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Asset Allocation – The Big Questions

Much of my time is spent considering the current and potential future events which may influence global investment markets. These events vary in size and scope and can lead to both opportunities and risk. The factors I spend time thinking about can be broadly classified as:

- *Drivers of economic growth*
- *Central banking policies*
- *Current and historical asset valuation*
- *Political environment*
- *Investor and business sentiment*
- *Leverage structure*

Why do I follow these topics? They tend to be some of the factors which drive asset pricing within the free markets. While it is important for individual stock fund managers, I don't spend time analyzing individual companies and what drives individual stock pricing. I focus my efforts on macro-economic and social issues which tend to drive expected returns for various asset classes.

The noted economic and socio/political factors are of limited value unless they're used to guide investors in their asset allocation preferences. Historically, upwards of 90 percent of the return in an investment portfolio is driven by the allocation to specific asset classes, and not by individual issue selection. It isn't so much whether an investor owns shares of Ford Motor Co. or Campbell Soup in their portfolio, but rather if they own stocks, and, if so, to what degree. Asset allocation is the long-term driver of portfolio returns and risks.

Investing Like the Big Boys

Most individual investors don't have hundreds of millions or billions of dollars to invest. Large investment pools are concentrated in tax-advantaged classifications. Pensions, profit sharing plans, endowments/foundations, and 401k/IRA accounts (in bulk) represent some of the largest investment pools in the world. Given that asset allocation (what portion an investment portfolio is exposed to various asset classes) has been the main driver behind realized returns and risks, how are some of the larger investment pools invested within the United States?

A recent study by the National Association of College and University Business Officers (NACUBO) and Commonfund reveals how our nation's endowment funds are invested. These endowments and foundations represent 851 colleges and universities and total $516 billion in assets. To say the least, these endowment organizations are among the "big boys" of the investment world. Perhaps smaller investors can learn something from the displayed asset preferences of these larger organizations.

The Data

Following is data revealing how the nation's colleges and universities had their foundations' assets invested as of June 30, 2014.

	Average Endowment	Assets Over $1 Billion	$101 Million to $1 Billion	$25 Million to $100 Million	Under $25 Million
Domestic Stocks	17%	13%	24%	35%	43%
Foreign Stocks	19%	18%	21%	20%	14%
Total Stocks	36%	31%	45%	55%	57%
Bonds	9%	8%	12%	18%	26%
Alternative Assets	51%	57%	38%	21%	10%
Cash	4%	4%	7%	6%	7%

Some general observations regarding the data above:

- The allocation to public stocks is less in the larger endowments, than the smaller endowments. This is more apparent in the domestic stock allocations.
- The lower allocation to domestic public stocks in the larger foundations may be due to alternative assets representing a dramatically higher allocation in the larger funds. Alternative assets include private equity investments, often viewed as potentially higher-return alternatives to domestic equity exposure.
- Bond exposure is lower in the larger foundations. Alternative asset classifications also include alternatives to traditional bond portfolios. Many times, these fixed-income alternatives are viewed as risk mitigation strategies. These strategies act like traditional bond portfolios, but alter a certain type of risk (duration risk, as an example). Earning good returns in an asset class that is paying sub-5 percent coupons is very difficult.
- Foreign stock is one of the few asset classes where exposure tends to be high. In the case of the largest foundations, more capital is allocated to foreign stocks than to traditional domestic public stocks.

Historical 10-Year Returns

Over the past 10 years, the large endowment portfolios earned 8.2 percent on an average annual basis, while the smallest endowments generated average annual returns of 6.6 percent (periods ending June 30, 2014). While the spread between these two realized rates of return doesn't seem that large, it does when you look at a longer span of time. Over a 10-year period of time, the larger endowments' cumulative return was 17.2 percent higher than the smaller portfolios. A portfolio of

$100 million invested within the larger allocations generated $17.2 million more in gains than the average, smaller portfolio over the same 10-year period. Hardly chump-change.

Insights From The Data – Risk Assumptions

Let's turn the conversation away from investment returns and toward assumed risks. Insightful investors are aware of the risks to which their portfolios are exposed. The wise investor not only knows and accepts the risks, but demands to be compensated, over the long-term, for the assumption of these risks.

Liquidity Risk

When hearing the word "risk," most investors think of principal risk…the risk of not getting one's cost out of an investment and realizing a dead loss. Investors take many types of risks on a regular basis. And, by assuming these different risks, investors should rationally expect to be compensated with higher expected returns. Looking to the largest pools of serious assets in the country may provide investors with some degree of valuable insight.

Liquidity risk is one of the lesser known risks most investors assume. ***It is the risk an investor assumes by owning an asset which can't be liquidated or priced on a demand basis.*** Looking at the data on the chart above, it's obvious the larger foundations may be assuming more ***liquidity risk than their smaller peers. Alternative investments represent a much higher portion of larger foundations than their smaller peers. Perhaps, it is the assumption of this additional liquidity risk that has led these larger institutions to higher realized returns.***

Liquidity Risk – An Example

Let's outline an example of a liquidity-hampered asset. Take your home as an example. Most of us won't sell our home immediately upon listing. Time lapses and the house stays on the market. We accept this liquidity risk as part of personal home ownership. Additionally, although we may have an idea of what we think our home is worth, we may not know the actual value.

Liquidity risk in the investment world acts the same way. An investor places capital in unlisted equities (called private equity exposure) with the idea that they can't sell the asset at any time, and they don't know the daily value of the asset. ***Due to the acceptance of this risk, the investor should expect to realize higher returns on this asset class than the alternative publicly traded stocks.***

The majority of foundations don't need 100 percent liquidity for 100 percent of their assets 100 percent of the time. They've moved capital into asset classes which have, historically, captured higher returns than most publically-traded assets. ***Most individual investors also don't need 100 percent liquidity in 100 percent of their portfolio 100 percent of the time. Many individual investors don't take advantage of the ability to assume some degree of illiquidity in their portfolios and generate higher returns for the assumption of that risk.***

The Wise Investor

It is the wise investor who works directly with their Wealth Advisor, uncovering different types of risks within a portfolio profile, and discussing various types of risk acceptance. Does it make sense for an investor to accept a certain amount of liquidity-risk? We can't say, but it may make sense to take a lesson from our nation's largest investors…they understand liquidity risk and how it can work for and not against them.

We will be back next week.

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