The importance of asset allocation

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"The Importance of Asset Allocation" by Roger G. Ibbotson, Financial Analyst's Journal, Vol 66, No 2, 2010

This paper should be considered required reading for any practitioner building portfolios using (in whole or in part), managed funds.

Ibbotson is a Professor of Finance at Yale School of Management, the founder of research firm, Ibbotson Associates, and Chair and CIO of Zebra Capital. He's also the author of some of the most important research in the area of asset allocation.

In this paper, Ibbotson revisits the seminal work of Brinson, Hood and Beebower (BHB), "Determinants of Portfolio Performance" published in 1986. BHB concluded that over 90% of the variation of a fund's returns was the result of asset allocation. Unfortunately, as Ibbotson highlights, the BHB paper has been misquoted for many years, as concluding that asset allocation makes up over 90% of the return in portfolios.

Extending BHB's work, the question, in Ibbotson's opinion, is "What portion of the variation in fund return differences is attributable to fund asset allocation policy differences?"

In other words, returns can be considered as having three parts:

1. The return from being in the markets at all (i.e. the decision to not just hold cash);
2. The return from asset allocation policy; and,
3. The active return – from timing and manager selection

BHB's study considered parts 1 and 2 and compared them to part 3 – which is why their answer as to what variation of a fund's return was the result of asset allocation was 90%+. Most fund returns (and portfolio returns) come about purely from moving out of cash.

However, most practitioners are interested in identifying 1, 2 and 3 separately – which is really why we all try to find superior asset allocation strategies, and timing and manager selection methodologies.

So what is the answer to Ibboton's question?

It depends... the answer is not static, as it depends on the fund sample you use and the time horizon you examine. Based on the most recent studies cited by Ibbotson, the answer to his question is that about 75% of a fund's returns come from market exposure (that is, part 1 of

the three return aspects above) and the rest is evenly split between parts 2 (asset allocation policy) and 3 (timing and manager selection).

In effect, what Ibbotson confirms in this paper is that after the decision to actually invest is made, asset allocation and manager selection are both crucially, and equally, important in explaining the variation in fund return differences.

Read "The Importance of Asset Allocation"

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