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Voices: Gerard Klingman, on Mixing Investment Strategies

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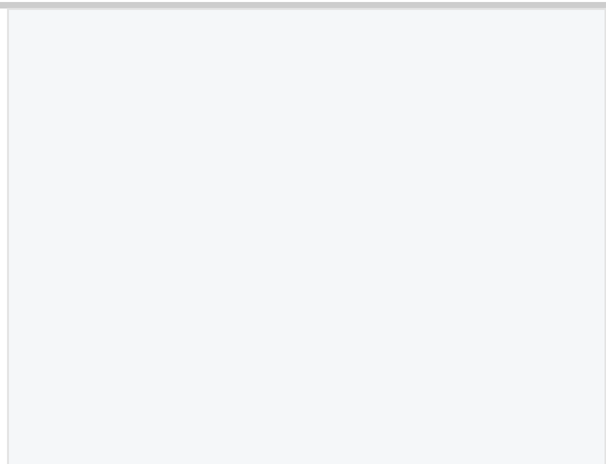
Gerard_Klingman

Like religion and politics, it is easy to be extreme in investing, to believe in only one strategy when it comes to strategic versus tactical asset allocation and active versus passive investment. Using a mix of all four strategies gives clients better risk-adjusted returns.

Before the financial crisis, most advisers practiced strategic asset allocation, or modern portfolio theory, where asset allocation was based on risk tolerance and time horizon. A number of advisers have stuck to that one extreme.

Staying dogmatic to strategic asset allocation ignores the fact that our financial markets create bubbles, as was the case with real estate in the 2000s, and we believe that it's creating a bond bubble right now. Additionally, assets can be dramatically mispriced based on historic valuations. A purely strategic asset allocation does not acknowledge that the world has gotten more complicated.

On the other extreme are those that have thrown strategic asset allocation out the window—those advisers who become tactical asset allocators and market timers. They want flexibility to do anything at any time based on market valuations, but the notion that you are always going to know what asset to be in at a given moment in time is not a realistic way to effectively manage money for clients.



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The thing to do is to marry the best of both schools of thought. We work with strategic asset allocation models from very low risk to high risk, very conservative to aggressive based on a client's age and tolerance for risk. On a quarterly basis, we do a tactical overlay, which takes into account our capital markets outlook, acknowledging that these models should be tweaked over time based on how different asset classes are priced.

The majority of the return from your portfolio is determined by your asset allocation. However, once you have determined that, you have to choose whether to actively or passively invest in each of those asset classes.

Again, advisers generally fall into one of two camps. The first does not believe that active managers can consistently add any value, so they index much of their portfolio. The second camp believes there are certain active managers who can outperform the indices, and those advisers spend a lot of time identifying and selecting those active managers.

We do not believe it is so black and white. Many asset classes lend themselves to using low-cost index funds. The majority of our portfolios use passive management to lower costs and transaction fees. However, we think that there are certain asset classes that lend themselves to active management, such as emerging markets, high yield and global bonds.

By starting with a strategic allocation model, we are able to take a client's specific risk profile into account when making investment and allocation decisions. We tweak this allocation based on our outlook for the markets over the short and medium-term. Then we make use of both active and passive managers, which allows us to manage all asset classes more effectively.

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