

# Asset Allocation and Manager Selection: Adaptive Allocation

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## Abstract

After the market dislocation of 2008, there has been much debate as to whether or not asset allocation is still a valid approach. Some have argued that investors should discount the merits of Modern Portfolio Theory<sup>1</sup> because all correlations tend to go to one during times of extreme duress. Mohamad El Erian, Co-CIO of PIMCO, argues that there is a “New Normal” and investors should spend more time evaluating “Tail-Risk.”<sup>2</sup> In this paper, we will consider a number of related topics, including the following:

- Is asset allocation still valid?
- Should investors be more tactical?
- What is the new normal?
- Is it active vs. passive, or active & passive?
- What are the practical implications of these changes?

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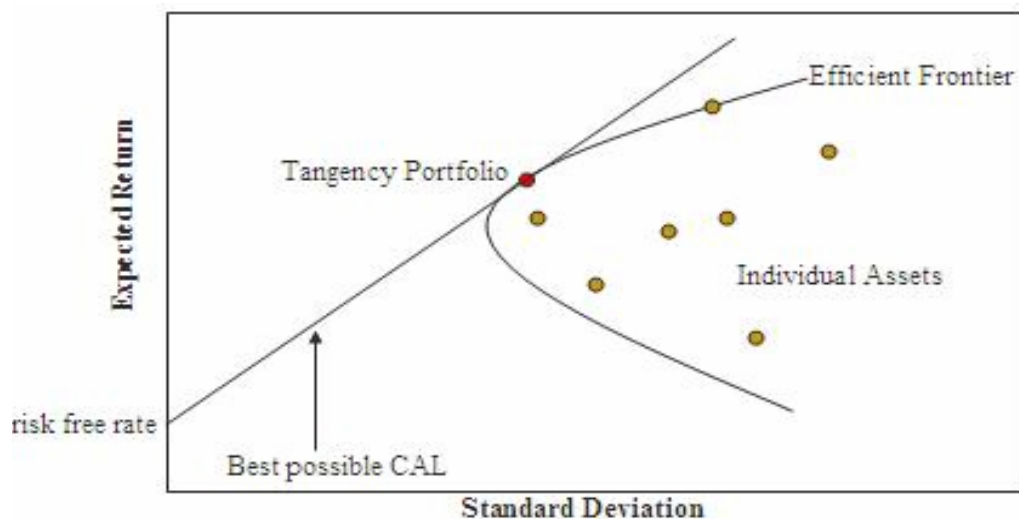
<sup>1</sup> A theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk which is emphasized as being essential in achieving a higher reward.

<sup>2</sup> A form of portfolio risk that occurs when there is a high probability that an investment will shift more than three standard deviations from the mean.

## I. Historical Perspective

Modern Portfolio Theory traces its roots to Harry Markowitz. In June 1952, a 25 year old graduate student named Harry Markowitz published a provocative paper in the *Journal of Finance* that would have a profound impact on MPT. His paper on “Portfolio Selection” received little notoriety at the time, but would help him win the Nobel Prize in Economics in 1990.

Markowitz’ paper discussed risk management through diversification. He suggested that in constructing a portfolio of two risky investments, with low historical correlation, an investor could reduce the risk of the overall portfolio. While this seems very practical today, this notion of risk reduction through diversification was cutting edge at the time. Building on Markowitz’ work, Bill Sharpe took MPT to the next level with the introduction of the Capital Asset Pricing Model (“CAPM”). CAPM is a model that describes the relationship between risk and expected return, which also introduced beta as a measure of market risk. It is used in the pricing of risky securities with the underlying premise that investors need to be compensated by the amount of risk taken and the time value of money.



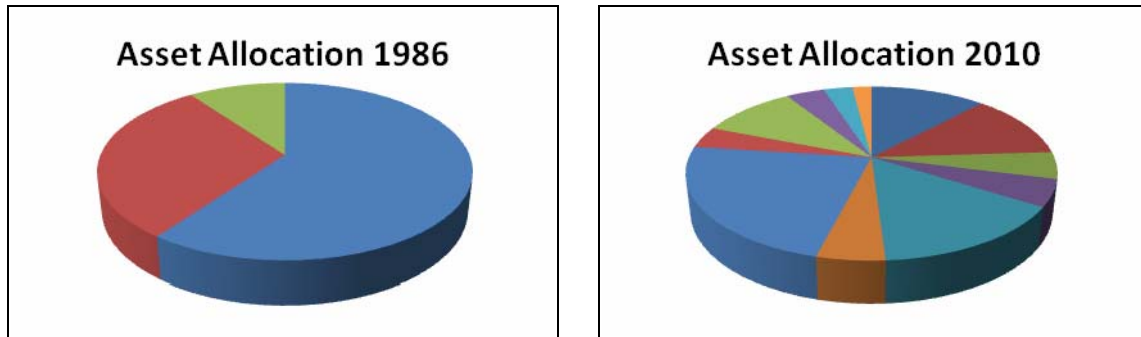
Source: *The (Markowitz) efficient frontier. Graphics Reference:*

[http://en.wikipedia.org/wiki/Modern\\_portfolio\\_theory](http://en.wikipedia.org/wiki/Modern_portfolio_theory). As the data above illustrates, the efficient frontier represents the optimal blend of asset classes (i.e., the optimal risk-return trade off). CAL stands for Capital Allocation Line which is a line created in a graph of expected return of all possible combinations of risky and risk-free assets. The Tangency Portfolio is the portfolio on the efficient frontier with the highest Sharpe Ratio that offers a greater return for a given amount of risk.

In 1986, Gary Brinson published his study evaluating the impact of the asset allocation policy decision. This is an often cited, but often misunderstood study that suggests that “. . . greater than 90% of a portfolio’s change in returns over time is attributable to asset allocation policy.” Interestingly, the Brinson Beebower Report studied the impact of stocks, bonds and cash as the only asset allocation decisions.

## II. History of Asset Class Decisions

Asset Allocation decisions have evolved beyond merely Stocks, Bonds & Cash (Brinson Beebower) to include distinctions between: large & small caps, value & growth, domestic & international, developed and emerging markets, and traditional and alternative investments.



*The charts above are for illustrative purposes only and are not intended as investment advice, nor do they depict any actual investment allocations.*

With the broader array of asset classes, investors struggled to determine the appropriate weightings in each asset class. While there are a number of commercial and proprietary asset allocation models available in the market, they are largely driven by historical data which introduces certain biases. Most asset allocation models use *mean-variance optimization* as their primary methodology. Mean-variance optimization is an analysis that exploits the risk, return and correlation characteristics across multiple asset classes. It generally assumes that future results will reflect their historical norms.

## III. Asset Allocation Today

In recent years, there has been considerably more attention paid to “Tactical Asset Allocation”. Tactical asset allocation recommends overweighting or underweighting certain asset classes based on forward looking views. This is not to be confused with Market Timing. Tactical asset allocation decisions can allow investors to respond more quickly to fundamental or technical factors driving the markets. Tactical calls allow investors to deploy capital more efficiently, and can either signal the need for investors to gain or increase exposure to an asset class, or signal the need to reduce or avoid a particular asset class.

	<b>Strategic</b>	<b>Tactical</b>
<b>Equity:</b>	<b>37</b>	<b>35</b>
U.S.	25	22
International	10	10
Emerging Markets	2	3
<b>Fixed:</b>	<b>37</b>	<b>35</b>
Investment Grade	25	25
Global	10	5
High Yield	2	5
<b>Alternatives:</b>	<b>20</b>	<b>24</b>
Hedge Funds	10	12
Real Estate	3	2
Private Equity	2	2
Commodities	2	5
Inflation-Hedged	3	3
<b>Cash:</b>	<b>6</b>	<b>6</b>
<b>TOTAL</b>	<b>100</b>	<b>100</b>

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The key to making the right calls and deploying capital more appropriately is dependent on one's access to, and understanding of, information. With the speed in which information is disseminated via the media, it is difficult for the average investor to process and respond to this information in a timely fashion, and more importantly, as quickly as needed.

In 2008, the world experienced a global melt-down. Some have labeled the events of 2008, a "Black Swan" or "Once in a Lifetime" event. In his book "The Black Swan", Nassim Taleb discusses a series of extreme events that have occurred over time. Like the Black Swan itself, nobody predicted these events because they have not occurred in the past, but they do occur with some degree of regularity. Unfortunately, when Black Swan events occur, including market-impacting crises such as those sparked by the 1994 Mexican Peso incident, 1998 Russian financial crisis and the fall of Long-Term Capital Management, the 2000 burst in the technology bubble, and the financial impact in the aftermath of the 9/11 terrorist attacks – market correlations tend to go towards 1.0 (i.e., most markets move in unison).

These events serve as a subtle reminder that markets aren't always rational and are often driven by fear and greed. Over longer intervals, the market tends to exhibit more normalcies. In other words, stocks outperform bonds and small stocks outperform large stocks, with an associated risk premium.

#### **IV. The New Normal**

As previously mentioned, Mohamed El-Erian has coined the phrase “*new normal*” and others have suggested that asset allocation decisions needs to be more *adaptive* or *tactical*. Before accepting these new terms, we should consider why so many are considering a new approach and whether things are really different this time. For comparison purposes, we should consider today’s environment relative to the market in 1990 when Markowitz and Sharpe won their Nobel Prizes.

In the last two decades, there has been a broadening in the array of investment options, and the complexity in the types of investment instruments. Investing is much more global in nature and, in fact, many companies have global strategies to sell their goods and services. Many have offices around the world, and seek to capitalize on the growth in less developed markets. We have moved beyond basic stocks and bonds purchased by institutions and well-healed investors, to a global environment with participants of all sizes and all levels of sophistication.

Information flow may also be a contributing factor to the changing investment landscape. In theory, the free flow of information should even the playing field and lead to more efficient markets. The unintended consequence may be more panic, and rash behavior as information is readily available, but not always properly analyzed as it reaches the public. The extraordinary growth of hedge funds over the last several years<sup>3</sup> has led to high velocity trading seeking to arbitrage away any pricing disparities.

The markets are indeed very different today than in the recent past. Investors need to adapt and change to keep pace; and evolve their views on investing in the current markets. Asset Allocation is not obsolete as much as it needs to evolve.

#### **V. Manager Selection**

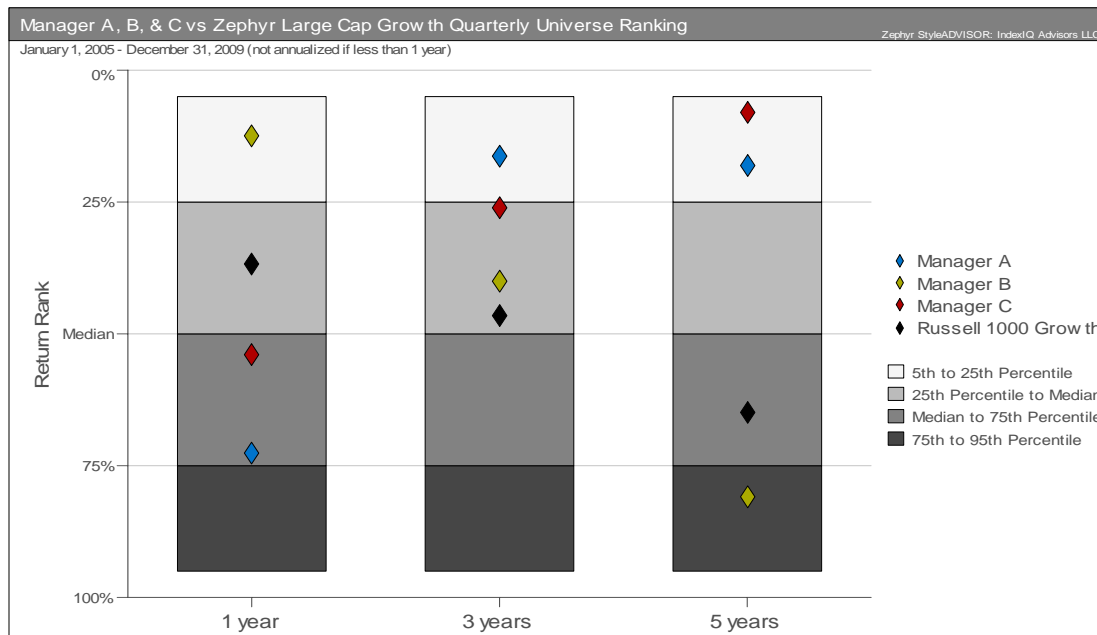
Asset allocation has evolved a great deal over the years. This is also true in the ways that investors gain exposure to the various markets. Investors used to merely seek a mutual fund that described themselves in a particular manner. In fact, many mutual funds have a tendency to drift as styles moved in and out of favor. A large cap mutual fund may dip-down and purchase small cap stocks when small cap is in favor, and may revert back to large caps when they come back into favor. This may be good from an investment perspective, but it likely will cause a deviation from the long term strategic asset allocation.

As Investment Professionals began to study and analyze investment results, they often avoided investment managers who drifted from value to growth, or up and down the capitalization spectrum. They were seeking “style pure” managers for asset allocation purposes. Unfortunately, many style-pure managers ended up delivering market-like results because of the limitations on the types of investments that fit their discipline.

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<sup>3</sup> Outlook & Opportunities, The Case for Alternative Beta, 2010.  
<http://www.indexiq.com/education.html#Newsletters>

Managers were limited in where they could invest, and often looked and performed very much like the index. With the growth of index-based strategies, the debate between “active” and “passive” investments grew louder and louder



*As the data above illustrates, it is very difficult to consistently outperform the benchmark. A manager may outperform one year, and then dramatically underperform the next. The chart above is for illustrative purposes only and is not intended as investment advice.*

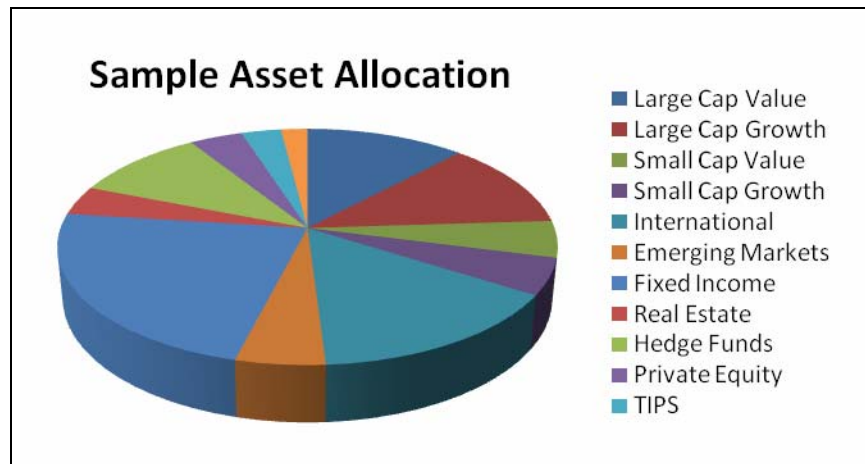
Investment Professionals not only evaluate individual manager results, but perhaps more importantly evaluate how multiple managers perform together. In other words, Investment Professionals emphasize the value in Portfolio Construction, combining managers in such a way to deliver favorable risk-return characteristics<sup>4</sup>. Investment Professionals will seek managers who exhibit low correlation to one another, and perform and react differently in various market conditions. To conduct this type of analysis effectively, an Investment Professional must analyze performance data and holdings of each manager.

Another important consideration is whether the “future will be like the past”. In other words, will the manager perform in a similar fashion in the future as they have in the past? Clearly this is a judgment call. To further complicate matters, the traditional manager search tools do not take into consideration the impact of taxes. This should be a big consideration for taxable investors. The impact of taxes can dramatically erode the gross returns.

In 1973, Burton Malkiel wrote “A Random Walk Down Wall Street”. In his book, Malkiel argues that the market is efficient, and the average investor will likely fail to beat the market with any level of consistency. Ironically, in 1973 there really was not much that the average investor could do if they sought passive exposure. Unlike today, since there are hundreds of Exchange-Traded Funds (ETFs), offering exposure to virtually every slice of the market.

<sup>4</sup> A manager’s past performance is not a guarantee of future results.

Investors need to consider how best to gain exposure to a particular asset class. They may consider Separately Managed Accounts (SMAs), Mutual Funds, ETFs or Limited Partnerships (LPs). Each of these vehicles has its own pros and cons.



*The above Sample Asset Allocation displays the evolution beyond the simple Markowitz Model, or even the Brinson Beebower Study, to break-out: large and small cap, value and growth, domestic & international, developed and emerging markets, traditional and alternative investments. The chart above is for illustrative purposes only and is not intended as investment advice, nor does it depict any actual investment allocations.*

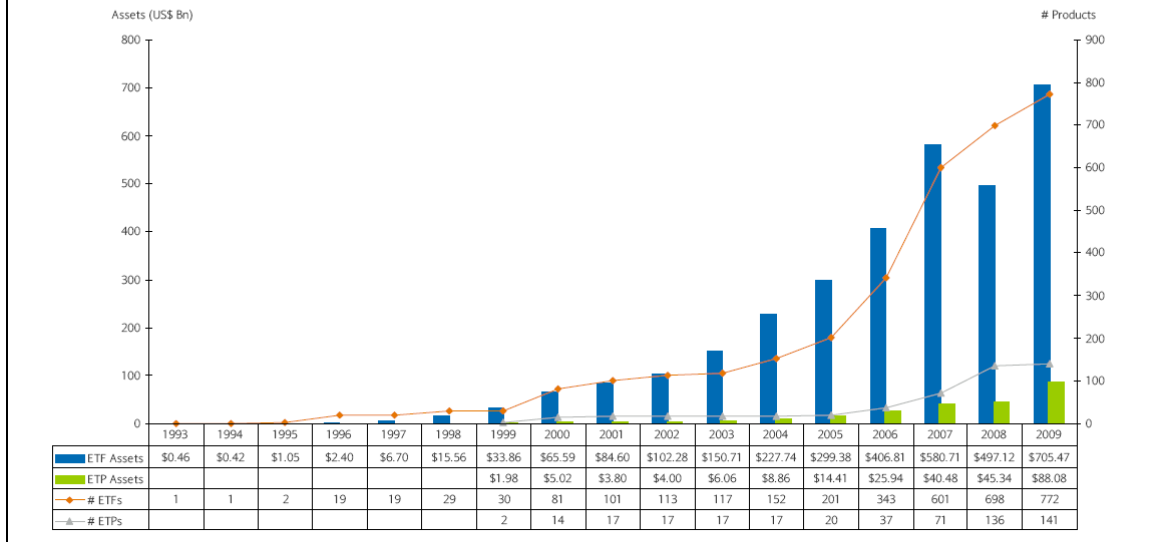
With such a broad array of investment strategies, investors need to consider asset allocation, manager selection and vehicle selection. They need to determine the correct percentage allocation to a particular asset class. They need to evaluate the various strategies, and they need to determine whether to access actively or passively. Deploying capital intelligently is much more complex today than it was with Markowitz' simple model.

## **VI. The Growth of ETFs**

One of the most significant developments over the last several years has been the extraordinary growth of Exchange Traded Products, such as ETFs and Exchange-Traded Notes (ETNs). As the data below illustrates, there has been tremendous growth in both the number of ETFs, and the types of strategies packaged in ETF structures. The first set of ETF products were designed to offer passive exposure to the broad-based market sectors. Today, ETFs are designed to provide exposure to the broad-based Equity markets, Country baskets, Sectors, Commodities, Fixed Income and Alternative Investments. ETFs have been embraced by institutions, family offices and financial advisors as a means of gaining exposure to a myriad of asset classes.

Today, investors can invest in ETFs that provide exposure to: Equities – large & small caps, growth & value, domestic & international, developed & emerging; Fixed Income – long & short duration, AAA or high yield, Treasuries or TIPS; Commodities – gold, silver, oil, water & combinations; Alternatives – hedge funds, merger arbitrage, & global macro.

## US ETF and ETP growth



Source: *Global ETF Research & Implementation Strategy Team, BlackRock, December 2009.*

The growth in ETF assets has been fueled by the difficulty of active managers in outperforming their passive benchmarks. The ETF structure is typically designed to offer cost-effective and tax-efficient exposure to the underlying benchmarks. There is also growing interest in “Active ETFs”<sup>5</sup>.

Investors have embraced ETFs as an efficient means of gaining exposure to virtually every asset class and/or market sectors. ETFs are valuable asset allocation tools, and way of implementing tactical decisions. More and more advisors are adopting ETFs as a primary means of gaining asset class exposure. If asset allocation remains the most important investment decision, then ETFs provide the raw materials to implement those decisions.

While the growth of ETFs has been a positive development, not all ETFs are created equally. Investors need to monitor each ETF to determine if they in fact deliver on their promise. In recent years, we experienced significant interest in ultra-short ETFs (ETFs that seek to achieve double the opposite return of their benchmark in a single day) designed to provide a hedge for a falling market. Some were designed to provide two and three times the downside protection<sup>6</sup>. Unfortunately, in practice many of the ETFs failed to mirror the downside largely due to reset features. Investors also realized that many of the commodity ETFs delivered K-1s rather than 1099s, and didn’t always perform as advertised.

<sup>5</sup> Active management in an ETF structure.

<sup>6</sup> An investments ability to limit the potential loss that would result from a decline in a security or a fall in the overall market.

Exchange Traded Notes (ETNs) garnered a lot of attention in 2008. Unfortunately, much of the attention was due to counter-party risk<sup>7</sup>. ETNs are an interesting structure, and in fact certain strategies fit better in an ETN than an ETF. Investors need to understand all relevant features and benefits.

## VII. Core-Satellite

Perhaps the debate shouldn't be "active versus passive", but maybe it should be "active and passive". Core-Satellite investing has gained a lot of attention over the years, as it seeks to offer active **and** passive investment solutions. There are many different variations of Core-Satellite investing. In the traditional context, an investor would seek passive / beta exposure to the most efficient markets, and seek active / alpha solutions to the less efficient markets.

### Traditional Core-Satellite Model



In the model above, an investor would view their exposure to hedge funds as alpha, because in theory hedge funds provide incremental return above and beyond the passive benchmark. With the extra-ordinary growth of hedge funds, it is becoming increasingly difficult for hedge funds to deliver alpha. In fact, many hedge funds deliver beta. More specifically, alternative beta, but beta none the less. Alternative beta is the return derived from having exposure to common systematic risk factors in alternative asset classes like hedge funds. Providing investors alternative beta is valuable, but not worth the excessive fees typically charged by hedge funds. An investor shouldn't pay "alpha fees for beta results".

The academic community has been studying the separation of alpha and beta for many years. In fact, Bill Sharpe first brought the concept to the consulting community in 1992. In recent years, academics have studied the results of hedge funds and have suggested

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<sup>7</sup> The risk to each party engaged in a contract that the counterparty will not honor its contractual obligations.

that hedge fund results can be replicated through sophisticated regression analysis<sup>8</sup>. If alpha and beta can be separated, and the hedge funds deliver alternative beta, then we can offer a more evolved Core-Satellite model.

### *Alternative Core-Satellite*



As the model above illustrates, the Alternative Core-Satellite Model breaks-out the alternative exposures into various sub-asset classes. Like traditional investments, certain of these strategies are more prone to deliver alpha relative to the market than others. Please note that we are using the hedge fund universe as the market for this exercise.

### **VIII. Conclusion: Investment Implications**

As we have discussed throughout this paper, investors need to evolve their views on asset allocation and manager selection. Rather than thinking about asset allocation, manager selection and vehicle selections as separate decisions, investors need to consider them all as part of an integrated decision making process. They need to evaluate asset allocation (strategic & tactical) and manager selection (active vs. passive) as part of the same investment process. We are not suggesting that MPT has become obsolete, but merely suggesting that with the rate of change and the complexity of the investment landscape, investors need to be more responsive.

Investors have a number of factors to consider in developing an investment strategy. The following is a check list for investors:

- ✓ What is the appropriate long-term strategic asset allocation?
- ✓ Should you allow for tactical changes?

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<sup>8</sup> White Paper, Alpha/Beta Separation – Getting What You Pay For, 2009.  
<http://www.indexiq.com/education.html#WhitePapersandArticles>

- ✓ Who is qualified, and who should make them?
- ✓ How frequently should portfolios be rebalanced or reallocated?
- ✓ Is the market efficient? Is the market **always** efficient?
- ✓ How should you evaluate investment options (individually and collectively)?
- ✓ Does active management perform better than passive management?
- ✓ Should you consider a core-satellite approach?
- ✓ Can you use core-satellite for alternative investments?
- ✓ How do you determine success or failure of your investment strategy?

In addition to developing an appropriate asset allocation strategy, investors must also consider how best to gain exposure to a particular asset class. Investors need to evaluate individual managers and managers in combination, to build the optimal portfolio. Investors also need to evaluate which vehicle represents the best way of accessing a manager. They need to consider the value of an SMA structure vs. a Mutual fund structure. They need to evaluate attributes of an ETF structure and the limitations of a Limited Partnership structure.

Modern Portfolio Theory still offers valuable lessons, but with the changing investment landscape, investors need to evolve their views. With the increasing rate of change and flow of information, investors need to be more responsive to these changes. Whether you call that the *new normal*, or just being more *tactical* or *adaptive* in nature, it suggests the need to evolve ones thinking about asset allocation. With the complexity and expansion of investment strategies, investors need to evaluate the merits of individual solutions, and how investments perform together over time.

Now more than ever, investors are seeking and may need professional help in developing a long-term investment strategy. They need guidance in responding to the rapidly changing investment landscape. Investors need to develop a strategy that is adaptive and responsive to the changes, but disciplined enough to keep them on the right path. Investors need help and guidance from trained professionals who have evolved their views on the new investment paradigm.

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For additional information, please visit our website [www.IndexIQ.com](http://www.IndexIQ.com) or call (888) 934-0777.

## **About the Author**

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**Alpha** is a measure of a portfolio's actual excess returns and expected performance, given its level of risk (as measured by Beta); **Beta** reflects the sensitivity of a portfolio's return to fluctuations in the market; **Correlation** is a measure of the relationship between two variables (e.g., portfolio returns and the S&P 500 Index); **Arbitrage** is the purchase and sale of an asset in order to profit from a difference in the price.

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