

The View from the Land of **Steady Habits**

In May 2005, I attended the Annual Conference of the Institute of Chartered Financial Analysts (CFA) in Philadelphia and was reminded by the very first speaker of why the non-profit community needs a publication dedicated to the subject of asset allocation. Why? Because not enough people are paying attention to asset allocation – neither the owners of wealth nor the managers of wealth – despite the fact that it is the most important factor in the risk and return management of endowment and foundation assets.

Charles Ellis, one of the founding fathers of professional investment management, opened the conference with an overview of the state of the industry. He described five “levels of the game”:

- 1. Determining the long-term goal and asset mix**
- 2. Determining the equity mix – growth, value, etc.**
- 3. Choosing active vs. passive management**
- 4. Selecting managers**
- 5. Selecting securities**

He ranked these in order of value added to the investment process. Note that asset mix is number one. He then asked the room of investment professionals (who in aggregate probably managed several hundred billion dollars, if not a trillion) how it earns its money. The answer was in exactly the reverse order!

We put most of our time, energy, and resources into picking stocks, picking managers, and picking investment strategies. We put the least amount of time, energy, and resources into determining long-term goals and asset allocation.

Why do we neglect the most important fiduciary responsibility in endowment management? It's partly Peter Lynch's fault, partly the fault of human nature, and partly due to the nature of the discipline.

Peter Lynch, of course, is the legendary former manager of the Fidelity Magellan Fund. He was successful at generating excess returns, at beating the market, in a manner that we all envied. And that's the problem! We all want to have the next Peter Lynch manage our wealth for us. We don't want to just match the market. Our endeavors deserve better than that. We

want to generate excess returns from our investments so we can better serve our mission and the needs of those we serve.

How do we know that the next gang of investment managers doesn't include the next Peter Lynch? How can we pass up the opportunity to hire him or her to manage our institution's assets? Don't we have to put our time and energy into finding this expertise? Don't we need to hire someone to help us find him or her? So the rationale goes, and in the search for the next Peter Lynch, time, energy, and resources are exhausted that could be otherwise spent on more intelligent and better informed asset management.

We can't just blame Peter Lynch, however, for being the exception to the rule that you can't beat the market. We are just as much at fault, for we are seduced by the process of trying to find the next Peter Lynch. Money management has an irresistible attraction or glamour to it. We enjoy interviewing prospective fund managers and learning about how they select stocks or bonds for their portfolio. If we are a manager or a board member without much financial expertise, picking an investment manager is an opportunity to learn about the world of high finance. If we have financial expertise, we enjoy sharing that with our colleagues and the esteem it earns for us from them.

Make no mistake. We are too easily seduced by those who manage money into believing that they must have talents and abilities that set them apart and that will benefit us. We want to believe this, the investment management industry wants us to believe it, and so we do.

But it ain't necessarily so! Beating the market is all but impossible. Those who do it are lucky and are unlikely to have their luck repeated. As Ken French later reminded us at the CFA conference, why do we think we can find the next Peter Lynch if Fidelity has not been able to do so (with no disrespect for Mr. Lynch's successors)?

The effort we all put into finding the right manager with the right strategy to pick the right stocks is effort better spent on understanding asset allocation and prodding our managers to develop sound and active allocation strategies.



But asset allocation management is not very sexy, and this is the third reason we neglect it. It can be both abstract and counterintuitive. It doesn't seem as concrete as picking stocks, and it requires us to understand risk in a way that may not jive with our naive sense. Highly intelligent board members may resist the notion that the risk of a portfolio can be reduced by adding patently risky assets to it. But effective asset allocation management is the single most powerful factor in achieving superior risk/return performance.

So, how does an organization improve its asset allocation management? In three ways. First, get informed and get smart about the art and science of asset allocation. Second, don't rely on your investment managers to do it for you. The knowledge and skill set required of an effective stock fund or bond fund manager is not the same knowledge and skill set required of an asset allocation manager or advisor. Third, be prepared to accept the responsibility for asset allocation management.

Asset allocation management requires sound judgments about the future – about economics, politics, demographics, and psychology, to name just a few besides finance. Since the judgments required are ultimately about human behavior, they should be shared and discussed by all who share in the fiduciary responsibility for endowment management. The aim of this publication is to enable better informed discussions about the future of our world, so that fiduciaries and endowment managers can make the best asset allocation choices possible.