Demystifying and dealing with "Diversi-fiction"

The question is a familiar one to family officers, trustees, and those who serve as investment fiduciaries: How does one ensure adequate capital is available for future needs in today's increasingly complex and risky investment environment, while avoiding blow-ups and the Bernie Madoff's of this world?

Too often the approach taken to reconciling the competing demands of the present with those of the future is ad-hoc. Investment fiduciaries systematically underestimate the importance of professional asset management in the achievement of this goal. A successful investment program requires thoughtful strategy, efficient implementation, and a greater attention to risk management. Michael Maubussin, chief investment strategist at Legg Mason Capital Management in the US, was asked what advice he would give to a novice analyst coming into the asset management industry. He cited an understanding of four different dimensions that would lead to success: capital markets, strategic issues, valuation, and behavioral finance. His remarks are pertinent to structuring a charity endowment today. However, this "back-to-basics" approach is not being systematically applied. Where are so many investment programs going wrong?

Key Challenges

Investment performance often suffers due to cultural or behavioral barriers, including unwarranted risk aversion and the belief that conservatism is the only proper approach. A tendency towards consensus-seeking can leave trustee committees prone to "groupthink" and herding behavior. Past return-chasing and unrecognized "survival anxiety" are further barriers to out-performance. Structural factors such as limited staffing, difficulty in accessing and retaining top talent, ineffective or unclear governance structures, an evolving regulatory environment, difficulty in trustee recruitment, as well as the complexity of investment options further compound the problems.

A 2008 study by the UK's Institute for Philanthropy brings the above issues into perspective. The study found a large dispersion in investment results over the five years ending December 2007, ranging from 22.1% to 3.1%, suggesting that family offices and charities would do well to reconsider their strategy. A more professional approach to investment management can yield more consistent and better results, improving a program's ability to plan future expenditures, while higher investment returns clearly results in faster capital growth.

Traditional Solutions

Let's consider the widely followed approach to asset allocation as developed by Markowitz and others: broad diversification will provide higher return for each unit of risk when compared to a non-diversified portfolio. In other words, combining assets with different return behaviors ("uncorrelated assets") creates an optimal "efficient portfolio". This underpins the notion that "diversification is the only free lunch". This quantitative framework provides credibility (Nobel Prizes help too), and discipline, in the form of long term strategic targets for each asset category under consideration, which in turn helps avoid behavioral pitfalls. Where then does this approach fall short?

Behavioral factors can only partly be blamed for poor investment results. Standard advice comes from a variety of specialist sources, consultants and fund managers alike: equities should be over-weighted relative to bonds, which historically have not provided sufficient growth to keep up with inflation and spending. Alternative asset classes in the form of hedge funds, private equity, and "real" assets serve to further diversify the portfolio, but trustees and family officers typically suffer from lack of selection expertise, even more important in asset categories where transparency and illiquidity are essential considerations and a poorly-researched decision can have serious consequences.

However, advice in the form of generalizations too often results in a "copycat" approach to building a portfolio. This approach does not translate well to the individual needs of a charity or trust, each of which have unique operating goals and spending needs which need to be considered. This is especially true when trust and charity officers deal with the complexity of various asset classes, in addition to the behavioral and implementation challenges discussed above. Indeed, officers may understand the benefits of diversification and the broad relationship between risk and return, but lack the tools to implement these ideas, leaving the portfolio unduly concentrated in a few risk factors.

Diversification only goes so far

Over the long term, the greatest risk to perpetuities such as trusts or endowments is the erosion of purchasing power. Diversification among asset classes helps mitigate this, but only to a point. The phrase "in a crisis, correlations [of all risky assets] go to one" is borne of bitter experience: the traditional assumptions on which asset allocation are based are of little benefit in a steep market decline. In the current crisis, government bonds are the only (sub)-

asset class to have held up well. In addition, traditional methodologies fail to adequately address the liquidity characteristics or the leverage of the asset class in question. The credit crisis fed off itself as banks and investors got caught in a liquidity squeeze and were forced to sell assets as their balance sheets could no longer support the rapid turnover of funds that had characterized the buoyant market.

These investors and companies broke the "Golden Rule" of finance, namely to link a project's funding structure with its investment horizon. But when credit is cheap and money is plentiful and circulating rapidly, there are few discernible consequences to breaking this rule.

Another weakness of the traditional asset allocation approach is that models do not address market cyclicality, or how to adapt to specific opportunities created by the market. "Better late than never" will not deliver consistent excess return. On the contrary, early entrants into the next hot asset class tend to get stellar returns, while those who delay will pay, most typically in the form of, at best, middling returns.

But why (and when) did diversification become "diversi-fiction"? In the past, bubbles developed in single asset classes only, the most infamous being the IT bubble in the late 1990s. Other asset classes remained relatively fairly valued or even cheap (e.g. emerging markets, small cap, listed real estate). This past summer, the bubble formed across all risky assets as investors embarked on a relentless "search for yield", believing they were combining uncorrelated strategies, to be eventually held hostage at the mercy of market volatility. As market events in the past year have made clear, traditional measures of risk upon which core assumptions are based are far from comprehensive enough.

Minimizing Risks, Seeking Opportunities

In a "back to basics" approach, diversification by asset class should remain the guiding principle, but the goal should not be to fill out asset class buckets blindly.

A more professional approach is to focus on the "real" goal of diversification, namely to generate return at the lowest risk possible, by identifying assets with unrelated characteristics and buying them when they are selling at a discount.

To achieve this, a more active approach to strategic asset allocation is needed. The traditional methodology of focusing mainly on historical average returns (and/or risk premia) to predict the future is not enough, as most models do not sufficiently adjust for high or low current valuations. Setting a long term strategy, but over- and underweighting asset classes and styles depending on current valuations, helps to balance strategic goals with a more opportunistic approach.

As distinctions between asset categories blur, the best approach may be to give talented fund managers more latitude to exploit mispriced valuations, making manager selection decisions even more crucial and requiring sophisticated overall risk management to keep track of the underlying exposures. 'Endowments which are confined to the traditional "pigeonhole" approach may be leaving money on the table,' says Vanderbilt endowment CIO Bill Spitz.

Governance and Implementation

Fiduciaries can better understand their clients' true portfolio exposures by, for example, using specialist parties employing tools such as holdings-based analysis to facilitate aggregated exposure management.

In fact, implementation was found to explain over 60% of the difference between top and bottom quartile endowment fund performance from 1997 to 2001, according to a study by a large consulting firm. To give a concrete example, during the summer of 2008, we believed equities were close to fair value, only offering a 7% return. When bonds began yielding over 6%, we increased our clients' allocations to credits. Spreads did widen further, but we protected our clients from the deeper equity decline.

How does this help the under-resourced charity struggling with today's behavioral and implementation challenges? We can look to the experience of small endowments and foundations in the US where a fitting solution is gaining traction. These endowments are increasingly "outsourcing" the investment function to a third party, freeing trustees from the details of investment management and allowing them to focus on bigger picture governance issues where they can be much more effective.

The focus here is on spending decisions, setting broad guidelines and risk tolerance, establishing ESG or SRI policies, while limiting the monitoring function (where they have a legal responsibility) to one umbrella relationship.

In Europe a similar trend is emerging. For example, in the Dutch institutional market, small and mid-sized pension plan boards, similarly burdened with stringent regulatory oversight and governance requirements, have decided to focus on governing, leaving the day-to-day portfolio management to specialists.

Specialized third parties can help fiduciaries meet their main goal of preserving future purchasing power, while dealing with the complexity in the market today. The key is to establish long-term strategic asset allocation targets, implement efficiently, while paying greater attention to risk and considering common sense metrics. This helps avoid common behavioral and implementation pitfalls and the phenomenon of "diversi-fiction".

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