Making Your Portfolio About #Goals

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The full article may be accessed here.

Central Issue of the Paper

If you're a social media junkie, you have probably seen "#goals" in your timeline. In most cases, the hashtag is referring to an attractive couple or an aesthetically pleasing plate of food. But what if people found your investment portfolio to be #goals?

What if allocators shifted their thinking to aligning their portfolio allocation to targeted and measurable outcomes? In his article, "Outcome-Oriented Alternative Investments," Masao Matsuda, CAIA explores this concept. This Viewpoint provides a high-level overview of the applicability of this concept, and shows how investment performance measurement can morph from a "relative to a benchmark" game to more of a "relative to a stated goal" game.

Approach Employed by Paper

Traditional vs. Outcome-Oriented

One of the most traditional ways to start an asset allocation process is to determine the end-investor's willingness or ability to take risk. Then, the allocator creates an efficient portfolio by making forward-looking assumptions on variables such as return, risk, and correlations. These are entered into a portfolio optimizer, which generates an allocation across these multiple asset classes. The final portfolio is meant to maximize an average return for a given level of risk. While this is a popular approach to portfolio management, Matsuda highlights two issues with it: (1) it completely ignores the underlying objectives of the investor or institution, and (2) it assumes that markets inputs, such as return, risk, and correlation, are static.

Alternatively, an investor could adopt an outcome-oriented investment approach, which seeks to align the total portfolio with different goals that an investor or institution might have. For example, a public pension or endowment could make allocation and manager selection decisions that would increase the probability of achieving the objective of regular cash distributions. This shift in process seeks to shift the mindset from measuring relative performance ("did my diversified portfolio outperform the S&P 500?" or "did my large cap

manager outperform their benchmark?") to measuring objectives ("did my portfolio's performance allow me to fund another year of retiree income?" or "did I maintain the real value of my portfolio after that inflation spike?")

What Are the Objectives?

In the paper, Matsuda believes that objectives of institutional investors can be broken down into four distinct categories: (1) inflation protection and real return, (2) volatility and risk management, (3) equity risk diversification and market neutrality, and (4) alpha opportunities from expanded sources of returns. What's more, none of these objectives are necessarily mutually exclusive. In fact, a portfolio that achieves one of these outcomes may actually achieve another simultaneously.

The Outcomes Applied

Matsudo believes that alternative investments are perfect for outcome-oriented portfolios since many alternative investments behave differently from traditional stocks and bonds; additionally, they may even have dynamic exposures to multiple asset classes. Using his four-outcome framework, Matsudo neatly categorizes different alternative investments into different objectives. For example, the "inflation and real return" outcome might be solved by exposures to commodities or global REITs, while the "alpha opportunities form expanded sources of return" outcome might be solved by exposure to private equity or distressed lending.

While outcome-oriented investing might better align investor portfolios with stated objectives, it doesn't come without risk. Many of these alternative investments are heavily dependent on manager selection, which means a strong due diligence framework will be a key driver of success. Manager dispersion is wide in many of these asset classes, and a manager with strong investment acumen may not necessarily be a good match for the objective of the portfolio.

Matsudo points to the Yale Endowment, led by David Swensen, as an outcome-oriented investment strategy success story. Yale's portfolio is over 75% invested in alternative investments, with the remaining balance in traditional equites and fixed income. Yale's portfolio could be divided in to all four of these objectives based on the underlying allocation, and it has handily outperformed traditional benchmarks, such as the S&P 500 Index.

Findings of the Paper

Outcome-oriented investing is an alternative way to manage a portfolio relative to traditional asset allocation techniques. By determining the objectives first, an investor can allocate to more eclectic strategies and has the opportunity to improve the probability of meeting outcomes. However, this approach doesn't come without risk. In order to successfully implement a strategy like this, investors must be comfortable with investing in benchmark-agnostic and unconstrained managers, some of which might have dynamic exposures to multiple asset classes over time. All this considered, if this investor's portfolio leads to better outcomes…well, then some might say that investor's portfolio is #goals.