

Making the Case Why Objective-Based Portfolio Construction Is the Right Approach

by John Diederich, CFA

In the past ten years, two significant developments have slowly emerged and rendered the traditional approach to asset allocation obsolete. One is the evolution to objective-based portfolio management and the other is the evolution to more complex investment strategies which have blurred the lines between traditional equity and fixed income markets. This document reviews both developments and presents a new framework for investment policy in today's environment.

The History of Asset Allocation

In 1952, Harold Markowitz's *Portfolio Selection* ushered in the era of Modern Portfolio Theory (MPT) and provided a framework to construct portfolios that maximized return for a given level of standard deviation. In 1964, William Sharpe expanded on Markowitz's work by publishing the capital asset pricing model and introducing the concept of beta. In 1990, the two shared the Nobel Prize in Economics, along with Merton Miller, for what has become a broad theory for portfolio selection. Despite this work, portfolios were largely managed by balanced managers who allocated between stocks and bonds based on expected future performance with little regard to the unique profile of the investor. An asset allocation that reflects the risk and return objectives was not institutionalized until 1986 when Brinson, Hood and Beebower published *Determinants of Portfolio Performance*, showing that asset allocation was the primary determinant of the risk and return in a portfolio. Investors then tailored their level of risk and return in asset allocation by varying the level of equity and fixed income within the portfolio.

The idea of manager style was introduced by AG Becker in the 1980's and later was refined by Sharpe when he included the notion of style risk. This expanded the traditional asset allocation process to components within equity such as growth vs. value stocks and large vs. small capitalization stocks, leading to the use of niche specialist managers. Despite this, the original framework remained as most investors built 60/40 or 70/30 portfolios to try to maximize return for a given level of standard deviation.

Along Comes Objective-based Portfolio Management

The shift towards objective-based portfolio management was influenced by the work in the field of behavioral finance which dismantled a number of assumptions that supported modern portfolio theory. In addition, the bear market of 2000 forced investors, who had been myopically focused on relative risk, to reassess the real risks to meet their financial objectives. The capital markets have continually evolved to more customized risks and objective-based portfolio management is a way to construct portfolios to meet financial objectives while minimizing relevant financial risks.

An example of the effectiveness of this approach would be a corporate portfolio that requires a return schedule that matches the long-term liabilities of the organization's retirement obligations. Typically, pension liabilities have a much longer duration than their associated assets. This "mismatch" opens the portfolio to interest rate risk and can increase the plan's volatility which, in turn, can lead to unexpected contributions and ultimately hits to shareholders equity. To mitigate interest rate sensitivity, the organization must allocate assets to longer-term investments that are more closely related to the duration of their liabilities. The traditional investment approach focuses singularly on standard deviation as a risk measure, while objective-based portfolio construction is focused on other relevant risk measures such as interest rate sensitivity and long-term volatility. As a result, objective-based portfolios can help reduce risk, without compromising the level of return. Furthermore, the recent changes in pension legislation and accounting

standards requiring more stringent funding limitations and Balance Sheet disclosure have exponentially increased the importance of linking pension management to the organization's financial goals.

Evolution of Investment Strategies Have Blurred Some Traditional Lines

Investment strategies no longer fit neatly within traditional asset class categories such as equity and fixed income. Today, it is increasingly difficult to decipher between a traditional investment and an alternative investment, which historically had been defined as anything that is not a long-only investment in the stock and bond market. Complex financial markets have made investment strategies more complex in their continuous search for adding value. Hedge funds, for example, invest in both equity and fixed income markets but do so with the flexibility to go long and short securities to "hedge" out systematic market risks.

There are numerous other examples of newer investment strategies that have blurred the lines. If an investor hires a large cap manager to run a "120/20" portfolio where the manager has the flexibility to short stocks but still maintains the beta of a long only manager by going 120% long, do they belong in the equity category or the alternative category? How do you classify a portfolio which invests in TIPS but can also invest in commodities and has a Global Tactical Asset Allocation manager to enhance returns? Is that a fixed income portfolio or an alternative investment? The evolution of the capital markets has allowed skillful managers to navigate markets with fewer constraints while also allowing portfolio engineers to create more customized tools to meet investor's objectives. This does not fit in an asset allocation process that manages risk along traditional equity and fixed income.

A New Framework for Investment Policy

By recognizing the evolution to objective-based portfolio management, investors can achieve a more logical framework for incorporating investment strategies in the asset allocation. As corporations try to earn a return above their pension liabilities and minimizing the risk of loss, investment strategies need to align with either of the two primary objectives of many organizations; growth or stability.

Growth strategies are investment strategies designed to provide real growth to the organization over the long term and are also associated with higher year to year volatility of investment returns. Strategies of this variety (not be confused with the traditional definition of "growth stocks") include US equity, non-US equity, emerging debt, hedge funds, private equity, opportunistic real estate, and other return enhancement strategies. Stability strategies are designed to minimize volatility in various periods of macroeconomic and market environments, and should be focused primarily on interest rate protection. These should be more diversified than the traditional stability lever used by investors, nominal bonds, which in isolation will not offer protection in specific environments. Stability strategies include investment grade nominal bonds, real return strategies, high yield bonds, and other strategies which minimize risk of loss for the portfolio.

Setting investing policy from an objective-based standpoint provides more control to the policy makers. It provides clarity as to the role investment strategies have in the portfolio and it allows for a portfolio that more poignantly manages the risks in recognition of the investor's objectives.

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