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## ASSET ALLOCATION - FOOLED BY LABELING

*“For a successful technology, reality must take precedence over public relations, for Nature cannot be fooled.”*

*Richard Feynman*

By David B. Loeper, CIMA®, CIMC®

Unfortunately, this quote isn't very true when it comes to fund ratings as public relations tend to trump *Nature*. It has been about six months since we released [www.fundgrades.com](http://www.fundgrades.com) and just a few weeks since we launched our new portfolio features enabling you to grade an entire portfolio against your selected allocation. (By the way, thanks for all the hate mail and phone calls, it makes for some very interesting debates.)

The biggest gripe I get is about how FUNDGRADES exposes the diversification grade, despite about a third of all funds getting a grade of B- or better for this grading criterion. We could ignore this measure if we wish (it is just correlation coefficient, when did this become an evil measure?) but, as we will expose in this paper, diversification is important if you are modeling asset allocation for your clients. ERISA sort of requires you to pay attention to it as well.

Do you model, sell, or analyze asset allocation for your clients? Have you ever quoted the Brinson, Beebower and Hood studies that said, "90%+ of the variance in returns is explained by asset allocation?" Do you think asset allocation is important? Do you sell prospects by showing them an "improved" asset allocation relative to their current (or your competitor's) allocation?

**If you put no value on asset allocation, then don't bother reading further. However, if you do, you need to pay attention to this.**

Let's take a simple example of domestic equities. Domestic equities would include large, mid and small cap stocks in both value and growth styles. This could be just the domestic piece of an overall balanced global allocation that includes fixed income, foreign securities and even alternative investments. To simplify it though, we will analyze just domestic equities...the math carrying forward in any overall allocation model too and even more so with assets that have less covariance than segments of domestic equities.

Of course, one could make bets on style or market cap by overweighting such segments with a bit of a tweak here or there. But if asset allocation is one of the main decisions (and it is), when it comes time to select securities to fulfill the allocation you are recommending, **do you merely look at labels** or do you pay attention to *the nature* of your selections (i.e. how they actually behave relative to the asset class you are selecting for such securities?) After all, if asset allocation is so important and is the main thing I am modeling, am I really getting any value out of my allocation modeling effort if the funds do not *behave* like the asset classes I modeled? Or, is it just the label that is important?

Imagine you are sitting down with an important prospect. Your competitor has modeled the entire domestic equity portion of the portfolio in a mid cap blend index fund. How would you attack this?

Might you suggest that your competitor's domestic equity allocation is making a big bet and not very diversified? Would you suggest that small and large cap value and growth stocks should be part of the equation? Would you recommend 100% of the domestic equity allocation for your clients should be in mid cap stocks? Before you answer that, make sure that you are not being fooled by labels.

What's wrong with a domestic equity portfolio excluding large and small cap stocks? Is that a risky thing to do? All one needs to do to see the effect of making such a bet is look at a mid cap index ETF ([IJH](#)) on [www.fundgrades.com](http://www.fundgrades.com) to expose the risk relative to total domestic equities as shown in *Exhibit 1*.

*Exhibit 1- Mid Cap ETF (IJH) grades relative to total domestic equities.*

### Fund Report Card

**IJH** ⓘ - iShares S&P Mid Cap 400 Index Fund

Selected: **Total Domestic Equity**

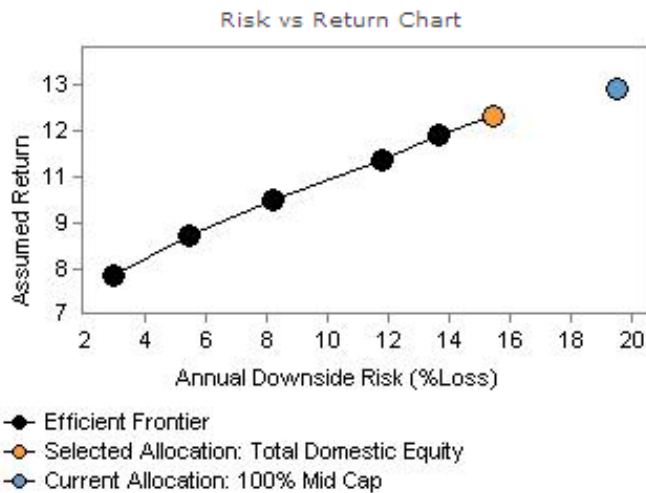
	Fund Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
Last 3 Years	C-	D+	A+	F	C+	C-
Prior 3 Years	B-	D+	A+	C	B	C+
Last 6 Years	C+	D+	A+	D+	B-	C

Here we see the impact of how investors (and many advisors) are fooled everyday by ignoring the diversification grade. **Three years ago**, your competitor would have seen an honor roll grade of B for return, with only market risk of C for the mid cap index fund relative to total domestic equities (see Prior 3 Years in *Exhibit 1*). If all I paid attention to were the risk and return stats (as many of those nasty emails and phone calls suggest we should do), it would be easy for someone to label this fund as "total market active winner" *if* we didn't pay attention to the name of the fund or its misbehavior evidenced in the diversification grade. Surely it would be a four or five star total domestic equity fund! Since the correlation is irrelevant (according to those that hate having their top fund picks exposed as having some price to what is

otherwise marketed as a free risk or return ride) a mid cap index fund would receive top scores relative to total domestic equity (just as total market index funds are four star funds relative to large cap blend today.) You are smarter than that though. You know that there is a big bet being made by putting 100% of your domestic equity allocation into a mid cap index fund. It is easy to see that merely by the name of the fund; we know it is 100% mid cap and not very diversified. But, what if the name of the fund and its holdings do not expose this? Would a D+ diversification grade for a fund regarding which we were ignorant about such details be otherwise ok? Does the mismatch and risk only apply to ETFs?

So, you proceed to design an allocation model that is more diversified. You equally weight growth and value to avoid style bets. You design an allocation that considers market cap. It falls on the efficient frontier and exposes the risk of a 100% mid cap allocation (see *Exhibit 2*).

*Exhibit 2 - Portfolio weighted 35% each to large value & growth and 15% each to small value & growth relative to 100% mid cap based on Finaceware Capital Market Assumptions.*



The 100% mid cap portfolio is clearly taking a lot more risk than a more diversified domestic equity portfolio.

Now it is time to pick investments for our "more diversified" and "less risky" allocation. We pick four funds, all currently rated "four stars" based on Morningstar's asset classification.

*Exhibit 3 - Inputting portfolio weights for my "more diversified" portfolio of four star funds based on Morningstar's asset class label:*

My 401(k)

Note: The following grades are based on the last three years of data

Total Value: \$100,000

Ticker	Description	Selected Asset Class	Amount	Delete?
<b>i</b> MALHX	<a href="#">BlackRock Large Cap Growth Inst</a>	Large Cap Growth	<input type="text" value="\$35,000"/>	<input type="checkbox"/>
<b>i</b> DFUVX	<a href="#">DFA U.S. Large Cap Value III</a>	Large Cap Value	<input type="text" value="\$35,000"/>	<input type="checkbox"/>
<b>i</b> FVFRX	<a href="#">Franklin Small Cap Value R</a>	Small Cap Value	<input type="text" value="\$15,000"/>	<input type="checkbox"/>
<b>i</b> NBMVX	<a href="#">Neuberger Berman SmallCap Gr Adv</a>	Small Cap Growth	<input type="text" value="\$15,000"/>	<input type="checkbox"/>

Add Ticker(s):

As we can see, we have equal weights of growth and value thus equaling a market style weighted blend so there is supposedly no style bet. Market cap (again, based on the label thus ignoring the fund's correlation relative to the asset class I'm using it for) is weighted 70% large versus 30% small so there is a bit of a small cap tilt, but not meaningful enough to move it off of the efficient frontier. So, how does this portfolio of four star winners grade relative to the asset allocation I was so focused on, and emphasized to the prospect of how they should diversify to lower their risk?

*Exhibit 4 - Portfolio grades relative to the portfolio asset allocation for the asset classes for which each fund is used.*

My 401(k) Report Card

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	Portfolio Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
Last 3 Years	C	C+	B-	F	C+	B-
Prior 3 Years	C	C	B-	C	C	C
Last 6 Years	C	C	B-	D+	C	C+

OUCH! I was supposed to be lowering the risk, but my portfolio grade for this blend of "four star winners" based on their labels and my designed allocation ended up with a standard deviation of more than 115% of the asset allocation I modeled (F grade for risk) with only a touch more return (C+) for the last three years. Isn't that what we saw on the risk versus return chart for a 100% mid cap stock portfolio...a lot more risk with only a little bit more return?

**In fact, if I graded the portfolio versus total domestic equities as we show in *Exhibit 5* (and shown in *Exhibit 1* for the mid cap ETF) I see this supposedly more diversified and less risky portfolio had the same or higher risk in all periods and a lower return grade in all periods, versus your competitor's 100% mid cap allocation relative to domestic equities!**

*Exhibit 5 - Portfolio grades based on the fund weightings relative to Total Domestic Equities*

### My 401(k) Report Card

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	Portfolio Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
Last 3 Years	C-	C	B-	F	C	C+
Prior 3 Years	C-	D	B-	D+	C	C+
Last 6 Years	C-	D+	B-	D-	C	C+

What this shows is that NEITHER the portfolio you created, nor the mid cap ETF are behaving like the more diversified domestic equity portfolio you modeled in your asset allocation. The superior return grades for the mid cap ETF (see *Exhibit 1*) ARE NOT representing that the mid cap ETF is a "better" alternative for a domestic equity portfolio, BECAUSE of the lack of diversification (D+ in all periods as shown in *Exhibit 1*). THEREFORE, THE REVERSE IS TRUE AS WELL. (Well, in reality it is true, but probably not if you are just acting as a salesperson coming up with misleading information to distribute the funds you are selling.) Just because a fund, or portfolio of funds has better risk and return grades DOES NOT mean that it is a good selection to fulfill the asset allocation you are modeling. It might be as bad as putting 100% in mid cap!

**What good is your allocation work if you show pie slices that give the appearance (labeling) of diversification but in reality what you are doing is the same as putting 100% in mid cap?**

You may wonder how this portfolio of funds, that by labeling standards has no mid cap stocks, ends up looking an awful lot like 100% mid cap stocks. Here again the diversification grade exposes this issue *which is why it is important and should not be ignored.*

NONE of these funds had a high correlation to their label as seen in *Exhibit 6* (and we also see the problem with peer rankings with the DFA fund getting four stars with only market level returns and a lot more risk.)

*Exhibit 6 - Individual fund grades relative to their "label"*

*Note: The following grades are based on the last three years of data*

				Fund Grades					
Ticker	Description	Asset Class	Overall	Divers.	Expense	Relative Risk	Return	UnderPer. Risk	
① MALHX	<a href="#">BlackRock Large Cap Growth Inst</a>	Large Cap Growth	D+	D	C+	F	C+	C+	
① DFUVX	<a href="#">DFA U.S Large Cap Value III</a>	Large Cap Value	C-	D	A+	F	C	C+	
① FVFRX	<a href="#">Franklin Small Cap Value B</a>	Small Cap Value	C	C-	C-	B-	C	C	
① NBMVX	<a href="#">Neuberger Berman SmallCap Gr A...</a>	Small Cap Growth	C	D+	C	C	B-	B	

We see that the *diversification grade* for three out of four of these funds relative to their "labeled" asset class are the same or worse than the diversification grade for a mid cap stock ETF relative to total domestic equities (D+ which is also an obviously bad fit). THIS EXPOSES they are not behaving like their label. In fact, most of them behave more like their mid cap style counterparts as shown in *Exhibit 7*.

*Exhibit 7 - Individual fund grades relative to their best fit diversification (correlation coefficient) grade:*

*Note: The following grades are based on the last three years of data*

				Fund Grades					
Ticker	Description	Asset Class	Overall	Divers.	Expense	Relative Risk	Return	UnderPer. Risk	
① MALHX	<a href="#">BlackRock Large Cap Growth Inst</a>	Mid Cap Growth	D+	C-	B-	D+	D+	D+	
① DFUVX	<a href="#">DFA U.S Large Cap Value III</a>	Mid Cap Value	C+	D+	A+	B	C	C-	
① FVFRX	<a href="#">Franklin Small Cap Value B</a>	Mid Cap Value	D	C-	C-	D-	C-	D+	
① NBMVX	<a href="#">Neuberger Berman SmallCap Gr A...</a>	Mid Cap Growth	D+	C-	C-	F	C+	C+	

The diversification grade exposes that three out of four of these funds behaved more like their mid cap style counterparts than their asset class label. Blending them together and grading them versus the blend of their mid cap style counterparts shows how much this portfolio of supposedly only small and large cap funds behaves like mid cap stocks (*Exhibit 8*).

*Exhibit 8 - Portfolio grades for our portfolio of large & small cap funds relative to their best fitting mid cap counterparts.*

## My 401(k) Report Card

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	Portfolio Grades					
	Overall	Diversification	Expense	Relative Risk	Return	Risk of Material Underperformance
Last 3 Years	C	B	B-	C-	C	D+
Prior 3 Years	C-	B-	B-	C-	D+	D+
Last 6 Years	C-	B-	B-	C-	D+	D+

If my allocation is modeled around having a diversified domestic equity portfolio, but the funds combine into behavior that is more similar to 100% mid cap portfolio, how would I know this without looking at the correlation? The labels certainly do not expose this! NONE of them are mid cap!

Should I just feel ok about it because the labels say otherwise and **a chunk of their actual holdings are not mid cap, but a significant piece of the portfolio really is in mid cap?** Should I mislead my client and tell them they are diversified by style and market cap because of labels when the portfolio selections I use to implement that allocation basically have the portfolio's *nature* behaving like 100% mid cap?

I understand how fund sellers do not like having their sales pitch disrupted by exposing the price of the choices that are being made. But we are an advisor, not a seller. As we quoted Milton Friedman in our last email, "there are no free lunches." **We** don't wish to hide uncertainties and instead prefer to expose and disclose them.

It is of course easier *to sell* a fund, or portfolio of funds, if we ignore the risks and uncertainties we are introducing. Is doing so the foundation upon you wish to build your business? If so, ignore your portfolio grades, pretend the label matters more and sell clients on being diversified even when they are not. Or stick your head in the sand and don't even bother to look.

Alternatively, one could expose there are no free lunches, pay attention to the real (as opposed to labeled) asset allocation behavior and how it affects the investor's goals. Some might consider such objectivity the future of financial advising.

## WEALTHCARE RESOURCES

### [Advisor Call](#)

Join us April 22, at 4:15pm ET, for an Advisor Call with Financeware CEO Dave Loeper. The Topic: "Measuring Temperature With a Ruler - Is Your Wealth Manager a Return Manager in Disguise?" To participate, please send an email to [support@financeware.com](mailto:support@financeware.com).

### [Featured Whitepaper](#)

One of our most popular educational email series has been combined into one complete whitepaper that exposes all of the reasons why wealth management is far different and more valuable than traditional return and risk management. Click now to read [Measuring Temperature With A Ruler](#).

### [Notice](#)

The federal and state income tax brackets, rates and deductions have been updated to reflect changes for 2008.