RE-ENGINEERING ASSET MANAGEMENT

New opportunities await the unconstrained manager.

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Of all the investment choices, which is most important—the allocation among broad asset classes, country allocation, the choice of sectors, or the selection of individual securities? In our 2003 article "The Hierarchy of Investment Choice," Mark Kritzman and I argue that many investors have a false impression of the relative importance of these choices for two reasons. First, they typically fail to distinguish between the activities investors choose to emphasize and those with the greatest potential to influence investment results. Second, when investors measure the potential influence of investment activity, they often base it on contrived portfolios that are unobtainable. We simulate thousands of realistic portfolios to determine the natural dispersion of performance arising from different investment activities, which enables us to evaluate the hierarchy of investment choice from a normative perspective.

Contrary to received doctrine, dispersion around average performance arising from security selection is substantially greater than dispersion around average performance arising from all other investment choices. It is also noteworthy that asset allocation, which is widely considered the most important investment choice, produces the least dispersion. Following publication of "The Hierarchy of Investment Choice," our critics argued that our methodology unfairly compresses dispersion arising from asset allocation. We have since then demonstrated that our conclusion holds unless the investor restricts the minimum asset mix shift to 50% and never diversifies across stocks, bonds, and cash simultaneously.

In this context, Kritzman and Lee Thomas, in their 2005 article "Re-engineering Investment Management," argue that the conventional approach to building portfolios, which starts with the asset allocation decision, is inefficient. They define the beta portfolio as the portfolio that is passively invested in various asset classes, and the alpha portfolio as the sum of the active positions taken by active managers around the beta portfolio. Kritzman and Thomas argue that investors should independently optimize the beta and alpha portfolios, as opposed to sequentially optimizing the beta portfolio and then searching for alpha. In doing so, investors can benefit from an unconstrained and therefore much wider array of alpha opportunities.

Consider the example where an investor excludes the emerging market asset class from her allocation because it is not part of her optimal beta portfolio, ipso facto excluding all emerging market alpha products from her opportunity set. By separating beta from alpha, the investor might find that exposure to pure (i.e., net of beta exposure) alpha in emerging markets is quite optimal. Then, the investor can optimally combine the alpha and beta portfolios.

The modern finance paradigm demonstrates that every time a constraint is removed, the portfolio's risk-adjusted return increases. Kritzman and Thomas show a progression from the traditional approach to investment management to a completely unconstrained model, where the investor can borrow to finance both the portable alpha and portable beta portfolios. They show that to eliminate the need to sacrifice the alpha portfolio in order to optimize the beta portfolio, investors should allocate a portfolio's capital to the risk-free asset, and then introduce both the alpha and beta portfolios as overlays to it. The bottom line is that our industry is undergoing significant changes—conventional wisdom is being challenged. Several (risk-adjusted) free lunches are expected along the way for those ready to unconstrain the investment management process. The separation of the liability-defeasing portfolio, the beta portfolio, and the alpha portfolio will offer investors a whole new world of global investment opportunities! ■

"ASSET ALLOCATION, WHICH IS WIDELY CONSIDERED THE MOST IMPORTANT INVESTMENT CHOICE, PRODUCES THE LEAST DISPERSION."