October 20, 1999

Recent research by Roger Ibbotson and Paul Kaplan seeks to clarify the relevance of asset allocation by reevaluating the Brinson, Beebower study with an eye to confirming their findings and elaborating on the role of asset allocation as it relates to differences in returns across plans and absolute levels of return. Using a similar methodology to Brinson et al., Ibbotson and Kaplan tried to answer three distinct questions:

- **How much of the variability of returns across time is explained by policy? This is the question that Brinson, Beebower asked. Here they were interested in finding out what drives the portfolio returns quarter by quarter.**
- **In other words: "Why is the portfolio up 5% one quarter and down 2% the next?"**

- **How much of the variation across funds is explained by differences in asset allocation policy? This portion of the study is trying to determine what role asset allocation plays in explaining the differences in cumulative returns of funds over time.**
- **In other words: "Why does balanced fund A have a 12% return and balanced fund B a 16% return?"**

- **What portion of the return level is explained by the policy return? To what degree does asset allocation drive the absolute level of return to a portfolio?**
- **In other words: "Why did the investor get a 6% return when the equity market was up 10%?"**

In their study, Ibbotson and Kaplan reaffirmed the earlier analyses, finding that the variations in a portfolio's returns over time were highly correlated to the target asset allocation benchmark returns. On average, the quarterly returns of the benchmark accounted for 90% of the variability in quarterly portfolio returns. So if the equity market is up 5% one quarter and down 2% the next, an investor holding only equities should not be surprised to experience similar volatility in return.

To answer the second question, Ibbotson and Kaplan looked at the 10-year compound returns of 94 balanced mutual funds to determine how much of the variation in returns across funds is explained by the asset allocation policies of these funds. In a simplistic example, if all of the funds were

invested passively with the same asset mix, they should all have exactly the same returns gross of fees. In this analysis, they found that 40% of the variations in compound returns across funds was attributable to the target asset allocation of the funds. For this universe, manager decisions such as market timing, style tilts, and security selection combined with differences in fund fees to create wide disparities in returns across funds.

Again, the results should not be surprising. Portfolio managers routinely move away from their target asset allocation policies as a result of market timing decisions, liquidity concerns or lax rebalancing policies. In addition, the variation in security selection ability across managers is widely documented. This conclusion in no way undermines the importance of asset allocation; rather it highlights how arbitrary manager decisions impact portfolio returns. In our example above, the manager with the 12% return may have held a substantial cash position in the portfolio.

In the final portion of their study, Ibbotson and Kaplan found that 100% of the level of return is explained by the asset allocation policy. This result is highly intuitive. If equities are expected to return 10% over time and cash 6%, a portfolio that is equally split between stocks and cash would be expected to return 8%. And our hapless investor with the 6% return may have had no equity exposure at all.

For investors, this study further confirms the importance of proper implementation of a chosen asset allocation policy. Over time, both the volatility and the return on a portfolio will be largely driven by that asset allocation decision.