Our Multi-Asset Class Investment Philosophy

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PART 1

In the first segment of a multi-part investment education series, Biagio Manieri, Ph.D., CFA, will provide readers with a detailed understanding of PFM Asset Management's (PFMAM) multi-asset class investment philosophy. Future segments will provide granularity regarding his thoughts on a variety of other topics, including the generation of formal capital market assumptions, proper asset allocation, the use of alternative assets in portfolios, portfolio implementation considerations and manager selection.

An Overview of Our Investment Philosophy

Successful investing is predicated upon a coherent investment philosophy that guides the investment process from start to finish. To that end, PFMAM's multi-asset class investment philosophy and framework guide us as we analyze economic conditions and capital markets seeking above-benchmark investment returns. Coupling this framework with a deep understanding of asset classes helps to prevent investors from reacting to short-term movements in the markets, or attempting to time the market, which could lead to suboptimal investment returns and/or the assumption of excess risk. Further, our investment philosophy ensures that we focus on the intermediate- and long-term but not overreact to short-term "noise" in the capital markets. Our investment philosophy and beliefs are rooted in finance and economic theory and are supported by empirical analysis and research.

Our Investment Approach

The primary drivers of (investment) returns for multi-asset class portfolios are: (1) strategic and tactical asset allocation, (2) security selection and (3) market timing. At PFMAM, we do not attempt to "time the market." We also avoid short-term technical analysis (e.g., perceptions that the market may be overbought or oversold) and do not make changes to allocation based on technical analysis. The reasoning behind this is simple. Market timing/ technical analysis has not been shown to be consistently reliable when making short-term portfolio changes.

Also, as a practical matter, when attempting to time the market, one needs to be right twice: the first time when making the initial deviation and the second when reversing the move (re-entering the market).

PFMAM's investment philosophy is based on empirical observation and backed by numerous studies by academics and practitioners that *the most important driver is strategic and tactical asset allocation* (see Exhibit 1). What these studies have consistently shown is that asset allocation explained 100% or more of investment return, while all other decisions, including security selection and market timing, on average, detracted from investment returns. Therefore, when managing multi-asset class portfolios, our primary focus is on asset allocation. Asset allocation can be divided into two components: (1) strategic or long-term and (2) tactical or deviations from the long-term strategic targets.

Exhibit 1:Historical Plan Performance vs. Index

	Median Plan Performance	Index
BSB (1991)	13.4%	13.5%
BHB (1995)	9.0%	10.1%
PFMAM (2015)	9.1%	10.1%

Source: Brinson, Hood & Beebower,1995; Brinson, Singer & Beebower, 1991; PFMAM 2015 white paper study.

When constructing multi-asset class portfolios, we first want to ensure that the long-term or strategic asset allocation is efficient. The fundamentals of certain asset classes, e.g., equities, make them ideally suited for inclusion in portfolios at all times, although, to be clear, not always at the same weight. Over long periods of time, it is important to note that equities deliver superior returns relative to other asset classes for the risk that is being assumed (Exhibit 2).

Exhibit 2:

Arithmetic Average Historical Return

	S&P 500 (total return)	Tbill	U.S. T. Bond	IG Corp Bonds	Real Estate
1928-2022	11.5%	3.3%	4.8%	7.0%	4.0%
1972-2022	11.9%	4.4%	6.5%	8.9%	4.8%
2012-2022	13.7%	0.6%	0.5%	4.6%	4.3%

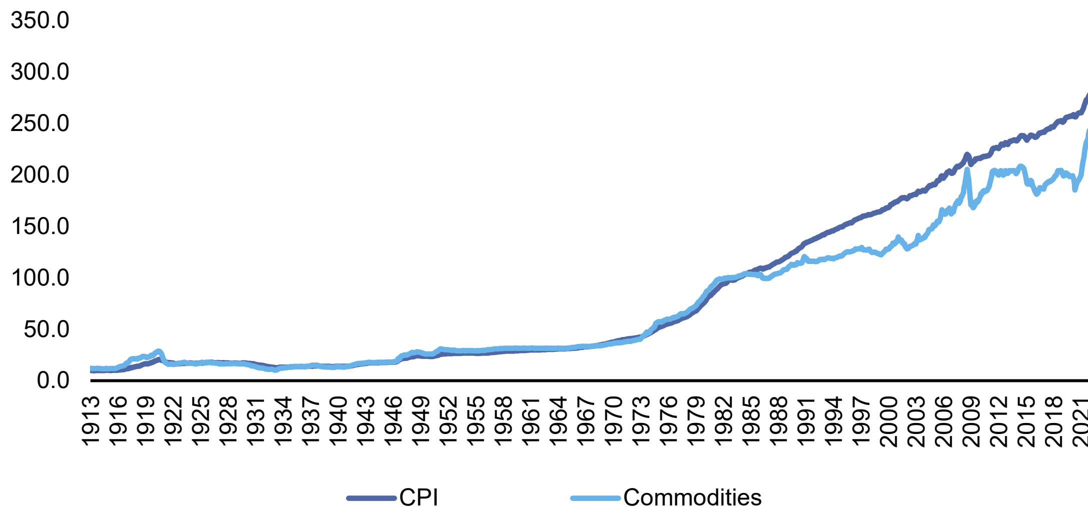
Geometric Average Historical Return

	S&P 500 (total return)	Tbill	U.S. T. Bond	IG Corp Bonds	Real Estate
1928-2022	9.6%	3.3%	4.5%	6.7%	3.8%
1972-2022	10.4%	4.3%	6.0%	8.6%	4.5%
2012-2022	13.3%	0.6%	0.1%	4.3%	3.6%

Source: https://www.stern.nyu.edu/~adamodar/pc/datasets/histretSP.xls.

However, other asset classes, such as commodities, should not be part of portfolios at all times since they deliver sub-optimal returns over long periods of time. Rather, investors should take a tactical approach in their use. Put simply, there are periods of time when commodities are attractive, but over long periods of time, commodities deliver suboptimal returns for the risk assumed. In fact, over extended periods of time, commodities have barely kept up with the pace of inflation (see Exhibit 3).

Exhibit 3: CPI vs. Commodities



Source: Data from Dept of Labor Statistics, analysis by PFMAM.

While the priority is getting the strategic or long-term asset allocation correct, we do not believe that investors should re-balance back to strategic targets in a mechanistic way (e.g., at quarter end). In other words, strategic asset allocation does not and should not mean static asset allocation. We instead look to make tactical adjustments to strategic targets based on fundamental analysis to help enhance investment performance.

At times, certain asset classes may be overvalued or expensive and offer poor forward-looking returns. While at other times, certain asset classes may be undervalued/cheap and offer attractive forward-looking returns. In our approach, we overweight or hold more than the typical benchmark allocation to asset classes that are undervalued and underweight or remove from portfolios asset classes that are overvalued.

Using equities as an example, analyzing historical data, we have observed a relationship between the average stock market performance over five- and ten-year periods and valuation at the beginning of the period. What we have seen is that there is an inverse relationship between valuation and forward returns. In other words, when stock prices have an above-average valuation, investment returns over the following period are below average, and vice versa (Exhibit 4). Our analysis is backed by a long-term track record calculated in accordance with GIPS® that leads us to believe tactically overweighting and underweighting asset classes as investment opportunities present themselves can add to performance over time as valuation discrepancies revert to historical levels.

Exhibit 4

Current PE	Average Next 10-Year Annual Return
Less than 10	15.7
10-15	13.4
15-20	7.4
>20	4.7

Source: Data from Bloomberg, PFMAM analysis.

It should be noted that we recognize that an expensive asset can become even more expensive and a cheap asset can become even cheaper over the short-term. Therefore, we do not tactically overweight and underweight based purely on valuation; in other words, we do not attempt to catch a "falling knife." Rather, we incorporate fundamental research to help shape when to overweight and underweight specific asset classes.

Tactical Asset Allocation is not Market Timing

To those that do not have experience managing multi-asset class portfolios, tactical asset allocation may sound similar to market timing. After all, both strategies deviate from strategic or long-term targets. However, there is a distinct difference. Our tactical asset allocation decisions are based on fundamental analysis. In practice, we analyze economic and capital market conditions and trends to conclude which asset classes are overvalued and which are undervalued. Our approach to tactical asset allocation relies on fundamental analysis and valuations.

Conversely, market timing does not recognize the concept of valuation, but instead relies on technical analysis, or what some may term "reading the tea leaves." Technical analysis relies on charts and price patterns. Again, we do not incorporate market timing when managing multi-asset class portfolios. Our approach is based on a fundamental analysis of economic and market conditions.

Stay tuned for our next segment. Biagio will be back to describe our capital market assumptions practice in detail.

To learn more or discuss in greater detail, please contact us:

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