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Editor

The Policy Portfolio Problem

In the March/April issue, I pointed out some of the “forests” in portfolio management issues that we often ignore as we concentrate on the “trees” of asset selection.¹ In this column, I want to address another unhealthy prop—the typical long-term, static policy portfolio—and why we need to rethink it.

Peter Bernstein lowered the boom on the policy portfolio in May 2003, triggering an anxious, sometimes heated debate on the riskiness of the long-term, static policy portfolio—for example, a portfolio of 70 percent equities/30 percent bonds—so embedded in much of the institutional investing world.² Peter suggested that policy portfolios are overused, are misused, and often lead to a singular focus on an irrelevant metric of risk—tracking error relative to a policy portfolio or relative to our peers.³ This one-dimensional view of risk has cost the pension community hundreds of billions of dollars since 1999.

We printed a version of Peter’s presentation in the *FAJ*, and indeed, the observations in his “Points of Inflection” speech led to a CFA Institute (formerly, AIMR) conference of the same name in February 2004.⁴

The challenge of asset allocation boils down to three problems: (1) asset allocation has many elements, (2) asset allocation requires ongoing management, and (3) liabilities do not always track assets.

Problem 1: Many Elements

Asset allocation is not simple. One of the many elements in asset allocation is the policy asset mix or policy portfolio: What mix is likely to meet the investor’s long-term needs? Is the policy asset mix the source of some of investors’ worst errors? Absolutely. Is it misspecified? Absolutely. It is a poor fit with most investor objectives, and importantly, it should not be static over time. The dividing line between strategic policy allocation and tactical

asset allocation (TAA) is not a clear demarcation; there is a continuum.

Some people might view the policy asset mix as simply “slow TAA,” which, as most investors manage money, is typically a bad tactical model. Allocations to equities drifted up in the 1980s and 1990s in response to the 18-year bull market. As a consequence, “normal” policy equity exposure was at an extreme high in 2000. Such a drift was not new: It happened in the relentless bull market leading up to 1972 before the market broke in 1973–1974.

At the other end of the spectrum is purposeful TAA: a focus on measured departures from the policy mix that are deemed likely to garner rewards. TAA comes in various flavors—domestic or global, simple or sophisticated, directly moving money between markets or using overlay management. And it can be moved *down* a level to, for example, tactical style management within equities or *up* a level to embrace alternative assets in a tactical framework.

In addition, investors have shown a renewed interest in mechanistic option-replication strategies, which generally protect assets from specific risks over a specific short-term horizon. Curiously, by using such approaches, long-term investors responsible for 20-, 30-, or 40-year liabilities seek to guard against unpleasant outcomes over a much shorter horizon. But when investors are defeasing long-term obligations, the use of “costless collars,” portfolio insurance, surplus insurance, and other popular approaches is questionable (and certainly not costless!).

Problem 2: Asset Allocation Management

Investors cannot forgo asset management. They cannot put asset allocation on autopilot; it should be based on a thoughtful, well-reasoned analysis. Asset allocation must be *managed*.

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Not many people remember the 2000–03 period as a fun and exciting time to be in the markets, a time of great profit opportunities. But as **Table 1** shows, for those who were not wedded to an equity-centric policy portfolio, it *was* an easy time to make money. Most markets rose handily. Every asset class in Table 1 except stocks and equity-dominated balanced accounts did fine. Even the dull Lehman Brothers Aggregate Bond Index was up to a 39 percent return. In contrast, all the equity indexes were down and a 60/40 passive mix provided a measly 4 percent cumulative return.

The problem with 2000–2003 was not a lack of return opportunities. The problem was that one asset category (equities) performed poorly and most investors were heavily concentrated in that asset class. It was a bear market for practically everyone because they were wedded to an equity-centric “normal policy portfolio.”

A key element in the debate about policy portfolios is setting *reasonable* long-term return expectations. From my other writings and Editor's Corners, here's what I think are reasonable nominal returns: For bonds (the Lehman Aggregate), from current levels, a bit over 4.5 percent. For stocks, a 5 percent internal rate of return seems reasonable. That's 150 bps from income, 100 bps from real growth, and 250 bps from inflation. It assumes *zero* from expansion of valuation multiples, which may prove to be optimistic.

In short, equity returns are likely to *match* bond returns in the next 25 years. That's the upside if no reversion to the mean occurs. I disagree with those

who say that 2003 disproves the low equity risk premium. It does not—not if one computes an equity risk premium based on the simple arithmetic of yield and growth.

The implication is that balanced portfolios are likely to deliver up to about 5 percent, less costs. The situation can be faced in two ways: We can say, “I was counting on 9 percent. So, I need 9 percent.” But hope is not a strategy, so a better alternative is to say, “If 5 percent is what the markets are going to deliver, that is the reasonable expectation. I will plan on it, although I will certainly seek more.” Also, we should get credit for performance above a rate we can *assuredly* earn, rather than above an unrealistic dream return.

Certainly, as Table 1 shows, some asset classes do better than others in certain environments. Interesting investment returns in markets that are liquid enough for even the largest fund sponsors will be easily found, but the 5 or 10 largest fund sponsors in the world cannot all do so at the same time and all get good results.

Seeking out the opportunities means stepping away from the typical policy portfolio. An investor can probably make about 50 bps of alpha from systematic rebalancing, maybe another 100 bps from alpha in asset selection (if the investor is good at choosing active managers), possibly another 100 bps or so from successful TAA (if the investor can identify managers skilled in TAA), and perhaps 100 bps from material allocations to selected opportunistic alternative markets.⁵ This path provides a return north of 8 percent—but not if everyone takes it.

Table 1. Performance by Asset Class, 2000–2003

Asset Class	Cumulative Return	Annual Standard Deviation ^a	Correlation with 60/40 Mix ^a
Commodities ^b	+89%	14%	9%
Emerging market debt	+69	12	58
TIPS ^c composite	+54	6	-12
Long-term U.S. government bonds	+49	10	-7
Lehman Brothers Aggregate Bond Index	+39	4	1
Salomon World Government Bond Index	+38	8	-3
Ginnie Mae ^d bonds	+34	3	-5
Short-term U.S. government bonds	+26	2	-17
High-yield bonds	+24	9	52
Convertible bonds	+22	15	76
60/40 passive mix	+4	11	100
S&P 500 Index	-20	18	99
MSCI Europe/Australasia/Far East Index (local currency)	-44	17	73

^aRisk and correlation from January 1997 through December 2003.

^bReturn on Dow Jones–AIG Commodity Futures Index collateralized by short-duration TIPS.

^cTreasury Inflation-Indexed Securities.

^dGovernment National Mortgage Association.

Problem 3: Liabilities vs. Asset Returns

The third problem is that liabilities do not always track assets. As a consequence of the 2002–03 equity market performance, almost all institutional investors, even if they did fine relative to their peers, failed to deliver profits and suffered a severe shortfall relative to their liabilities. The liabilities of most pensions behave like long-duration bonds, and the *real* obligations served by most endowments and foundations behave like long TIPS (Treasury Inflation-Indexed Securities). Long-term bonds and TIPS rose more than 50 percentage points during the 2000–03 span. If our assets are down as much as 20 percentage points and our liabilities are up 50 percentage points, we have a problem.

Moreover, the problem is no longer simply an institutional investor problem. More money is now invested in defined-contribution (DC) plans than in defined-benefit plans. This trend has shifted the problem of a mismatch between liabilities (or needs) and assets from the institution to the individual.

Suppose a 30-year-old employee is making \$35,000 a year. Most companies will view her situation with the following logic: Suppose her income grows 4 percent a year, *suppose she makes 8 percent on her assets*, and suppose she sets aside 6 percent of her salary (which is matched with 3 percent from the company), then the assets in her 401(k) will be almost \$1 million when she reaches retirement age at 65. At an 8 percent rate, she can then buy an annuity that will pay her \$88,000 a year until age 85, which (if her final salary is the \$138,000 the company predicts) is close to two-thirds of her final pay. Social Security is added on top of that \$88,000, so she will be just fine in retirement.

But if we no longer live in a world of high returns, a focus on real, inflation-adjusted terms becomes critical. Suppose, in reality, this employee's *real* wage growth is 2 percent, so her final salary will have doubled to \$70,000 in real spendable terms by the time she reaches age 65. Suppose that her *real* asset returns are only 3 percent (which may be on the high side for most investors); then, her *real* assets will be about \$250,000 instead of \$1 million—a big

step down. If she wants to retire on two-thirds of her pay, she'll need to work until age 74, not 65.

The essence of this liabilities puzzle is our definition of "wealth." Is wealth the size of our portfolio? Of course not. Is it our *real* asset base? This answer is a small step in the right direction. Is wealth the purchasing power of our asset base—the income stream that the portfolio can purchase? We're getting closer. The best definition of wealth in the pension, endowment, foundation, and individual's world is the real purchasing power that a portfolio can support over the span that the purchasing power is needed.

Conclusion

Investment committees are often given answers to a handful of important questions: How much the portfolio is worth. How much it went up or down last year (or last quarter or last month). How it performed relative to its peers.

We should go further. If we answer a few additional questions, board members can make better decisions about their investment portfolios. Specifically, how did the portfolio perform last year relative to our liabilities? This question captures the cost of defeasing the organization's obligations at an *assured* market yield (for example, the TIPS that match the obligation).

The board should also examine risks. What's the worst likely outcome (value at risk) in absolute returns, in returns relative to the organization's peers, or in returns relative to liabilities? Suppose an investment committee sees that in three bad years, the portfolio could fall by 25 percent, could lose 35 percent relative to liabilities, but could lose only 6 percent relative to peers. How many committees would remain wedded to the policy mix, itself closely shackled to the peer group, in the face of such evidence? Yet, this situation is typical today in pensions, endowments, foundations, and the DC holdings of individuals.

It's time to rethink the ways we define and use policy portfolios. Those who do so soon, rather than following the pack, may even find an opportunity to outperform as the world moves toward a more balanced view of investment risk.

Notes

1. Robert D. Arnott, "The Meaning of a Slender Risk Premium," *Financial Analysts Journal* (March/April 2004):6–8.
2. Bernstein's original speech was given to the 2003 AIMR (now, CFA Institute) Annual Conference.
3. See also Robert D. Arnott, "Managing Investments for the Long Term," *Financial Analysts Journal* (July/August 2003):4–8.
4. The FAJ article is "Points of Inflection: Investment Management Tomorrow" (July/August 2003):18–23. The conference proceedings are available in *Points of Inflection: New Directions for Portfolio Management* (Charlottesville, VA: CFA Institute). Webcasts of selected presentations are available at www.aimrdirect.org.
5. Considering the range of returns in Table 1, adding 100 bps from TAA is not overly aggressive.