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Overcoming the Complexity Bias

Building a Portfolio that can Withstand the Test of Time

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Executive Summary

- The investment industry has embraced more complex portfolio construction models in recent years to accommodate alternative and illiquid assets.
- Several studies have revealed how complexity doesn't necessarily equate to effectiveness when it comes to portfolio risk and return outcomes.
- Adopting a simpler 'Total Portfolio Approach' may make it easier for portfolio owners to manage risk, generate returns, and make better governance decisions.

Background

Ultimately, portfolio owners want two (seemingly) simple things: 1) to generate returns to meet the portfolio return objectives; and 2) to manage portfolio risk constraints, balancing capital preservation with growth. The world of foundations, endowments and pensions is a little more complex as trustees are subject to further oversight designed to ensure allegiance to the fund's objectives and guard against conflicts. But even the basic responsibility of pension trustees can be stated in a similar fashion: define a return objective and a liability-aware portfolio risk appetite that is sufficient to deliver on the 'pension promise' without increasing contribution rates.

The Alternatives Rush

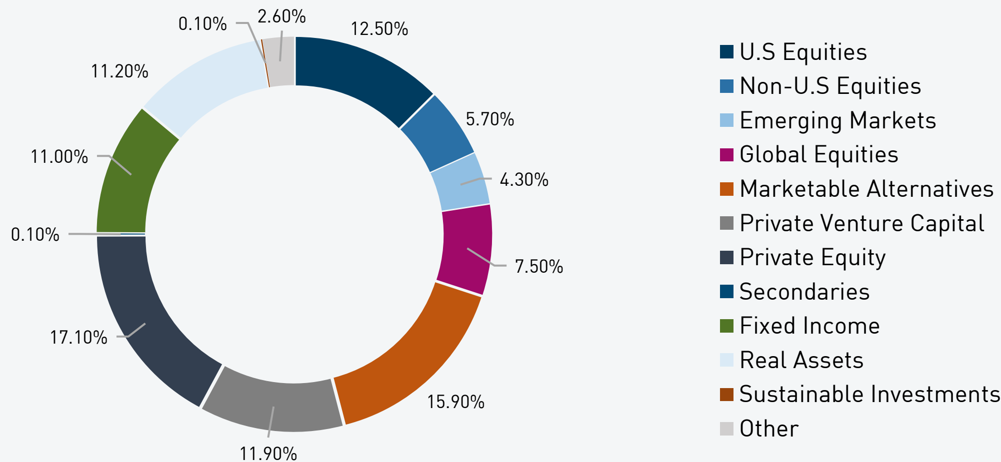
Since 2010, a series of structural conditions (moderate starting valuations, increased globalization, slow inflation, low interest rates, steady economic growth, etc.) have combined to create an extremely favorable environment for investors to accomplish their objectives without taking undue risk. For example, a simple US portfolio with moderate risk (i.e., 60% equities and 40% fixed income) produced a total annual return of 9.9% while the similar Canadian portfolio generated an annual return of 6.3% over this 15-year period.[1]

The investment industry also embraced more complex portfolio construction models during this period (see, for example, the chart below). Inspired by the writings and success of David Swensen[2] and the Yale Endowment office, many investors shifted allocations away from equities and bonds to alternatives and illiquid assets (hedge funds, private equities, infrastructure, private real estate, private credit, etc.).

[1]Source: Bloomberg. Data as of August 31, 2024. Returns are calculated by applying 60% and 40% to the annualized returns of US and Canadian equities and fixed income index, for the period from January 2010 to August 2024. US Equities = S&P 500 Index; US Fixed Income = Bloomberg Barclays US Corporate IG Index; Canadian Equities = S&P/TSX Composite Index; Canadian Fixed Income = FTSE TMX Canada All Corporate Bond Index.

[2]Swensen, David, "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment", Free Press, 2009.

More Complex Portfolios - Average Asset Allocation of U.S. Endowments (2023)



Source: FY2023 NACUBO-Commonfund Study of Endowments.

As a result, the investable universe now includes a wider variety of asset classes, complicating the two primary goals of portfolio owners and raising some difficult questions. Which asset classes or buckets should be prioritized? How much should be allocated to each? How should opportunities that do not fit easily into one segment be bucketed?

Answering these questions often involves the development of longer-term risk/return expectations, resulting in the identification of 'optimal strategic allocations' for each of these asset buckets. The target portfolio is then comprised of a discrete combination of these asset classes. The resulting Strategic Asset Allocation ("SAA") portfolio's success is measured as 'alpha' above the numerous individual benchmarks and an aggregated one.

At this point one might reasonably question whether this increased complexity (and cost) has been worth the effort.

Recent Studies Suggest More Complexity May Not Equal Better Outcomes

Several studies published over the last year have delved into that exact question.

For example, a June 2024 US study[3] examined the returns of 145 public pension plans from June 2000 to June 2023 compared to those of a simple 60/40 US index portfolio. It concluded that - in the search for higher returns relative to the index portfolio - **"while pension plans outperformed prior to the Global Financial Crisis, they fell short thereafter."**

[3]Aubry, Jean Pierre and Yin, Yimeng, "How Do Public Pension Plan Returns Compare to Simple Index Investing?", Brief 24-13, Centre for Retirement Research at Boston College, June 2024.

Another paper[4] studied the performance of 6,000 private funds covering buyout, venture, credit, and real estate from 1980 to 2022. The authors examined absolute performance, benchmark-relative performance, and correlations between public and private assets. It highlighted the wide dispersion of returns in every segment and thus the critical importance of manager selection (itself not a costless activity). In analyzing relative performance, the study demonstrated that **outperformance was highly dependent on the choice of benchmark used**. For example, private credit outperformed investment-grade corporate bonds (on average) but underperformed high-yield corporate bonds. Finally, the results regarding private-public correlations (difficult to measure) suggest that while some diversification benefits remain, correlations with public markets have gone up substantially post-2007 and investors would be wise to temper their expectations around such benefits.

A third relatively recent paper[5] examines annual average returns (net of all investment costs) across 200 public and private sector pensions and 12 aggregate asset classes with appropriate adjustments for the reporting lags associated with illiquid asset classes (e.g., unlisted real estate, private equity, and other real assets). Over the 24-year period (1998-2021) covered by this study, there were striking differences in performance across aggregate asset classes. Two of the more interesting observations were: **1) private real estate produced average net returns noticeably less than public REITs**; and **2) broad US fixed income and US long bonds had the highest risk-adjusted returns** among the asset classes covered by the study.

How do these results square with the fact that many institutions regularly report outperforming their benchmarks? Understanding this difference starts with the realization that most of a portfolio's return (and around 90% of its return volatility) can be ascribed to the policy benchmark chosen.

Considering the Sum, Not Just the Parts

With an SAA, or complex asset class bucketed worldview, the tendency is for each asset class to be individually benchmarked and each asset class team to manage their allocated silo of capital relative to this narrow benchmark with limited context of the impact on the total portfolio.

However, summing the returns of those 'optimal' components can yield quite different results than when one manages a portfolio in a more coordinated manner. A Total Portfolio Approach ("TPA") involves examining competing opportunities and allocating to those perceived to offer the best risk-adjusted return in terms of impact on total portfolio results.

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[4]Hendrix, Kaitlin and Medhat, Mamdouh, "Understanding Private Fund Performance", Dimensional Fund Advisors, July 2024.

[5]Beath, Alexander and Flynn, Chris, "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States 1998-2021", CEM Benchmarking Inc., October 2023.

To quote the co-founder of EnnisKnupp , a well-known institutional consultancy (now part of Aon plc.),

> *"…Most institutional investors, such as public pension funds and endowments, report their performance using biased benchmarks. The benchmarks are biased downwardly, meaning their returns tend to be less than a fair return for the market exposures and risk exhibited by the institutions' portfolios… This bias enables a sizeable majority of both types of funds to report outperforming their chosen benchmarks when, in fact, most underperform an appropriate passive-management benchmark by a wide margin."*

A Comparison of Portfolio Construction Approaches

Performance assessed vs.	Benchmarks	Fund goals	
Success measured by:	Relative value added	Total fund return	Better decision framing
Opportunities for investment defined by:	Asset classes	Contribution to total portfolio outcome	Better decision framing / Better decision making
Diversification principally via:	Asset classes	Risk factors	Better decision making
Asset allocation determined by a:	Board-centric process	CIO-centric process	Better decision making / Greater dynamism
Frequency of change:	Infrequent, calendar meeting based	Continuously monitored, changes made in real time	Greater dynamism
Portfolio implemented by:	Multiple teams competing for capital	One team collaborating together	Greater dynamism

Source: Thinking Ahead Institute.

The diagram above illustrates the clear differences between the SAA model and the TPA model, specifically how each impacts decision-making throughout the whole investment process, from framing to monitoring. The only real constant is change and, as such, it should be obvious that the SAA asset allocation model is not built to be optimal for all points in time. A TPA model provides the advisor and/or investment team with the flexibility to dynamically manage asset allocation regardless of market conditions.

Building on this perspective, a strong argument can be made that it might be better for portfolio owners to adopt a simple and more transparent benchmark like a 60/40 Reference Portfolio combined with an enhanced set of risk constraints that focus on the underlying risk exposures that are most important to the plan's risk and return profile (i.e., equity, rates, inflation, liquidity, etc.). Doing so would clearly assign accountability for active management and allow the advisor and/or investment team, the latitude to pursue the best investment opportunities as long as they maintain allegiance to the pre-defined portfolio risk constraints.

An additional benefit of this approach in the higher interest rate and more volatile world that seems likely to lie ahead, is its potential usefulness in more meaningfully constraining allocations to illiquid assets, where the incremental relative value continues to diminish relative to costs incurred. It would also more explicitly recognize that bonds now offer greater value to a portfolio than before, not only in their typical role as a diversifier but also as a source of return and liability hedging. Adopting such a simple benchmarking approach would also make it easier for the portfolio owner to specify risk exposure and required return, judge performance, and likely reduce manager and transaction fees as well as governance time.

If you would like to learn more about our views on institutional investing or how RPIA strategies fit in your portfolio, please do not hesitate to reach out to a member of our team.

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