

Response to The Hierarchy of Investment Choice: Comment

MARK KRITZMAN AND SEBASTIEN PAGE

We thank Renato Staub for his interest in our article, "The Hierarchy of Investment Choice: A Normative Interpretation," and we are especially pleased we can address these important issues once again.

Staub attempts to reconcile our conclusion that asset allocation is less important than security selection with his interpretation of Brinson, Hood, and Beebower [1986] that asset allocation is the most important investment decision. Our contrary conclusion to BHB arises for none of the reasons he cites, but rather because the BHB article does not address the importance of asset allocation.

Staub, in his defense of BHB, observes that total portfolio return and policy return are highly synchronized through time, and he equates this synchronicity with the importance of asset allocation. We did not address this misconception in our article because others have done so previously, and we had assumed it to be well understood by most investors. Apparently it is not.

Yes, it is true that total return and policy return are highly correlated. This high comovement is true whether the asset mix policy is 100% stocks, 100% bonds, 100% cash, or any combination thereof. The comovement comes from the choice to invest—in *anything*—not the choice to invest in one asset mix versus another. It therefore has nothing to do with the importance of the asset allocation decision.

Asset allocation is important to the extent that differences in asset mix lead to differences in performance. Our analysis shows that, after controlling for investor behavior, asset allocation has much less impact on performance than commonly assumed—and much less than security selection.

We do not know what question BHB attempted to address. If they intended to address the importance of asset allocation, however, they should have measured cross-sectional variation in asset mix policies, as noted by Ibbotson and Kaplan [2000].

The innovation in our methodology is to disentangle investor behavior from investment opportunity. BHB analyze the realized returns of managed portfolios, returns that are as much a product of investor decisions as they are a product of investment opportunities. Indeed, many of the funds in the BHB sample employed multiple managers, each deviating only slightly from a benchmark. That BHB find little variation through time from security selection is not because security selection is unimportant, but because many of these funds, in aggregate, did not meaningfully engage in security selection.

Our bootstrapping methodology overcomes both of these BHB deficiencies, because it examines cross-sectional variation in performance, and because it is based on potential portfolio returns rather than realized portfolio returns.

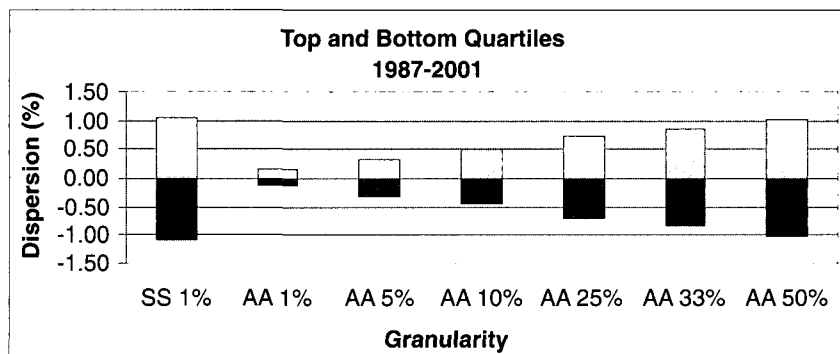
Staub offers three criticisms of our article, none of which we believe to be valid. First, he implies we are indifferent to absolute risk. To the contrary: We explicitly consider absolute risk in our analysis.

Our Exhibit 5 shows the absolute volatility through time of total portfolio return, and we state: "Although security selection has the greatest potential to generate dispersion around average performance, this broader opportunity set does not come at the cost of greater absolute risk" [2003, pp. 16-17]. In addition, in Exhibit 6 we show the dispersion of utility, and state: "We provide further evidence that greater dispersion does not imply greater risk by measuring the dispersion of utility, which encompasses both return and risk" (p. 17).

Staub argues next that our simulations do not allow for sufficiently aggressive shifts in asset mix because we allow the mixes to change by increments as small as 1%. Staub claims that larger shifts are more appropriate. In our article we establish uniform rebalancing rules across different investment activities, and then compare the resulting dispersion in performance. Even though we restrict the minimum shifts to 1%, we do not preclude larger shifts.

EXHIBIT

Dispersion as a Function of Granularity



Staub apparently does not believe we should apply uniform rebalancing rules to make such a comparison. He seems to suggest we should apply aggressive rebalancing rules for asset allocation while preserving conservative rules for security selection.

Let's see how disparate these rebalancing rules must be in order for asset allocation to generate as much dispersion as security selection. The Exhibit shows the dispersion between the top- and bottom-quartile portfolios for random security portfolios selected from the Russell 3000, assuming minimum shifts of 1% within the stock component of the portfolios, along with the dispersion for random asset mix portfolios, assuming minimum shifts ranging from 1% to 50%.

These simulations support our original conclusion that security selection generates a wider opportunity set than asset allocation, even if the investor restricts the minimum asset mix shift to 50%. With this restriction, about half the time the portfolio would be invested entirely in a single asset class, and it would never be diversified across three asset classes at once. We suspect most investors would be uncomfortable with such a harsh restriction, and it would still not validate Staub's criticism.

Finally, Staub criticizes our results because we vary the asset mixes around an average exposure of 60% stocks, 30% bonds, and 10% cash. He states that because we anchor our allocations to this mix, our analysis is not normative. Our analysis, though, is normative in the sense that it is not dependent on actual investment decisions.

Nonetheless, we must start with some sample in order to proceed with a bootstrap. For security selection, we started with capitalization weights. For asset allocation, we started with a mix that we perceived to be reasonable. We could just as well have started with an equally weighted

sample, or any weighting scheme for that matter. Yet it would not matter, as long as the average asset mix is equal to the asset mix of the security selection portfolios. The dominance of security selection would still prevail.

Staub attempts to validate the relative importance of asset allocation by offering some generalities, such as "over the past three years we experienced a massive return differential between the stock and the bond market" [2004, p. 119]. Note he fails to say anything about the return differentials among securities during that period. In our article, we explicitly measure the range of opportunity associated with random exposure to asset classes versus random exposure to individual securities within asset classes, cumulatively over our entire sample and each year within our sample. In no year did the dispersion associated with asset allocation approach the dispersion associated with security selection, despite Staub's observation about the last three years.

We recognize our results may trouble those who focus on asset allocation, and that some readers may even interpret our results as a call to emphasize security selection over asset allocation. This is not our message. We merely demonstrate that, after controlling for investor behavior, asset allocation has less potential to impact performance than other investment activities.

We acknowledge that investors may still choose to focus on asset allocation if they believe they are more likely to succeed at this activity than at others. And even if investors do not believe they are more likely to succeed at asset allocation than security selection, they may still choose to emphasize asset allocation over security selection because it has less potential for harm.

REFERENCES

Brinson, G.P., L.R. Hood, and G.L. Beebower. "Determinants of Portfolio Performance." *Financial Analysts Journal*, July/August 1986.

Ibbotson, R.G., and P.D. Kaplan. "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" *Financial Analysts Journal*, January/February 2000.

Kritzman, M., and S. Page. "The Hierarchy of Investment Choice: A Normative Interpretation." *The Journal of Portfolio Management*, Summer 2003.

Staub, R. "The Hierarchy of Investment Choice: Comment." *The Journal of Portfolio Management*, Fall 2004.

Editor's Note

Mark Kritzman is a managing partner at Windham Capital Management Boston, LLC, in Cambridge, MA. He may be reached at mkritzman@wcmblc.com. Sebastien Page is a vice president of State Street Associates in Cambridge, MA. He may be reached at spage@statestreet.com.

To order reprints of this article, please contact Ajani Malik at amalik@ijournals.com or 212-224-3205.

©Euromoney Institutional Investor PLC. This material must be used for the customer's internal business use only and a maximum of ten (10) hard copy print-outs may be made. No further copying or transmission of this material is allowed without the express permission of Euromoney Institutional Investor PLC. Copyright of Journal of Portfolio Management is the property of Euromoney Publications PLC and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.