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# Viewpoint

## Asking about Asset Allocation

Asset allocation is the primary determinant of variability in investment returns, and diversification among asset classes is the principal tool available to reduce that variability while maintaining (or even increasing) returns. Thus, one of the key tenets of portfolio construction is to identify asset classes that truly are uncorrelated with each other—that is, with returns that do not move up and down together.

Over the last quarter-century, this quest—simple enough to state—has proved increasingly difficult to achieve using traditional, long-only investing techniques. For example, a domestic equity investor in the 1980s could improve diversification by including in the portfolio a mix of small cap, mid-cap and large cap stocks. Further diversification could be achieved by including developed-country international stocks from nations such as France, (West) Germany and the U.K. This is because, during the mid- to late 20th century, these investments did in fact perform differently from each other in a significant way.

These diversification principles are still practiced today, but the benefits from such traditional diversification strategies have become less clear. It is a hard truth of investing that when the broad investor base begins to pursue a profitable strategy that previously was practiced only by a few, the excess return will decrease or, possibly, disappear entirely. Thus, in a world where investing by capitalization weighting (small/mid/large) has become extremely common and where globalization has made international investing almost as easy to implement as domestic investing, it should not be surprising that the relative benefit of pursuing these strategies has shrunk.

With these developments in mind, we have paid close attention to educational endowments' asset allocation shifts since the onset of the economic crisis. While we have not, contrary to the expectations of some observers, seen a flight by educational institutions from the highly diversified "endowment model" that delivered superior returns during the 1990s and mid-2000s, we have noted the growth during the past decade of a set of new approaches to asset allocation, which we made the subject of specific inquiry this year.

The core of these new approaches is to define asset classes differently from the traditional buckets that most investors continue to use. Rather than describing what the investments *are*—domestic equity, fixed income, international equity and so on—these approaches describe what they *do* in the context of the portfolio.

class-dependent, considers the role of various alternative strategies, takes account of the risk to perpetual pools from inflation as well as deflation and is consistent with the basic principles of the endowment model: growth (equity/risk asset bias), the time value of capital and diversification.

## Endowment Principles – Evolving Portfolio Dynamics

*Hypothetical example*

	Risk Assets/Growth	Inflation Hedges	Deflation Hedges	Diversification
<b>Most Liquid</b>	▪ Public equities (large)	▪ Commodities	▪ Cash	▪ Commodities
	▪ Public equities (small)	▪ TIPs	▪ U.S. treasuries	▪ Fixed income
↑ ↓	▪ Long/short equities	▪ CTAs	▪ Short equity bias funds	▪ Currency (non-U.S. \$ investments)
	▪ Activist funds			▪ Trend following hedge funds
	▪ Event funds			▪ Global macro hedge fund strategies
	▪ Opportunistic credit			▪ Relative value strategies
	▪ Distressed debt			▪ Distressed debt
	▪ Venture capital	▪ Core real estate		▪ Real estate
	▪ Private equity	▪ Natural resources		▪ Natural resources
	▪ Opportunistic real estate	▪ Infrastructure		
	▪ Value-add real estate			
	<b>Least Liquid</b>			

Note: For illustrative purposes only. Asset classes and investment strategies listed are representative and not intended to be all inclusive.

Source: Mission Matters Spring/Summer 2009

In a recent article in Commonfund’s magazine *Mission Matters*, Lyn Hutton, Commonfund’s Chief Investment Officer, presented a table with four broad asset categories: risk assets/growth, inflation hedges, deflation hedges, and diversification (see above).

The author notes:

[This model] is a fundamental, bottom-up approach to constructing a policy portfolio that is being used by a number of leading institutional investors today. It is one that is not asset

With this intellectual framework as background, it seemed that the inaugural NCSE would be a good occasion to inquire about the extent to which these concepts are being taken up by educational endowments in general. When asked whether they had changed or were considering changing their approach to constructing the asset allocation of their portfolio, one-third of the 842 institutions participating in the NCSE responded in the affirmative. This response was surprisingly broad, with 30 to 39 percent of institutions with assets up to \$1 billion stating that they

## Changing/Considering Changing the Portfolio's Asset Allocation

<i>numbers in percent (%)</i>	<b>Total Institutions</b>	<b>Over \$1 Billion</b>	<b>\$501 Million-\$1 Billion</b>	<b>\$101-\$500 Million</b>	<b>\$51-\$100 Million</b>	<b>\$25-\$50 Million</b>	<b>Under \$25 Million</b>
	<b>842</b>	<b>52</b>	<b>60</b>	<b>219</b>	<b>164</b>	<b>137</b>	<b>210</b>
Changing/considering changing	<b>33</b>	<b>21</b>	<b>37</b>	<b>39</b>	<b>32</b>	<b>32</b>	<b>30</b>
Classifications considered <sup>♦</sup>							
Growth assets	<b>42</b>	<b>36</b>	<b>55</b>	<b>38</b>	<b>35</b>	<b>43</b>	<b>48</b>
Risk reduction	<b>57</b>	<b>64</b>	<b>68</b>	<b>59</b>	<b>60</b>	<b>48</b>	<b>52</b>
Inflation protection	<b>51</b>	<b>73</b>	<b>73</b>	<b>64</b>	<b>44</b>	<b>48</b>	<b>31</b>
Opportunistic	<b>29</b>	<b>55</b>	<b>41</b>	<b>39</b>	<b>27</b>	<b>20</b>	<b>13</b>
Liquidity	<b>34</b>	<b>73</b>	<b>45</b>	<b>40</b>	<b>23</b>	<b>36</b>	<b>24</b>
Other	<b>13</b>	<b>0</b>	<b>9</b>	<b>11</b>	<b>17</b>	<b>20</b>	<b>13</b>

<sup>♦</sup>multiple responses allowed

had made or were considering making such a change. Among institutions with assets over \$1 billion, only 21 percent answered affirmatively—presumably because a greater proportion of these institutions already have made these changes.

When asked what specific classifications were being considered, the most frequently cited was risk reduction at 57 percent, followed by inflation protection at 51 percent. Growth assets were next at 42 percent; liquidity followed at 34 percent, and a catch-all opportunistic category was chosen by 29 percent. Institutions with larger endowments were generally more likely to cite all of the categories, but risk reduction and inflation protection were popular choices across the board.

When the responses are viewed by type, “public only” institutions were much more likely than others to have considered risk reduction, inflation protection, opportunistic and liquidity strategies—an observation that demonstrates that this new asset allocation approach is not limited to private institutions.

In the market collapse of 2008–09, it was noted that previously uncorrelated asset classes suddenly exhibited strong correlations—at least downward—as portfolio values for nearly all types of investments plunged across the board. It is natural to ask whether the institutions that responded affirmatively to our question are reporting different asset allocations, or better performance, than those institutions that did not. The answer, unfortunately, is that the asset allocation and performance of this group is not materially different from that of the whole. On the other hand, the responses include those institutions that are considering the approach as well as those that actually have implemented it. It is fair to conclude that this area is still developing, and a future inquiry might yield a different result.

Similarly, because so many of the specific alternative investment strategies broken out in the table above are included in the broad category of marketable alternatives in our asset allocation table, it’s not possible for us to restate the traditional asset allocations used into the newer classifications this year. But this new approach to asset allocation is a trend that we are monitoring and, in the future, we may seek a way to present this leading edge of thought in more detail in our reports.