A comment

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Variations of the assertion that “asset allocation explains over 90% of a fund’s return” have plagued the investment fund industry now for almost two decades. In July 1986 Brinson et al. published a paper “Determinants of Portfolio Performance” that purported to identify the contributions made by different elements of the portfolio management process. That their paper, and its sequel in 1991, contributed materially to our knowledge of investment management is undeniable. That their findings should be treated with some as unambiguous and almost a law of nature is unfortunate. As we shall see, it is neither.

The paper by Kirievsky and Kirievsky in this issue of JASSA is correct to highlight the shortcomings of the Brinson paper and its progeny. In particular, Brinson et al.’s choice of time series analysis rather than cross-sectional analysis has always seemed unintuitive. It has also been a barrier to explaining the findings of the study to non-experts. Proposing an alternative methodology is therefore appropriate. However, in view of the near universal adoption of the Brinson results, it remains to be seen whether the Kirievsky approach will replace the Brinson orthodoxy.

Perhaps more importantly, the Kirievsky paper does not address the main problem of the Brinson paper in practice: the frequency with which the findings of the Brinson paper are misinterpreted. A few examples:

- The percentages cited relate to the variability of returns, not to the quantum of returns themselves. Brinson et al. made this clear, but many who quote the study miss this important nuance. Few investors think naturally about variability and the natural tendency is to lapse mentally back to thinking in terms of returns.
- Investors, particularly those acting as trustees for superannuation funds, are exorted to focus on the asset allocation decision on the basis of the Brinson study. In the Brinson study, investment policy (sometimes mistakenly called the asset allocation effect in current literature) effectively measures the difference between hiding money under the mattress and passively holding the fund’s “normal portfolio”. Brinson found an explanatory value of 91.5% for this effect. A naïve 60/40 portfolio would also give rise to a high value, though probably lower than 91.5%.
- So what value the incremental step offered by asset consultants and financial planners in finetuning the allocation from a 60/40 portfolio to a bespoke Strategic Asset Allocation? Not the 90% sometimes claimed.
- Brinson’s methodology was inherently empirical. It measured the experiences of a finite set of funds over a particular time period. That subsequent studies using similar methodologies found comparable results does not materially change this basic point. As Ankrim and Hensel point out, simple common sense tells you that you would most likely find different results using investors whose approach to portfolio management varied from the pension fund paradigm. Imagine for instance a portfolio containing just a handful of stocks plus some corporate bonds, or a small number of hedge funds, or one where the asset allocation was aggressively traded on a daily basis.

The question asked by Brinson et al. was a very specific one. Their finding must necessarily therefore be read narrowly. Their finding cannot, for instance, be used to infer that one should place on the different decisions (spend more of your risk budget on asset allocation, for instance) as it says nothing about your chances of success in any decision. Nor can it realistically be used to guide the amount of attention you should spend on the decision; the fact that something might have a heavy influence on realised returns does not mean that thinking about it more will lead to a more satisfactory result.

Of course each of these problems of interpretation also apply to the Kirievsky paper. For instance, the specific question Kirievsky addresses (what is the single effect that best explains returns) is only one of the questions that practitioners researching in this general area would regard as important. Most often practitioners are interested in the relative importance of the different factors taken together, since they occur that way in real portfolios. There is therefore a risk that the results found by Kirievsky may be mis-read to have broader application than the authors claim. There is even the risk that readers will attempt to compare Kirievsky’s findings with those of Brinson et al. when quite clearly the differences in methodology mean that the results in Kirievsky cannot be compared directly to those reported by Brinson and others using his methodology. These limitations, I submit, are not a fault of the authors. They do, however, pose a challenge to the audience to recognize the valuable, but narrow import of the piece and not to repeat the error of reading as much into the findings as has been, incorrectly, attributed to Brinson and his co-authors.

Notes
3 With respect, it is difficult to agree with the conclusion of Eversky et al. when they liken this type of analysis as “akin to resolving how many angels can fit on the head of a pin”. Eversky, H., Jahneke, W. and Zurz, R., “The Asset Allocation Debate,” Journal of Investing, Spring 2000. The basic point that asset allocation matters is an important one for investors to understand, however difficult it might be to measure contributions precisely.
4 For ease of exposition, these observations ignore the Kirievsky criticisms and treat the Brinson methodology as though it is above reproach.
5 Brinson doesn’t report a result, except to say that it “resulted in virtually the same average results” Brinson (1991) at p. 46.