“Modern portfolio construction within defined risk parameters”

Written by Asim Javed, Senior Investment Manager Alpha Beta Partners

Various studies have been conducted by academics and professionals studying the determinants of portfolio returns. These include the seminal work of Brinson, Hood and Beebower, who published a paper in 1986 titled “Determinants of Portfolio Performance”. The paper studied how asset allocation impacts the level and pattern of portfolio performance using a three asset class model. Their study concluded that 93.6% of the variation in portfolio returns could be explained by asset allocation. In 2000 Ibbotson and Kaplan published their study which confirmed that asset allocation did indeed explain 90% variability in portfolio returns. The studies collectively demonstrate the importance of asset allocation and being “in the market”. The “level” of portfolio returns depends on the asset allocation, the timing of asset allocation changes, its implementation efficiency and other factors such as costs.

An optimal asset allocation is a mix of asset classes (defined by a homogenous set of returns) that, in theory should maximise the reward per unit of risk. Whilst, this has been true over 5 decades since the advent of Modern Portfolio Theory where generic asset classes such as bonds and equities exhibited negative correlation, it is less true for the last one decade where all the usual investible asset classes have delivered positive returns and therefore led to positive correlations, thanks largely to central banks and the phenomenon of Financial Repression.

The celebrated Markowitz Modern Portfolio Theory, introduced in 1952, talks about diversification and distinction between systematic and idiosyncratic risk. Let’s take diversification and risk one step further and question what is “beta” or “systematic” risk? If one considers a single asset class (homogenous returns) then it is, of course, easier to attribute it to a market of which the portfolio is a subset. For example, a UK mid-cap fund’s systematic risk or beta can be attributed to UK’s mid-cap index, but in that it is fully exposed to the systematic risk affecting the UK market. Now, if we consider a global multi-asset portfolio where the manager emphasises dynamic asset allocation to drive returns, these regional systematic risks can be diversified and therefore managed owing to different business cycles in different economies. In this the “systematic risk” or “beta” is attributable to global indices that incorporate different asset classes. Portfolios are more diversified and mitigate regional systematic risks. In doing so we are not saying that there is a negative correlation between equities in different economies, what we are looking for is to mitigate economy specific systematic risk.

As an investment manager who believes in risk aware multi-asset investment management, asset allocation is the absolute centrepiece and the single most critical component of the investment process. The goal is to maximise returns whilst remaining within the agreed risk tolerances of each mandate. To that end it is only logical that we spend most of our time weighing portfolio risks, researching impacts, fine tuning asset allocation and developing forward views. A dynamic asset allocation married to a global multi-asset approach allows us to be agile. As such, using the Alpha Beta Partners tried and tested techniques we stand a very good chance to outperform over the medium term whilst remaining anchored to the risk parameters agreed per mandate.

So far, we have discussed asset allocation, risk-return and timing of asset allocation change. Moving to implementation, we have been asked many times about use of passive and active instruments as portfolio building blocks. Our response invariably includes a statement about “an optimal approach incorporates dynamic asset allocation, implemented efficiently and using passive instruments…”.

The reasons are:

- Asset Allocation is in our DNA at Alpha Beta Partners and how better can a manager express his/her view in its purest form than by using an instrument that is physically replicated, low cost, fully liquid and widely available.
- An index instrument offers the benefit of total diversification in the market it represents. Over the course of time there will always be some companies which will fail, but the general direction of the market will be determined by the majority, and in turn the economy in which it operates.
- An example of failures throughout the 2008-2011 period shows the idiosyncratic risks of individual companies and sectors. However, a decade later the S&P 500 stands five times higher than it did in 2009.
- Whilst diversified passive vehicles cancel the idiosyncratic risks in the index they represent, each market carries a systematic risk. Passive instruments enable investment managers such as Alpha Beta Partners to timely mitigate systematic risks by changing exposures to asset classes and economies over time.
- No idiosyncratic risk means there is no permanent loss of investment due to an index component's bankruptcy.
- Another critical factor is superior cost efficiency of passive instruments and their inherent liquidity – a vital consideration for Retail investors. Compounded over a medium to long term, the difference in costs between active and passive manager solutions is of course huge.
- We do acknowledge there are some immensely talented active managers who consistently deliver performance ahead of the market. They are rare indeed compared with the vast array of active managers claiming brilliance. Such managers are, as shown by research undertaken by our partners at The Adviser Centre, less than 3% of the entire fund population. One common trait between successful active managers is that they are focused on one single asset class and possibly in one economic area.

To conclude, at Alpha Beta Partners our goal is to capture maximum returns using dynamic asset allocation within an agreed investment risk framework, implemented using passive instruments incurring low transaction costs. Over time this is the most efficient way to invest for success and for positive customer outcomes.

Alpha Beta Partners is a *Five Diamonds* and *Five Star* (Defaqto) rated Investment Manager and currently has £450m AUM.

About the author, Asim Javed: 

Asim is a highly qualified Senior Investment Manager and Risk Manager. He is a Chartered Financial Analyst (CFA) charter holder and a Chartered Accountant with over ten years investment management and portfolio oversight experience. With his team, Asim is responsible for day-to-day management of Alpha Beta Partners Core and Core Plus portfolios.

Do let me know if you would like to discuss this or any other topic.

A.Thompson, Alpha Beta Partners. February 2020.

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