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THE EVOLUTION OF ASSET ALLOCATION

By,
John Micklitsch, CFA, CAIA
Chief Investment Officer
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In April of this year, Morningstar Inc., the influential investment research firm and creator of the widely followed investment style box, announced that it was time to think beyond the traditional style matrix approach to portfolio construction and wealth management. Speaking at an industry conference, Scott Burns, Morningstar's head of asset management stated, "The style box is a two-dimensional risk map. It's a really nice simplification." However, he noted, "The world has evolved beyond this two dimensional framework." As a refresher, the style box refers to the nine box equity cube constructed with the style labels Value/Blend/Growth across the top and the capitalization labels of Large/Mid/Small along the side. In terms of the lesser known fixed income cube, the horizontal part of the matrix is comprised of the interest rate sensitivity classifications Limited/Moderate/Extensive and vertically the credit quality classifications of High/Medium/Low.

The theory was, and still is for many investors and their advisors, that by simply checking multiple boxes across both the equity and fixed income style boxes, an investment portfolio was optimally constructed. However, during the 2008 crisis, the correlation of many of the style box components shot up close to 1.0 (perfectly correlated with each other). Investors realized that diversifying amongst large and small, growth and value and even U.S. versus international equities had its limitations. What has evolved from the lessons of the financial crisis, and the historically low interest rate environment that has followed, is the emergence of portfolio construction methods based less on the notion of style box completion and more on the basis of risk and liquidity "budgets." In addition, portfolios focused more on outcomes such as CPI+ or absolute return targets in the institutional world and more of a total return versus income mindset for individuals when it comes to retirement income planning.

To achieve these outcomes, portfolios are increasingly being constructed and being viewed as a collection of diversified return streams. Increasingly, these return streams are extending beyond traditional stock and bond risk premiums (returns associated with taking risk). In casting a wider net to include alternative risk premiums, such as long-short investing, advisors seek to provide clients with

solutions that better mitigate risk across full market cycles while still generating sufficient returns to achieve targeted return goals. All of this comes, however, against a backdrop of unprecedented low, global interest rates and central bank policy which makes asset allocation decisions more difficult than ever.

Another reason the investing world is moving beyond style box investing is the regulatory fallout and central bank actions that followed the financial crisis. Regulation such as Dodd Frank has significantly curtailed certain bank activity such as proprietary trading. With big bank liquidity removed from certain trading related activities and central bank actions having huge impacts on investor sentiment, markets have gotten more volatile. Money managers have responded with products that are more tactical in nature and purposely unconstrained by historical benchmark limitations in order to take advantage of this increased volatility. Many of these more flexible or unconstrained strategies simply don't fit neatly into the old style box framework but can provide significant utility value to a portfolio.

The investor takeaway from all of this is that portfolio construction continues to evolve and investors and advisors should evolve with it. The good news is that collectively, investors of all sizes have never had access via innovative investment products to so many varied return streams from which to build portfolios. The bad news is the choice and product proliferation can be overwhelming. For example, investors can now invest internationally through active or passive strategies, broad based or country specific allocations and via exposure that is hedged or unhedged back to the U.S. dollar. It is reminiscent of the retail studies that show decision paralysis when consumers are presented with too many choices. However, as the famous saying goes "time waits for no man", so too could the saying go, "the market waits for no investor." And so despite the ever more complicated world investors must navigate to achieve their goals, investment decisions have to be made and returns must be generated or long-term goals will not be met.

At Ancora we work diligently on behalf of institutions and individuals to keep up to date on the latest portfolio construction methods so that we can build portfolios that blend the best of traditional asset management with the evolving world of asset allocation.

John Micklitsch, CFA, CAIA, is the Chief Investment Officer at Ancora Advisors LLC a SEC Registered Investment Advisor.

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