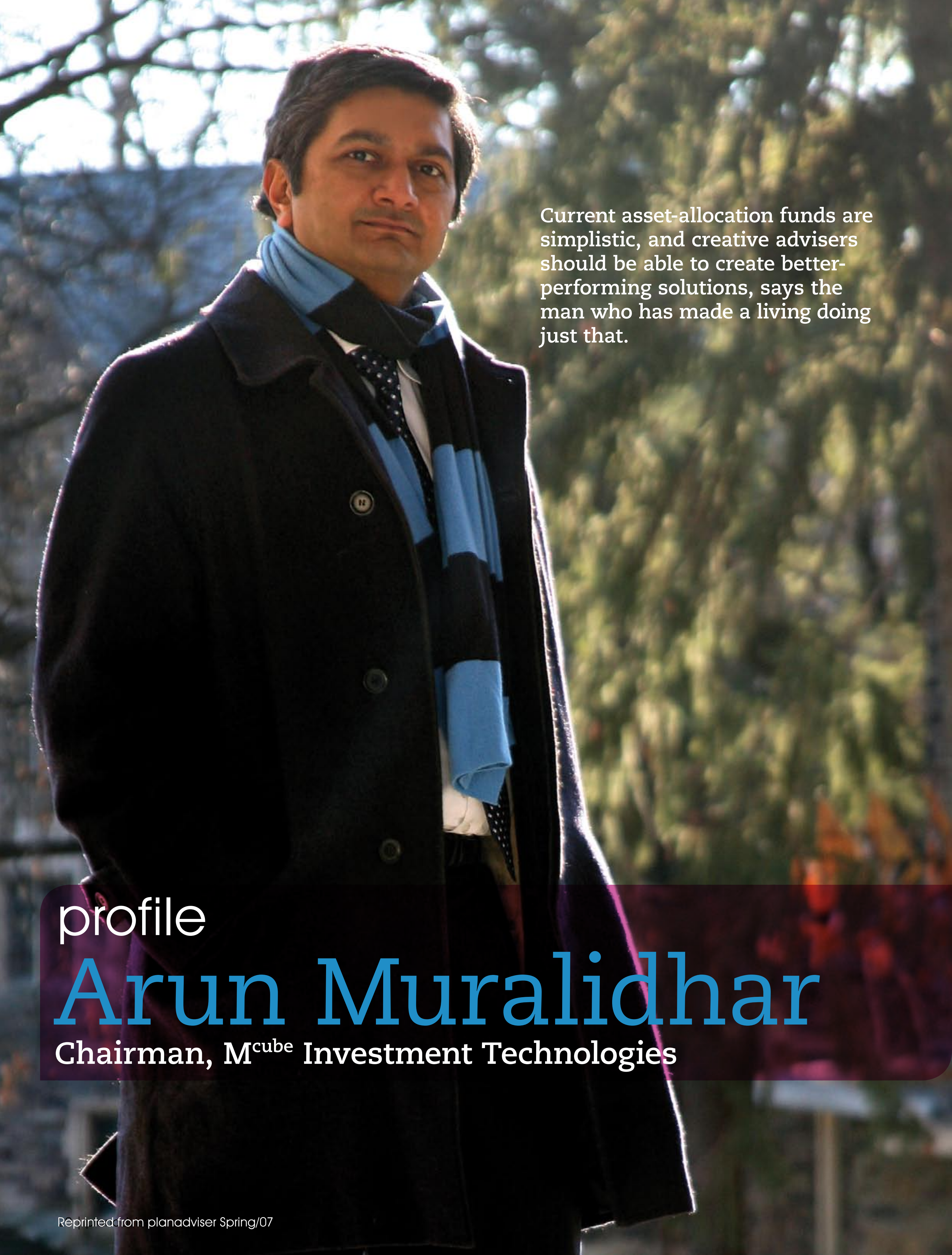

Current asset-allocation funds are simplistic, and creative advisers should be able to create better-performing solutions, says the man who has made a living doing just that.

profile

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Retirement advisers add value to their institutional clients in myriad ways but, historically, one of the principal ways they have added value is fund selection. However, in the defined contribution world, the locomotive bearing down on advisers is asset-allocated funds; by some estimates, more than 75% of all assets in defined contribution plans will be allocated to these lifecycle funds within the next three years. What's an adviser to do? *PLANADVISER* posed that question to Arun Muralidhar, an academic and entrepreneur who has made a career in asset allocation—including a stint as head of research at World Bank's pension fund. He now is Chairman of M[cube] Investment Technologies, a Plano, Texas-headquartered asset management group and technology solution provider. He talked to *PLANADVISER* about the present crop of asset-allocated solutions in the market, and their shortcomings.

Your clients at M[cube] are some of the most sophisticated defined benefit plans in the country. When you compare their asset-allocation strategies with the solutions you see emerging in the defined contribution world, what is the difference?

The principal difference as I see it is not in the actual asset allocation itself, although defined benefit funds do have access to more asset classes. The real difference is apparent when it comes to rebalancing. Somehow, these target-date funds in 401(k) lineups have given investors the impression that they are not market-timing but, of course, they are. They are market-timing every time they rebalance and, worse still, they are rebalancing in an absolutely unintelligent and naïve way, based on either some date that is dictated by the age of the participant or the changing value of stocks versus bonds, without regard to whether the market is conducive to such a transaction, thereby potentially affecting returns. Increasingly, defined benefit funds are realizing that every investment decision they make with regard to rebalancing their assets can affect future performance and risks and, hence, are moving to a paradigm of intelligent rebalancing. The same concepts and practices can be applied to defined contribution funds.

So, how does an adviser add value when it comes to selecting or even creating asset-allocated solutions?

You hear a lot about how these lifecycle and target-date funds are so much better than the alternative, which is leaving participants scrambling about making their own suboptimal choices among mutual funds, and, of course, that's true; but why should that stop an adviser or a plan sponsor from looking around for the very best asset-allocated funds that can be created?

The first generation of solutions that I have seen in the mutual fund arena are naïve and simplistic, from start to finish—and nothing is more naïve than this assumption that they reallocate based on the calendar or some range around a target, as opposed to using market intelligence to make these decisions. So, the first place an adviser can add value is to understand what goes into these various asset-allocated funds, and pick from the very best of them, rather than go with the most convenient. The second thing they can do is create their own processes for making such intelligent rebalancing decisions that can allow them to create customized solutions for clients.

So, they should be recommending a managed account solution that allows them to create individual portfolios for participants?

Even the managed account solutions I have looked at seem to reallocate unintelligently—that is, they move from stocks into bonds or vice versa based on some predetermined calendar event. The opportunity for the best advisers to add value is by using intelligence when it comes to timing—even delaying a month when all the market information you have says that, say, bonds are overpriced vis-à-vis equities can make a huge difference to the outcome of a particular portfolio. Interestingly, in the work we have done with defined benefit plans, almost all of the ideas that go into developing market intelligence regarding factors affecting the performance of various asset classes are in the public domain and available on the Internet. For example, it is not that difficult to look at the yields between stocks and bonds at a specific point in time and factor that intelligence into an allocation decision as to whether to sell stocks and buy bonds. In addition, creative advisers will be able to take a range of rules and combine them into a diversified strategy so as to minimize risks. We have done numerous case studies to show that such an approach consistently and handily can outperform the naïve rebalancing along many risk dimensions. Moreover, advances in technology can allow advisers to create such customized, intelligent rebalancing schemes easily.

What you're saying then is that there is a role for tactical asset allocation, and that is a role that the adviser can play?

All asset-allocation solutions, whether labeled as target-date funds or asset-allocated funds, are tactical. Even doing nothing and letting the portfolio drift is tactical as it implies a view on the market. The key is whether the tactical decisions are made using factors that one can explain with robust economic logic or whether they are arbitrary, based on the age of the participant. What we are looking at now is only the first iteration of asset-allocated funds. As time passes, these funds will be designed better and customized more easily, and advisers clearly can play a role in that. Naïve rebalancing is very, very risky—and isn't that exactly what these solutions are looking to avoid?

Photography by Joshua Lutz