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Is Asset Allocation The Single Most Important Investment Decision?

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The proper implementation of asset allocation, and the correct application of its processes has been a concern for investment practitioners since the founding of modern portfolio theory by Harry Markowitz in 1952. As part of New Frontier's legacy of investment research in daily practice, Dr. Richard Michaud will deliver a series of presentations on "Rethinking Asset Allocation" consisting of four topical areas for understanding the historical context of asset allocation for investors, and the competing theories that have arisen around its proper execution – something Dr. Michaud has thought about since his 1989 study on traditional portfolio optimization, and the statistical uncertainty of risk-return estimates in investment information.

Below is a 2017 blog Dr. Michaud wrote on the Hensel, Ezra, Ilkiw (1991) study detailing advancements in passive versus active investing, portfolio optimization, and why the proper implementation of asset allocation continues to be an important message 30 years later.

For the last twenty-five years, the strategic investing mantra has been that long-term asset allocation risk policy is the single most important investment decision. Risk policy is usually defined as the stock/bond ratio of the asset allocation.¹ Many large financial intermediaries as well as financial advisors consider asset allocation risk policy as dominant in long-term portfolio investing.

The research associated with strategic investing policy is based on Brinson, Hood, Beebower (1986).² They were the first to examine the long-term performance of institutionally managed pension plan portfolios. They reported that 94% of the variance of institutionally managed portfolios was associated with the stock/bond ratio of the portfolio. They also found that the two other components of performance, fund selection/management and market outlook, were negatively related to long-term return.

The Brinson et al studies were a shock to institutional investment community. Their results were totally at odds with what institutional asset managers had believed. Policy, not active management, was the only important factor in managing long-term portfolio return. The results were viewed as confirmation of the academic notion of the Efficient Market Hypothesis (EMH).

¹The more modern version is stock/non-stock ratio. This is because mortgages, commodities and other fixed income asset classes are also often included in the definition of asset allocation risk policy.

²The follow up study Brinson, Singer, Beebower (1991) extended the data and confirmed the original conclusions.

In an often neglected study, Hensel, Ezra, Ilkiw (1991), using a separate though similar database, also examined the long-term performance of institutionally managed portfolios. They noted that the Brinson et al studies were interpretable as the importance of asset allocation risk policy relative to riskless rate investing. In their study they decomposed the components of long-term asset allocation portfolio performance focusing on the stock/bond ratio decision, fund management, and market outlook. In contrast to Brinson et al, they find that the stock/bond decision and fund management were equal in importance, each representing roughly 40% of portfolio variance. Market outlook was attributable to most of the remaining 20% of portfolio variance.³ They also noted, as in Brinson et al, that fund management and market outlook were negatively related to long-term return.

In hindsight, the nearly universal acceptance of the Brinson et al results may seem surprising. Why would anyone dismiss portfolio management or market outlook as insignificant in long-term asset allocation performance? One reason may have to do with effective marketing campaigns by consultants of policy based strategies. Another has to do with the iconic academic authority of the EMH. However, even accepting Hensel et al as the superior study, no component of performance other than the stock/bond ratio decision affected return in a positive way.

An alternative to the EMH consistent with similar evidence seems important for the investing community to consider. Perhaps the market is not informationally efficient but that asset management is deficient. For example, Michaud (1989) noted that traditional portfolio optimization is ineffectual because it does not consider the statistical uncertainty of risk-return estimates in investment information. Consequently, even in the presence of valid investment information, the limitations of traditional portfolio optimization would likely limit any benefit.

Asset management technology needs to show evidence of additive investment value. New Frontier multi-asset core ETF strategies benefit from significant 21st century technological advantages. Simulation tests show that the Michaud optimizer is superior out-of-sample compared to traditional portfolio optimizations.⁴ In addition, the Michaud-Esch resampled portfolio rebalancing technology is the first of its kind to use portfolio similarity methods to decide when rebalancing may be advisable on a statistical basis.⁵ It is worth noting that our ETF strategies are often above standard benchmarks and highly ranked relative to competing alternatives over extended time periods.⁶

³Ibbotson and Kaplan (2000) confirm the Hensel et al decomposition of long-term portfolio performance.

⁴Michaud (1998).

⁵Michaud et al (2012).

⁶The Morningstar ETF Managed Portfolios Landscape Report includes comparative performance of many multi-asset ETF strategies over various time periods including New Frontier.

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Disclosures:

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