Alternatives, Managers and Your Asset Allocation

Common-sensical thoughts on alts and finding talented portfolio managers

Everyone wants a killer asset allocation, with the perfect lineup of stocks and bonds, the right collection of investment styles, and the best balance between risk and caution. But putting such a portfolio together is tough.

Harry Markowitz, a Nobel Prize winner, created the modern framework for asset allocation with his Modern Portfolio Theory, which explored how best to diversify your assets, balancing risk and reward. Many questioned the worth of good asset allocation after the 2008 financial crisis and after COVID struck in 2020, when almost everything tanked.

Building a smart portfolio can be done, though. Getting there goes beyond slicing up the investment pie in creative ways. These elements are needed: alternative assets, good managers and true active management. The goal is to provide superior risk adjusted returns relative to a stock and bond portfolio over a market cycle. Studies show that asset allocation explains close to 90% of returns. Adding alternatives and good managers can expand upon that.

Think About Alternatives

Alternatives have been in vogue for some time now, since they don't correlate directly with stocks or bonds. Among the domain of hedge funds, an alternatives strategy can encompass selling long and short, commodities and derivatives.

Investors who understand alternatives, and use them properly, could have a distinct advantage over those that do not. For this reason, endowments and other institutional investors have large allocations to alternatives.

For example, Yale and Harvard have about 30% of their assets in alternatives and that number might be closer to 50% depending on what one considers "alternative." The most sophisticated investors in the world use alternatives to increase their risk adjusted returns.

Portfolio Managers Matter

When receiving coronary care, do you want your primary care physician to treat you? Or do you want a heart specialist? Portfolio management should be no different.

Within each asset class, there is a small group of truly talented money managers with world-class resources and expertise. The goal is to find these managers and partner with them.

Here are a few common-sensical thoughts on finding talented portfolio managers:

- Concentrated portfolios with low turnover. A portfolio that focuses on a limited number of investments can often outperform broader ones, provided that the manager has chosen wisely. A concentrated list of investments means that the manager knows them well. Low turnover indicates that the manager has confidence in these choices. Plus, turning over your holdings runs up transaction costs, which sap returns over time.

- Managers with significant money in their own fund. Intuitively this makes sense: Their own financial wellbeing is on the line. It's disturbing how many managers do not invest in their own funds. Many studies show that managers who eat their own cooking tend to outperform those who don't.
- A stable team with a consistent, explainable, proven process. Over longer-time periods, these should beat those with a history of manager turnover and shifts in investment approaches. Especially in down markets.
- Active management is a hotly debated topic as many studies show the benefits of passive management and just as many show the benefits of active management.

  But look very carefully at funds that are classified as active – because often they are not. They are closet indexers – meaning, those who hew closely to an index.

What Should You Do?

Your financial advisor can help you incorporate alternatives into your overall financial plan as well as select from among the best portfolio managers in the world.

In sports terms, think of your financial advisor as your coach, helping you (the owner) determine which players work best together. So you can win.