FOCUS ON WHAT YOU CAN CONTROL

October 2015

Market volatility can serve as a reminder of what investors can and can’t control. What is information, and what is noise? What is predictive of the future, and what is just the past? Long-term investors should focus on what they can control and stay the course – provided they are on the “best” course. The best course is the result of a plan that incorporates goals and risk preferences, along with implementation that captures the fullest share of available capital market returns.

Three foundational concepts help us understand how markets work and inform what we can and can’t control:

- Financial markets are highly competitive;
- Expected return and risk are related;
- Short-term returns are noise.

We know that financial markets are highly competitive pricing engines because true alpha is uncommon. True alpha is risk-adjusted excess return that is not random (i.e., not lucky). We presented the rarity of true alpha in our research article, “Detecting True Alpha in Highly Competitive Markets.” This is strong evidence that markets dynamically adapt to new information (news) and price a competitive expected return to compensate for risk. If financial markets were not competitive, there would be systematic mispricing and alpha would be prevalent.

It is important that investors understand expected return and do not confuse mispricing with risk. The market’s expected return is not the guaranteed return (unless it is a risk-free asset). It is an average return expectation based on investors’ aggregate forward-looking views of the probabilities associated with innumerable potential return outcomes. The expected return is the market’s best guess – the center of gravity – but that average incorporates a multitude of uncertain return outcomes, some of which are undesirable. That is compensated risk in a nutshell, and it has important implications.
If markets are competitive and investors are risk-averse (i.e., require compensation to bear more risk), then expected return and risk are related, and riskier assets have higher expected returns. History provides corroborating evidence. Since 1926, the average (arithmetic) annual returns for cash, U.S. bonds and U.S. equities were 3.5%, 5.4% and 12.1%, respectively, while their standard deviations (risk) were 3.1%, 5.6% and 20.1%.1 Progressively riskier assets were compensated with progressively higher average returns. Exhibit 1 graphs the high dispersion of historical annual equity returns relative to the average.

Risk is part of earning the higher expected return, and indeed you are compensated on average (but not always) for bearing that risk.

Volatility around the average annual equity return is significant, but it is an expected and normal part of the return-generating process, even for extreme events. For example, over the 89 calendar years of returns since 1926, we observe three calendar years (including 2008) with returns of less than -28% (a -2 standard deviation event), while random chance would have predicted about the same (two years). We observe two calendar years with returns greater than +52% (a +2 standard deviation event) and again random chance would have predicted two years.2 This high volatility in annual equity returns is largely random because markets are forward-looking, attempting to quickly price new information (news) into the present value of an uncertain future.

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Short-term returns are noise. In our research article, “Get Invested – Overcoming the Fear of Market Entry,” we showed that there is no meaningful relationship between previous and subsequent returns over the short term. Recent short-term returns contain no reliable information about subsequent future returns that would inform a diversified portfolio. This is because recent past returns have already priced any new information. Ignore short-term returns and stay the course, provided you are on course.

But are you on course? With a foundation in how markets actually work, investors can focus on what they can control to improve long-term investment outcomes:

• Asset allocation
• Value for expense
• Tax efficiency

WHAT YOU CAN CONTROL

In the well-regarded paper, “Determinants of Portfolio Performance,” Brinson et al. (1986) find that more than 90% of the return variation of corporate pension plans is explained by asset allocation policy. We came to the same conclusion for elite university endowments in our research article, “Illuminating the Returns of Elite Investors.” Asset allocation is the primary driver of portfolio return and risk for all investors.

Investors control their asset allocation. They should find the optimal asset mix that balances risk preference with expected return, in consideration of financial goals. Asset allocation should maximize expected return per unit of risk while seeking broad diversification that increases confidence in achieving the portfolio’s expected return by muting the dispersion (risk) around it. Investors have different financial goals and risk preferences, so asset allocation should be customized to the investor’s circumstances.

EXHIBIT 2 – ASSET CLASSES TO RISK PREMIUMS

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Market Beta</th>
<th>Term Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed Global Equity</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>1.3</td>
<td></td>
</tr>
<tr>
<td>Global Real Estate</td>
<td>1.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Global High Yield</td>
<td>0.6</td>
<td>0.2</td>
</tr>
<tr>
<td>U.S. Treasury</td>
<td>1.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Northern Trust Research and Morningstar
A key asset-allocation decision is to determine the appropriate mix between diversified risk assets (market beta) and risk-control assets (term beta and cash) today and through time. These two risk premiums dominate the return and risk of asset classes and diversified portfolios. Differences in the mix between the two risk premiums spread out risk and terminal wealth outcomes over the long run. Exhibit 2 shows that market and term betas are the underlying return drivers of major asset classes, with high explanatory power and no residual unexplained return premium.5

All else being equal (i.e., expenses and taxes) for well-diversified portfolios, asset allocation is much more important than manager selection in determining total portfolio return and risk. In reviewing the historical performance for all institutional share-class equity and bond mutual funds over the last five years, market and term factors explain more than 80% of fund returns.6 We can improve the explanatory power across fund returns by adding secondary risk premiums like size and value factors to equity and credit to bonds. But the market and term risk premiums that dominate major asset class returns do the heavy lifting. The bottom line: Consider your goals and risk preferences, and get your asset allocation right.

Investors control their expenses, which can weigh heavily on returns. The goal is not necessarily the cheapest portfolio but to obtain the most value for expenses paid. Passive (indexed) investment solutions are very low cost and provide efficient exposure to generic market and term betas. They offer good value. Engineered investment solutions are semi-passive. They cost marginally more than passive solutions, but in return the investor captures intentional exposures to additional sources of return including size, value, momentum and profitability (quality) premiums. Active solutions are more costly, and their expenses should be weighed carefully relative to the expected value received from risk-adjusted performance, net of fees (and taxes). Alternative assets such as private equity and hedge funds come with the highest fees, but select alternative managers can contribute non-traditional sources of return that diversify and/or augment net portfolio returns. The key is to be highly selective, know where value is generated and seek investor-friendly terms. Expenses should be controlled, but they need to be considered relative to the value received by the total portfolio.

Finally, private investors also control their tax efficiency. Although gross returns grab the headlines, private investors consume after-tax returns. In “Tax Efficient Wealth Management,” we showed that taxable investors should minimize exposure to assets and strategies that generate ordinary income and short-term capital gains. That is, unless such assets can be located in tax-deferred accounts or offer exceptional diversification benefits. Ordinary income and short-term capital gains are taxed at more-onerous rates, materially reducing the realized gross return.
But tax efficiency should not be considered in isolation. For private investors, the real objective is to fund lifetime goals efficiently, which requires a more strategic approach to tax management. For example, suppose equity assets ultimately will be liquidated and reallocated or consumed (e.g., to fund lifestyle needs), and realizing a long-term capital gain is inevitable. In that case, the compounding benefit of a deferred long-term gain is marginal. It is typically not worth deferring the gain’s realization if the investment portfolio is becoming sub-optimal (e.g., off-target asset allocation, reduced diversification or inferior manager mix). For equity-oriented assets that ultimately will be reallocated or consumed, the main value of tax management is avoiding short-term capital gains. The realization of long-term gains to maintain an optimal investment portfolio aligned with lifetime financial goals is often prudent.

In contrast, if assets will be gifted to philanthropy or bequeathed with a step-up in tax basis, then the compounding benefit of the deferred long-term gain may be more meaningful. In that case, avoiding a taxable gain may be more appropriate. Tax-efficient wealth management is not about avoiding taxes altogether but means incurring taxes when it is prudent to do so relative to optimal goal funding.

Focus on what you can control. Plot the “best” course, incorporating goals and risk preferences to drive asset allocation plus implementation that considers value for expense and tax efficiency. Then ignore the noise and stay the course. The best course for you will most likely lead to the best outcome.

Notes
1 Based on calendar-year returns of Ibbotson SBBI US Large Stock, IA SBBI Intermediate-term Government and IA SBBI 30-day Treasury bill indexes from 1926 to 2014. The compound annualized (geometric mean) returns are 3.5%, 5.3% and 10.1% for U.S. Treasury bills, bonds and stocks, respectively. Source: Morningstar and Northern Trust Research.
2 Equity returns are close to normally distributed at the annual frequency.
3 There is evidence for momentum and trend in asset returns, but these leveraged, long/short strategies are systematic, not market-timing strategies, and are best implemented by specialty managers within the alternatives allocation.
5 The average R2 is 0.85, with no statistically significant alphas. Asset classes are represented by MSCI World IMI, MSCI Emerging Markets IMI, FTSE EPRA NAREIT Global Real Estate, Barclays Global High Yield and Barclays U.S. Treasury. Betas are estimated using a 10-year window ended March 2015.
6 Based on all institutional share class equity and bond mutual funds in the Morningstar database with 5-year returns ending June 30, 2015.

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