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# the appliance of science



Graham Bentley puts asset allocation under the microscope and explains why a scientific approach will help to ensure optimum long-term positioning of clients' portfolios.

Before the rise of science the world was a mysterious and often dangerous place with disease, famine and other misfortunes seemingly falling at random on an unfortunate and superstitious populace. The wise man could read the runes and see the future, thus helping us make better decisions and increasing the chance of healthy outcomes. As Thomas Hobbes said 300 years ago, 'knowledge is power'. Today, the investment industry has its fair share of blind faith too. Varying degrees of investment knowledge and a belief that many fund managers are virtually supernatural beings might lead to errors in judgement and an uncomfortable chat with indignant clients.

Can anyone forecast the future? Before you answer, think of the lorry load of fund manager commentaries you might have read over the past month, and the attention you paid to predictions of future interest, inflation, growth rates, share prices and so on. Was there a consensus view? Do we ever look back to see if their predictions were correct? Consider the fact that in order for there to be a market, there has to be a multitude of opinions; otherwise, everyone would be buying the same

thing. The fact is nobody can predict the future on a repeatable basis.

## the reality of fund selection

Suppose I take an imaginary 1,000 fund managers and I stack the odds against them to the extent that they have a 55% probability of losing money each year. After four years, 41 of them will have made money. They will be seen as 'experts', and will doubtless be lauded by the adviser community at large. They are less than 5% of the sample, but nobody will mention the other 95%. The point here is that a theoretical universe composed entirely of sub-standard managers will nevertheless produce a small number of great track-records, and we will assume that this ability to outperform every year for four years is cause and effect.

Some of those 41 managers will almost certainly use what is known as confirmatory bias, taking facts that seem to explain their out-performance, and ignoring those that do not. We will accept these explanations, and thus justify our subsequent fund selections from these 41. Now 23 of these will do badly next year, but 18 will do well again,

thus presumably securing their place in the fund managers' hall of fame. Essentially, even if all fund managers were incompetent there would still be a number who had exceptional results, purely because volatility means some of them would make money.

I have faith that fund manager skill exists. However, for my mind the value of fund management is in its contribution to portfolio returns that are benchmarked against a client's requirements, not a proprietary index. Thus, the key performance attributes are strong investment disciplines, adherence to aims and objectives, and robust risk controls.

Academic research (and Ron Sandler to boot) tells us that over 90% of the variability in portfolio returns can be explained by asset allocation. Yet the key skill on which many advisers continue to focus is stock selection, even though that same research relates that only around 5% of the variability in a portfolio can be explained by it. Stock selection is a key driver of *relative* risk (and therefore *relative* returns), when assessing portfolios *within the same asset class*.

## 'Strategic Asset Allocation helps limit the degree of error – diluting the impact of 'unlucky' fund managers'

### bad science

Investors, like all humans, pay most attention to unusual stimuli - those which are most observable. Take a market of 1,000 companies and assume that, on average, they return the risk free rate (ie three-month Treasuries) and they engage in all forms of volatile business. At the end of the first year, we will have 500 companies showing an increase in profits (assuming no inflation), and 500 'dogs'. After three years, we will have 125 'stars' that will be strong buys on analysts' lists, and probably a selection of these will be in your manager's fund. However, if an idea is familiar to one fund manager, chances are it is familiar to the others too, which means it will be reflected in share prices. Only strange ideas are not in the price – so only those can make exceptional profits. You make money by exploiting other people's cognitive biases, or by taking risks that they are avoiding. Researching share price movements could be seen as due diligence, but is also an example of the 'representativeness fallacy' – the belief that changes in share price must be indicative of a company's performance.

### all in the preparation

If your clients are like me, they are long-term investors, saving for the sunny day when they retire. My concerns are at portfolio level - to blend assets in such a way as to give the portfolio the highest chance of reaching my target, with the lowest consequence to my financial health if it does not. I therefore need to understand the potential variance in expected returns, rather than try to predict the actual returns.

To understand this, consider you are going on a trip, and you need to get an idea of the weather before you go. If you are going to Paris, with a temperature of 60°F, plus or minus 10°, then you wouldn't pack snow clothes, or a portable electric fan. But what if you were going to Russia, where you are told that while the current temperature was 60°, the weather may vary by 30° either way? Of course, you would pack both summer and winter clothes. Hence, your choice of clothing is not dependent upon the forecast temperature – it is the variance that matters.

Further, suppose you were going to a planet where the expectation was also 60° but plus or minus 500°. Then what would you pack? In other words, investment activity depends far less on where anyone thinks the market is going than on the degree of error around a confidence level. Strategic Asset Allocation helps limit the degree of error, and dilutes the impact 'unlucky' fund management might have.

The ability to build bespoke portfolios, matched to risk profiles (ie the consequences of variability), has been beyond the reach of most advisers until now. Access to Modern Portfolio Theory and associated research, along with portfolio construction tools to put that theory into practice, are no longer 'secret knowledge' available to the privileged few. Current theories on portfolio construction attempt to replace a superstitious deferential faith in judgement with science – portfolio construction as chemistry, not alchemy. Welcome to the real investment world.

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