Strategic asset allocation, or: How I learnt to stop worrying and love the dispersion

By Rens Götz

FOR decades, strategic asset allocation has been considered the driving force behind investment portfolio returns. But the old adage that allocation determines 90 per cent of performance is rapidly becoming outdated.

Over the course of 2020, we have seen how the world of investing is shifting from one in which declining interest rates drive beta performance, to one with increasing dispersion of returns within asset classes, regions, and sectors. This dispersion is amplified by retail investors who have greater access to the markets through supposedly zero-cost investment platforms.

Going forward, in an era of near-zero or rising interest rates, beta will play a secondary role in performance generation. Since early 2020, three phenomena are propelling the future of investing, pushing it towards more precision-oriented strategies.

Pricing mechanism

The combination of near-zero interest rates, fiscal and monetary stimulus, and the increased market access among retail investors has transformed the pricing mechanism. Many times over the past year, whether with GameStop or AMC Theatres, price discovery seems to have been thrown out the window.

Because of excess liquidity and the behavioural "bigger fool" expectation, investors believe they will be able to sell quickly at a higher price. Leverage in public markets has grown: while retail investors used to just trade stocks, thanks to falling derivative transaction costs, many are now acting as marginal buyers through options.

Many times last year, pension funds, sovereign wealth funds (SWFs), and other institutional investors with long time horizons acted pro-cyclically rather than being the buyer of last resort during a market downturn. For example, large pension funds removed tail-risk hedges just weeks before the start of the bear market, and some had to sell assets in the midst of the correction to facilitate their sponsor's unforeseen liquidity requirements.

The removal of this "rational investor" pricing mechanism makes it much more difficult to set return expectations for various asset classes. There is uncertainty about the validity of pricing. This is then compounded by the greater dispersion of valuations among seemingly similar businesses: think, for example, of Volkswagen's valuation catch-up to include the so-called electric-vehicle (EV) premium in March.

As beta has become more uncertain, so have expectations for risk measures and correlations. This then decreases the utility of classical beta-oriented strategies.

Private assets

The growing importance of returns on private assets makes it harder to determine portfolio risk and returns using classical methods.

Over the past decade, institutional investors have rapidly expanded into illiquid and non-public private market investments in real estate, private equity, private debt, and direct lending. There are several reasons for this, some more valid than others: It makes sense to expand the investment opportunity set and diversify income streams, for example.

But the valuation lag and supposed risk reduction benefits of non-market valued assets hardly seem logical. Especially in classical strategic allocation studies, such biases lead to naive private investments that ignore proper diversification within the asset class.

Why else are investors looking to the private markets? Because there are targeted investment opportunities not found on listed exchanges. Potentially disruptive sector developments, in particular, are sometimes hard to capture through the mid- and large-cap companies in the public markets.

Thanks to greater computing power, knowledge distribution, and outsourcing opportunities, developing novel products in industrial automation, oncology, and behaviour nudging software, among other areas, has become much easier, given access to the right intellectual and venture capital.

The potential of these fields will endure for a long time. But only when their full technological developments become widely investable will they sort into winners and losers while lifting the field as a whole.

In pharmaceuticals, for example, many of the most profitable innovations of the last few decades have been developed locally, in bio-science parks. Investing in, say, the top 10 pharmaceutical companies would not have been precise enough to profit from these developments.

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Whether it is in anti-viral treatment or gene therapies, precise – and risky – investments in companies placed in sectors that are ripe for disruption offer more reward than moving up in the risk spectrum of public markets.

Yet, strategic asset allocation often sets constraints. It can be difficult or impossible to select niche managers with deep ties into the sector in question. Generally, these targeted investment strategies do not fit into top-down oriented investment policies and are therefore discarded. Consequently, large institutional investors are leaving return opportunities to the smaller players, such as entrepreneurially oriented family offices.

For investors, the larger opportunity set should outweigh the potential downsides, even after mitigating the overly positive biases in the investment process.

Careful bottom-up oriented portfolio construction techniques should offset concentration risks, and reasonable risk and return expectations could be fed into allocation decisions. Better yet, public and private equity investments could be merged into a single portfolio construction to improve diversification.

Regime changes everywhere

Last year's developments have accelerated the pace of transformation in the industry. The evolution of a long list of performance drivers is now making it more critical to review risks on a dynamic and single investment basis.

Longer-term trends combined with the policies instituted to counteract Covid-19's impact on the global economy have only amplified the effect. Changes in the way people work – offices versus remote, physical versus digital, and local versus global – influence the short-term perception of investments. What will happen to office buildings? How many logistical centres will be needed? How much is a restaurant franchise chain worth if it can only do home deliveries? Over the longer term, the winners will be differentiated from the losers as some industries emerge more resilient than others.

Governments across the globe have all responded differently to the crisis, but most have drawn from the same toolbox and pursued stabilisation and compensation through debt issuance. Even when the resulting debt levels are considered perpetual, policy will have to be normalised at some point to avoid a much more centrally planned economy relative to the pre-Covid era.

At this point, dispersion within asset classes will again increase. Which regions, sectors, and companies have taken more effective long-term steps to prevent capital destruction when the pandemic-related fiscal support is withdrawn?

Another factor driving market dispersion is the greater focus on environmental, social, and governance (ESG) factors. Governments have contemplated various Green New Deals that would provide financing to "green" companies or projects. Central banks, the International Monetary Fund, and the World Bank have embraced a similar focus. From a macro governance perspective, the direction of lawmaking is becoming clearer – some investments will be better situated than others.

The geopolitical situation is another factor. Increased competition, combined with deglobalisation efforts to create more robust supply chains, whether for semiconductors or the production of agricultural staples, may lead to heightened tensions. A rift in global relationships could create both risks and opportunities. The Asian Tiger economies could see their fortunes wane, while those of Latin America and India could see theirs improve. These growing long-term uncertainties make it particularly difficult to establish a sound strategic asset allocation process and sticking to it over the next decade.

The evolving environment and accelerated pace of change will require a deeper understanding of financial and behavioural dynamics, geopolitics, and the underlying investments. Without a more holistic and hands-on approach, investors will leave returns on the table, while risking more by unwillingly accepting economic concentration risks.

What's next?

Generating optimal returns in this new era will require investment governance that delivers detailed investment decisions that are in sync with the times. That means a more integrated investment framework and new and different methods of assessing risk.

Sticking to the status quo will only sacrifice performance.

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