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Asset Allocation As Active Investing

Fred D. Snitzer

fsnitzer@prudentmanagement.com

On October 25th of this year, the PMA investment committee held its quarterly investment meeting to review the current state of the financial markets and to discuss what changes, if any, we will make to our clients' portfolios. This is a critical meeting for the firm; it gives us a chance to remove ourselves from day-to-day pressures and focus solely on the big picture, the investment decisions that ultimately drive the risk and the return of our clients' portfolios. The discussion is spirited, frank, and uninterrupted.

One of the main topics we discuss is asset allocation – what percentage of a portfolio should be in stocks and what percentage in bonds. And we discuss asset allocation within these categories – for the equity portion of the portfolio, what percentage to international equities, aggressive equities (typically small –cap funds, large-growth funds) and conservative equities (typically, large and mid-cap value funds); and for the fixed-income portion of the portfolio, what percentage to government bonds, corporate bonds, and high-yield bonds.

In this sense, we are active investors - we do not simply put together portfolios that mirror the market weights of the world market. We make a choice when presented with these questions. For example, at our last meeting, one of the issues we discussed was what should be the allocation to international stocks in our clients' portfolios. If we were to simply mirror market weights, the percentage allocation would look like this:

United States:	54%
Developed Foreign Markets:	36%
Emerging Markets:	10%

However, given what we know about the volatility of international markets, and given what we have previously estimated to be the future returns of international equities, we have, in the past, deliberately underweighted out clients' exposure to international markets so that our clients' portfolios have been weighted more like this:

United States:	80%
Developed Foreign Markets	18%
Emerging Markets	2%

Discussing these kinds of issues is not an idle intellectual exercise. It goes to the heart of what is, in our opinion, the Holy Grail of investing: diversification. Diversification is one of the few free lunches. By putting together in the same portfolio securities that act in different ways (one goes up when the other goes down), you can actually increase your return AND reduce your risk.

Now, anyone can say they diversify, but it's one thing to say that you do it, and another thing to actually have a methodology for doing it. One of the main tools we use in deciding precisely how to diversify is the idea of correlation. If two stocks, or two mutual funds, or two asset classes (i.e. large cap stocks and mid-cap stocks) have a correlation of 1, they move in exactly the same way and have no diversification benefit whatsoever. If the correlation is -1, they move in exactly the opposite way every time, and if the correlation is 0, there is no relationship at all.

We spent a considerable amount of time discussing the fact that the correlation between international equities and U.S. equities has gone down considerably over the last few months, which is good, because it means that the diversification effects of having international equities in a portfolio just went up (the correlation between international and U.S. stocks had risen as high as .93 in 2011 but recently has fallen to about .73). This decrease in the correlation between U.S. equities and international equities is an argument to increase the allocation to international equities and decrease the allocation to U.S. equities. However, we are not yet convinced that this reduction in correlations will persist, and we decided to revisit the issue at our next meeting on January 10th.

Just as advisors have to decide how to weight the different sectors of the equity market, we have to make a similar decision with the bond market.

Here are the current weights of the U.S. bond market, as of Q1 2017, according to the Securities Industry and Financial Markets Association:

U.S. Bond market (in billions)

Category	Amount	Percentage
Treasury	$13,953.60	35.16%
Corporate Debt	$8,630.60	21.75%
Mortgage Related	$8,968.80	22.60%
Municipal	$3,823.30	9.63%
Money Markets	$937.20	2.36%
Agency Securities	$1,981.80	4.99%
Asset-Backed	$1,393.30	3.51%
Total	$39,688.60	100%

Now, an advisor could simply structure the bond portion of their clients' accounts to look like this, putting 35% of their bond assets into Treasuries, 22% in corporates, 23% in mortgages, etc.

At PMA, we have deliberately overweighted corporates since the end of the financial crisis in 2009. We made this decision and have stuck with it because of the continuing large differential in yields between corporate and government bonds.

These are just two examples of where we made active allocation decisions. These are not market timing decisions, but long-term asset allocation decisions, based on our reading of the relationship between risk and returns in these assets classes. We make these decisions to deviate from market weights because we believe that these decisions will improve the ratio of return to risk in our clients' portfolios. Improving this ratio is as much about reducing risk as it is about increasing returns or, to be more precise, it's about reducing risk *without also reducing returns*.

An investor must make many decisions: whether to use individual securities or mutual funds, what percentage to allocate to stocks versus bonds, whether to use alternative investments, how much to allocate to high-yield bonds, etc. At PMA, we center all of these decisions around one question: how can we get the best, most efficient trade-off between risk and return for our clients? For 35 years, this question has guided us in every investment decision we make.