Asset allocation is as much an art as a science

By Donald B. Trone InvestmentNews

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Whether asset allocation is of overwhelming importance or only the most important decision managed by a fiduciary is a minor distinction. It's the fiduciary's duty to diversify a client's portfolio prudently to a defined risk/return profile appropriate to the client's goals and objectives. In the case of a participant-directed retirement plan, the fiduciary must provide adequate asset classes so that the participant can diversify prudently.

The overarching role of the fiduciary is to maximize the benefits to be gained from following a prudent investment process. With this in mind, it is important to consider the following: In spite of the rigor and specificity of the decision-making process, asset allocation is still as much art as it is science. Although helpful, recent advances in portfolio theory, technology and comprehensive databases have not reduced the asset allocation decision to a computerized, mathematical solution.

Continuing with an examination of the 27 practices that define a prudent process for investment fiduciaries, the following five questions frame the asset allocation practices:

Has a risk level been identified? A client is far more likely to abandon an investment strategy for its volatility than for any other reason. Consequently, the client's understanding of a portfolio's level and sources of risk is a crucial practice. The term "risk" has different connotations, depending on the client's frame of reference, circumstances and objectives. However, the simplest, and often most accurate, measure of risk is to ask the client: "What percentage of the portfolio can you afford to lose over the coming year?" Though the client's initial response invariably will be understated, it does mark the trailhead for further exploration.

Has an expected, modeled return to meet investment objectives been identified? There is no requirement that the fiduciary forecast future returns. Rather, the fiduciary is required to state the presumptions that are being used to model the probable outcome of a given investment strategy. Experience suggests that for modeling expected returns, historical data on asset classes are quite useful with respect to standard deviations - "reasonably useful for correlations and virtually useless for expected returns."

Simple extrapolations of historical data are not only likely to be poor estimates of future performance; they also may lead to models that suggest buying an asset class at its peak and selling at its trough. A more appropriate approach would be to employ a risk premium model that was adjusted for likely economic scenarios and long-term equilibrium trends.

Has an investment time horizon been identified? It is important that the fiduciary prepare a schedule of a portfolio's cash flows so that the fiduciary can determine the point in time when more money is flowing out of a portfolio than coming in. Time is a fiduciary's greatest ally - the longer an investment strategy can remain invested, the more "aggressive" a portfolio can be allocated without compromising the client's risk tolerance. Therefore, the identification of a client's time horizon will be the primary variable in determining the appropriate allocation between equity and fixed income. Unfortunately, most clients underestimate their time horizon just as they underestimate their risk tolerance.

Are selected asset classes consistent with the identified risk, return and time horizon? The fiduciary's role is to choose the appropriate combination of asset classes that optimizes the client's identified risk and return objectives, consistent with the portfolio's time horizon. The fiduciary's choice of asset classes will have far more impact on the client's long-term investment performance than any other decision.

Is the number of asset classes consistent with portfolio size? There is no formula the fiduciary can follow to determine the best number of asset classes; the appropriate number is determined by facts and circumstances. How

many asset classes should be included? The answer is dependent upon the size of the portfolio, the fiduciary's investment expertise, the fiduciary's ability to monitor the asset classes (reconsider the use of hedge funds) and the sensitivity to investment expenses. The additional cost of adding an asset class should be evaluated in light of the price the fiduciary pays for being less diversified.

The fiduciary has a duty to diversify a portfolio prudently; it is not something the fiduciary can choose to do or avoid. The fiduciary must manage the decision-making process to choose an asset allocation that meets the client's risk/return parameters - or the collective activities of the client's money managers and the markets will determine one by default.

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