

The 93.6% Question of Financial Advisors

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Good strategic asset allocation is like tailoring a well-fitting suit. Good tactical asset allocation and security selection is like weaving the suit's fabric at a low cost. Both are important, but they are distinct. High-quality fabric woven at a low cost provides little comfort when it drapes a size 40 body in a size 46 suit.

Financial advisors are tailors more than they are weavers; they are *investor* managers more than they are *investment* managers. But investors see more value in weaving than in tailoring. They are more willing to pay for *investment* management, with its focus on beating the market, than for *investor* management, with its focus on the examination of financial resources and goals, diagnosis of deficiencies, and financial education and care. It is no wonder that investment advisors seize upon a study that seems to imply that investor management is more important than the investment management.

Brinson, Hood, and Beebower (BHB) [1986] studied the performance of ninety-one large U.S. pension plans over the 1974-1983 period and conclude that "investment policy dominates investment strategy (market timing and security selection), explaining an average of 93.6% of the variation in total plan returns" [p. 39]. A sequel by Brinson, Singer, and Beebower (BSB) [1991] puts the number at 91.5%.

The BHB's study is now at the center of a debate, a debate initiated by William Jahnke [1997]. "The fundamental problem

with BHB's analysis," writes Jahnke, "is its focus on explaining portfolio volatility rather than portfolio returns" [p. 109]. But, as Robert Veres [1997] notes, Jahnke's real target is the many financial advisors who have used the BHB study to magnify the asset allocation part of their investor management role while abdicating the market timing and security selection roles of investment managers.

Financial advisors do indeed use the BHB and BSB studies to elevate asset allocation and emphasize investor management. For example, SEI Investment Group highlights the BSB study in a brochure aimed at financial advisors and investors:

As noted in the authoritative study of pension fund performance, the overwhelming determinant of the success or failure of an investment strategy is not which securities of mutual funds were bought or sold but how the assets were divided among the various asset classes (stocks, bonds, cash equivalents).

SEI concludes that the value of financial advisors is mostly in investor management:

The most *important* steps in the investment process are those in which an investor's objectives are carefully *defined* then *implemented* with the appropriate asset allocation strategy. ("SEI Investment Philosophy" [p. 5]).

Jahnke is right in his criticism of the interpretation of the BHB study. He is also right to call attention to the role of financial advisors and the fees they charge. My first goal is to focus the debate on the role of financial advisors by distinguishing *investor* management from *investment* management. My second goal is to clarify the interpretation of BHB's figures.

TERMS OF THE DEBATE

The terms in the asset allocation debate are confusing. I use three terms in my discussion: strategic asset allocation, tactical asset allocation, and security selection. *Strategic asset allocation* is what BHB call "investment policy" and what SEI calls "asset allocation." Strategic asset allocation involves the allocation of portfolios among asset classes, such as 60% to stocks, 30% to bonds, and 10% to cash.

Jahnke refers to strategic asset allocation as "fixed weight asset allocation," but investors might change their strategic asset allocations if they change their trade-off between expected returns and risk. Investors might also change strategic asset allocations if they revise their estimates of expected returns or risk, but strategic asset allocation estimates are founded on an acceptance of current market valuations, not on challenge to them. Investors who restrict themselves to strategic asset allocation are "passive" investors, and they hold passive portfolios.

Tactical asset allocation is what BHB call "market timing" and what Jahnke calls "asset allocation." Tactical asset allocation challenges current market valuations. It involves shifts in allocations, relative to the strategic allocations, in an attempt to benefit from divergence of current values asset classes from their "correct" or "rational" levels.

Security selection is used here as in BHB. It involves selection of particular securities from all securities in an asset class in the belief that the selected securities have higher values than others in that asset class. Investors who deviate from their strategic asset allocation portfolios for tactical asset allocation or security selection reasons are "active" investors, and they manage active portfolios.

MANAGING INVESTORS AND INVESTMENTS

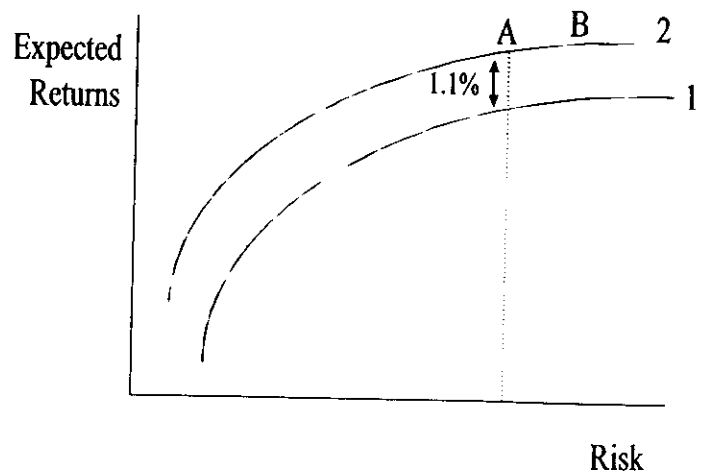
Strategic asset allocation is important, and so are tactical asset allocation and security selection, but they are important in different ways. Strategic asset allocation is

part of the management of *investors*, while tactical asset allocation and security selection is part of the management of *investments*.

Strategic asset allocation involves movements *on* the efficient frontier, while tactical asset allocation and security selection involves movements *of* the efficient frontier. Good strategic asset allocation requires selection of portfolios *on* the efficient frontier that fit the risk and expected return preferences of investors, such as portfolio A or portfolio B in Exhibit 1. Good tactical asset allocation and security selection call for upward shifts *of* the efficient frontier, such as a shift from 1 to 2, to provide higher expected returns for each level of risk.

The ability of investment managers to add value through tactical asset allocation and security selection is in dispute (the market efficiency dispute). I will not comment on that dispute here other than note that BHB's work bears on it. BHB [1986] report that the average return of portfolio managers in their sample is 9.01%. The average return would in fact have been 1.10 percentage points higher had managers forsaken their efforts at tactical asset allocation and security selection in favor of strategic asset allocation alone.

EXHIBIT 1
Strategic Asset Allocation versus
Tactical Asset Allocation and Security Selection



Strategic asset allocation involves moves on the efficient frontier (e.g., from A to B). Tactical asset allocation and security selection involve moves of the efficient frontier (e.g., from 1 to 2). The tactical asset allocation and security selection efforts of the pension portfolio managers in BHB's sample result, on average, in a 1.1% down move of the efficient frontier, from 2 to 1.

HOW HIGH IS 93.6%?

To understand the 93.6% figure, consider a simulated version of an average BHB portfolio manager. BHB's manager is an active investment manager, employing both tactical asset allocation and security selection. The annual returns of this manager's portfolio over the eighteen-year period 1980-1997 are presented in Exhibit 2. The average allocations to stocks, bonds, and cash over the eighteen years are 50%, 28%, and 22% respectively. So we deduce, following BHB's method, that the manager had a 50-28-22 strategic asset allocation benchmark. The annual returns of the 50-28-22 benchmark are also presented in Exhibit 2.

BHB's 93.6% figure is the mean R^2 in regressions of the returns of portfolio managers on the returns of the same managers' strategic asset allocation portfolio benchmarks. We design BHB's manager so that its R^2 is 93.6% and the manager lags the benchmark by a mean 1.1 percentage points per year, the mean lag for BHB's managers. We do this by letting the manager beat the benchmark by 1.16 percentage points in even years and lag the benchmark by 3.36 percentage points in odd years. The regression of the returns of BHB's manager on the returns of the strategic asset allocation portfolio is presented in Exhibit 3A as a basis for comparisons.

Now consider TAA, a portfolio manager who is perfect at tactical asset allocation. TAA knows at the

EXHIBIT 2 Returns of Portfolios (%)

Year	Stocks (S&P 500 Index)	Bonds (Long-Term Treasury Bonds)	Cash (30-day Treasury Bills)	Strategic Asset Allocation Portfolio	Typical BHB Portfolio	Perfect Tactical Asset Allocation Portfolio	Perfect Tactical Asset Allocation and Security Selection Portfolio
1980	32.4	-4.0	11.3	17.6	18.7	32.4	115.1
1981	-4.9	1.9	14.7	1.3	-2.1	14.7	14.7
1982	21.4	40.4	10.5	24.3	25.5	40.4	40.4
1983	22.5	0.7	8.8	13.4	10.0	22.5	89.6
1984	6.3	15.5	9.8	9.6	10.8	15.5	15.5
1985	32.2	31.0	7.7	26.5	23.1	32.2	88.1
1986	18.5	24.5	6.2	17.5	18.6	24.5	24.5
1987	5.2	-2.7	5.5	3.1	-0.3	5.5	5.5
1988	16.8	9.7	6.4	12.5	13.7	16.8	66.7
1989	31.5	18.1	8.4	22.7	19.3	31.5	81.0
1990	-3.2	6.2	7.8	1.9	3.0	7.8	7.8
1991	30.6	19.3	5.6	21.9	18.5	30.6	127.3
1992	7.7	8.1	3.5	6.9	8.0	8.1	8.1
1993	10.0	18.2	2.9	10.7	7.4	18.2	18.2
1994	1.3	-7.8	3.9	-0.7	0.5	3.9	3.9
1995	37.4	31.7	5.6	28.8	25.5	37.4	85.6
1996	23.1	-0.9	5.2	12.4	13.6	23.1	71.9
1997	33.4	15.9	5.3	22.3	18.9	33.4	92.7
Mean return	17.9	12.5	7.2	14.0	12.9	22.1	53.1
Excess (percentage point) return over							

beginning of each year, with perfect foresight, the identity of the best asset class for that year, and allocates the entire portfolio to that class. TAA's portfolio is entirely in stocks in 1980 when stocks returned 32.42%, beating bonds and cash. It is entirely in cash in 1981 when cash returned 14.72%, beating stocks and bonds.

TAA's portfolio was entirely in stocks in 50% of the eighteen years 1980-1997, in bonds in 28% of the years, and in cash in 22% of the years. So, following BHB, we assume that TAA's strategic asset allocation portfolio benchmark is 50-28-22. TAA's portfolio returns exceed the returns of the benchmark portfolio each and every year, by a mean of 8.10 percentage points per year. The R^2 of a regression of the returns of the active portfolio on the returns of the benchmark portfolio is 89.4%, not far from BHB's 93.6% (see Exhibit 3B). Tactical asset allocation explains only the remaining 10.6%.

Last, consider TAA-SS, a portfolio manager who combines TAA's tactical asset allocation ability with the ability to replace the S&P 500 index with the top fifty stocks in the S&P 500 index whenever stocks are chosen. The R^2 of the regression of the returns of TAA-SS portfolio on the returns of his benchmark portfolio is 55.5% (see Exhibit 3C). TAA-SS beats the benchmark each and every year, by a mean of 39.1 percentage points per year.

To sum up, a 93.6% R^2 is not high in our context, and it tells us nothing about the dominance of strategic asset allocation, tactical asset allocation, or security selection.

CONCLUSION

Financial advisors claim that the 93.6% figure in the Brinson, Hood, and Beebower [1986] study implies that strategic asset allocation is more important than tactical asset allocation and security selection, and therefore that their role as *investor* managers is more important than their role as *investment* managers. Financial advisors are right to focus on the BHB study but they focus on the wrong number. The number that bolsters their claim is 1.1 percentage points. BHB find that, on average, the tactical asset allocation and security selection work of investment managers *detracts* 1.1 percentage points from the return that would have been achieved with strategic asset allocation alone.

Financial advisors are *investor* managers. They examine the financial resources and goals of investors, diagnose deficiencies, and provide financial education

EXHIBIT 3A

The Case of Typical BHB Active Portfolio Manager

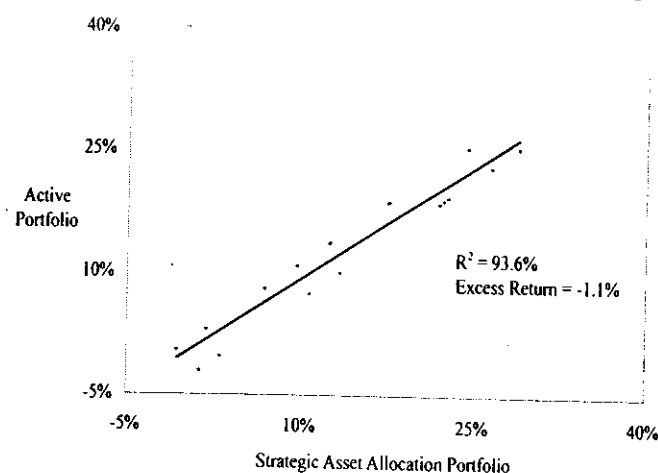
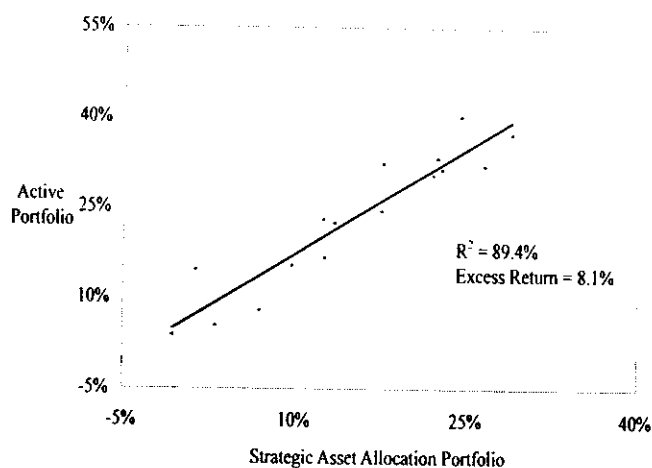


EXHIBIT 3B

The Case of TAA — Active Portfolio Manager with Perfect Tactical Asset Allocation Skills

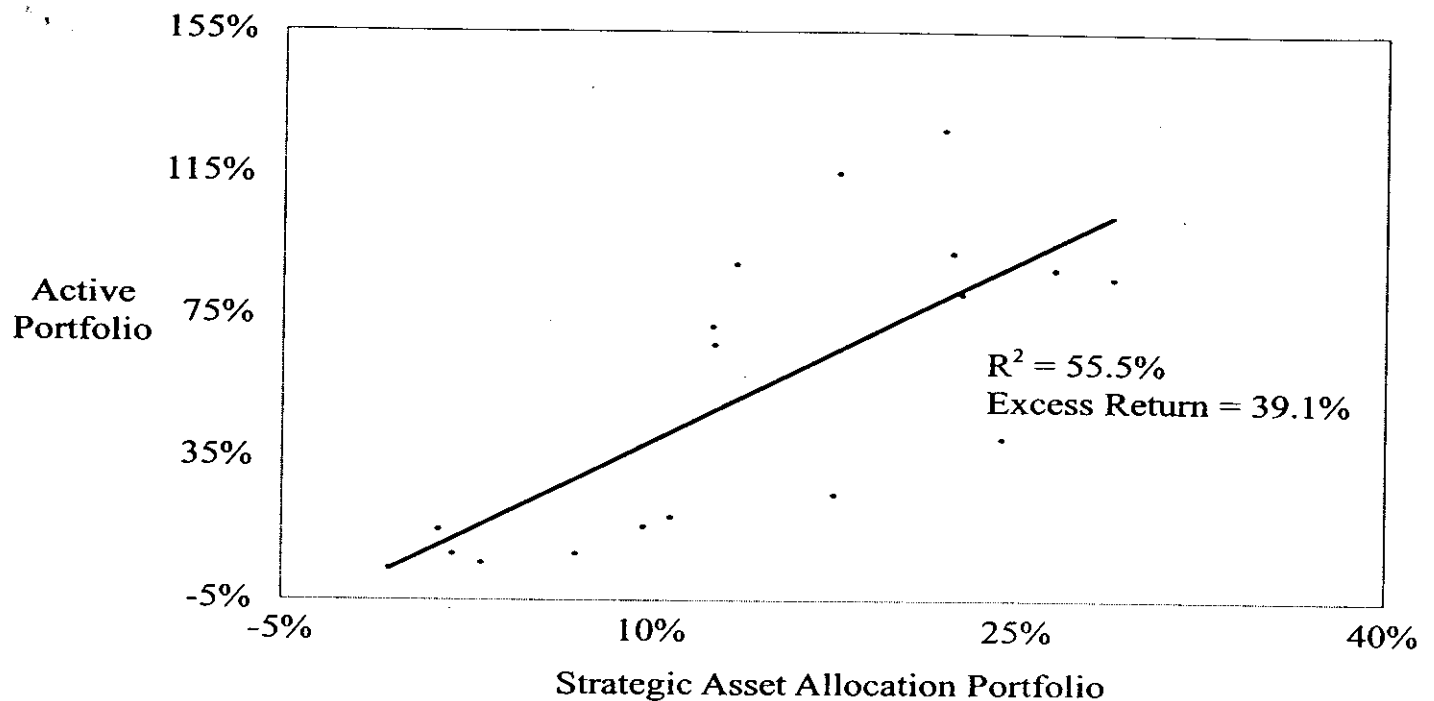


and care. Their work is different from the beat-the-market work of *investment* managers, and it calls for different skills. The 93.6% figure does not show that the investor management role of financial advisors is important, but the role is important indeed.

Financial advisors focus too little on the value of their investor management contributions and too much on obfuscating the fees that they justly charge for their contributions. Financial advisors move fees from front-end to back-end and to 12b-1, trying to make them invisible. They would do better to explain the importance of their investor management work and the fairness of their fees.

EXHIBIT 3C

The Case of TAA-SS — Active Portfolio Manager with Perfect Tactical Asset Allocation and Perfect Security Selection Skills



ENDNOTE

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