12 DAYS OF INVESTMENT WISDOM - DAY 1: THE MOST CRUCIAL FIRST QUESTION: ASSET-ALLOCATION OR SECURITY SELECTION?

Rodrigo: **00:06** Hello everyone and welcome to ReSolve's 12 Days of Investment Wisdom mini-series, where Michael Philbrick, Adam Butler, Jason Russell, and myself, Rodrigo Gordillo, will explore timeless evergreen principles that will help you and your clients achieve long-term investment success. From the importance of asset allocation, thoughtful portfolio construction, and maximum diversification, our aim is to offer you a comprehensive framework for a more thoughtful investment approach that may change the way you view the complex arena of investing altogether. We hope that you enjoy the series as much as we enjoyed putting it together.

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Rodrigo: **01:11** So what we're trying to do with this series is, we're going to try to present a narrative arc, starting with how we think about the problem, what arena we like to invest in, and why practical applications of the arena, which is asset allocation, and then talk a little bit about the behavioral side of things over the next 12 days. How does everybody feel about that?

Mike: **01:28** I'm excited. It's 12 drops of wisdom.

Rodrigo: **01:32** Alright. So, day one when we were going to start with our topic that's near and dear to our heart, and it's asset allocation versus security selection. And we've written a couple of pieces. We've written a bunch on this, but there's a couple of key pieces that we like to re-share with everyone, but the point of this was just to give you a quick intro, maybe 10, 15 minutes, we can do it. Talk a little bit about what the benefit of asset allocation versus security selection is and why it's important. So Adam, why don't you…

Adam: **01:55** I don't think any of us independently has ever spoken for less than 15 minutes-

Rodrigo: **02:00** It's going to be interesting.

Adam: **02:01** Each, each. So, this should be really interesting exercise.

Rodrigo: **02:03** It may take an hour, it might be worth it. We're going to try for 15. Let's do our best.

Adam: **02:08** Okay, well we're already looking at minute and a half in and so.

Rodrigo: **02:09** Oh my God, totally.

Adam:	**02:10**	So why do we care about asset allocation? When we started out this business actually going all the way back, sort of 7-8 years when we started sort of rethinking about the problem, we zeroed in on asset allocation and Samuelson's dictum. Paul Samuelson being one of the most prominent economists of the past century and in the sort of middle of the 20th century, he came up with this dictum where he said that, "Markets are micro efficient but macro inefficient." Just meaning that at an individual security level, the market agents are able to keep prices at approximately or close to general equilibrium, but there are large structural barriers to arbitrage that keep markets from finding equilibrium at the macro level, at the, at the asset class level. A really good example of this, and here I am already jumping around a bit on the, on the, on the themes.
Rodrigo:	**03:04**	It's not going to take this. (laughing)
Adam:	**03:06**	We examined the returns to mutual funds over the last five years and specifically looked at the fifth percentile, U.S. equity mutual funds, so the mutual fund that was outperformed by 95% of other mutual funds in the U.S. or on U.S. equities over the last five years. And then we compared those results to an emerging market oriented mutual fund that outperformed 95% of its peers. So it's a 95th percentile result for emerging market funds. And the 95th percentile result for the emerging market funds was a total return of about 12 percent over the last five years. This is ending November 30th of this year, and the fifth percentile, so one of the worst U.S. equity funds produced about 32% compound or, or, or total return over the same period. So, the point being that you can't sort of stock select your way out of the fact that if you are invested in the wrong market than you are going to underperform regardless of how good your stock picking ability is. I mean this is an ex post analysis. We're able to actually look back and say who actually performed the best, which mutual fund actually performed the best, believe even ex post, the exponent best could not perform the ex post worst because of bad choice of markets.
Rodrigo:	**04:32**	You can only do as well as the opportunities presented in front of you. And if the opportunity is presented in front of you, happen to be emerging markets purely and the best you could do is that, or you know the 12%?
Adam:	**04:40**	Exactly right. So, so it just again the market that you're invested in as far more important than the individual securities that you're invested in within that market. That's the basic lesson. And more broadly, just getting back to Samuelson's dictum, we're emerging markets vastly overpriced five years ago relative to U.S. markets. I mean that's the implication, right? If they, if they so substantially underperformed U.S. markets over the last five years, then clearly they must have been vastly overpriced. So the markets were inefficiently priced five years ago.
Rodrigo:	**05:10**	Mm-hmm (affirmative).

Adam:	**05:11**	And just sort of again, markets are micro efficient but macro inefficient. We're not going to talk too much about how markets are micro efficient today, but we are going to talk about the opportunity to take advantage of inefficiencies in the asset allocation domain.
Mike:	**05:27**	So why do you think that is, Why do you think that at the micro level you have this great level of efficiency, but at the macro level we don't seem to be able to arbitrage away those opportunities. What, why do you think that?
Adam:	**05:41**	If you go back to the fact that 99, maybe 99.99% of all cognitive and computational capacity …perhaps.
Rodrigo:	**05:47**	Is that 99.99%?
Adam:	**05:49**	99.99%
Rodrigo:	**05:50**	Just wanted to check back, fact checking here. (laughing)
Adam:	**05:52**	Cognitive and computational capacity and markets is focused on security selection, so let's take a typical institution and maybe a large pension plan. How are they organized? They've got this investment committee, this in charge of an asset allocation decision. They meet quarterly and they talk about big macro picture or whether or not the pension is on track to meet its liabilities, etc. They meet with the actuaries, but then once you go below that, the organization is divided into silos, so you've got this silo that's focused on equities, so maybe they're actually running equity portfolios within the institution or maybe they're focused on trying to find equity managers that can deliver alpha, but either way, this is a large sleeve of the company that is focused exclusively on equities and then you've got another sleeve of the company that is focused exclusively on bonds and then maybe you've got another sleeve that's focused on privates or illiquid investments or something like that. The point being that all of these different siloed groups are oriented exclusively toward security selection within that group and they're not thinking about the relative merits of stocks versus bonds, and so therefore, clearly we would expect the markets as, at an asset allocation level to be less efficient because there's less interest or there are fewer people that are motivated to arbitrage opportunities there. In addition, of course, we know that the way that especially a pension is organized, they've got to present their asset allocation, they're long term policy weights to an actuary and the actuary has got to validate that those policy weights are likely to produce returns that will meet their long-term liabilities.
Mike:	**07:30**	I think that's really key and if you think about that, that first point or that, that most recent point, how will that then affect the ability for that mandate to change? Maybe you can speak to that a little bit?

Adam:	**07:46**	Well, yeah, so this gets into these primary barriers to arbitrage which are mandate flexibility and-
Rodrigo:	**07:53**	Portfolio agility.
Adam:	**07:54**	Portfolio agility. So in terms of mandate flexibility, what we just talked about that, obviously there are actuarial requirements for a large institution that they need to meet and that gives them very little active risk budget in terms of how they can deviate from their long term policy weights and in addition to, just think about many of the largest endowments, are the largest pension plans. They've got so many assets that if they try to make large moves in their asset allocation, then that has the potential to actually move markets themselves. So they just don't have the portfolio agility that would allow them to effectively arbitrage inefficiencies.
Rodrigo:	**08:32**	Mm-hmm (affirmative).
Adam:	**08:33**	At that macro level.
Mike:	**08:34**	So let me see if I have this straight, from the, the mandate flexibility perspective. Part of it is that the committees that determine that are thinking about it in very long-term, from a long-term perspective and they will tilt very minorly around those, sort of long-term views on what the asset allocation should be. And that long-term asset allocation is being driven largely by some of the liabilities that they have. And so they sit down and think, "Well, what's the long-term risk premium I'm going to get from equities? What's the long-term risk premium I'm going to get from corporate bonds and some private equity? And if I have some active manager come in and shake that all about and say, well, this quarter I own 60% equities and 40% bonds, let's keep it super simple, but next quarter I owned 90% bonds and 10% equities. What's the implication to that over the long-term to meet my liabilities and obligations?" And so that, that's just something that categorically can't be done. You can't have that kind of swing.
Adam:	**09:37**	They're constrained.
Mike:	**09:38**	Right.
Adam:	**09:41**	They're completely constrained from a regulatory standpoint, because they need to be able to match their long-term policy portfolio against their actuarial guidance.
Mike:	**09:42**	Right.
Adam:	**09:46**	So yeah, absolutely no flexibility there, but we don't need to speculate. Some of the original research in the asset allocation arena, specifically this sort of seminal research by Brinson and Beebower in 1989. Well, he studied the degree to which asset allocation explained pension or institutional returns, and the result of this paper is often misconstrued or misunderstood, but what he actually did is, he regressed the actual

returns to a large number of pensions and other institutional portfolios against their benchmarks, and what he found is that the benchmark returns explain about 90% of the returns that were realized by the institution over the long-term or over the period that was studied. And the, the actual conclusion from that paper is that the institutions that he studied just don't deviate very much from their benchmark.

Mike: **10:41** That's from policy on their policy portfolio.

Adam: **10:42** On policy portfolio, exactly. So we can look at the organization of a typical institution and we can understand how, they would have great difficulty in making those types of large deviations from the policy portfolio either in the short term or the long term, because of mandate inflexibility and a lack of portfolio agility, but then we can actually observe that they do not deviate very much from their policy portfolios by looking at some of the literature.

Mike: **11:09** Right, which then leads back to the 99% of all the cognitive power being driven to here's the policy portfolio. If we're going to extract some excess return, let's do that at the security selection level. And I think one of our goals is to be able to take advantage of that opportunity that the institutional investor, that is the vast majority of the market, is leaving on the table for.

Rodrigo: **11:33** And it's a self-fulfilling prophecy, right? Because of these siloed realities of the largest pools of money. They're looking oftentimes for a slight edge and they're looking for security selection managers.

Mike: **11:44** Mm-hmm (affirmative).

Rodrigo: **11:45** Whether it's equity selection or bond selection, wherever the case may be, they're trying to edge out that little excess return above and beyond the beta they get from the policy portfolio.

Mike: **11:55** Mm-hmm (affirmative).

Rodrigo: **11:56** And so it, it makes sense that the vast majority of people, and intelligence, and mental brain power goes into that, into that framework because it's easy to get allocations. It is where the money is going. When you think about asset allocation, when we approach big pools and we say, “This is what we do, we're not adaptive asset allocation or risk parity,” And they're like, “Well, we already do that. So we don't need… our investment committee does that already.” We already do this. So even today we were chatting with the, uh, head quant at CPP and we're talking about where he came from. He came from an organization called The Completion Portfolio and Risk Premium, right?

The Completion Portfolio and Risk Premium, asking why, why is it not, isn't it global tactical asset allocation, yeah you know, you've got to call it the Completion Portfolio because it kind of fits better than saying asset allocation.

Adam: **12:41** That's better framing.

Rodrigo: **12:42** It's better framing it just, it's something that you can actually possibly get an allocation to. So it's just, it's not something that the vast majority of money that wants to handle or deal with.

Adam: **12:53** Let’s not blame exclusively institutions either. I mean, the private wealth portfolios have, are under exactly the same constraints. Thinking about a typical Wire House or typical RIA, they have guidelines. You've got an investor who's filled out a risk questionnaire. You've built a plan for that investor and there are very clear maximum and minimum equity exposure and exposure to alternatives that you're allowed to have in that portfolio. So even if an advisor wanted to make large bets, most of them are very heavily constrained on the extent to which they can take active risk relative to those ranges.

Mike: **13:25** What do you think about that in the context of so the policy portfolio now becomes the benchmark and benchmarking the idea that you know as, as you've talked about moving into that area of individual wealth and now we have a benchmark that we have to follow so we can't deviate too far from the benchmark because of the potential career risks that might be associated with that, and so now we have other behavioral gremlins that are manifesting in, in the decision making.

Adam: **13:52** Certainly, I mean it's not exclusively regulatory or compliance related. There's absolutely a large behavioral component and clients are uncomfortable deviating from the portfolios that they are familiar with, with allocations to sleeves that are different than what their friends are doing. It's painful to go to dinner parties or have conversations with your peer group where you are underperforming for even a few months or certainly for a few years. All of those are big drivers of long-term decision making and constrain advisor's ability to deviate from the policy portfolio.

Mike: **14:27** Yeah.

Rodrigo: **14:28** I just want to take a step back and how, why we're harping on all of this, right? The structural barriers to arbitrage conversation. What does that actually mean? What does that mean in terms of the opportunity going forward? I think there's a lot of conversation right now. It's speaking about risk premia and whether you know the value premium is going away because of overcrowding or any other traditional premium.

When people think about this, they're thinking about the traditional market neutral, long-short or smart beta strategies that billions of dollars are piling into. Now, the reason this is happening is because of these siloed realities, and indeed there are billions and billions of dollars going into this, but premiums, these type of factor premiums also exist on the asset allocation space, and the reason we think that structural barriers to arbitrage for the asset allocation are so important is because they're much larger than the security selection structural barriers to arbitrage, so they're significantly lower.

The vast pools of money cannot arb away trend, momentum, carry, volatility strategies in a way that we can, we can take advantage of.

Adam: **15:30** And in particular I think you're, yeah, talking about asset allocation vs. security selection, domain.

Rodrigo: **15:35** So we should be less worried about the testing that we've done on these factor premiums over the last 20, 30, 40, a hundred years and what we should be worried about is, is this alpha sustainable? It's a very important question and while I think that they're not likely to go away because as I observe human nature and, and even in this 2018, where factor premiums had done really poorly. People are not sticking to it and they're going to crowd out. They're going to get, they're going to get out of that position. It's more likely to see a shrinking factor, in security selection than we would see from asset allocation precisely because of large pools of money can't arb this away and are not willing to and, and, and, all of the things that we listed out.

So for you, from a business perspective, I think the reason we feel that focusing on asset allocation has more perspective is because we think that the alpha is more sustainable.

Adam: **16:23** Yeah, the magnitude and persistence of these premia that we're all familiar with are more like, is more likely to be larger and longer within the asset allocation space and than the security selection space. Because the first security selection, there are very few barriers to arbitrage other than behavioral barriers for arbitrage.

Mike: **16:42** So let's summarize for a moment and say, "Okay, so there's a reason why the excess return lives. Why it should continue to live, continue to be able to be harvested? I'm buying what you guys are selling. Okay, I get it now. How should I do it? What should I do in my portfolio? How should I do this guys? I'm in, but what's next?"

Rodrigo: **17:03** I'm so glad you asked, because that's exactly what we're going to talk about it in the following 12 days, talking about how when we first wanted to lay the table, we want to understand why we're not talking about security selection. Why is it that we're just focusing on asset allocation? I think we laid out the groundwork. So over the next couple of days what we're going to do is really maybe we lay out a bit more as to the benefits in terms of return opportunities that you get from asset allocation versus security selection and then get into the application of it and of course we're going to talk about the typical, you know, equal market cap-weighted risk parody, tactical and so on. Right? So we will get to that in the next coming up.

Mike: **17:41** Sounds good. I'm excited to hear more.

Adam: **17:42** Me too.

Rodrigo: **17:45** Thank you for listening to our 12 days of Investment Wisdom mini-series. You will find all the information we highlighted in this episode in the show notes @investresolve.com/12 days. You can also learn more about ReSolve's approach to investing by going to our website and research blog at investresolve.com, where you will find over 200 articles that cover a wide array of important topics in the area of investing. We also encourage you to engage with the whole team on Twitter by searching the handle @investresolve and following Adam, Mike and myself. If you're really enjoying this series, please take the time to share us with your friends through email, social media, and if you really learned something new and believe that our series would be helpful to others, we would be incredibly grateful if you could leave us a review on iTunes. Thanks again and see you next time.