
PRACTITIONER'S DIGEST

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THE IMPACT OF COSTS ON RECENT TARGET DATE FUND PERFORMANCE

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In 2016, investment into Target Date Funds (TDFs) passed the \$800 billion mark due to additional investments and positive investment returns. Estimated net cash flows into TDFs during the 2015–2016 period alone were approximately \$118 billion. The level of investment returns on TDFs offered by firms vary significantly. The various funds differ in a number of ways including the individual assets invested in the funds, management policy (active vs. passive), load policy, glide path (the move to more conservative assets over time), and expenses. This research focuses on the question of whether returns generated by the various funds with higher loads and expenses are sufficient to offset the greater investment performance burden of those costs.

To answer our question we look at the expenses, loads, and investment performance of 2,248 TDFs. We find front-end loads running as high as 5.75 percent and deferred loads as high as 5.00 percent. We also find expense ratios ranging from 0.10 percent to 2.10 percent. While looking for patterns, we find that the length of the period to retirement has only a small impact on the size of expense ratios and has no impact on the size of load fees. In terms of investment performance, the size of loads and expense ratios are found to have a statistically significant impact on the return that investors received. TDFs with the lowest expense ratios provide higher returns and risk-adjusted returns to investors. All results consistently point to the desirability of avoiding investor charges. Whether considering total risk or only downside risk with the Sharpe and Sortino ratios, respectively, the difference in investment performance of TDFs with higher and lower loads and expenses is significant at the 0.01 level. Similar results were obtained using Morningstar rankings and systematic risk measures to examine TDF performance. Although it should be pointed out that TDFs underperform the stock market due to the inclusion of

debt, the difference in market-excess, risk-adjusted performance between the highest quartile and lowest quartile of TDFs, on the basis of expense ratios, was 1.45 percent per year.

INVESTMENT HORIZON RISK AND VOLATILITY METRICS

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Robert Korkie

Conventional but old wisdom says that stock returns are less risky over longer investment horizons; however, some recent research contrarily finds that stocks are more risky over longer horizons when viewed from an investor's perspective. The cause is imprecise conditional expected returns and their uncertain future path that is surely descriptive of financial markets. The issue is an important one for asset allocation, liability directed investment, portfolio rebalancing, hedging, and glide paths, for example.

This paper concludes that the use of better diagnostics results in the conclusion that, in short to long investment horizons, stocks are less volatile than in an annual horizon but are of equal or greater volatility in very long horizons.

In comparisons with 1-year risk, we conclude that, from an investor's perspective, stocks are less risky at short to long horizons but more risky at very long horizons. This conclusion may affect a portfolio manager's policy asset allocations, including hedges, or the allocation reaction to anticipated future regime shifts that are dependent upon the optimization horizon. The "Brinson effect" is horizon dependent and describes managers who have a medium to long run return horizon but are sensitive to short horizon risks; this optimization is available in some asset allocation software.¹ Portfolio rebalancing policy, including frequency and allocations, may be revised to reflect the different horizon risk behavior. Finally, allocations along a glide path may change to reflect the horizon risk behavior because it affects the confidence intervals around terminal value.

A PORTFOLIO STRATEGY WITH HEDGE FUNDS AND LIQUID ALTERNATIVES

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E. William Stone and Paul J. White

Asset allocation between liquid alternatives in mutual fund or ETF format and hedge funds in limited partnership format is an ongoing field of development. Any portfolio strategy that incorporates these types of investments should address the issue of possible overlap of risks since the economics for investments differ so much. Most investors would not want to pay for risks more cheaply accessed in liquid form versus its non-liquid counterpart. We offer a portfolio construction methodology that seeks to address these concerns in a broader context with traditional investments of stocks and bonds. The technique would be of interest to any investor combining traditional investments, liquid alternatives, and hedge funds. The technique incorporates straightforward geometric considerations and has the advantage of being independent of returns distributions assumptions, which can be especially hard to identify with any alternative investment. The application could apply to larger or smaller portfolios.

¹See for example www.ALMOptimizer.com

**HOW TO CALIBRATE THE RISK OF BUYOUT INVESTMENTS?
THROUGH BUYOUT-BACKED INITIAL PUBLIC OFFERINGS****PAGE 51***Jean-François L'Her, Ram Karthik and Stéphanie Desrosiers*

Despite the economic importance of buyout funds and the abundant empirical literature, there is still a huge debate on their risk-adjusted performance. Three main methods using unlisted private equity data have been used to assess the exposures of buyout funds to risk factors. All three try to address the stale pricing issue inherent in the appraisal-based valuation process (i.e. partial adjustment of the reported net asset value to market prices). There is a significant lack of convergence in the results, notably on the exposures to four main risk factors: market, size, value and liquidity.

Only two methods, to our knowledge, use publicly traded information to avoid the pitfalls related to smoothed appraisal-based returns. The first one uses market prices on publicly traded funds of funds holding unlisted private equity funds and listed private equity funds; the second one uses the public market returns of buyout-backed initial public offerings (BO-backed IPOs) as a proxy for buyout funds' appraisal-based returns. The latter is the focus of this paper. These last two methods tend to produce convergent results.

Because BO-backed IPOs provide an economically significant route to exit, and their leverage and fund ownership are still significant three years after the IPO, they represent unique public candidates to directly assess the risks of buyout investments, and to circumvent the stale pricing issue inherent in appraisal-based returns. Our sample covers the 1980 to 2013 period, and comprises 1,063 BO-backed IPOs. Our risk factor analysis shows that the market betas are close to 1.2, and the loadings on size, value and liquidity are significantly positive. Further, the loadings on the Fama and French profitability and investment are both significantly negative. These results can guide the calibration of the expected return and risk of buyout investments in strategic asset allocation: beyond exposure to Large Cap Equities, approximately 40% of the risk and return of BO-backed IPOs is explained by additional exposure to the market, and exposures to risk factors.