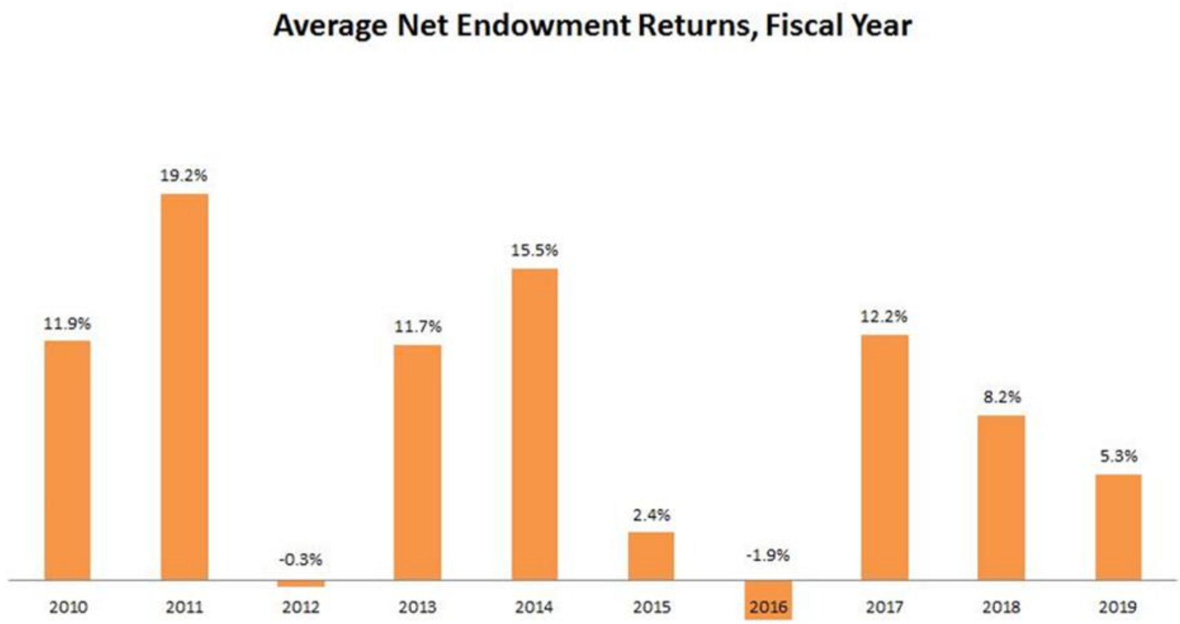
For several years, the top 20 university endowments were outperforming the public pension funds. Within the last 10 years public pension funds have started to diversify into alternative investments. As a side note, in 2019, Yale and a many of the major school endowments did fall into the reversion-to-the-mean "value trap" in the case of international equity markets. They increased their international equity allocation to 15.3% while decreasing their US equity allocation to 3.5%. Since the reversion-to-the-mean didn't occur (and has not occurred for over 10 years) this resulted in poor performance of just 5.7% compared to the S&P of 28.79%.



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The individual investor has more difficulties taking advantage of the same opportunities in this strategy due to net worth requirements for the private investments and lack of liquidity. There have been some 1940 Act funds that have tried to provide opportunities but have lacked quality managers in these areas. In the private investment area, it is really the top 10% of managers that separate themselves from the rest of the field in the alternative investment space.

Summary: What an Investor needs to think about!

Charlie Munger once said ,“The idea of diversification makes sense to a point. If you do not know what you're doing and you want the standard result and not be embarrassed, why, of course, you can widely diversify.”

The style of asset allocation has evolved from the Modern Portfolio theory in the 1950s to the benchmark 60/40 portfolio and then in 1985 to the endowment allocation. All these asset allocation styles have found places within the investment community. The main problem is that these styles fall back on the mathematical models and correlation for diversification. Asset strategists at many firms alter weighting to traditional asset classes and claim they are tactical. The weights do not change significantly and therefore there is no dramatic difference to their models or returns. No single mix of assets will remain optimal over the long term. With below normal economic growth rates, low inflation and historically low interest rates, correlations will continue to shift over time. Assets that were negative in the past may very well change to positive as the macro situation changes, such as with longer-term bonds.

The Strategic model/multi asset model in theory may sound wise but in sharp downturns has offered little protection. The weakness of those models is their blind belief in the reversion to the mean – which may in fact be mathematically true but also may leave the investor underperforming for decades. Perhaps a way to think about the Tactical model is to simply realize that investors like Buffet and Munger continue to point out that “homework”, a concentration of asset classes, and some very selective individual “companies” (specifically calling them companies here and not just “stocks”) can help the investor avoid over-diversification. A tactical manager not relying solely on statistical measures can use fundamentals and valuations to take advantage of mispriced asset classes for the benefit of a portfolio i.e. recently muni and corporate bonds as substitute for government bonds, as well as sector and individual stock selection.

Accredited investors have the opportunity to increase portfolio efficiency with the use of alternative/private investments such as life settlements, private lending and real estate to replace the income needs of fixed income, and to use venture capital, private equity and volatility hedge for equities.

I’d like to thank my colleague John (Jay) O’Toole for his contribution to this article.

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