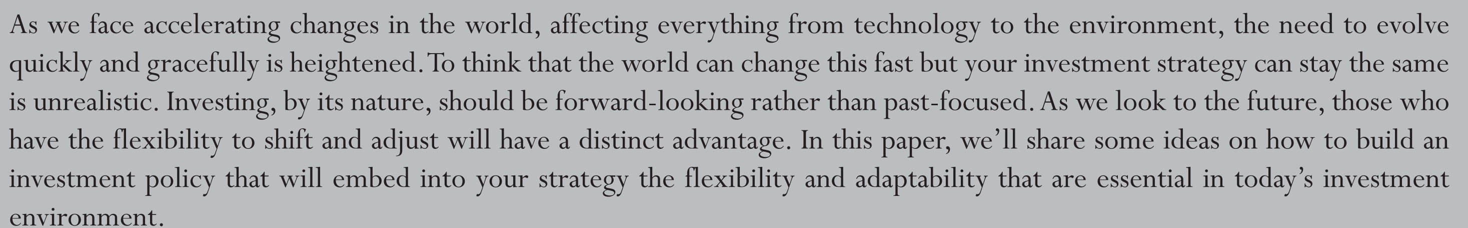
Arnerich Massena
Building Better Portfolios

The Investment Policy of the Future

Arnerich Massena, Inc.

September 2013

Contributors:
Tony Arnerich; Sheree Arntson; Arthur Coyne, CFA; Scott Dunbar, JD; Jillian Perkins; Chris Van Dyke, CFA, CAIA



As we face accelerating changes in the world, affecting everything from technology to the environment, the need to evolve quickly and gracefully is heightened. To think that the world can change this fast but your investment strategy can stay the same is unrealistic. Investing, by its nature, should be forward-looking rather than past-focused. As we look to the future, those who have the flexibility to shift and adjust will have a distinct advantage. In this paper, we'll share some ideas on how to build an investment policy that will embed into your strategy the flexibility and adaptability that are essential in today's investment environment.

Introduction . . . . . page 1

Accelerating Change . . . . . page 1

The Investment Policy of the Future . . . . . page 2

Build an Adaptable Asset Allocation . . . . . page 4

Conclusion . . . . . page 7

Endnotes . . . . . page 9

The Investment Policy of the Future

> "You can never plan the future by the past."
>
> *~ Edmund Burke, Member of British Parliament in a letter to Members of the National Assembly in 1791*

Do you still call it "dialing" someone's telephone number, despite the fact that the telephone dial has been gone for decades? Do you "roll up" the car window, even though you aren't rolling anything? Perhaps you have asked your kids to "turn the channel" and received a strange look questioning what it is they are supposed to turn. People can be slow to adapt to change, as is apparent in some of our outmoded language. But as we face accelerating changes in the world, affecting everything from technology to the environment, the need to evolve quickly and gracefully is heightened.

To think that the world can change this fast but your investment strategy can stay the same is unrealistic. Investing, by its nature, should be forward-looking rather than past-focused. However, like language, our ideas about investing can become entrenched and difficult to adapt. As we look to the future, those who have the flexibility to shift and adjust should have a distinct advantage. In this paper, we'll share some ideas on how to build an investment policy that will embed into your strategy the flexibility and adaptability that are essential in today's investment environment.

In *The Investment Policy of the Future*, we'll discuss how to develop an investment policy that aligns with your objectives and makes possible a more adaptable, nimble investment strategy. We'll propose some innovative ways to approach your investment objectives and asset allocation process. With the understanding that change can be difficult, we will demonstrate how these changes can be beneficial not only in the short term, but in terms of creating a solid framework from within which your investment strategy can adapt to a shifting landscape.

Accelerating Change

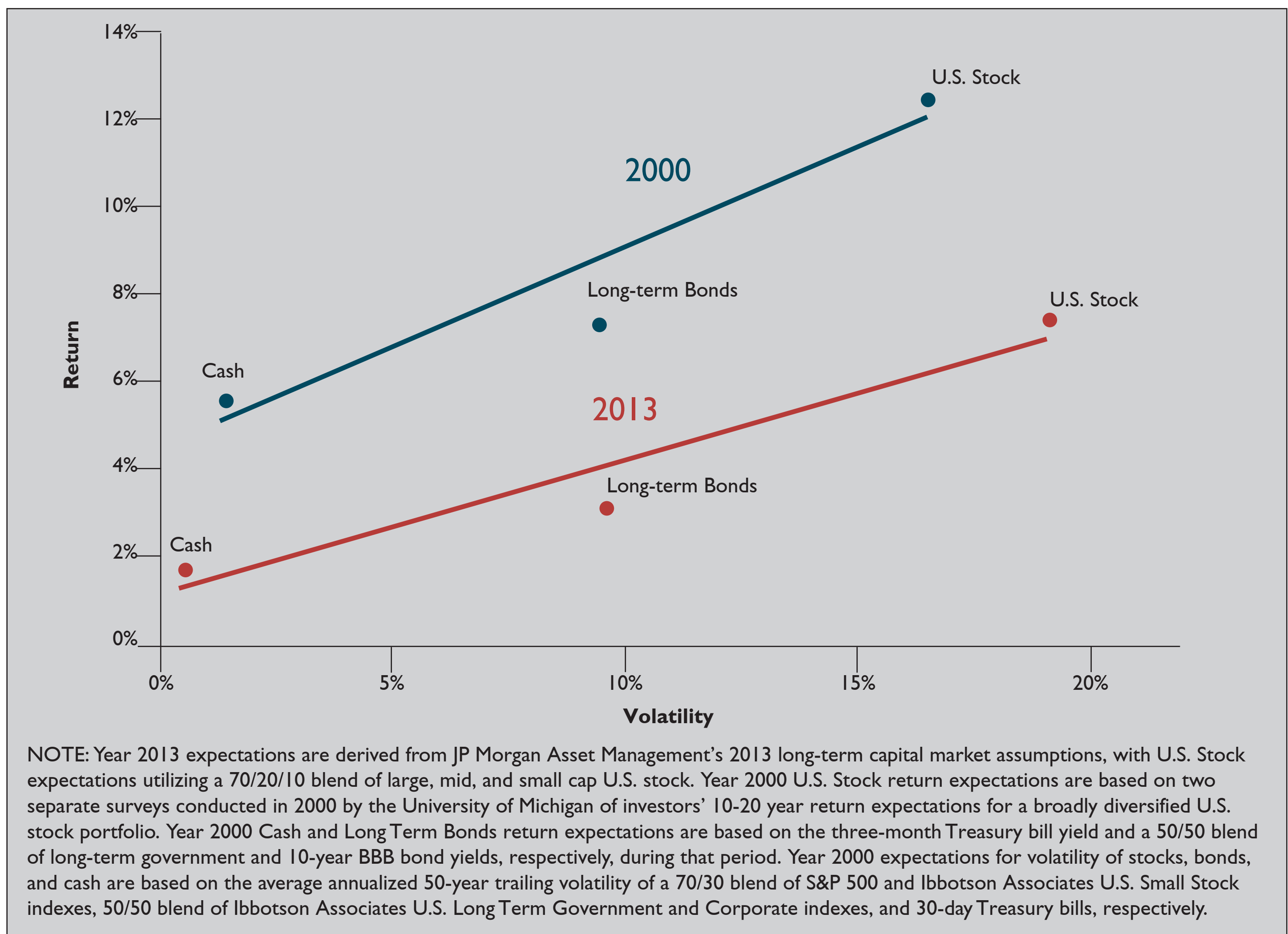
A common adage tells us that "the only constant is change," but while things constantly change, change is anything but constant; in fact, the pace of change appears to be accelerating. For example, it took mutual funds decades to become a broadly used investment tool, but it only took about a single decade for exchange-traded funds to move from relative obscurity into the mainstream.

> "Capitalism is taking us toward a future of accelerating change. The first twenty years of the twentieth century saw as much technological progress as the entire nineteenth century. Currently, industrial societies appear to be doubling their rate of technological progress every ten years. If this continues, and there is every reason to suppose that it will, the twenty-first century will experience the equivalent of twenty thousand years of 'normal' human progress."
>
> *~ Mead, 2008*

Consider the rapid transformation of global financial markets over the past ten years, much of which is being driven by rising economies, advancing technologies, and increased consumption around the world. For example, China is now the world's top consumer of luxury products *(Atsmon, et al, 2012)* and, according to McKinsey & Company, Africa has been the second-fastest growing region in the world in the past decade. *(Fine, et al, 2012)*

If we wish to participate in this exciting and challenging future, we will need to change the way we invest and adapt to the heightened uncertainty that comes with rapidly changing circumstances and expectations. Figure 1 illustrates how investors' return expectations have changed over the past 13 years. Based on this outlook, the long-term, static investment strategy of the past may no longer be suited to achieve the same return objectives. Maximizing return potential requires a more tactical approach.

FIGURE 1: CHANGING CAPITAL MARKET EXPECTATIONS 2000-2013



NOTE: Year 2013 expectations are derived from JP Morgan Asset Management's 2013 long-term capital market assumptions, with U.S. Stock expectations utilizing a 70/20/10 blend of large, mid, and small cap U.S. stock. Year 2000 U.S. Stock return expectations are based on two separate surveys conducted in 2000 by the University of Michigan of investors' 10-20 year return expectations for a broadly diversified U.S. stock portfolio. Year 2000 Cash and Long Term Bonds return expectations are based on the three-month Treasury bill yield and a 50/50 blend of long-term government and 10-year BBB bond yields, respectively, during that period. Year 2000 expectations for volatility of stocks, bonds, and cash are based on the average annualized 50-year trailing volatility of a 70/30 blend of S&P 500 and Ibbotson Associates U.S. Small Stock indexes, 50/50 blend of Ibbotson Associates U.S. Long Term Government and Corporate indexes, and 30-day Treasury bills, respectively.

> "WRITE YOUR GOALS IN CONCRETE AND YOUR PLANS IN SAND."
>
> ~ *ANONYMOUS*

THE INVESTMENT POLICY OF THE FUTURE

When crafting your investment policy, we suggest following the adage, "write your goals in concrete and your plans in sand." Policies need to embed flexibility and adaptability into the investment strategy, building an adaptable asset allocation that makes it possible for the portfolio to change with the environment.

In order to build an adaptable asset allocation, anchor your investment goals in concrete with the elements that don't change much over time: the purpose of the portfolio, the return objective, and the risk profile. Your investment strategy will flow from these three components, so the better they can be defined, the more closely you can align your asset allocation with your circumstances. Having clarity in your investment objective and a well-defined risk tolerance can form the strong foundation for developing a nimble strategy tailored to your needs. This foundation will help move your investment policy into the future.

Identify the portfolio's purpose and return objective

The portfolio's purpose and return objective provide the target toward which to steer the portfolio. The purpose is a big-picture statement, describing the investor's or organization's primary long-term financial objectives: what is the portfolio *for*? If there are multiple objectives, prioritize which goals should be primary and which secondary. The purpose should also outline the time horizon of the assets.

The return objective is more specific, identifying what success would mean for the portfolio. This can be a moving target, such as outperformance of a broad market index or a certain rate of return over the rate of inflation, and will likely depend in part on how you view risk. The return objective should define any liquidity requirements, spending rates, and additional constraints. Given the portfolio's risk constraints, the return objective should be obtainable; be aware of the difference between a desired return and required return. Pinpointing the return objective will make it possible to monitor and measure the success of the portfolio against its stated objectives.

Define your risk profile

An asset allocation model typically measures risk as standard deviation of return (or volatility). However, depending on the investor, risk can mean more than volatility of return. For example, risk can also mean:

- Not generating enough return to meet investment objectives over a time horizon
- A permanent loss of capital on a total portfolio basis or on a single investment
- Performing below peers
- Performing below an indexed portfolio that has the same objective

"While [absolute measures of risk] may be helpful, [they] do not fully address an investor's risk concerns. The field of behavioral finance has contributed an important element to the risk equation, demonstrating assymetry between how people view gains and losses. In the language of prospect theory... investors exhibit loss aversion — they put more weight on the pain associated with a loss than the good feeling associated with a gain."

~ Lamb, 2011

- An inability to meet immediate liquidity needs or longer-term distribution needs
- Underperforming relative to inflation, regardless of market direction

With so many potential definitions of risk, standard deviation of return, the typical measure, may be a less-than-perfect measure of risk. To create a thoughtful investment strategy, it is useful to identify the specific risks of concern to the investor, making it possible to identify ways to address those risks. For example, an investor who views underperforming peers as a significant risk may choose an allocation that resembles that of peers, whereas an investor concerned with underperforming relative to inflation may select a portfolio with a greater proportion of inflation-sensitive investments.

Identifying the specific risks to be mitigated within the investment policy sets the stage for an appropriate asset allocation design, and also serves as a guideline for the investment advisor. Providing a more specific definition of risk means the portfolio can be better-tailored to meet the investor's risk management objectives.

BUILD AN ADAPTABLE ASSET ALLOCATION

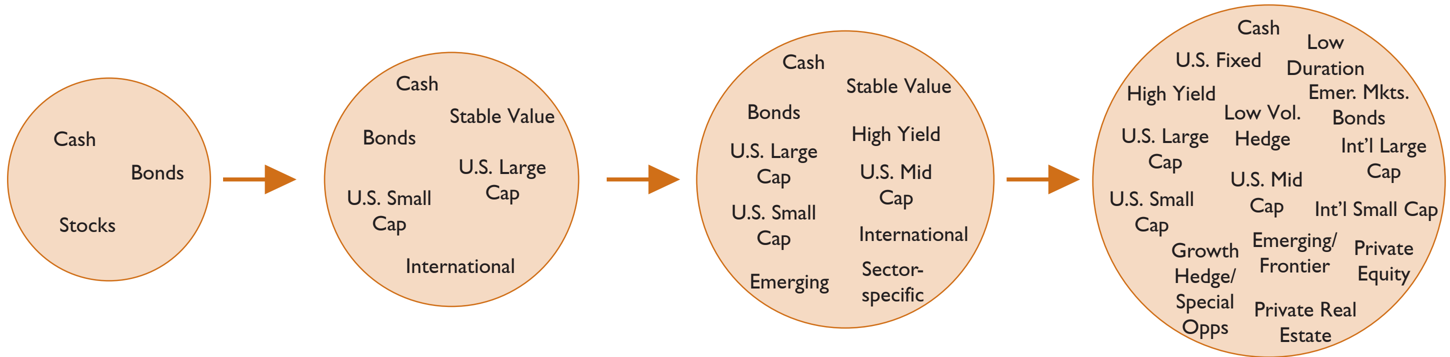
Prior to the 1980s, most asset allocation models were based on two primary asset classes: stocks and bonds. Developing an investment strategy was fairly straightforward. Then, new asset class categories began to arise: large and small cap, style differentiation, sector funds, etc. In the 1990s, hedge funds and emerging markets came into vogue. The ever-increasing list of specialty asset classes and sub-asset classes and sector strategies drove a trend to incorporate as many of them as possible into portfolios in the name of diversification. Investment policies have grown ever more complex and granular, with asset class categories often representing as little as one or two percent of a portfolio, creating undue complexity and clutter, product proliferation, and an illusion of diversification.

When the 2008 financial crisis hit, it taught a valuable lesson: simply adding asset classes does not automatically improve diversification. The increased number of asset classes and sub-asset classes did not necessarily add additional protection from volatility during the credit crisis. Many asset classes proved to be highly correlated, responding similarly to the market shocks. And, with such small representation in a portfolio, asset classes that could have had an impact were often relegated to relative irrelevance.

"I THINK THE FIRST THING IS THAT YOU SHOULD HAVE A STRATEGIC ASSET ALLOCATION MIX THAT ASSUMES THAT YOU DON'T KNOW WHAT THE FUTURE IS GOING TO HOLD."

~ RAY DALIO, BRIDGEWATER ASSOCIATES FOUNDER

Figure 2: The Proliferation of Asset Classes*



* For illustration purposes only

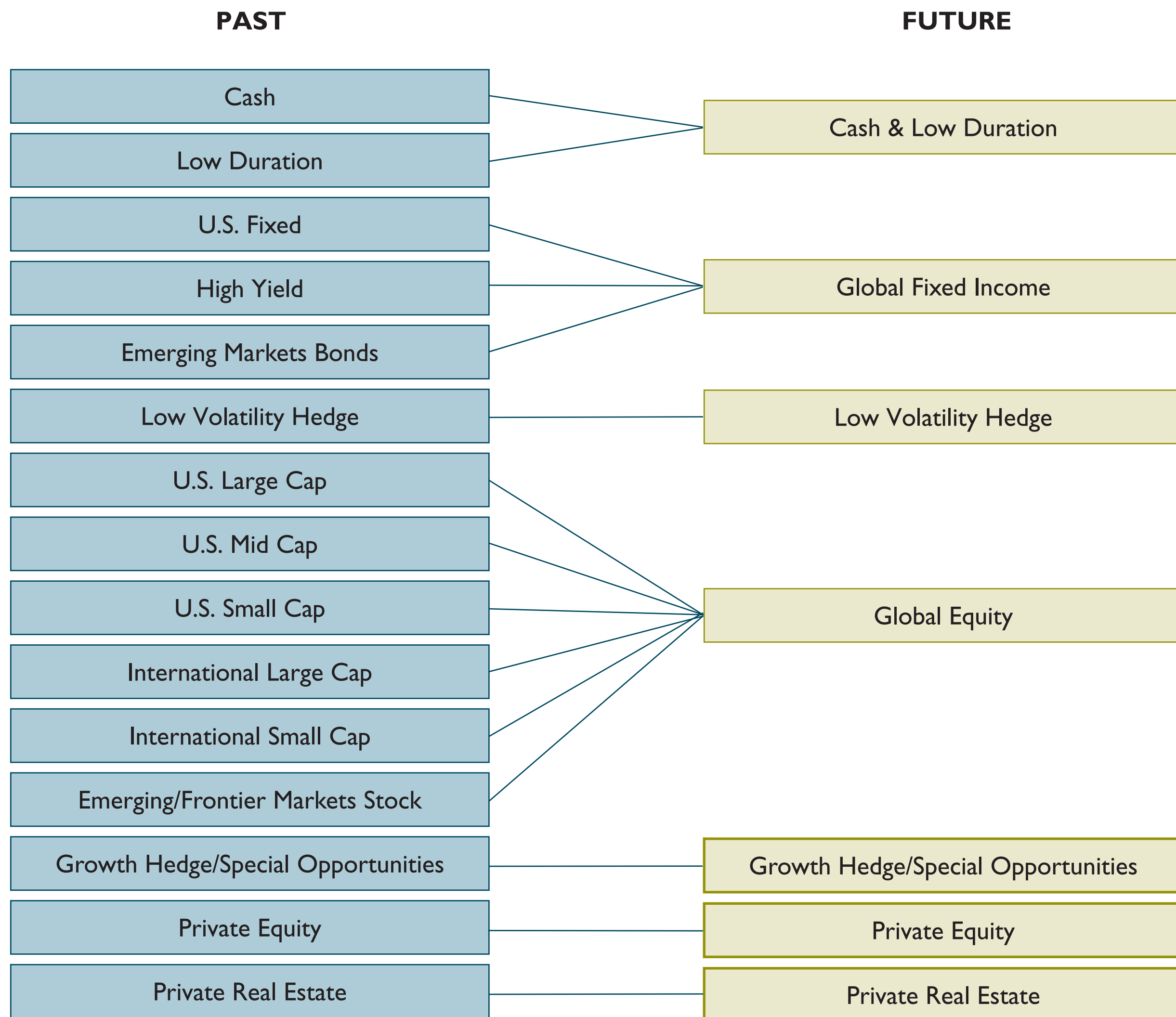
There are many different ways to look at what constitutes an "asset class." We believe that in this changing environment, it is beneficial to consolidate highly correlated asset classes into broad asset categories that are truly different from one another and that can provide real diversification benefits. By taking a less granular approach to defining asset classes, an investor can build a portfolio that is more flexible, more adaptable, and better suited to generating return in a rapidly changing market environment. Figure 3 provides an example of what it might look like to consolidate asset classes to build a more efficient structure.

Embed flexibility into your portfolio

Subdividing portfolios into so many asset classes necessitated a high degree of rigidity at the investment policy level. Each asset class was assigned a target weight that would stay in effect until the policy was revisited, and permissible ranges needed to be tight because small fluctuations could affect the entire allocation. This left little room for policy target weights to adapt over time; rather, a major asset allocation review would be required in order to adjust the policy mix. By shifting to more broadly structured asset class definitions, which allow for customized tactical implementation, a portfolio becomes more flexible and adaptable — characteristics that are highly desirable in an economic environment that is changing rapidly.

We believe that by combining broader asset class definitions with skilled active management, a portfolio is better positioned to respond to changing market conditions than it would be if it were constrained by investment policy to narrower asset class definitions. This is because an active manager can quickly respond to changing market circumstances by adjusting sector allocations strategically. A more granular policy approach would effectively prevent this.

Figure 3: Sample Asset Class Structure



It may be helpful to think of building an asset allocation strategy using a metaphor of building a balanced diet. You could identify all of the specific elements that you want to include in your diet: for instance, you might prepare a daily menu that includes spinach, yogurt, cucumbers, pomegranates, steak, bagels, et al. That could quickly become cumbersome to manage, without room to adjust for your changing tastes and the availability of each type of food. Or, you could select the broader food groups to include on a regular basis — some vegetables, some dairy, some grains, etc. — tailor the food groups and proportions to your needs (extra protein if you're an athlete, for example), and then have more options as to how you fulfill the menu. In this same way, the flexibility of the broad category asset class structure allows your portfolio to integrate a greater degree of tactical decision-making while eliminating burdensome and potentially costly restrictions.

As market conditions change more rapidly, we've begun to introduce more opportunistic, unconstrained, and tactical investment strategies, which allow managers greater latitude, within a certain framework, to manage assets tactically. An unconstrained bond fund, for example, might hold high yield bonds in one month and government bonds in the next, depending on the market. This ability to take advantage of short-term dislocations and market shifts is available only to those who adopt investment policy language that allows for a more open and flexible investment framework.

Benchmarking

As we build portfolios to be more forward-looking and flexible, we will also need to develop an appropriate benchmarking strategy adequate to the new structure, which presents some challenges. For example, newly emerging asset classes are often highly attractive opportunities, but are also among the most difficult to benchmark. With the transition to a more flexible and dynamic investment strategy, we expect benchmarking to focus more on a "big picture" perspective; for instance, measuring after-inflation returns at the total portfolio level with an eye toward meeting investor risk and real return objectives. Developing usable and meaningful standards for measuring portfolio success will require a thoughtful approach. We'll look more closely at possible solutions in a future white paper.

Conclusion

Investing is, without doubt, more complex now than it was 25 years ago. There are more types of investment instruments, more geographical diversity, and more available asset categories. The investment policy of the future needs to be more adaptable and flexible, focusing at a higher level and allowing managers greater room to navigate through changing environments.

"Adapt or perish, now as ever, is nature's inexorable imperative."

~ H.G. Wells

To provide the most solid foundation from which your investment advisor can operate, it is important to identify and define the objectives and risk profile of the investor. Clear objectives and an understanding of risk sensitivities will make it possible to manage the portfolio in a manner better-aligned with the investor's needs. It may not seem like a huge shift in thinking, but this different framework can significantly alter the way portfolios are constructed.

Broader asset categories and a more flexible investment policy statement will be easier to maintain, will no longer require micro-management, and will be less likely to lead to unintentional compliance breaches due to rapid changes in the investment landscape.

The most difficult aspect of developing the investment policy of the future will be to change the way we think about it. Change is never easy and habits can be difficult to break, as you know if you've recently called an album a "record" or referred to a good photo opportunity as a "Kodak moment." But on the other hand, consider all of the new words that have become such a natural part of our current lexicon in only the past couple of decades, it's as if they were always there: wifi, online, smartphone, tweeting, facebooking, etc. If you can learn to tweet, IM, text, and blog, adapting to the investment policy of the future could be as easy as googling.

Endnotes:

Atsmon, Yuval; Ducarme, Diane; Magni, Max; Wu, Cathy; "The McKinsey Chinese Luxury Consumer Survey: Luxury Without Borders: China's New Class of Shoppers Take on the World," *McKinsey Consumer & Shopper Insights*; December 2012

Coffey, Greg, CFA, "Elements of a clearly defined investment policy statement for nonprofits," Russell Research; June, 2011

Fine, David; van Wamelen, Arend; Lund, Susan; Abral, Armando; Taoufiki, Mourad; Dorr, Norbert; Leke, Acha; Roxburgh, Charles; Schubert, Jorg; Cook, Paul; "Africa at Work: Job creation and inclusive growth," *McKinsey Global Institute*; August 2012

Lamb, Katrina, "Measuring and Managing Investment Risk," *Investopedia*; August 27, 2011

Mead, Walter R., *God and Gold: Britain, America, and the Making of the Modern World*; Vintage; October, 2008

World Finances, "Investment policy statement (IPS). Return Objective. Risk Objectives." World Finances; May 11, 2011

© 2013 Arnerich Massena, Inc. All rights reserved.

This material is provided for informational purposes only to clients and prospective clients of Arnerich Massena, Inc. It is drawn from third-party sources believed reliable but not independently verified or guaranteed by Arnerich Massena. We do not represent that it is accurate or complete, and it should not be relied on as such. It does not constitute investment advice, which would need to take into account a client's particular investment objectives, financial situation, and needs. Opinions expressed are our current opinions as of the date appearing on this material. Past performance does not guarantee future results. Investments and strategies discussed herein may not be suitable for all readers, and you should consult with a legal, tax, or accounting professional before acting upon any information or analysis contained herein. The information, ideas, and context expressed herein are confidential, proprietary, expressly copyrighted and may not be sold, reproduced, republished, or distributed in any way without Arnerich Massena's prior written consent.