

Asset Allocation Research

“Time ... is on My Side”¹: Taking Full Advantage of the Institutional Investment Horizon

Research Note

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ASSET ALLOCATION RESEARCH

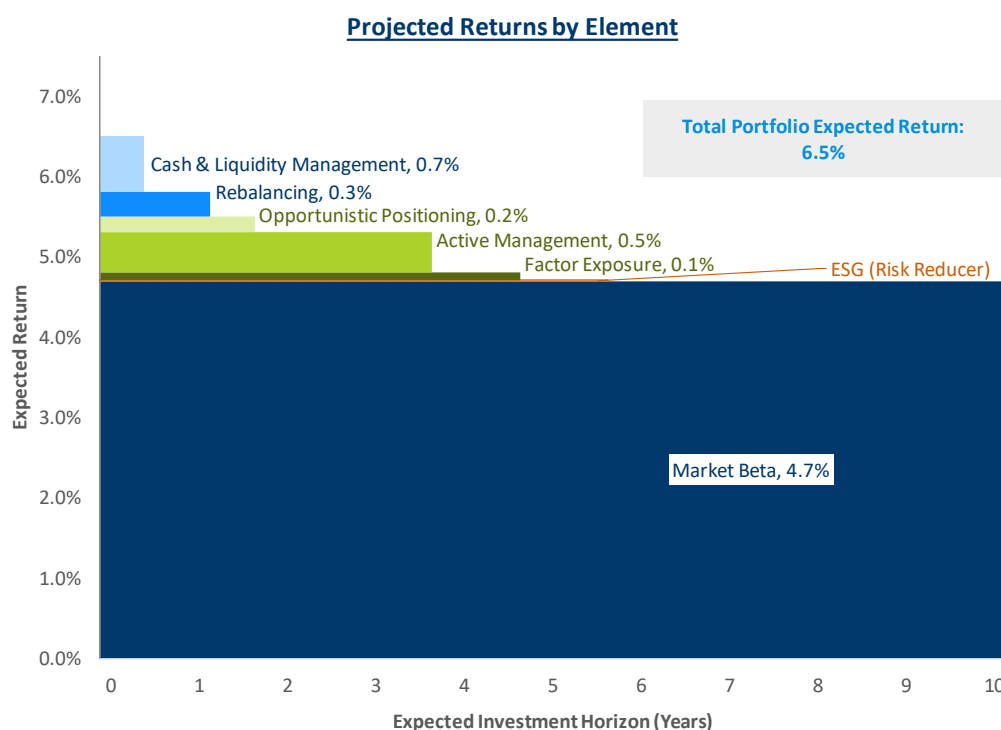
“Time Is on My Side”¹

Institutional investors have a significant advantage over most capital market participants: their long-term investment horizon. Many institutions, however, fail to fully capitalize on this advantage. In this research note, Wilshire introduces a new portfolio framework that facilitates the organization of the essential elements of portfolio construction according to an appropriate time horizon for each element. This framework allows institutional investors to fully realize the value of their advantage and improve on-going decision making processes.

Wilshire has been writing about the individual elements of portfolio construction for years – these concepts are not new, as noted by the references to select publications below. The value of this framework lies in the comprehensive way these elements come together to illustrate how each component contributes to the total portfolio expected return. The unique investment horizon for each element also helps to identify an appropriate schedule for framing and revisiting key portfolio decisions. This framework serves as an effective tool for both organizing and implementing a comprehensive portfolio management strategy.

Seven Essential Elements of Portfolio Construction

The long-term success of any portfolio strategy ultimately reflects how effectively the investor uses each of the seven elements of portfolio construction: Cash, Market Beta, Rebalancing, Factor Exposure, ESG, Opportunistic Positioning and Active Management. Each element contributes to the total portfolio’s expected risk and return profile, and each has a different implied investment horizon. Together, the elements provide a new perspective on how an institution seeks to achieve its target return.



Sample portfolio shown for illustrative purposes only.

¹ The Rolling Stones, “Time Is on My Side,” 12 x 5, 1964

Asset Allocation Elements: Cash + Market Beta + Rebalancing

Institutional investors have long recognized that selecting an appropriate asset allocation is the most important decision they make in portfolio management. An effective asset allocation strategy fulfills various objectives including protecting liquidity needs and maximizing the expected return at an appropriate risk level. The asset allocation decision is based on modeling that combines three elements of portfolio construction: Cash, Market Beta and Rebalancing.

Cash and Liquidity Management

Cash has the shortest investment horizon, as investors expect a consistent daily return on all assets held in money market funds or cash sweep vehicles. Investors have no control over the cash return, as it represents the risk-free rate of return and is based closely on short-term interest rates set by the Federal Reserve. As a result, investors should focus more on the utility of cash than the return. Every institutional portfolio has cash obligations, including periodic distributions, fees and expenses, and the cash strategy should protect the portfolio's ability to meet those obligations.

Wilshire Publication: [Liquidity Management: Bridge Over Troubled Water \(2017\)](#)

Market Beta Exposure

Market beta exposure occupies the opposite end, relative to cash, of the time horizon spectrum, as investors need to approach beta decisions from a long-term perspective. The short-term volatility of many market segments makes it ineffective to evaluate target exposures over a short-term horizon. Expected asset class returns are long-term in nature and include two components: the risk-free rate (cash, see above) and the compensation for taking the risk associated with each asset class or strategy. Separating those two components, as shown in the framework above, highlights the compensation investors expect for taking different market risks.

Wilshire Publications: [2020 Asset Allocation: Return and Risk Assumptions](#) (Annual Review, most recently published 1/28/2020)

[Returns as Far as the Eye Can See: Ultra-Long-Term Asset Class Assumptions](#) (2017)

[A Call for Patience: Keep Your Eye on the Horizon](#) (2015)

Rebalancing

The final component of the asset allocation decision is often overlooked in this context. Investors evaluate the diversification characteristics of different asset classes as they seek to optimize their portfolio's expected risk and return. While diversification has the biggest impact on the risk side of the ledger, it also affects expected returns. Asset allocation modeling incorporates the value of investing in diverse asset classes, as total portfolio expected returns are greater than the proportionate sum of the parts. It is up to the investor, through a disciplined rebalancing process, to capture the full return reflected in their asset allocation projections. While this sounds simple, it can be challenging – especially in volatile markets, when rebalancing requires buying into market segments that have recently experienced the largest losses. Rebalancing should be guided by a long-term policy but implemented in a short-term manner (hence its place beside cash in our framework).

Wilshire Publications: [Managing Through Market Drawdowns: In Case of Drawdown, Break Glass](#) (2020)

[A Rebalancing Act: Considerations for Implementing a Rebalancing Policy](#) (2012)

Together, the three elements that are reflected in asset allocation decisions account for nearly 90% of the total portfolio expected return in our sample portfolio ... a contribution percentage that, while not based on contribution to risk, should be quite familiar to any institutional investor.

Portfolio Management Elements: Opportunistic Positioning, Active Management, Factor Exposure

Investors that attempt to outperform a market-based benchmark turn to three elements that drive the majority of excess returns: opportunistic positioning, active management and factor exposure. Very simply, a portfolio must somehow differ from the market to generate returns that are better than the market. In seeking excess returns, however, investors must also be conscious of the excess risk they are introducing into their portfolio. The most effective applications of the portfolio management elements will be well defined (clearly identifying the likely source of positive excess returns), diversified (managing excess risk) and nimble (reflecting the time horizon of each element).

Opportunistic Positioning

Opportunistic investments have two key characteristics: they are infrequent, and the expected return is such that it warrants a temporary disruption in the portfolio's long-term strategy. As a result, opportunistic positioning requires an intermediate (but flexible) investment horizon. Capturing the value of an opportunistic investment typically requires adjusting portfolio exposures to exploit a perceived market dislocation. Position sizing is critical, as is the ability to evaluate the risk that will be introduced by deviating from the portfolio's long-term strategy. Opportunities will not always present themselves, so this element should be considered as an episodic contributor to portfolio returns.

Wilshire Publications: [Opportunistic Investing: "Carpe diem, quam minimum credula postero"](#) (2010)

Active Management

Active management is typically the largest contributor to expected returns among the Portfolio Management Elements, and it occupies the dead center of the portfolio construction framework. Active management is where institutional investors spend most of their time, and (possibly as a result) the area where they make the most mistakes. The process for selecting and monitoring active managers is a lengthy topic unto itself (as the publication list below shows), but three key questions can help investors avoid common mistakes when making decisions about the active managers in their portfolio:

- Understand strategy characteristics – when should the manager outperform, and when will it likely lag the benchmark?
- Set realistic expectations – how much value can the manager add, and how much active risk will it take to do so?
- Resist the urge to react to every disappointing quarter – what is an appropriate timeframe for evaluating the manager (hint: it is different from one strategy to the next)?

Wilshire Publications: [The Heightened Importance of Manager Research in These Volatile Times](#) (2020)
[2019 Active Management Review](#) (Annual Review, most recently published 4/1/2020)
[Manager Research Scoring Model Enhancements: A Dynamic Weighting Approach & More](#) (2014)
[Alternative Mutual Fund Strategies: Liquid Opportunities for Institutional Investors](#) (2013)
[Short-Extension Strategies: To 130/30 and Beyond!](#) (2007)
[Incorporating Active Management... Over Active Imagination](#) (2006)
[Institutional Use of Hedge Funds: Penetrating the Darkness on the Hedge of Town](#) (2005)
[Alpha: A Right or a Privilege? An Examination of the Challenges and Risks of Hedge Fund Investing](#) (2004)

Factor Exposure

Academic research has identified and reaffirmed the presence of long-term inefficiencies and/or risk premiums embedded in capital markets (particularly equities). Specific factors, when followed over a multi-year horizon, might offer a more efficient

combination of risk and return than the market as a whole. The most familiar of these factors are the small cap and value effects, but investors can also benefit from allocating to high quality, volatility and momentum factors. These factor trends serve as possible long-term tailwinds for investors, each potentially contributing unique characteristics to subtly improve the portfolio's risk/return profile. Factor based strategies are relatively transparent and inexpensive to implement, making this element an extremely cost-effective enhancement to most portfolios.

Wilshire Publication: [Smart Beta: The Space between Alpha and Beta](#) (2016)

Sustainability and Nontraditional Risk Reduction: ESG

The final element of portfolio construction has a greater direct impact on managing portfolio risks than in necessarily targeting increased returns. Environmental, Social, and Governance (ESG) considerations are focused on longer-term market trends, and as a result they require a longer investment horizon for considering and measuring their impact on the portfolio. ESG is a diverse category, and some of the associated risks are likely to have a shorter time horizon than others. The impact of an ethics violation or fraud, for example, would fall under governance and might have a more immediate impact than a company's carbon footprint (under environmental). As a result, the framework accommodates a longer term outlook to cover all aspects of ESG.

ESG

Environmental, Social and Governance (ESG) considerations remain underutilized in most institutional portfolios. While ESG has traditionally been the domain of mission-based investors, there is value to building these considerations into any portfolio. The objective of adding ESG to the portfolio management process can either be outcome oriented, for investors seeking to promote (or avoid) investment in specific companies or industries, or integrated, for investors seeking a unique and complementary perspective for evaluating individual investments or managers. In either context, applying ESG considerations as another element in portfolio construction can help identify and limit the portfolio's exposure to long-term risk factors.

Wilshire Publications: [ClimateLens Update: How to Prepare Portfolios for Climate Change](#) (2019)
[Asset Management Diversity in Action](#) (2019)
[Where's the "F" in ESG?](#) (2018)
[Wilshire ESG Client Survey](#) (2018)
[Climate Change: Evolving Risks and Opportunities for Asset Owners](#) (2016)
[ESG Investing Update](#) (May 2013)

Implementation

Each element in the portfolio framework makes a differentiated and complementary contribution to the overall risk and return profile of an institutional portfolio. Recognizing and distinguishing between these individual contributions can significantly improve the process for making investment decisions. The investment horizon of each element suggests a timeline for systematically reviewing portfolio strategy, while still offering the flexibility to revisit any individual element when necessary. The adoption of a portfolio management schedule balances the need to ensure every element receives appropriate attention with the patience required to allow each element to fulfill its role in the overall strategy.

PORTFOLIO MANAGEMENT SCHEDULE

Element	Investment Horizon	Formal Review
Cash	0-1 Months	Monthly

Rebalancing	1-3 Months	Monthly
Opportunistic Positioning	6-18 Months	Monthly (when applicable)
Active Management	2-4 Years	Every 2 Years
Factor Exposure	3-6 Years	Every 2 Years
ESG	5-8 Years	Every 3 Years
Market Beta	7-10 Years	Every 3 Years

Conclusion

The portfolio framework provides a new way of looking at portfolio strategy and understanding how different elements combine to shape the portfolio's risk and return profile. In this context, the framework can help institutions set their course and improve their decision-making process in pursuit of long-term objectives. Institutions that apply this framework to systematically develop and implement an appropriate portfolio strategy can greatly improve their chance of taking full advantage of their most valuable asset – their long-term investment horizon – and can ensure that time is indeed on their side.

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