

When folklore turns to fairy tale

Like any profession the investment industry has its fair share of conventional wisdom. The sort of thing nobody challenges because it has been repeated so often it must be true. The oft repeated assertion that asset allocation explains over 90% of performance is one that has irked active investors like us for more than two decades now. Surely active management counts too?

Writing recently in the Financial Analysts Journal professor of finance at Yale School of Management and general asset allocation guru Roger Ibbotson exploded the myth that asset allocation explains over 90% of performance. Addressing the issue of the actual impact of long-term asset allocation policy mix relative to the impact of active performance from timing, security selection and fees he found the answer to be that it accounted for just 40%.

The misunderstanding comes from a widely misquoted paper by Brinson et al, titled "Determinants of Portfolio Performance". What this 1986 paper actually concluded was not only different but was flawed because the data analysed aggregated asset allocation policy with market movement. Once a fund had taken the decision to move into markets from cash it was not asset allocation policy that dominated the return and created the high correlation but market movement.

Asset allocation policy matters less than you think

Writing in 2000 Ibbotson posed the slightly different question "Does Asset Allocation Explain 40, 90 or 100 Percent of Performance?" and came up with a rather surprising 40%. Subsequent studies using different samples have produced a range of 33% to 75%. However you look at it this is nowhere close to the "over 90%" used to champion the importance of asset allocation to returns.

The true answer seems to be that "It depends on the manager". At one extreme we could manage a portfolio using long-only passive index funds where the only influence is asset allocation policy and at the other we could manage it as a market-neutral hedge fund manager would, with all the return from active management.

Ibbotson goes on to conclude that the total return from a fund can be split into: return from overall market movement; incremental return from asset allocation policy and; the active return from timing, security selection and fees. He estimates that about three quarters of the return comes from general market movement with the rest split fairly evenly between asset allocation policy and active management. This is nowhere close to what the asset allocation enthusiasts would have you believe.

Something to think about

So security selection and market timing are as important as asset allocation. That opens up further questions.

For example, a slightly more radical step is to ask whether there is really a difference between the two or whether it is just the way the industry accounts. Something we measure because we can.

About three-quarters of the variation in returns comes from general market movement with the rest split fairly evenly between asset allocation policy and active management.

Consider for example an investor who wants exposure to global recovery with an emphasis on industrial recovery and financials. Should he take the geographic asset allocation route and overweight Japan or should he take the active management route and buy shares in GE, the US conglomerate? It has similar industrial exposures but better finances and the management doesn't change every year. With a little more imagination perhaps he could buy a UK listed engineer and a bank and still achieve a similar result. A more advanced strategy might be to leave most of his cash on deposit and buy a call option on Japan. Or perhaps on GE?

When you start to think like this every investment simply becomes a potential return and a potential risk. Different ways to play the same themes. That rigid divide between asset allocation and stock selection suddenly becomes a blur.

What it means for investors

Others have highlighted the same myth before but Ibbotson is well respected and his evidence compelling. It is news many in the investment industry would rather not see repeated. After all, if you have built your business model around the overwhelming importance of asset allocation you now find yourself wrong-footed. You have lost intellectual supremacy and a valuable marketing tool.

Many institutional investors are already up to speed and have adapted their offerings but a large chunk of the industry will continue to promote the myth. Private banks in particular have built their wealth management offering around the strategic asset allocation argument and are woefully short of relationship managers who understand either markets or the products their clients are invested in. The last decade included four major turning points in financial markets. Some missed them all.

Market timing, security selection or asset allocation?

All Ibbotson is saying is that conventional wisdom is wrong. Asset allocation and active management can be equally important to performance. Investment managers should play to their skills and do what they think will work best at the time rather than believe in fairy tales.

London
+44 (0)20 7659 8000

Stockport
+44 (0)1663 761980

Lincoln
+44 (0)1522 721984

Thought for the Weekend

Thought for the Weekend is an occasional research publication intended to draw readers' attention to topics and issues of general interest to investors.

To subscribe please speak to your investment manager or contact the editor.

Robert Merrifield MBA, FCSIE rmerrifield@savoyim.com

T +44 (0)20 7659 8000

www.savoyim.com

Regulatory Information

This document/communication is issued by Savoy Investment Management Limited ("Savoy"), which is authorised and regulated in the UK by the Financial Services Authority with Firm Reference Number 145877. Our regulatory details can be viewed on the FSA Register <http://www.fsa.gov.uk/register/home.do> using that reference number. Savoy is a member of the London Stock Exchange.

This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase any shares or any other interests nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract thereof. This document is not directed at you if we are prohibited by any law of any jurisdiction from making the information in this document available to you. Recipients of this document who intend to apply for shares or interests in any investment are reminded that any such application may be made solely on the basis of the information and opinions contained in the Prospectus or other offering document relating thereto, as and when they become available, which may be different from the information and opinions contained in this document. Securities and derivatives markets may be construed as high risk and may be subject to high levels of volatility. It is possible that Directors and employees of Savoy may from time to time own securities that are mentioned in this communication.

All data and statistics are sourced from Savoy unless otherwise stated. Performance statistics are not necessarily based on audited financial data. Past performance is not necessarily indicative of future results and you may not retrieve your original investment. Changes in rates of exchange may affect the price of units or shares.

For non-professional investors: if you have any doubt as to the suitability of any product, please consult your financial advisor.

Please use the following internet address to view important information about Savoy: <http://www.savoyim.com>
