Santander Asset Management

Reading between the lines of asset allocation

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You don't need to look far to see how much of today's investment landscape is still underpinned by the principle of asset allocation.

Nearly 70 years after Harry Markowitz laid the foundations of asset allocation-based investing in his work on Modern Portfolio Theory, many funds and portfolios are still built on the idea that mixing different asset classes will help produce optimal returns.

Model portfolios, multi-asset funds, balanced managed funds and most portfolios put together for and by long-term investors are constructed on the basis that because the main asset classes are largely uncorrelated, spreading investments across them reduces risk.

At its most simple, Markowitz's theory, for which he was awarded a Nobel prize, worked on the assumption that investors want to maximise the return they get for a given level of risk, and that holding a mix of unrelated assets which don't move in the same way at the same time will significantly reduce the risk of the overall portfolio.[1]

The full picture

Markowitz's theory was published back in 1952. It has been backed up by subsequent studies, perhaps the best known being the 'Determinants of portfolio performance' research published in 1986 by Brinson, Hood and Beebower. They found that 93.6% of total return variation is due to asset allocation, and not other factors such as manager and stock selection.[2]

Some research has challenged the key tenets of Modern Portfolio Theory, however.

In a 1997 paper entitled 'The asset allocation hoax', William Jahnke argued that the Brinson, Hood and Beebower paper mistakenly focuses on portfolio volatility rather than portfolio returns. He said "investors should be more concerned with the range of likely outcomes over their investment planning horizon than the volatility of returns". Jahnke added that asset allocation should be viewed not as fixed but as a dynamic process that changes in response to market opportunities and the individual's circumstances.[3]

In 2000, Roger Ibbotson and Paul Kaplan, also argued that Brinson, Hood and Beebower looked only at the variability of returns and not at actual returns or relative performance. Their paper, 'Does asset allocation policy explain 40, 90 or 100 percent of performance?'[4], found among other things that only about 40% of the return variation between funds is due to asset allocation, with the remainder driven by factors such as asset-class timing, fees, the investment style within asset classes and stock selection.

Exceptions to the rule

We know that the main asset types typically perform and correlate differently at various points in the economic cycle. In a 'normal' market, the prices of riskier assets such as shares and property will typically move together, as will those of less risky assets such as cash and bonds.

However there will be relatively little correlation between higher and lower risk assets.

For instance, property and shares both tend to perform well in a bull market (as the post-financial crisis era demonstrated). But when markets fall, property and shares are expected to perform less well and assets that are less correlated with stock markets, such as bonds, do better.

But those correlation assumptions aren't always borne out in practice. Research by Winton, an investment management and data science group, found that until the late 1990s, there was a much closer correlation between the main asset classes that many might expect.[5]

Similarly, data show that for long periods there has been a positive correlation between US government bonds and the performance of the S&P 500.[6] When markets dropped sharply in response to the unfolding coronavirus crisis in March, while the correlations between risky assets were as expected, there was also a positive correlation between those assets and US government bonds, which dipped too.[7]

One possible explanation is that when investors are getting out of stocks in times of market stress they aren't necessarily turning to bonds as a safe haven, but going back into cash, meaning bonds and equities are both experiencing a sell-off.

Striking a balance

It's clear there can be different interpretations of how asset allocation works, how it should be applied and the effect it has on performance. While Modern Portfolio Theory has had a profound impact on the way we invest, studies have also challenged the way Markowitz's work has been viewed.

The coronavirus crisis reminds us that there will inevitably be short-term periods of stress in which investors can benefit from a more diversified approach to portfolio construction once again underscoring the value of asset allocation-based investing strategies, particularly for long-term investors.

Even within single asset classes the underlying investment classes - such as particular regions and industries - can be expected to move in different ways at different times, providing a degree of portfolio diversification.

In other words, making sure that portfolios are diversified across unrelated asset classes that don't normally move in the same way still plays a fundamental role in optimising returns for a given level of investment risk over time.

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[1] Investopedia, 4 February 2020.
[2] CFA Institute, 16 February 2020.
[3] Published via Simonemarrioti.com, February 2020.
[4] Financial Analysts Journal, January 2000.
[5] Winton, 31 January 2014.
[6] MarketWatch, 27 December 2018.
[7] Medium.com, 31 March 2020.

Important Information