A widely accepted portfolio construction flaw

Michael Furey | Delta Research & Advisory | 30 September 2015

The typical approach to portfolio construction in the world of financial planning is a two-step process (of course, after the desired risk and return characteristics are settled). The first step is setting the asset allocation and the second is investment selection, for which most of the industry chooses to select from a variety of managed fund strategies.

While there may be many different outcomes across the industry with respect to the asset allocation decision, estimates of return and/or risk for a variety of asset classes are considered before settling on the recommended result – whether it be designed around risk profiles, return objectives, or risk allocation. Unfortunately, it is the second step of portfolio construction – that is, investment selection – where a major flaw exists across the industry, with the result that the final portfolio may introduce greater risks than realised.

Part of the problem is that the two steps are approached independent of each other. The asset allocation decision is a market beta decision – that is, the allocation is decided according to expectation of the performance of each particular asset class over a particular time period. Performance expectations are based around benchmarks such as the S&P/ASX 200 and MSCI World for shares and the Bloomberg Ausbond Composite (formerly UBS Composite) and Barclays Global Aggregate for bonds. So, if the asset allocation places 30% into Australian shares, the expectation is that the final portfolio will reflect that 30% allocation.

Where the portfolio construction flaw comes in is that the investments selected may resemble nothing like the asset class they are supposed to represent. For example, within an equities allocation, managers may take positions such that the return outcome is completely unrelated to the equity market intended in the asset allocation decision. Some of these strategies may be variable beta, market neutral, or those with specific geographic exposures such as emerging markets (or as extreme as India or China). While there may be potential return merit in the chosen strategies because the decision is independent to the asset allocation, the investor's experience (i.e. the performance of the end portfolio) may be very different to that which was expected.

Figure 1, while intentionally ridiculously messy, shows the three-year rolling market beta over the last 11 years for more than 250 Australian equities strategies. They are all long-only or long-biased strategies. While the average beta of all strategies is 1 (the average line on the far left of the graph), the variation in beta, or market exposure, of this strategy universe is enormous, ranging from 0.2 to 1.8.

Figure 1: Market Beta (S&P/ASX 200 TR) exposure of Australian Share funds ... each dot point is rolling 3 year average
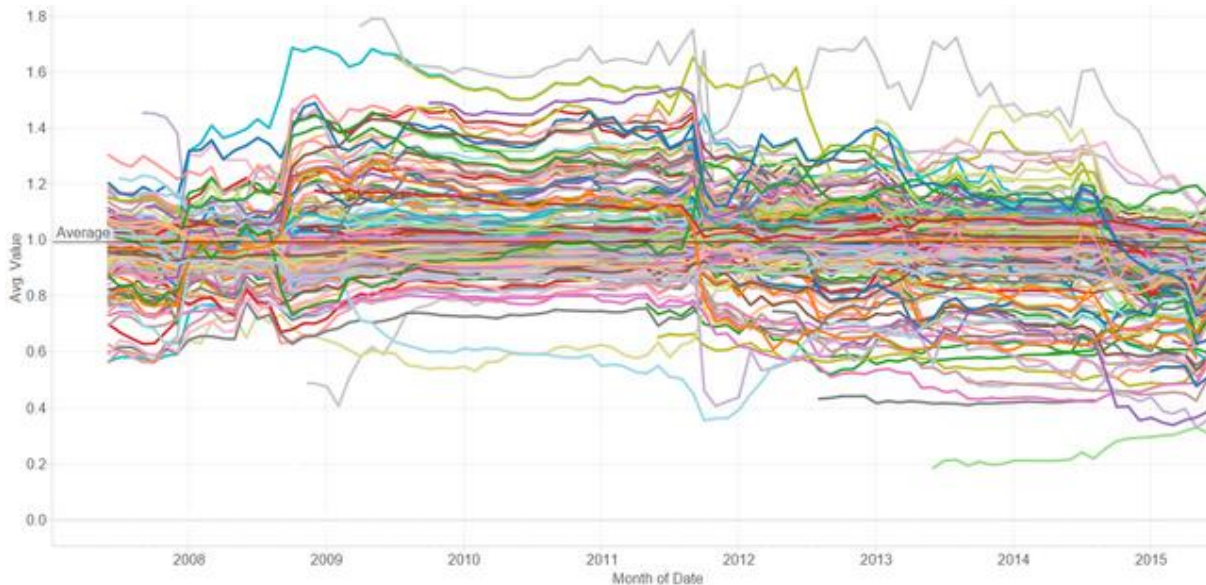
Source: Delta Research & Advisory

Believe it or not, the fund with the 1.8 beta is not a geared share fund (as would normally be the case) but is a long–only, sector specific strategy. The strategy with the 0.2 beta is a deep value, long–only strategy that uses cash when the manager doesn't see opportunities. These types of strategies are quite frequently selected as part of an Australian equities allocation despite their performance history suggesting they are either much riskier than the market (akin to a geared share fund i.e. beta = 1.8) or provide very little exposure at all (beta = 0.2). If a portfolio constructor is looking to choose investments that reflect an intended asset allocation, these extreme strategies would be very poor selections.

So what to do?

To be true to an asset allocation requires consideration of the likely market beta of the strategies in a portfolio – and strategies with market betas of between 0.8 and 1.2 consistently are possibly best, as choosing strategies outside of this range increases the risk of significant underperformance and heavy reliance on a strategy generating large alpha (which is not always easy to come by). We know that past performance rarely equates to future performance – but the same is not the case of a strategy's beta, as a very high proportion of strategies do show consistent beta (often mandate determined).

It is expected that many portfolio constructors – particularly objective–driven believers – will not like or appreciate the "beta 1" approach to strategy selection and, in the context of their investment philosophy, that is fair enough. As mentioned above, the root cause of this

portfolio construction flaw is that the asset allocation decision is independent of the investment selection decision.

The true solution of this portfolio construction dilemma may be that there is no two-step process to portfolio construction - rather, the asset allocation and investment decision are performed simultaneously. Earlier in the year, there was a widely held belief (perhaps still true today) that all major asset classes were expensive. If this is the belief, then beta of 1 may be a poor investment decision and movements away from market risk and towards smart beta and/or alpha potential is best. Either way, understanding the beta of investments selected is an important part of the portfolio construction decision and one that will aid in aligning with the desired portfolio philosophy and outcomes.

Michael Furey is Managing Director of [Delta Research & Advisory](#), which specialises in providing independent, conflict-free investment research and asset consulting services to dealer groups (AFSLs), financial planners, and self-directed investors. He has worked in the financial planning industry since 1999, both in research and financial planning roles.