

## QUESTION ASSUMPTIONS

It's time to sharpen a blunt instrument and reassess conventional wisdom on asset allocation

This year has been a tough one for the markets and a good time to ask questions. It is readily apparent that the investment industry and capital markets have continued to evolve in significant ways, and the recent behavior of many individual asset classes—as well as the correlations between them—have caught investors off guard.

As we strive to capture returns and limit losses, we need to ask ourselves whether the blunt tools of broad asset class definitions and traditional asset allocations provide an adequate defense against the complex risk and interaction of today's markets.

Let's consider how asset allocation is currently used in creating client portfolios. Generally speaking, asset allocation is the way that an investment portfolio is aligned with a client's life situation, both current and future.

Client suitability is usually measured, in one way or another, against the classic risk/return trade-off. How much risk can a client tolerate in the pursuit of return objectives? And what return might be reasonably expected for this level of risk? Any estimate of the measure of "reasonably expected" will consider past investment returns, and historical return data is most readily available for asset classes.

It's not a great leap to see why asset allocation has been viewed as the next step toward a properly matched client portfolio. And through practice and belief, common asset classes are seen as adequately representing the fundamental risk and reward landscape over time.

But if we step back and reconsider current practice, it's clear that the assumptions about asset class diversification and the traditional role of asset allocation would benefit from some scrutiny. Many classifications—developed or emerging, growth or value, small-cap or large-cap, and so on—represent

convenience in what is unfortunately an inconvenient world.

Emerging market equities, for example, are a heterogeneous basket of exposures that include export demand from developed countries, indigenous consumption trends, currency policies and resource intensity. The waters get even murkier when we question the basic assumptions of asset allocation. Why should emerging market equities help diversify developed market equities in a world of globally integrated trade? Do you even have to own emerging equities to benefit from emerging market growth rates? Where a company is domiciled is also taking a back seat to where it derives its revenues and accrues its costs.

Fundamental risks (and possible opportunities) often defy attempts to be proxied by a broad index or a string of historical returns. While the proliferation of exchange-traded funds and other vehicles points toward a more granular management of portfolios, the mere availability of new products is not reason enough to consider their use.

Still, their development provides a means to evaluate the broader implications of a more specific targeting of return-and-risk exposures. A more focused approach redefines return and risk in terms of specific fundamentals such as consumer spending, financial regulation, demographics and global economic trends. Implementation involves both active security selection and passive beta allocation, with a primary goal of managing the shared risks that exist across capital markets.

Building an effective portfolio requires taking into account fundamental economic drivers and a willingness to recognize asset allocation assumptions for what they are. This approach will set the stage for a more rigorous implementation that is better aligned with both client and economic reality. ■



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✱ *The role of asset allocation would benefit from some scrutiny.*

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