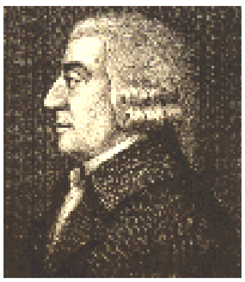
Understanding Asset Classes

Asset Class vs. Industry Sector Allocations

Talking about what is or isn't an asset class might seem trivial, but it's important because asset classes are the key components for constructing diversified portfolios. For this purpose each asset class needs to have a specific risk-return function.

Sorting securities on anything other than the dimensions of expected returns can fudge the clarity of the investment process and undermine portfolio diversification. When investors mistake where returns come from, the asset classes they assemble become arbitrary. For example, investors sometimes manage industry exposure, as if such sectors constitute asset classes. The commentaries of analysts and brokers cover what companies produce and how it affects the prospects for their share prices, this perpetuates and inaccurate impression of sector relevance to asset classes.
As Adam Smith pointed out over 200 years ago, a company's industry bears no direct relation to the flow of capital. Expected returns relate far more to a company's health and size than to whatever the company makes.



Adam Smith (1723 – 1790)
Regarded as the founder of
contemporary economic thought

Three Factor Dimensions of Risk

In the academic study by Eugene Fama and Ken French entitled "Industry Costs of Equity", they find that risk factors of market, size, and book-to-market ratios seem to account for virtually all the differences in returns across industry groups (except real estate shares, which constitute a separate asset class aligned to property market rather than the share market). For example, technology shares had spectacular performance in the late 1990's, because tech shares happened to be growth shares in a market that strongly favoured growth. Many investors believing that technology, and more acutely internet stocks, defined a "new economy" were sorely disappointed when growth shares went out of favour in 2001.

Shares should be sorted along the true explanatory dimensions and include whatever industries happen to fit that asset class. After all, industries drift in and out of asset classes. They get bigger and smaller, healthier and more distressed through time.

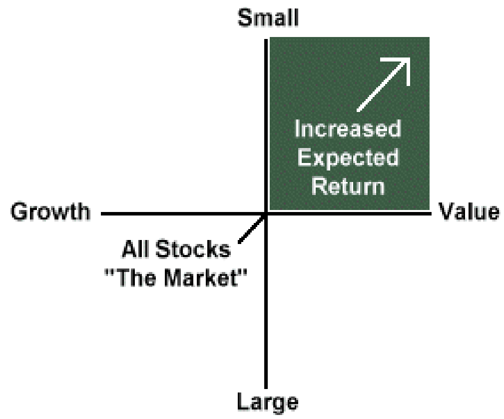
Shares can be sorted any number of ways that don't directly relate to expected returns. The dimensions of returns dictated by a multifactor framework can guide us to the most consistent and flexible way to characterise asset classes and achieve the best investment structure.

Added Value: Structure for increased returns

The most basic investment truth is that risk and return are directly related. Therefore, most investors expect to receive higher returns from shares than bonds over time *because shares are riskier*. Shares of small companies are also riskier than large companies and, as expected, have generated higher average returns over time. Value shares — those that sell at lower prices relative to their earnings and book values—are also perceived by investors to be riskier than growth shares (representing strong companies generally trading at higher Price Earnings multiples). Accordingly, value shares have produced higher returns over time as well.

Axiome portfolios are diversified among shares and fixed interest securities, large and small company shares, and value and growth shares according to each investor's objectives and risk tolerance. Since all of these asset classes tend to move in different directions, at different times, and in varying degrees, asset class diversification tends to smooth out portfolio returns and provide greater downside protection.

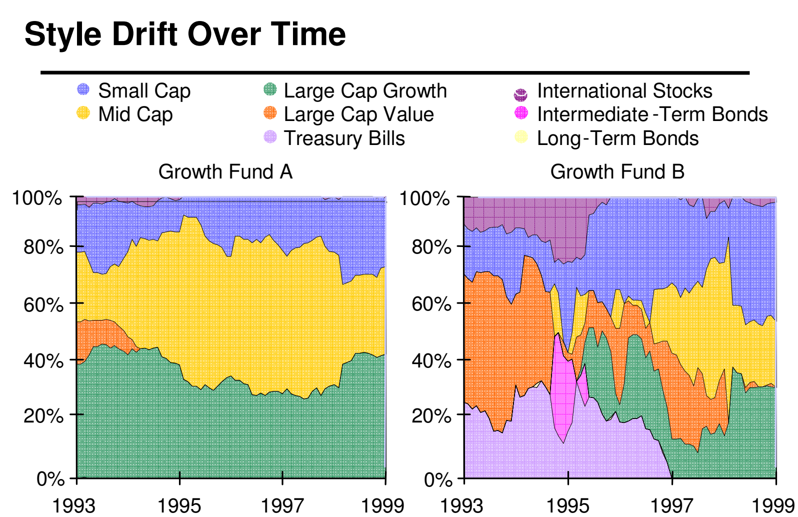
Our ability to efficiently target at low cost the ‘small’ and ‘value’ dimensions through structured asset class funds is a key point of difference and ‘value add’ that we bring to clients. Neither active nor traditional index funds management approaches can effectively harness the small and value premiums available.



Implementation

It is critical that we use ‘structured asset class funds’ rather than actively managed funds to develop client portfolios. Active managers have so much latitude in selecting and timing the purchase and sale of underlying securities, they are subject to concentration risks and exhibit ‘style drift’ (do not maintain constant exposure to the target asset class consistent with the client’s objectives).

The graph below demonstrates how much style drift can be present in actively managed funds. Each of the colours below represents an asset class. Two funds are represented below, each branded and marketed as ‘Growth Funds’ with a mandate to pursue that component of the market. Fund A has generally allowed varying levels of exposure to prevail between three primary asset classes instead of retaining pure exposure to the Growth category depicted in green. The manager of Fund B has pursued a very active policy of entering and exiting a wide array of different asset classes regularly.



Data provided by Wiesenberger.
Based on monthly data over the period 1993-1999. Data calculated using 36-month rolling returns.

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Neither of the funds in the graph would be useful for constructing an asset class portfolio as they do not retain a consistent exposure to a defined part of the market. Therefore there is no ability to implement a client specific plan with any integrity.

The examples above, exposed by *Ibbotson Associates* research are not isolated examples. *The Journal of Economics and Business* published an analysis of Morningstar data in 2000 which observed:

- Only 46% of funds have investment attributes consistent with stated objectives
- Over ⅓ of funds were severely misrepresented
- 54% of funds that survived changed their investment style at some point
- Only 27% of funds held consistent attributes over a three year period
- 31% were more risky that their stated objectives; and
- One quarter of managers shift style towards 'hot' asset classes within most 12 month periods

Conclusion

Shares can be sorted any number of ways that don't directly relate to expected returns. The return characteristics explained by a multifactor framework can guide us to the most consistent and flexible way to characterise asset classes and achieve the best investment structure.

Once an investment structure is optimised for an investor's individual needs and objectives, it must be implemented with care to gain exposure to the desired asset classes. To opt for an active fund management approach will likely distort and undermine the desired asset allocation. A structured asset class implementation has the highest probability of achieving a positive outcome for the investor in a deliberate and accountable manner.