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The Asset Allocation Merry-Go-Round

Why Most Investors Are Over Allocated but Under Diversified

Investors are frustrated with diversification. They've been told investing across different asset classes (known in the industry as asset allocation) is the best means of diversifying their portfolio, yet they continue to experience violent swings in the value of their wealth with each successive crisis. The typical prescription is to remain focused on the long term and consider adding more asset classes and sub asset classes to the myriad already in their portfolio, which promises to ameliorate the problem. But, it doesn't. There is a paradox of asset allocation in that uncorrelated assets attract money flows which cause them to become more correlated, thus eroding the very diversification benefits investors hope to achieve. At Rain, we believe traditional asset allocation leaves investors over allocated and continually under diversified. The reality is, investors aren't frustrated with diversification, they're frustrated with the consensus approach to getting there.

> *'There is a paradox of asset allocation in that uncorrelated assets attract money flows which cause them to become more correlated . . . eroding the very diversification benefits investors hope to achieve.'*

Diversification is the holy grail of investing. It's the so-called free lunch, whereby a portfolio of multiple investments with different risk characteristics offers up similar returns with less risk than an undiversified portfolio. Asset allocation theory, developed more than five decades ago, was an attempt to quantify the don't-put-all-your-eggs-in-one-basket intuition of diversification. It - along with the other theories that together make up 'modern portfolio theory' - was wildly successful; by allowing individuals to make quick and confident decisions around the allocation of capital (whether in portfolios, risk management, corporate finance decisions, company

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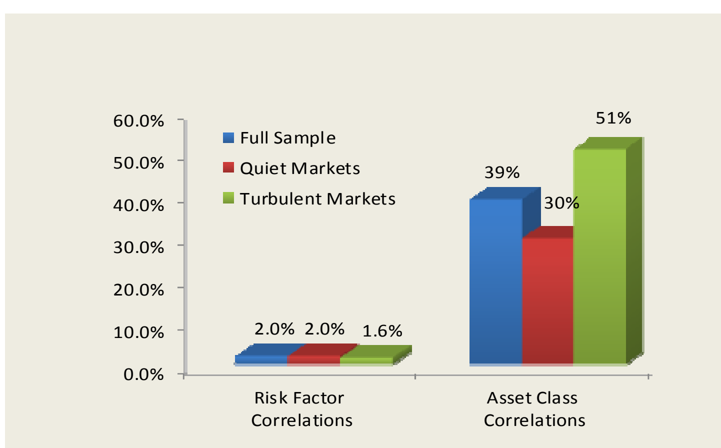
valuation or structuring complex mortgage derivatives), it has allowed capital markets to become deeper, more liquid, and in some ways more efficient.

That's why modern portfolio theory, including asset allocation, has become deeply ingrained in the workings of the financial services industry. Mutual fund and hedge fund companies have developed an alphabet soup of different products to allow for better implementation; consultants have built profitable businesses around evaluating money managers and tweaking asset allocations on a regular basis; Target-date funds add a layer of automaticity (and fees) to asset allocation; Indexing has been marketed as super diversification with rock-bottom fees.

The only problem with this picture is that the relationships that made asset allocation an effective way to diversify have changed. Correlations between most asset classes have been creeping steadily upward since the mid-1990s. By early 2008, most asset classes were moving significantly in step with the S&P 500. By the fall of that year, at the peak of the credit crisis, correlations spiked further and asset classes of nearly every kind (with the exception of safe-haven treasuries) experienced severe losses. Many studies have pointed to the fact that in a typical 'balanced' portfolio of 40% bonds and 60% equities, more than 90% of the portfolio risk comes from equities, *during normal markets.* Naturally, during crisis periods when correlations spike, that number is even higher. (This also touches on the subject of how risk is measured, which we will address in subsequent letters).

Figure I

Average Cross-Correlations (March 1994-December 2009)



Source: PIMCO

Enter zombie finance. Asset allocation was intended to be a means by which to diversify, not an end in itself. Despite ample examples of how insufficiently asset allocation diversifies risk – the Fall of 1998, the dot-com crash of 2000, the high yield debt rout of 2003, the credit crisis of 2008, and so on – the industry overwhelmingly continues to use it as the primary means by which to build portfolios. Part of its persistence as a diversification tool is in its quantitative purity; technically it *had* been a mathematically correct way to diversify for many years and it conveys a sense of discipline. Furthermore, much of the industry's quantitative tools and machinery, regulatory structure, language and so on have evolved from several generations of its use. While the world has changed around it, it continues to march on as the dominant method of portfolio construction.

At Rain, we start with the premise that risk considerations should drive capital allocation, rather than letting capital allocation drive portfolio risk. This means that the building blocks of our portfolio construction are the direct risk factors that drive asset valuation like inflation, economic growth, interest rates, liquidity, volatility, and so on. The logic is simple: *correlations are significantly lower and more stable over time between risk factors than they are between asset classes* (See figure I). For instance, most asset classes contain primary or secondary exposure to equity risk. Rather than just using rough proxies of exposure, Rain uses primary risk factors as building blocks in portfolio construction. Not only does this approach limit unintended portfolio risks, it also allows us to evaluate strategies based on the merits and characteristics they bring to a portfolio, rather than the typical check-the-asset-class-box first cut of diligence required by traditional asset allocation. The result is truer diversification and materially less risk for a similar level of return (or, in industry terms, more efficient portfolios).

Rain portfolios embrace modern portfolio theory but correct for many of its shortcomings. While research strongly supports this approach as a better way of diversifying portfolios, we have also found it's a better way of communicating with clients. Most people understand concepts like volatility, interest rates, inflation, etc. far better than they understand the many confusing industry names and purposes of different asset classes. This is an important point and gets at a central part of our philosophy: we invest for the long-term, and the client who understands the role of each investment on an intuitive level is far more likely to adhere to it for the entirety of the investment thesis. We believe this ultimately translates into better investment performance over time; higher quality growth and stability with less of the merry-go-round of asset allocation.

Happy Holidays!

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