Although it seems like it was a century ago, it was less than 10 years ago that the wealth management industry proposed a new solution to the asset allocation challenge set before individuals and families. The problem was simple: Traditional finance required individuals to evaluate their challenge in terms of a single financial goal with a single risk tolerance, using mean–variance optimization based on some terminal utility. Although most certainly the appropriate theoretical solution, this approach failed on two important counts. First, it required individuals to learn a “foreign language,” as their advisors asked them to speak the advisors’ own financial language rather than learning theirs. Second, it failed to recognize what behavioral finance understood, i.e., that individuals and families have multiple goals, each of which may have its own risk profile. Thus, goal-based allocation was born, and many individuals and families now report a much more satisfying rapport with their investment policy.

A conceptually analogous challenge has arisen in the recent past, and it may be that a similar conceptual departure from traditional financial theory or thought might be the solution.

Many individuals and families, together with their advisors, view the current environment as confusing. They recognize that the unfolding of long-term economic and investment cycles implies not only periods of generous returns and almost euphoric economic activity but also times of economic difficulty and challenging investment environments. Yet, they ask what can only be viewed as a very reasonable question with respect to the current environment: What if this is not a “normal” (although somewhat extreme) business or investment cycle? What if this is something quite different? Although there are only a few precedents in the last 50 or so years, the U.K. in the early 1970s, France in the early 1980s, and Japan in the early 1990s offer examples, along with Sweden, Southeast Asia, or even Argentina in the last 20 years.

Before moving further along this path, it is worth it for our reader to consider an important example. Imagine that you are not in early 2010; rather, imagine yourself as a Japanese investor, living in Japan in 1990. Capital market theory would be telling you that equities produce higher returns than bonds, and that bonds produce better returns over time than cash. Your own experience would validate this. Your equity return experience over the previous 20 years would suggest that Japanese equities ought to earn a total return over time (i.e., including dividends) of between 16% and 22%, with the lower end of that range based on your assumption that the recent past (say, 1985 to 1989) was
quite rewarding to Japanese investors but somewhat extreme in the greater scheme of things. Yet, with real GDP growth and inflation averaging 4.2% and 5.5% per year, respectively, over the previous 20 years, your equity market experience was not totally extraordinary! Your experience with Japanese long government bonds, though less scintillating, was no less pleasant, with an average return of 7.3% over that same 20-year period. Capital market theory assumptions seem to have held.

Now consider how disappointed you would have been, today, looking back! Assume indeed that, informed by capital market and traditional finance theories, you had decided to maintain your long-term portfolio allocation principally focused on Japan (which well-documented and worldwide home country bias would have led you to have done) and thus still heavily dependent upon Japanese equities. What would your portfolio returns have been, and more importantly, would they be generally similar to or quite different from your experience of the prior 20 years? You would find that your equity portfolio earned an average annualized –4.2% total return, more than 20% lower than what you might have been expecting based on the prior 20 years’ experience! Your bond portfolio returned an average of 4.9% and cash earned a paltry 0.3%! Focusing only on the first 10 years since January 1, 1990, your equity portfolio would still have been compounding at a –3.7% rate, while bonds provided almost the same return as they had in the previous 20 years: 7.2%!

Consider this: In the year 2000, you had a 10-year return history that is not just different but radically different from what you might have been expecting based on the prior 20 years! What are the odds that you might have changed horses at that point in the race?

What was happening then to a Japanese investor—and which could be happening now at least in the U.S.—was one of those rare instances when the fundamental assumptions underpinning capital market theory appeared faulty. Whether or not they were is obviously the topic of a much broader debate; one could ostensibly argue that the 40 years encompassing the 20 years before the bursting of the Japanese bubble and the 20 years after are in fact, collectively, a much better timeframe over which the capital markets in Japan ought to be analyzed. Yet, again, whether right or wrong from a theoretical standpoint, the fact remains that our Japanese investor may have become discouraged, thinking that our definition of “long term” had become totally unrealistic. He or she might even have commented, in the words of economist John Maynard Keynes: “in the long term, we are all dead” and even added an impious: so what? At that point, potentially having had to make adjustments to his or her lifestyle, our Japanese investor is unprepared to believe the theorists who would appear to have been far from reality.

If this is the state of mind in which many individuals and families find themselves, at a time when the range of possible economic and capital market outcomes appears to be so wide, perhaps we need to seek an alternative framework. If the original inclusion of behavioral finance into the process led to what we now call goal-based allocation, one might consider a process that we might call time-horizon-based allocation. This concept is the central theme of one of the articles in this issue of the Journal of Wealth Management, by Robert Jaeger, Michael Rausch, and Margaret Foley.

In this design, the fundamental assumption would be that the individual or family is not comfortable with the assumption that the future is truly continuous. Said differently, the individual or family does not accept the assumption that the best estimate for next year’s return is the long-term return forecast. Rather, the future might comprise at least two materially different sub-periods; at some indeterminate future point, long-term trends may reassert themselves, but the interim interval might well involve a dramatically different outcome. Chaos theorists would describe this as the normal and predictable transition between two different states (which they might, however, view as inherently unstable). One could thus postulate that the individual has, at least, two time-horizon-dependent sets of goals. On the one hand, he or she is ready to retain some of his or her long-term policy portfolio as he or she is not ready to argue that the world is radically changing, with a new state to appear that is totally different from the past: “my really long-term goals are unchanged, and I do not know enough about the future to assume a completely different state.” However, during some interim period of time, the individual or family would aim to achieve different goals, all focused on dealing with the tension or stress that can arise when one feels one has lost control, and which are thus focused on the expected—or feared—intervening disruptions. First, the individual or family would want to ensure that their worst nightmare does not happen: having to change their lifestyle. Second, they would like to have some form of hedge against a few other nightmares that they feel could significantly affect or simply trigger the unsettled intermediate period they worry about. Third, they might
want to hold some cash, not as a protective asset but as an opportunistic investment with which they could, in due course, buy other assets when they are “on sale,” following the sell-off they fear.

Practically, this might involve the creation of “buckets” or sub-portfolios that are different from those that might have led to their policy portfolio but yet proceed from the same logic: “provide me with a sub-portfolio that is designed to meet or defend a simple and sole goal. This will allow me better to associate with that sub-portfolio and to judge how well I am doing. Implicit in this statement is the observation that I may be able to deal with the depreciation of some asset that I have bought to protect myself against an event that either has not happened or at least has not happened yet. It might be much harder to judge and assess the impact of that hypothetically depreciating asset on an overall holistic portfolio that may be optimal, but to which I cannot relate.” The first bucket might be an income defeasance, declining balance portfolio, targeted to whatever number of years covers the bulk of the investor’s “worry” period. The second might involve a few strategies designed to provide a form of “insurance” (with all the appropriate caveats as to the use of the word insurance in an asset management context) should selected serious worries come to pass; one might think of a geopolitical hedge, as a major global economic realignment would be bound to expose the world to political miscalculation risks, of some hedge against a change of reserve currency, of some hedge against a government bond crisis in one or another high-budget-deficit country or even, if the amount dedicated to the policy portfolio appears low, a hedge against equity markets continuing a strong rally! The third portfolio might involve cash deposits in the home currency or in some mix of global currencies, while the policy portfolio would be consistent with the investor’s original strategic allocation.

Purists will, probably mostly correctly from a theoretical standpoint, argue that parceling out individual goals and attempting to meet them piecemeal rather than in a holistic manner should be sub-optimal. Several authors offered this line of thought with respect to goal-based allocation, and it is hard to argue with their views on purely financial theory grounds. Yet, integrated wealth management is unfortunately not solely about managing the financial assets of any family in some vacuum devoid of any and all emotions. As nice as it would be if everyone truly was able to leave their emotions at the door of the office before entering and dealing with their portfolio, the world is not built that way. If it was, why would the level of cash held by professional managers in equity portfolios be a solid reverse indicator of future market movements? In short, professionals and amateurs alike are human beings and are subject to their emotions. The interactions between these emotions, the family’s financial assets, and all the other forms of capital which the family needs to manage are simply too complex for anyone to worry about some minor financial or investment sub-optimality when considered in an overall context.

If it is then true that advisors should help their clients manage the risks to which they, the clients, are exposed—in short, to view the world as it is rather as they might wish it to be—then it must be true that finding a way to help individuals and families today deal with what many view as a particularly challenging environment might be the right thing to do from a practical standpoint, even if this fails certain theoretical tests. Ostensibly, this may be harder today than it was as recently as a year ago: markets have rebounded soundly and the losses of 2008 are somewhat of a distant memory for those who had solid results in 2009. Yet, the lesson that our Japanese investor might wish us to heed would be that bear markets can have many short-term rallies. If we are truly in the midst of some major global economic restructuring, a short one-year bear market appears too little a disruption. Our Japanese investor would thus keep asking us whether the improvements in global economic fundamentals justify the euphoria currently found in many capital markets.

Before concluding, it is important to remind ourselves of our mission, and of the mission of the Journal of Wealth Management. Ours is not to foray into the world of investment advice! We do not have a view on what economic trends are and correspondingly as to whether capital markets will prove generous or stingy in the years ahead. Our mission is to offer thought for others to incorporate into their own thinking when confronted with problems that may be of a tactical as well a strategic nature. It is in this context that this commentary must be read.

- Thus, families who are blessed with long enough time horizons, with little or no cash needs, or with a level of investment savvy that allows them to remain comfortable with long-term trends and the continued validity of the assumptions underpinning traditional capital market theory should stay with a long-term
examined the published results of the Yale endowment and suggest that heavy exposure to common equity risk factors and manager skill in private equity drove the Endowment’s sizable returns, more than solely the skill of their active managers as is often argued.

The next three articles deal with global equity markets. Dan Trosch first addresses the issue of the use of global equity managers to diversify portfolios and points to four principal advantages: global flexibility allows the pursuit of unconstrained alpha; country of domicile has become a less important driver of stock performance; the non-U.S. stock universe increasingly dwarfs that of the U.S.; and global managers have outperformed a blend of U.S. and international managers. Ray Sturm then looks into the advent of sector-focused exchange-traded funds and concludes that an equally weighted portfolio of the sector funds reliably outperforms the overall index over all measures of performance and notes that his findings are robust across time. Finally, Roland Füss, Julia Hille, Philipp Kindler, Jörg Schmidt, and Michael Schmidt analyze the relationship between a fund’s Morningstar rating and its subsequent performance and its rating and subsequent inflows or outflows of funds, concluding that the Morningstar rating has a limited ability to predict future fund quality for the German fund market.

Our final two articles are for the mathematically inclined among our readers. First, Robert B. Durand, Hedieh Jafarpour, Claudia Klüppelberg, and Ross Maller focus on the concept of value at risk (VaR) and illustrate the way this VaR, and related quantities, vary along the efficient frontier, emphasizing the special role played by the tangency portfolio. Finally, François-Éric Racicot and Raymond Théoret offer an improved method of estimating financial models of returns and especially the parameters that are relevant for portfolio managers, such as Jensen alpha, a popular measure for stock selection, and beta, a well-known systemic risk measure.

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