portfolio construction CONFERENCE
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ASSET ALLOCATION MASTERCLASS – KEY TAKEOUTS

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The Asset Allocation Masterclass provided participants with a variety of different topics, all around the central theme of asset allocation practices and building better portfolios for investors and clients.

The Masterclass started with Tim Farrelly, Principal of farrelly's Investment Strategy, reviewing the well known strategic approach to Asset Allocation (SAA), based on Modern Portfolio Theory. This was followed by a review of farrelly's long term forecasting approach, the central to the concept of Proactive Asset Allocation, an asset allocation approach that sits somewhere between the static model offered by SAA and Tactical Asset Allocation (TAA). The Masterclass also looked at the way the experts do it, reviewing the Harvard and Yale Endowment Funds and why they have been so successful over the long term. The audience heard from David Hudson of Blackrock who runs a very active and diversified TAA approach and then looked at where Alternatives fit into the asset allocation debate. The Masterclass finished with a look at the secure or income part of a portfolio, highlighting the fact that this part of an investor's portfolio is just as crucial to get right as the growth component.

Overall, my three key takeouts from the day were:
- The idea that equities do not always outperform bonds over the long term;
- There are a number of different approaches to asset allocation, which suit different businesses;
- The secure part of investors' portfolios deserves more attention than it gets.

These three key takeouts are discussed in detail below.

Equities do not always outperform bonds over the long term

Which is the better performer over the long run? The Masterclass audience was challenged to rethink the notion that equities always outperform bonds. Evidence was presented for the US market in which, over the 40-year time period to early 2009, equities did outperform bonds. This point was reinforced again by Rob Arnott later during the PortfolioConstruction Conference, where he went to so far as to say equities are unlikely to ever outperform over the longer term, and that we have now categorically seen 40 years of equities underperformance in all the major markets.

The Masterclass also examined the concept of market bubbles, busts and risk, possible ways of identifying bubbles and how this might translate into portfolio decisions, for example by reweighting or taking profits. With regards to risk, the discussion developed on from the concept of bubbles and what do you do about them, to whose risk should be managed in these circumstances – business risk, client's portfolio risk, or a combination? The challenge presented, and a key takeout was – if we can no longer assume that equities will always outperform bonds in the long term, how does that change current portfolio construction practises?

There are a number of different approaches to asset allocation, which suit different businesses

There are a number of different approaches to Asset Allocation currently operating in the market. The traditional SAA model, based on Model Portfolio Theory, was agreed by almost all presenters not only in the Masterclass but over the entire Conference, to be outdated and limited in what it can achieve in the current environment. A number of TAA approaches were also discussed such as the fully active and diversified approach used by David Hudson at Blackrock, and the newer Proactive Asset Allocation approach which sits somewhere in the middle.

The Harvard and Yale Endowment Funds case study was fascinating. These funds put state of the art research into practice and have been the role model for the investment world for the past decade. Both funds outperformed their peers by large margins over this time period. The clear message was that asset allocation is important – but that manager and stock selection is even more critical. Diversification is also key, but investors need to choose their diversification strategy wisely. Chasing successful strategies is not going to give the same results for clients! In fact, while there are excellent lessons to be learned, and every practitioner should aspire to a better way of doing things, the reality is in most businesses there are other issues to consider:

- client expectations (this also relates to my earlier comments about managing client's risk);
- liquidity (the Harvard and Yale Funds don't have to worry about this); and,
- access (do the really good deals actually see the light of day for ordinary investors?).

The question could be asked, would you settle for a second best investment for clients in an asset class such as Private Equity? Neither the Harvard nor Yale fund has to make that decision – they have large allocations to Private Equity, securing access to the best deals, which has been a significant contributor to their overall performance.

The key takeout was that each business is different. Each has different clients and different objectives and each therefore requires its own tailored asset allocation approach. There is no easy answer – should businesses be doing more of the asset allocation function themselves? Less of it? Some of it, or should it be outsourced completely? Two prominent researchers put forward the argument toward the end of the Conference that the SAA approach was in fact not dead in the water and it was a superior approach to implement for clients if well structured in the first place, and therefore it still has a role to play in modern day portfolio construction. It's fair to say the jury is still out on this one.

The secure part of investors' portfolios deserves more attention than it gets

The third and final key takeout from the Asset Allocation Masterclass was to take a closer look at the secure part of clients' portfolios – defined as the low returning portion of the portfolio. Delegates were challenged with the assertion that lower returning assets can actually give better outcomes than we might normally expect. What is the value of certainty? Post GFC, we'd say it can't be underestimated, but 18 months ago, was there certainty and what did it mean for risk profiling? Should the weightings between riskless and risky assets change?

Following on from those concepts is implementation – how do you build a portfolio of secure assets or riskless assets? Even in this part of the portfolio, diversification is very important. For example, the Masterclass heard from Michael Korber, Head of Credit at Perpetual, who reviewed the hybrid universe compared to the overall fixed interest universe and examined how diversification can be better achieved in having a broader universe. The question was asked – can the funds you are buying into stand up if one security goes under?

Finally, how does this all accord with our businesses and clients if we are now thinking in terms of "risky" and "secure" assets as opposed to the very familiar concepts of "income" and "growth" assets? Is this just a concept or will this affect the way we, as an industry, construct portfolios going forward and also the way in which we communicate to clients? The industry has moved forward on a lot of these issues – investors now understand that bubbles really exist and that they can hurt their returns very quickly. Investors also have a better understanding that income assets can be highly risky. The key takeout form this session was that we should all continue to invest in our ongoing understanding and application of current best global practices for the construction of above industry benchmark investor portfolios.