

Our goal in this series of articles is to put investment management in the context of today's capital markets. A disciplined, well structured investment program includes five steps: identify the investment objectives, establish an asset allocation, build the portfolio through security selection, rebalance the portfolio and manage the overall risk. This article focuses on the role of asset allocation in the investment program and specifically the need to measure the underlying value of the markets considered for investment.

Identify Objectives

Asset Allocation

Security Selection

Portfolio Rebalancing

Risk Management

Strategies and vehicles for investing have changed over the years. From the 1930's to the 1970's investment management focused on identifying securities and companies that were undervalued and earned a reasonable return for investors. In 1974, ERISA became law which established the "Prudent Man" rule. Effectively, this helped to define portfolio structures with a level of risk that a prudent man would reasonably incur and became the backbone for every bank trust department. In the 1990's with the growth in computer power and access to historic return and risk data, investment management moved rapidly into the realm of Modern Portfolio Theory which focuses on standard deviation as the measure for risk and diversifying

the portfolio by managing the correlation between the returns of asset classes.

Establishing the Asset Allocation within the Investment Program

"The single most important dimension of your investment policy is the asset mix, particularly the ratio of fixed-income investments to equity investments." -Charlie Ellis

Asset Allocation is an important part of any investment program. Studies show that asset allocation explains over 93% of the variation of quarterly portfolio returns¹. Thus, asset allocation is more important than sector and security selection to portfolio performance.

The process of designing an asset allocation includes estimating the expected return and risk for each asset class. We believe a best practice is to project expected returns and risk by measuring the value inherent in each market at the time you establish the target allocation. Valuations change as market prices change. Thus, we recommend rebalancing a portfolio to the model allocation on a regular basis as market valuations change. Further, we recommend changing the target asset allocation when markets dislocate and valuations move to extreme levels as they did in 2008.

The Misconceptions of Asset Allocation

As a discipline, with every investment it is important to recognize the underlying assumptions that are being made in the decision to purchase or sell. The biggest misconception in a well structured investment management program is that the asset allocation *will actually* reflect the expected risk and return profile and it will actually work the way we expect. That is to say that the asset allocation will reflect the expected returns, risk and correlation in a manner which we expect. However, since we operate in an environment of uncertainty, this obviously is a flawed assumption.

In our experience, one of the single biggest challenges in implementing an investment program is the use of standard deviation as the *sole* measure of risk. Our work with foundations and endowments confirms that for many institutions risk is really defined as the loss of principal or not earning a return on the portfolio that meets their spending target. *Simply put, risk is not always measured as standard deviation*

¹ Gary Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," Financial Analysts Journal, July/August 1986.

or volatility. However, by assuming that the variance of return was the single measure of risk for all investors, Harry Markowitz was able to develop Modern Portfolio Theory and apply it to portfolio construction of liquid assets. In the article [The Breakdown of Modern Portfolio Theory](#), which was published in 2009, we discuss in more detail the flawed assumptions that are the underpinnings of portfolio management in today's investment industry.

One of the flawed assumptions in portfolio management is that historic investment returns can be used to project future returns. This is often used as a short cut in the investment industry because investment returns are assumed to be "normal" or bell-shaped. If returns are considered normal, then from a statistical standpoint they are considered unbiased or random. Thus, if returns are random, then historic average returns may be used for estimated future returns. *This is an exceptionally poor practice in the industry and investors should be careful to recognize when this is being done.* Investment returns are not random. In fact, return patterns are asymmetric and considered "biased".

Another misconception is that historic risk measures can be used to project future risk for a specific asset class. Again, we believe this is a flawed assumption since returns and risk occur in history over specific "regimes." For example, the investment environment leading up to the market crash of 1929 resulted in significant legislation including the Securities and Exchange Act of 1933 and 1934 and the Investment Act of 1940 which forever redefined the financial markets. In 1971, President Nixon took the United States off the "gold standard" effectively ending another regime where monetary policy was linked to the value of gold. Another Regime ended in 1999 with the repeal of the Glass-Steagall Act which effectively removed the remaining barriers for banks to compete in previously restricted businesses including investment banking and insurance. We believe that investment returns and corresponding risk measures are different for each regime and should not be applied to today's regime without careful consideration of the massive debt burden, the significant government intervention in our capital markets and the uncertainty surrounding the details concerning the future regulation of our banks and financial markets.

Recognizing the Changes Taking Place in the Financial Markets

The capital markets serve investors as a means to price risk. However, we believe that several of the structural problems in our capital markets today are currently masking the efficient pricing of risk. As a result, investors are not compensated for the risk they are taking investing in many of the financial markets today. As an example, since 2009 the Federal Reserve has manipulated interest rates lower and intentionally forced a steep yield curve. At the same time that interest rates are near historic lows, the federal debt is at historic high levels. We estimate that net federal debt outstanding today is nearly 80% of current Gross Domestic Product, the highest level since World War II. The deterioration on our domestic fiscal position was alarming enough for Standard & Poor's rating service to put the credit rating of the U.S. government on negative outlook last month.

Your current investment program should not be blindly implemented without serious consideration to the underlying assumptions being made in the decision process. For example, a rational investor would not want the same level of fixed income exposure today that it had over five years ago. Interest rates five years ago reflected a different economic environment, risk-free rate and level of expected inflation than today as the bond market appears to be overvalued by most every measure. Does your portfolio look like it did in 2008? Are you doomed to repeat the same mistakes if the markets dislocate again as they did in 2008? Hope is not a strategy.

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