Why asset allocation is the most important contributor to long-term returns

By Rupert Hare

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Stories are often enthusiastically shared around the dinner table about who has picked a winning stock or how much value a share offers, but it's very rare to hear mention of how an investor picked a winning asset class - or more to the point avoided a losing one (aside from the dreaded Bitcoin conversation, but we'll thankfully avoid that!).

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In reality, however, for the majority of investors it is predominantly the choice of the asset classes in an investment portfolio that shapes the long-run return profile, rather than the underlying stocks.

Whether we like it or not, we engage in asset allocation in many aspects of our financial life. Think of a young professional who believes they only pick single stocks for their portfolio but in reality also have assets and liabilities like a house, a car and possibly a home loan to their name. Or consider a portfolio run by a wealth manager specifically designed to diversify across asset classes that includes all the assets on the individual’s holistic balance sheet. There is always a degree of choice between different types of assets and investment opportunities.

Two primary tools

When considering what asset allocation means for investors, it’s important to understand the two primary tools used in the process. The first is strategic asset allocation (SAA), which is the portfolio mix of one type of asset over another in the long run. The second is tactical asset allocation (TAA), which are the portfolio tilts away from those long-term asset allocations to take advantage of shorter-term opportunities. Both of these processes add value, but in general it’s the foundation of the portfolio, namely strategic asset allocation, that is responsible for generating the lion’s share of multi-asset portfolio performance.

By way of an example of the mechanics of a multi-asset investment offering, a portfolio may have a base strategic asset allocation of 60% to equities and 40% to bonds, which broadly aligns with the fund’s risk profile. Should equities become less attractive than bonds in the short term the portfolio manager would take an overweight tactical allocation away from equities and into bonds. That tilt would be controlled in size to also align with the fund’s risk profile. For instance, a flexible fund might sell out of equities completely while a high equity fund would only rotate 10% out of equities.

Top down vs bottom up

There is a further level of differentiation between asset allocators - that being whether they are top-down macro focused allocators or bottom-up single stock focused allocators. Bottom-up allocators will pick a combination of stocks that they perceive as having intrinsic value versus other stocks, run the same process for securities in other asset classes like bonds and property and build individual portfolios within each asset class. In theory they should be bullish on all their individual holdings or else why hold them? They would then weight the portfolios of different assets (equities, bonds etc) according to what they view as an optimal mix. Where the conundrum comes in is at this last step when they may have to down weight equities as an asset class even though they have strong levels of conviction in the individual stocks. This is in contrast to top-down allocators who put more emphasis on the mix of asset classes than the securities within them and often invest in hyper-diversified passive instruments rather than taking on single stock risk.

Where the concept becomes more complicated is when investment managers try to combine top-down macro thinking with bottom-up micro stock picking. Extending the previous example; how does one justify that equities as an asset class is unattractive and therefore you down weight them, but the single stocks you picked look more attractive than usual, so you are compelled to upweight them. It’s incredibly hard to equate a single stock to its parent asset class when making long term decisions, and it takes a healthily diversified portfolio of those stocks to reduce that single stock risk. The most efficient and effective way of combining the two challenges (putting vindication into long-term decisions while at the same time reducing risk) is to diversify across a broad index (at the same time minimising fees) and to concentrate on the asset class weights and ignore the single stock noise.

Balanced portfolio

So what evidence do we have that the long-term strategic asset allocation of a portfolio is the most important to get right? Perhaps the most clear-cut evidence comes from a series of research papers from different authors who have statistically decomposed returns for portfolios into asset allocation and securities selection. The resounding winner in a balanced multi-asset portfolio – explaining around 90% of the variance – is asset allocation.

How does that level of explanatory power from asset classes come about? Well if we take an expanding windows of randomised monthly returns on the JSE All Share Index since 1995 and work our way from one year all the way out to 30 years to form a so-called funnel of doubt that shows the range of returns you could have earned as an investor (per year). The trend as the timeline expands is quite clear – the longer you invest the more certain you can be of your intended path.

For a multi-asset portfolio manager, the most important step is to combine assets in a portfolio to align with the investors’ risk profiles, and to do so by exposing the portfolio to the least amount of risk. By relying on assets at the high level to deliver the long-term returns and diversifying away single stock risks, the path towards that long-term return target can be relatively smooth sailing, while at the same time equipping the portfolio to weather whatever storms may come.

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