

How important is asset allocation?

Received (in revised form): 31st January, 2001

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Abstract Strategic asset allocation is part of the management of *investors*. Tactical asset allocation and security selection are part of the management of *investments*. Financial advisers provide great value as managers of investors as well as managers of investments; they do not increase their value by misinterpreting Brinson, Hood and Beebower's study to imply that strategic asset allocation is more important than tactical asset allocation and security selection. This paper focuses on the value of financial advisers, the importance of strategic asset allocation, tactical asset allocation and security selection, and the interpretation of Brinson, Hood and Beebower's study.

Keywords: *portfolios; strategic asset allocation; tactical asset allocation; financial advisers; behavioural finance*

Good strategic asset allocation is like tailoring a well-fitting suit. Good tactical asset allocation and security selection is like weaving the suit's fabric at a low cost. Both are important, but they are distinct. High-quality fabric woven at a low cost provides little comfort when it drapes a size-40 body in a size-46 suit.¹

Financial advisers are tailors more than they are weavers; they are *investor* managers more than they are *investment* managers. But investors see more value in weaving than in tailoring; they are more willing to pay for *investment* management, with its focus on beating the market, than for *investor* management,

with its focus on the examination of financial resources and goals, diagnosis of deficiencies, and provision of financial education and care. It is no wonder that investment advisers seized upon a study that seemed to imply that investor management is more important than the investment management.

Brinson *et al.* (BHB, 1986) studied the performance of 91 large US pension plans over the 1974–83 period and concluded that 'investment policy dominates investment strategy (market timing and security selection), explaining an average of 93.6% of the variation in total plan returns'. A sequel by Brinson

et al. (BSB, 1991) put the number at 91.5 per cent.

BHB's study has become the centre of a debate, a debate initiated by Jahnke (1997). 'The fundamental problem with BHB's analysis,' wrote Jahnke, 'is its focus on explaining portfolio volatility rather than portfolio returns.' But, as Veres (1997) noted, Jahnke's real target are the many financial advisers who have used BHB's study to glorify the strategic asset allocation part of their investor management role while denigrating the tactical asset allocation and security selection roles of investment managers.

Financial advisers do indeed use BHB's and BSB's studies to glorify strategic asset allocation and emphasise investor management. For example, SEI Investment Group highlighted BSB's study in a brochure aimed at financial advisers and investors. 'As noted in the authoritative study of pension fund performance,' stated SEI, 'the overwhelming determinant of the success or failure of an investment strategy is not which securities of mutual funds were bought or sold but how the assets were divided among the various asset classes (stocks, bonds, cash equivalents).' SEI concluded that the value of financial advisers is mostly in investor management. 'The most *important* steps in the investment process are those in which an investor's objectives are carefully *defined* then *implemented* with the appropriate asset allocation strategy.' (SEI Investment Philosophy, p. 5.)

The first goal of this paper is to focus the debate on the role of financial advisers by distinguishing investor management from investment management. The second goal is to clarify the debate on the importance of strategic asset allocation, and the third goal is to discuss tactical asset allocation and the ability to execute it well.

Terms of the discussion

The terms in the asset allocation debate are confusing. The discussion uses three terms: strategic asset allocation, tactical asset allocation and security selection. Strategic asset allocation is what BHB call 'investment policy' and what SEI calls 'asset allocation'. Strategic asset allocation involves the allocation of portfolios among asset classes, such as 60 per cent to stocks, 30 per cent to bonds and 10 per cent to cash. Jahnke refers to strategic asset allocation as 'fixed weight asset allocation', but investors might change their strategic asset allocations if they change their preferences for expected returns and risk. Investors might also change strategic asset allocations if they revise their estimates of expected returns or risk, but strategic asset allocation estimates are founded on an acceptance of current market valuations, not on challenge to them. Investors who restrict themselves to strategic asset allocation are 'passive' investors, and they hold passive portfolios.

Tactical asset allocation is what BHB call 'market timing' and what Janke calls 'asset allocation'. Tactical asset allocation challenges current market valuations. It involves shifts in allocations, relative to the strategic allocations, in an attempt to benefit from deviations in current values asset classes from their 'correct' or 'rational' levels.

Security selection is used here as in BHB. It involves selection of particular securities from all securities in an asset class in the belief that the selected securities have higher values than their asset class brethren. Investors who deviate from their strategic asset allocation portfolios for tactical asset allocation or security selection reasons are 'active' investors, and they manage active portfolios.

Table 1 Returns of portfolios (%)

Year	Stocks	Bonds	Cash	50-28-22	BHB	50-28-22	BHB
1980	25.4	-4.0	11.3	17.3	16.7	32.4	16.1
1981	-1.3	1.9	12.7	1.3	1.3	15.7	1.7
1982	21.4	20.4	12.7	26.6	26.6	26.6	26.6
1983	22.5	27	12.7	26.6	26.6	26.6	26.6
1984	6.3	16.6	12.7	12.7	12.7	12.7	12.7
1985	22.2	22.2	12.7	22.2	22.2	22.2	22.2
1986	12.2	24.2	12.7	12.7	12.7	12.7	12.7
1987	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1988	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1989	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1990	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1991	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1992	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1993	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1994	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1995	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1996	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1997	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1998	12.2	12.2	12.7	12.7	12.7	12.7	12.7
1999	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2000	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2001	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2002	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2003	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2004	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2005	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2006	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2007	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2008	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2009	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2010	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2011	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2012	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2013	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2014	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2015	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2016	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2017	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2018	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2019	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2020	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2021	12.2	12.2	12.7	12.7	12.7	12.7	12.7
2022	12.2	12.2	12.7	12.7	12.7	12.7	12.7

How important is strategic asset allocation?

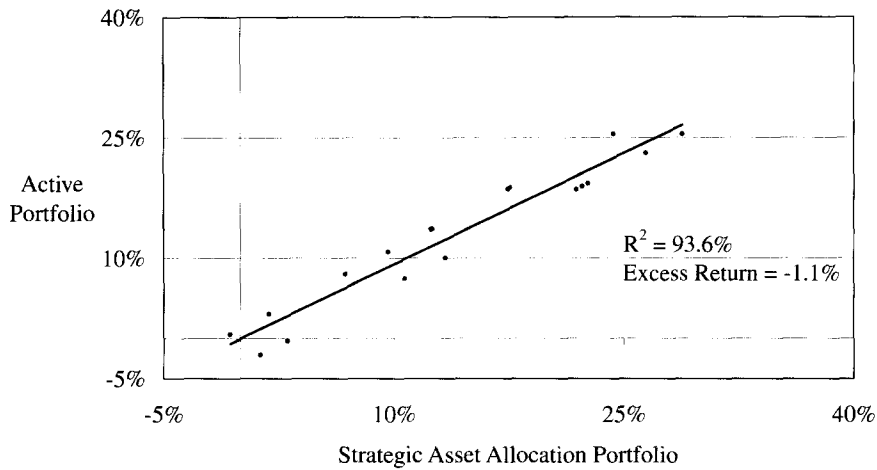
BHB wrote that strategic asset allocation dominates tactical asset allocation and security selection, since it explains, on average, 93.6 per cent of variations in returns. But the 93.6 per cent figure does not indicate that strategic asset allocation is more important than tactical asset allocation and security selection.

To understand the 93.6 per cent figure, consider a simulated version of an average BHB portfolio manager. BHB's manager is an active investment manager, employing both tactical asset allocation and security selection. The annual returns of his portfolio over the 18-year period 1980-97 are presented in Table 1. The average allocations to stocks, bonds and cash of BHB's manager over the 18 years were 50 per cent, 28 per cent and 22 per cent respectively. So we infer, following BHB's method, that he had a 50-28-22 strategic asset allocation benchmark. The

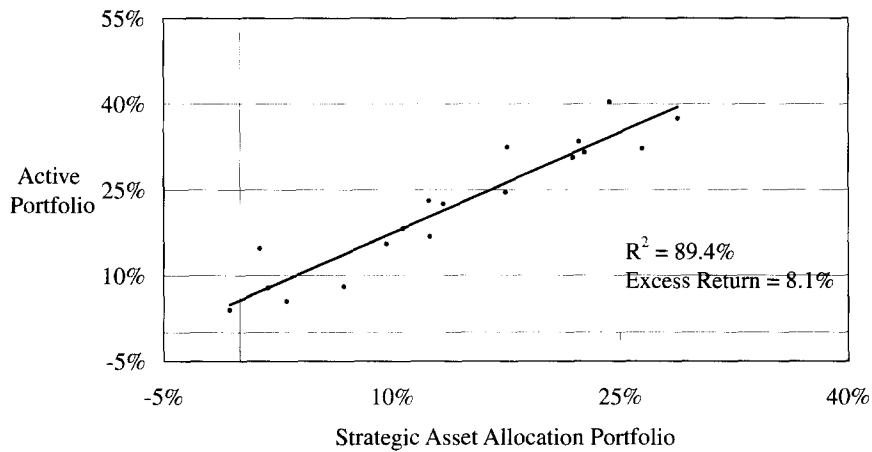
annual returns of the 50-28-22 benchmark are also presented in Table 1.

BHB's 93.6 per cent figure is the mean R^2 in regressions of the returns of portfolio managers on the returns of the same managers' strategic asset allocation portfolio benchmarks. We designed BHB's manager such that his R^2 is 93.6 per cent, and he lags his benchmark by a mean 1.1 per cent per year, the mean lag for BHB's managers. We did it by letting the manager beat the benchmark by 1.16 per cent in even years and lag the benchmark by 3.36 per cent in odd years. The regression of the returns of BHB's manager on the returns of his strategic asset allocation portfolio is presented in Figure 1a and serves as a basis for comparisons.

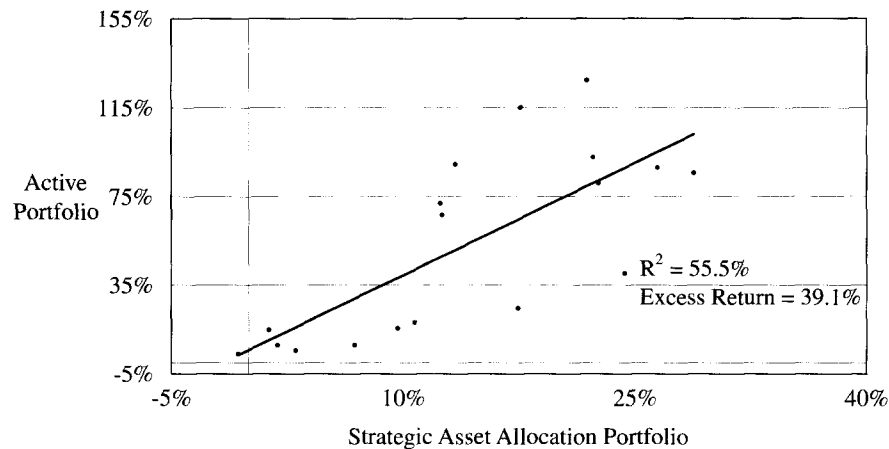
Now consider TAA, a portfolio manager who is perfect at tactical asset allocation. TAA knows at the beginning of each year, with perfect foresight, the identity of the best asset class for that



(a)



(b)



(c)

Figure 1 Regressions of simulated returns of active portfolio managers against their strategic asset allocation benchmarks, 1980–97. (a) The case of the typical BHB active portfolio manager. (b) The case of TAA, an active portfolio manager with perfect tactical asset allocation skills. (c) The case of TAA-SS, an active portfolio manager with perfect tactical asset allocation and perfect security selection skills.

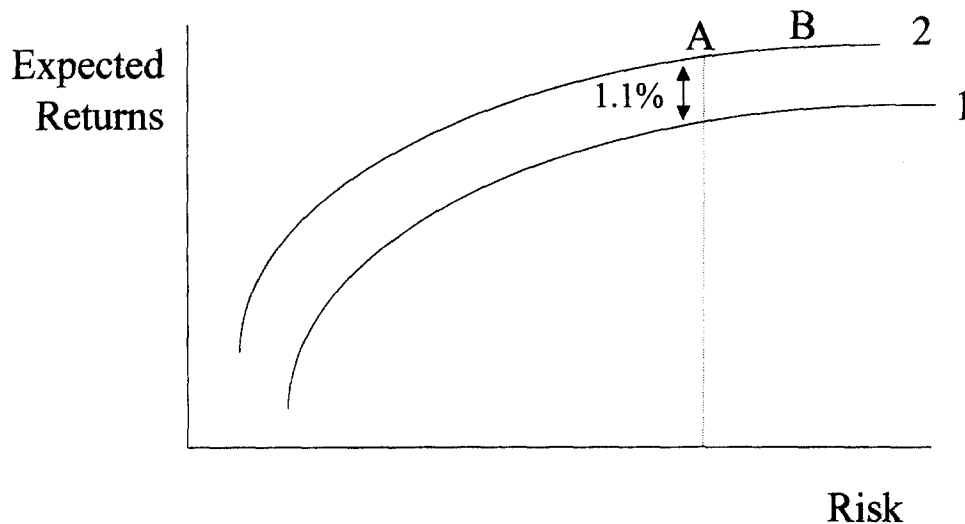


Figure 2 Strategic asset allocation involves moves on the efficient frontier (eg from A to B). Tactical asset allocation and security selection involve moves of the efficient frontier (eg from 1 to 2). The tactical asset allocation and security selection efforts of the pension portfolio managers in BHB's sample resulted, on average, in a 1.1 per cent down move of the efficient frontier, from 2 to 1.

year, and she allocates her entire portfolio to that class. TAA's portfolio was entirely in stocks in 1980, when stocks returned 32.42 per cent, beating bonds and cash. It was entirely in cash in 1981, when cash returned 14.72 per cent, beating stocks and bonds.

TAA's portfolio was entirely in stocks in 50 per cent of the 18 years 1980–97, in bonds in 28 per cent of the years and in cash in 22 per cent of the years. So, following BHB, we assume that TAA's strategic asset allocation portfolio benchmark is 50–28–22. TAA's portfolio returns exceeded the returns of her benchmark portfolio each and every year, by a mean of 8.10 per cent per year. The R^2 of a regression of the returns of her active portfolio on the returns of her benchmark portfolio is 89.4 per cent, not far from BHB's 93.6 per cent (see Figure 1b). Tactical asset allocation seems quite unimportant if judged by its contribution to the R^2 , it explains only 10.6 per cent of the variation of returns. But can tactical asset allocation be unimportant when it beats the benchmark by 8.10 per cent per year?

Last, consider TAA-SS, a portfolio manager who combines TAA's tactical asset allocation ability with the ability to replace the S&P500 Index with the top 50 stocks in the S&P500 Index whenever stocks are chosen. The R^2 of the regression of the returns of TAA-SS portfolio on the returns of his benchmark portfolio is 55.5 per cent (see Figure 1c) TAA-SS beat his benchmark each and every year, by a mean of 39.1 per cent per year. Can tactical asset allocation and security selection be unimportant when they beat the benchmark by 39.11 per cent per year?

In sum, a 93.6 per cent R^2 is not high in our context, and it tells us nothing about the importance of strategic asset allocation, tactical asset allocation or security selection. Strategic asset allocation is important and so is tactical asset allocation and security selection, but they are important in different ways. Strategic asset allocation is part of the management of *investors*, while tactical asset allocation and security selection is part of the management of *investments*.

Strategic asset allocation involves

movements *on* the efficient frontier, while tactical asset allocation and security selection involves movements *of* the efficient frontier. Good strategic asset allocation requires selection of portfolios *on* the efficient frontier, such as portfolio A or portfolio B in Figure 2, that fit the risk and expected return preferences of investors. In contrast, good tactical asset allocation and security selection calls for beating the market. It calls for upward shifts *of* the efficient frontier, such as a shift from 1 to 2, to provide higher expected returns for each level of risk.

Tactical asset allocation

Tactical asset allocators build models that use current data to forecast future returns of asset classes such as stocks, bonds and cash. The data include measure of economic activity, yield differentials, investor sentiment and many others. The forecasts are used to allocate funds among asset classes favouring those with higher expected returns. An ideal model has a perfect correlation between current data and future returns; it provides perfectly accurate forecasts. A model is useful, however, even when correlation between current data and future returns is much less than perfect. Clarke *et al.* (1989) found that a correlation of 0.3 (R^2 of 0.09) can help tactical asset allocators beat a buy-and-hold benchmark by an average of 5.9 per cent per year.

Tactical asset allocators and traditional market timers have identical goals, but different methodologies. Traditional market timers, like most people, trust their intuitive judgement and distrust 'mechanical' forecasts. Psychologists such as Dawes (1979), however, have shown that, while intuition is indispensable in identifying variables for forecasting models, these variables must be examined through systematic methods, such as regression analysis.

Fisher and Statman (2000) studied the market timing records of individual investors, Wall Street strategists and writers of investment newsletters, and found that all three groups fail to time the market. Indeed, they found that bullish forecasts of all three groups are more likely to precede *declines* in the stock market than *increases*. Ironically, the perverse forecasts of market timers provide an opening for tactical asset allocators. The correlation between the combined forecasts of the three market timing groups and subsequent stock returns is 0.28 (R^2 of 0.08), perhaps sufficient for profitable tactical asset allocation. Still, tactical asset allocation remains a difficult craft. Philips *et al.* (1996) found that while tactical asset allocators were generally successful in the period through the crash of 1987, they were much less successful afterwards.

Managing investors

As noted earlier, investors believe that *investment* management offers more value than *investor* management and that fees for managing investments are more fair than fees for managing investors. Similar perceptions are common. While we have moved from a manufacturing economy to a service economy and now to an information economy, people still think that charging for manufacturing is more fair than charging for services and that charging for services is more fair than charging for information.

The tendency to value manufacturing over services is longstanding. Adam Smith wrote in 1776 that '[t]here is one sort of labor which adds to the value of the subject upon which it is bestowed: there is another which has no such effect' (p. 315). Manufacturing labour adds value, according to Smith, but service labour does not. Karl Marx agreed with few of Adam Smith's

perceptions, but he agreed with this one. Adam Smith and Karl Marx are long dead, but their perceptions live on.

Education can help eradicate poor perceptions, but education is a slow and difficult task. Today's typical investors hold the equivalent of Smith and Marx perceptions, they are willing to pay for the execution of trades, accepting execution as real work, but they are less willing to pay for advice that leads to these trades. Similarly, investors are more willing to pay for the beat-the-market work of tactical asset allocation and security selection than for the education work of strategic asset allocation.

Teaching investors that good investment education is more valuable than good trade execution is hard work. Work was much easier in a world where execution and education were bundled together. That was the comfortable world of US financial advisers before 1st May, 1975. Trade commissions were fixed, making it easy for financial advisers to maintain the fiction that they paid for execution, not education. But May Day ushered in discount brokers who unbundled execution from education, providing cheap execution with no education. Today, in the age of the Internet, cheap execution means free execution.

The old truth remains true; nothing is free. But framing can hide fees or make fees seem small. Hiding fees is a major occupation in the financial services industry, consuming much effort and creativity.

Mutual funds that charged 8.5 per cent loads for years found that these fees are too 'transparent'. So they made them 'opaque' by turning front-end loads into back-end loads and 12b-1 fees.² Internet traders who think they are escaping commissions are trapped into the bid-ask spread. But as in the old story, you can run, but you cannot hide. Investors are

getting better at spotting fees.

There is more to fees than money. People care about fairness. People do not mind much standing in line for an hour to get an \$80 ticket to a Broadway show even when theatre production costs amount to only \$10. But the same people mind standing in line for five minutes to cash a personal cheque at their bank, and they resent paying a \$1 fee for using the ATM.

People often walk away from profitable deals that seem unfair. Consider the Ultimatum game. Imagine that I am holding \$1,000 in cash, facing Michael and Jane. I say to Jane, 'Make an offer for the division of the \$1,000 between Michael and you. But the offer is an ultimatum, not open to negotiation. You, Michael, can either accept it, in which case I will divide the money between you and Jane, as you agreed, or you can reject it, in which case I will keep the money and neither of you will get anything.'

Suppose that Jane offers a split of \$980 for her and \$20 for you. If you accept, you will be \$20 richer. Do you accept? Many Michaels reject the deal. They say, 'I would rather see my \$20 burn than submit to such an unfair deal.' Fairness matters, and frames affect the perceptions of fairness.

The financial services industry is at a disadvantage when it comes to framing. Pricing in the financial service industry is 'transparent', while it is 'opaque' in many other industries. For example, promoters of Broadway shows are not required by the SEC to disclose their 'expense ratios'. Customers do not know how much of their \$80 ticket price goes to 'obscene profits' and how much goes to cover costs. Hiding the components of price in the financial service industry is more difficult. Customers who withdraw \$100 from the ATM and find \$101 charged on

their bank statements know precisely how much they paid in fees.

Investors are not averse to fees as long as they perceive them as fair. Patients know that good physicians charge high fees and earn high incomes. Yet most patients are not angry when they pay for office visits, even when office visits conclude without prescriptions for medicine. Patients know that the real value they get from physicians is more than a prescription, it is expert diagnosis, expert education and expert care. It would be good if financial advisors could emulate physicians.

Conclusion

Financial advisors are *investor* managers, they examine the goals and financial resources of investors, diagnose deficiencies, and provide financial education and care. Strategic asset allocation is part of this work. Financial advisors are also investment managers, they attempt to beat the market. Tactical asset allocation and security selection are part of that work.

Financial advisors claim that the 93.6 per cent figure in the Brinson *et al.* (1986) study implies that strategic asset allocation is more important than tactical asset allocation and security selection, and therefore that their role as *investor* managers is more important than their role as *investment* managers.

Strategic asset allocation is important, and so is tactical asset allocation and security selection, but they are important in different ways. Financial advisers focus too little on the value of their investor management contributions and too much on obfuscating the fees that they justly charge for their contributions. They

would do better to explain the importance of their investor management work and the fairness of their fees.

Note

- 1 This paper extends Statman (1999) and Statman (2000).
- 2 12 b-1 fees are payments by mutual funds to financial advisors. The payments are proportional to the amount of client money that financial advisors placed with these mutual funds. Ultimately, this money comes out of the pockets of clients. 12 b-1 is the section in regulations that authorises such payments. Clients might be aware that financial advisors receive payments from mutual fund companies but such information is obscured by the indirect route of money, from client to mutual fund and from mutual fund to financial advisor.

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