

Is your Investment Policy Statement a Dinosaur?

While often viewed as a mere formality that summarizes the investment discussion between client and advisor, the Investment Policy Statement (IPS) can and should be utilized to enhance the client/advisor relationship, ultimately leading to a deeper understanding of the risk/reward tradeoff born by the client.

It should briefly summarize objectives, goals, risk tolerance and constraints of the investor, creating structure without losing sight of the need to maintain the flexibility in order to best manage a client's assets.

Coming from the perspective of a U.S. based investor, for years a typical investment portfolio was comprised of 60% domestic blue chip stocks, and 40% high quality corporates, treasuries, or municipal bonds for individuals. This U.S.-centric approach made sense given that the U.S. stock market represented over 50% of global equity market capitalization through the mid-1980s (over 60% in the late 1960s and early 1970s), according to the World Bank. Today, U.S. equities account for 36% of the global market cap, as of 2014; an IPS should reflect the fact that well over 50% of the world market capitalization is non-U.S. Furthermore, with regards to emerging markets, their share of global GDP has accelerated from approximately 20% in 1990 to 40% in 2010 (see chart below). In addition to being too U.S. focused, we would argue that most policies are too conservative in their targeting of emerging market investments, and could suffer a large opportunity cost if these targets are not increased.



Mitigating the domestic bias in your policy statement

While we have clearly observed a significant departure from the aforementioned "60-40" model in most policy statements, it is also apparent the focus has shifted toward market capitalization and even occasional style constraints within the domestic market, e.g. U.S. Large Cap, U.S. Mid Cap, U.S. Small Cap. Much less attention is being paid to non-U.S. investments such as international developed equity and

emerging markets; a typical target might be 20% developed and 5% emerging markets, which we feel is no longer representative of the global opportunity set.

Since over 50% of global market capitalization is outside of U.S. borders, we believe that an IPS should reflect this reality by broadening the opportunity set. Furthermore, many money managers analyze companies by revenue source as opposed to domicile, further muddying the classification of U.S. versus international. Therefore it makes sense to redefine both equity and fixed income by replacing these traditional categories with broader definitions of “global equity” and “global fixed income.” While such a reclassification could potentially create unwanted concentration or overexposure to certain areas, this risk can be mitigated through intelligent manager selection, selecting managers who are complementary to the overall portfolio.

Is Fixed Income Really Fixed Income?

A standard IPS will classify high yield corporate bonds (those rated below BBB or investment grade) and emerging debt as fixed income. While it is true that these investments represent IOUs of the issuer and are higher in the capital structure than equity, it is also true that their historical correlations are more in line with equities. According to Morningstar, looking at U.S. high yield bonds from 2005-2014, they have a 0.75 correlation with U.S. stocks, whereas the Barclays US Aggregate Index, an investment grade index with 38% in U.S. government obligations as of January 15, 2015, exhibits a correlation of 0.04 during the same period. Likewise, emerging market bonds have a 0.56 correlation to U.S. stocks from 1994-2012, but only a 0.26 correlation to U.S. bonds. These relationships will likely be accentuated during times of crisis and flight to quality, and since the main goal of asset allocation is risk control, we would argue that U.S. high yield and emerging debt should be classified as equity.

Inflation Hedging Assets

As of this writing the breakeven rate, or the difference between ten year nominal treasuries and ten year TIPs (or Treasury Inflation Protected Securities) is approximately 1.6%, which means that the market is expecting inflation to average 1.6% per year over the next ten years. Despite the recent sell-off in commodities and low inflation expectations, we believe portfolios with long-term horizons should maintain some inflation protection, especially if fixed income is a significant component of the asset allocation policy. Hedging assets can include some combination of gold bullion, TIPs, and commodities.

Alternatives

The landscape for alternatives has shifted dramatically since the 2008 financial crisis as many investors have shunned restrictive lock-ups and higher fees for the transparency of more liquid investments. The proliferation of liquid alternatives in the form of funds or ETFs has increased the opportunity set for most investors. We believe alternatives still have a place and can certainly be additive to client portfolios, but it is also important to identify strategies that are unique and not easily replicated in the public markets. Why pay for equity beta in a hedge fund structure?

“Look Through” Your Asset Allocation

Earlier we made the case for treating high yield and emerging market bonds as equity investments for risk control purposes. How about emerging markets and inflation hedging assets, how should they be treated? Since much of the worldwide demand is from the developing world, it makes sense that many

inflation hedging investments such as commodities often move in tandem with emerging markets investments. This relationship can be expressed through the correlation between the Bloomberg Commodity Index and the MSCI Emerging Markets Index, which was 0.67 over the last 10 years according to Morningstar. A portfolio's allocation weights should reflect this reality. In other words, consider looking at them as one consolidated bucket for risk management purposes. Likewise, how much exposure do your broadly diversified equity managers have to commodity sensitive areas such as energy, materials, etc.? As you monitor these managers, have their exposures shifted? Is the portfolio more sensitive to commodity swings as a result? Has it drifted outside of your comfort zone?

In conclusion, the ever-changing investment landscape necessitates a shift in the traditional view of Investment Policy guidelines, definitions, and weights. The interconnectedness of the global markets requires a fundamental shift in how we view asset classes and risk buckets. By reconsidering some traditional paradigms about Investment Policy design, we believe the investor will be better equipped to control risk, while seeking opportunity in the global marketplace.