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BOOK REVIEW

Mark Kritzman, Senior Editor

A PRACTITIONER'S GUIDE TO ASSET ALLOCATION

William Kinlaw, Mark P. Kritzman and David Turkington (*Reviewed by Sharon Hill*)

The Global Financial Crisis left an indelible mark on investors. In some cases, valuable lessons were learned, such as the prudent limits to leverage and counterparty risk. In other cases, the take-away was counterproductive, with some financial advisors and individual investors questioning the fundamental principles of asset allocation. After ten years, it is time for market participants to revisit the principles and redefine the best practices of asset allocation. A recommended first step would be to read "A Practitioner's Guide to Asset Allocation" by Kinlaw, Kritzman, and Turkington.

In Chapter 1, the authors address one of the difficulties inherent in asset allocation, namely defining what an asset class is and how granular that definition should be. Granularity of underlying asset classes is intensely subjective. One investor's atom is another's quark. However, settling upon the spanning set is a prerequisite for a productive discussion on asset allocation and the authors do just that.

The next few chapters take on common misperceptions in asset allocation, offering clear examples to dispel commonly-heard false catchphrases. For example, the authors defend the practice of optimizing and discuss its superiority above equal weighting. Less convincingly, the authors challenge the Brinson, Hood, and Beebower (BHB) observation that asset allocation explains over 90% of risk. While their argument is straightforward, one should not ignore that security selection can only go so far in changing the risk characteristics of an aggregate portfolio. SImilarly, tactical allocation within tight bands will also not cause a portfolio to stray too far from the implied risk derived from its stock/bond mix. Once a traditional asset mix is decided, regardless of the underlying securities used to express that mix, within reason of course, the portfolio risk level is a foregone conclusion.

The chapter on factor investing shows that "any portfolio built from factors can also be built from asset classes," which is a much needed reminder. Factor investing has been compellingly packaged, and even more compellingly marketed, but the authors' work suggests that the true benefits to investors versus "traditional" asset allocation are unclear.

They concede that factor investing could be advantageous for an investor who has factor rotation skill, and that some factors offer risk premia, but are careful to point out that this activity is generally accompanied by noise and transaction costs.

Following the chapters on myth dispelling, the book presents a variety of important asset allocation concepts, such as rebalance frequency, currency hedging, and financial turbulence.

The section on rebalance frequency offers a process for testing various rebalance schemes. It is replete with equations and a discussion of how the methodology can be used as a simpler alternative to the more robust, computationally intensive, dynamic programming method.

The chapter on currency hedging may also serve as a myth dispeller in that none of the modal behaviors of 0%, 50%, and 100% are optimal. The discussion provides economic and empirical rationale for distinguishing among currencies for hedging purposes.

The text contains a succinct description of "financial turbulence", which Kritzman and co-authors introduced in 1999. This statistical measure, based on Mahalanobis distance, characterizes the degree of unusualness in historical multivariate return distributions, going beyond the metrics which typically measure volatility by capturing interactions among markets. Be sure to experiment with the calculations presented here. Not only can you use this as a regime indicator, but you can also adopt these metrics for a variety of applications. After all, one of the main motivations for reading literature in this genre is idea generation.

This book also contains a well-written addendum on statistical concepts. There is a clear elucidation of the meaning of higher moments and a reminder of the importance of the invertibility of the covariance matrix. This section brings to mind a memorable experience from quite a few years ago. A strategist at a financial advisory firm gave me a set of mean returns and a covariance matrix, and asked me to calculate the optimal portfolio. I did what any reasonable quant would do: I ran a mean-variance optimization with the returns/covariance matrix provided. To my surprise, I discovered that the covariance matrix was not positive-definite. Of course, I asked the advisor where the matrix originated. And, as you would guess, this matrix was the result of a subjective assessment. Had this advisor read Kinlaw *et al.*, he would not have attempted to present such a matrix for analysis. Amusingly, the authors liken subjectively constructing a covariance matrix to playing Sodoku.

In short, not only can this book serve as a valuable resource for the practitioner questioning his assumptions and methodology, it also offers a strong introduction to applied asset allocation, questions common wisdom, and provides a handy addendum and glossary for quick reference. Whether you are ready to learn the principles of asset allocation or revisit those principles, pick up this book and enjoy.