

It's Time to Dump Static Asset Allocation

By William Jahnke

In a meeting in 1998 attended by 70 financial planners, the audience was asked if they believed in a static asset allocation. With a show of hands everyone in the audience agreed. In 1991, Eugene Fama, the most outspoken academic advocate for the efficient market hypothesis, in his paper, "Capital Markets II," rejected the random walk model and promoted the idea that expected returns vary with time. At a recent conference of the Institute for Quantitative Research in Finance, attended by 150 sophisticated institutional investment professionals, the audience was asked if they believe that expected returns vary with time. By a show of hands, everyone in audience agreed. In a session on asset allocation policy, there was consensus that asset allocation should be "fluid" and not static. The practice of setting and sticking with a static asset allocation only makes sense in a world where asset class return expectations do not vary with time. The most sophisticated institutional investors do not believe in a static asset allocation. It's time for the financial planning community to dump static asset allocation.

Denigrating all forms of active asset allocation became broadly accepted in the financial planning community in the 1990s. Active strategic asset allocation solutions based on changing investment opportunities got lumped together with short-term market timing as a failed practice. But there is a big difference between trying to outguess the market in the short term and adjusting the asset mix based on changes in long-term fundamentals. The worst bear market since the Great Depression has financial planners questioning some closely held practices. One of them is setting an asset allocation mix and sticking with it regardless of what is happening in the market.

Static asset allocation is based on the belief that asset class returns are produced by a stable return-generating process: returns from period to period are drawn from a return-generating process that has a stable mean and standard deviation. Such a process will produce successive returns that are independent, identically and normally distributed. These are the assumptions of the random walk model that form the basis for the common practice of extrapolating asset returns and risk premiums. The assumptions of the random walk model are among the most extreme and unrealistic assumptions in all of economics. Many practitioners seem to be unaware that there is no economic theory underlying the model and that there is an absence of empirical support for it as well.

The random walk model became popular among academics because the standard statistical tool kit requires mean returns and standard deviations that are stable and normally distributed. Statisticians loathe distributions that are not normal. But practically all of the empirical work on equity returns has discovered that their distributions are not normal; rather, returns distributions have "fat tails." The most reasonable explanation for the fat tails is instability in the return-generating process, causing mean returns, standard deviation, and the correlations with other asset classes to vary across time.

The reaction of researchers to fat-tailed distributions varied: some ignored them, some felt they were simply anomalies, and some fudged the data. The existence of fat tails in the distribution of stock returns can be the result of market bubbles, reaction to changes in consensus-earnings expectations, or changes in the pricing of uncertainty. The variation in return expectations can be consistent with the efficient market hypothesis, or it can reflect market inefficiency. In either case, the idea of setting an asset allocation strategy and sticking with it is not the best course of action. It takes more than belief in efficient markets to support static asset allocation.

The notion that asset class returns conform to the random walk model was popular for ideological reasons in the influential Chicago School academic circle in the 1960s and 1970s. These academics believed in classical economic theory, free markets and the limited role of government in economic affairs. They saw the random walk model and the efficient market hypothesis as demonstrations of the effectiveness of free markets in allocating assets. As is generally the case with true believers, they looked at the empirical data through an ideological lens.

Stage Set for Static Allocation

By the end of the 1980s, the cumulative evidence against the random walk model was sufficient that academics still preaching efficient markets had largely abandoned it. Unfortunately, by that time, the stage had been set for static asset allocation to become the industry standard of practice. The financial planning community was largely unaware that the rug had been pulled from under the random walk model. The practice of extrapolating historical risk premiums in formulating static asset allocation solutions was underway.

The financial planning community adopted static asset allocation for several reasons. While academic support for the random walk model had waned, many financial planners falsely believed that it provided support for static asset allocation. Financial planners had also been misled to believe that a static asset allocation explained over 90 percent of portfolio performance, based on the famous Brinson studies of pension fund returns. When William Sharpe and Harry Markowitz were awarded the Nobel Prize in Economics in 1990, many financial planners falsely believed that Sharpe's capital asset pricing model and Markowitz's mean-variance security selection provided support for static asset allocation.

What many financial planners did not understand at the time was that static asset allocation was supported by the random walk model, not the efficient hypothesis. Second, they did not understand that the Brinson studies' findings were based on an analysis of quarterly variation in returns, not cumulative returns, which provides a very different perspective of the roles of asset allocation policy, market timing and security selection in funding financial objectives. Third, Sharpe's CAPM supported investing in the world wealth index, where the asset mix changes, not a static asset allocation. Finally, Markowitz was for using analyst forecasts of returns, not an extrapolation of historical returns or risk premiums.

Given that expected returns vary with time, the practice of extrapolating returns generally results in the high expected returns being produced at market tops and the low expected returns at market bottoms. There exists at such times a significant mismatch between the long-term historical average return and future asset class returns based on economic fundamental variables, represented by the yield curve, dividend yields, consensus long-term earnings-growth forecasts, and price/earnings ratios. These fundamental variables are now being referred to as "supply side" variables. As the top of the stock market bubble approached in 2000, some notable investment professionals working with supply-side variables were forecasting long-term stock market returns of 6 percent or lower per year, while those who extrapolate historical returns were forecasting 11 percent returns or higher. From a financial planning perspective, it makes a big difference whether one believes the most likely return for the stock market is 6 percent rather than 11 percent, and it makes a big difference in asset allocation.

In Favor of Active Strategic Asset Allocation

The proposition that financial planners should not take a more flexible approach to asset allocation is popular for good reasons. Static asset allocation is easy to market and easy to implement. It works well for financial planners as long as asset class returns are well behaved. In the long run, it does not work well for clients if it results in over-consumption in the wealth-accumulating years, and a failure to recognize and react to market bubbles. It should be noted that active strategic asset allocation is no panacea, but arguably it is a better approach over the investment planning horizon for most clients.

Active strategic asset allocation does not require the planner to make short-term forecasts on asset class returns. It does, however, require the planner to approach forecasting from the supply side and to be somewhat contrarian, which means at times lightening up on asset classes that have performed well in the past and increasing exposure to asset classes that have performed poorly. This is a hard thing to do; leaving the party early and standing apart from the crowd is not fun. But this is what professionals should be paid to do.

Determining an active strategic asset allocation strategy can be accomplished by forecasting asset class returns for a set of scenarios and evaluating alternative investment solutions in terms of how well they fund the client's financial objectives. The benchmark for evaluating the appropriateness of alternative strategic asset allocation, market timing and security selection strategies is the funding ratio. A client's funding ratio is similar to an actuarial calculation that evaluates the over- or under-funding of projected pension fund liabilities. In this case, the projected

liabilities are the client's multi-period consumption objectives. Risk is defined in terms of the funding ratio dispersion projected for a given investment strategy and financial plan. The client's tolerance for risk taking is captured by the willingness to accept the expected rewards as well as the downside risk of aggressive investment strategies in funding long-term, multi-period cash-flow budgets. The modeling of this process can capture a great deal of the complexity found in the real world.

Static asset allocation became financial dogma in a period of extraordinarily high stock market returns and low market volatility. The bubble in stock prices with the mark-up of return expectations masked the risk of failure in many financial plans. With asset allocation based on "stocks for the long run," risk defined in terms of the "client's ability to sleep at night," and the advice that clients "stay the course" with their asset allocation policy, most financial planners did not respond to the lowering of return expectations and the increasing risk of a market correction from a supply-side perspective. One lesson from the recent past is that return expectations are not constant and financial planners need to take a more fluid approach to asset allocation. It's time to dump static asset allocation.

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