There's more to it than asset allocation

Investors who believe that asset allocation is the most important consideration in their portfolio' construction are possibly making a mistake. In today's world, it looks increasingly clear that manager selection will be the crucial differentiator of future performance.

By David Crosoer 27 Jun 2013

It's become blasé to make a case for active management: It's a zero sum game and who's to say you are any better at selecting active managers than the next person? Why not just opt for low-cost index funds? E in a global environment where we can't rely on asset class returns to deliver inflation-beating returns, we m have no choice.

For at least 20 years the investment community has held onto the idea that asset allocation (rather than manager selection) is the most important decision to get right in generating long-term returns for clients. Ir widely cited, but little read, article in the Financial Analyst Journal, Brinson, Hood and Beebower (1986) appeared to argue that more than 90% of performance was explained by the asset allocation policy of a fund.

In fact, Brinson et al argued that most of the variation in a portfolio's returns could be explained by its asse class benchmark. Nevertheless, the importance of asset allocation above manager selection stuck in mos investors' minds.

Equity risk premium

This tied into another commonly held belief, that most of an investor's performance is determined by the extent to which he is willing to hold equities over other asset classes. The investment community even coined a term, "equity risk premium", to describe the additional return investors should receive for holding "volatile" assets like equities over "safer" assets like government bonds. They further came up with the number of 7% p.a. to indicate the extent equities should outperform bonds in the long term.

The evidence for this 7% p.a. risk premium is surprisingly weak. It might come unexpectedly when told tha global equities have only compounded at 4% real over the past 25 years and have actually underperforme global bonds. Most analysts now think the equity risk premium is closer to 4% p.a., if it exists at all.

South African equities have bucked the trend and compounded at over 8% real over a similar 25-year period. But this is unlikely to continue. Passive equity exposure does well when markets are inexpensive o global growth surprises on the upside. Today, however, broad equity market indices - including South Africa's - are no longer inexpensive and the risks to global growth in this global deleveraging environment are very much on the downside.

We believe that our equity market, like global markets over the past 25 years, is unlikely to deliver real returns significantly greater than 4% pa. after inflation. In such an environment, a passive exposure to equi markets is unlikely to deliver inflation-beating returns of the magnitude that most clients will need. Rather, t crucial determinant of performance will be the actual stocks your managers choose to hold. As a result, we believe that for the next decade manager selection rather than asset allocation may be the most important thing for investors to get right.

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