Top Down Asset Allocation:
The La Jolla Economics Approach

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All investors face capital-market risk. Managing that risk, evaluating opportunities in the context of your goals, and accessing specific investments efficiently requires broad, objective, close-to-the-capital-markets thinking. An asset-allocation framework does not need to be a black box that processes a large number of statistical variables and spits out an investment plan. It should be a logical framework that lays out the choices for investors. Stocks or bonds? Domestic or international? Large or small? Index or active? Traditional or non-traditional? Committing to a single strategy may only guarantee you mediocrity in the long run. Don't limit your options. You can do better.

The La Jolla Economics Asset Allocation Process

Fiscal and monetary policy produce shifts in the economy's aggregate demand and supply. Depending on the nature of the shocks, as the economy returns to a new equilibrium, a new and temporary economic environment will be created. To the trained eye, inflation rates and GDP growth rates change in *predictable* patterns, and so do asset returns. The latter gives rise to the cyclical asset allocation (CAA) strategies described in *Cocktail Economics* and *Understanding Asset Allocation.*

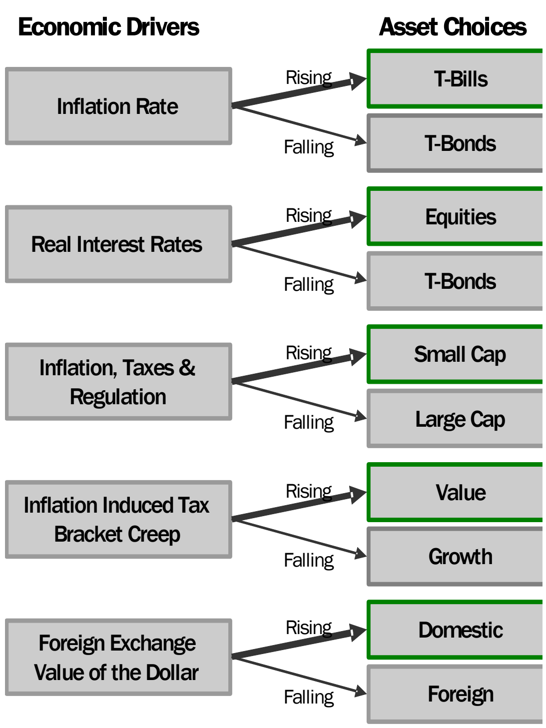
The CAA strategy is based on the assumption that politicians and policymakers have particular views of the world, and they will adopt policy measures that are consistent with these views. This is important, for it is the continuity of these responses that give rise to predictable cycles or deviations from long-term trends. Once these new (and historically true) trends are identified, it is a matter of *tilting* portfolios to take advantage of the patterns of returns anticipated by the likely policy responses.

Identifying the Economic Environment

Correctly identifying the economic environment is the first step in deriving economic-based CAA strategies. Through a formal modeling of historical relationships, a more rigorous approach can be developed. Historical relationships, combined with information contained in the futures markets, can provide the signals necessary to develop a forward-looking view of world markets that correctly anticipates the turning points in various return cycles. Forecasts by economists and investment advisors regarding the future path of the inflation rate and the economy can easily be translated into forward-looking *strategic* asset-allocation recommendations. A top-down global view that focuses on government policy changes and geopolitical events is also useful in identifying and anticipating some of the secular and cyclical changes in relative performance, both domestically and across countries. See the figure to the left, which depicts the formal decision rules that guide the CAA process.

Armed with the information presented in the figure and an economic forecast, decision rules can be developed for determining how and when to choose a style (i.e., value versus growth), location (domestic versus international), and size (large versus small cap) allocation of an investment, and whether to do so in a passive or active mode. We call this process the value-timing approach to asset allocation.

The LJE Value Timing Approach



Investments are made to meet the goals and lifestyle needs of the investor and not necessarily to beat industry benchmarks. But making an allocation decision between equities and bonds or large- and small-cap stocks requires not just a return-assumption, but also a conviction in the *likelihood* of success. That's why the asset-allocation process needs to be *probability* based. First, the probabilities of asset-class returns need to be formulated. Next, these probabilities need to be applied to an investor's long-term goals, producing a recommended asset allocation.

Finally, this allocation needs to be run through a quantitative framework that overweights the opportunistic sectors and underweights the overvalued ones. Let's consider an investor who has no strong feelings about any one asset class. A 50% probability suggests an equal chance any one asset class will outperform the other, and the investor should buy and maintain a default allocation. Now, if one is 100% certain that large-caps are going to outperform small-caps, the size allocation should be 100% to large-caps and zero to small-caps, conveying certainty in conviction. A 50% allocation conveys an absence of conviction. The deviations from a basic allocation should be in direct proportion to how much the probabilities deviate from the 50% mark. This is exactly how one deviates from a long-run SAA to tilt the portfolio to take advantage of a changing economic environment.

The cyclical approach differentiates itself in additional important ways. The probabilities for cyclical allocation are derived from, and are related to, the overall economic environment and the outlook of the investor. If probabilities and/or allocations do not match an investor's outlook, either the allocations or the outlook must change in order to align the two, and more than likely the allocations will be changed to fit the outlook. This is an important characteristic of the CAA strategy. It says that cyclical allocations are intuitive and that investors can see the adjustments that need to be made to their portfolios. There is no need for investors to rely on black-box results before making their allocation decisions. Nor is there a need for investors to have knowledge of advanced statistics and matrix algebra.

The CAA approach minimizes the possibility of unintended bets in the asset-allocation process. While it does not guard against undesirable outcomes, it protects investors from being wrong *because of* unintended outcomes. While all investors prefer not to be wrong, most would rather be wrong because they made the wrong choice and not because they were blindsided by an unintended bet. As with a traditional strategic asset allocation, the CAA approach is flexible and robust enough to accommodate differences in risk tolerances, investment objectives, and other investor constraints. But it's also flexible enough and robust enough to merge with, enhance, or outright revolutionize traditional approaches to asset allocation.

The Versatility of the Framework

The asset-allocation model can be changed to find opportunities, such as incorporating investment decisions that do not correlate with traditional capital-market indices yet *do* have value. In addition, it addresses the use of active versus passive vehicles. Indexing alone will produce inferior results, compared to a strategy that focuses on taking advantage of the relative performance of different asset classes during *cycles*. This is not a traditional tactical allocation, but an intermediate step between tactical and strategic allocation. Call it cyclical asset allocation.

Such a strategy emphasizes different asset classes, as well as active-versus-passive management, as cycles dictate. When markets do not provide selection opportunities for securities, the index fund is a cost-efficient tool to access broad market moves. But market efficiency has cycles too. Correspondingly, reallocating index funds is another source of value that can be added through the asset-allocation process.

There is a time for everything. There is a time for active management and a time for passive management; a time for value stocks and a time for growth stocks; a time for large-caps and a time for small-caps.

On a risk-adjusted basis over the long-term, no single asset-allocation strategy should dominate another. Sometimes an active approach works, other times passive is the way to go. Sometimes it is large-caps, other times small shine. As cycles persist there will be times when each of the strategies will outperform.

Hence, an investment plan shouldn't behave as if it has one hand tied behind its back. Instead, it should be free and flexible, with *all of the investment alternatives* at its disposal. And when this is the case, an asset-allocation consultant who can identify the relative attractiveness of different strategies over time should administer it.

Applications in Today's Market Environment

If the recent stock market volatility was caused by excessive leverage, we know the solution is a reduction in the overall leverage of the economy. If so, we expect to see a decline in the velocity of money and the inflation rate as the de-levering occurs. As credit tightens and spreads widen, we should see slower growth.

Slow growth and a lower inflation rate is a good environment for long term government bonds (see figure above). Slower growth relative to the rest of the world leads to a weaker dollar. That in turn suggests an increased exposure to foreign equities is warranted.

Domestically, one way to increase that exposure is to shift to the larger cap growth stocks. Large companies tend to have multi-plant facilities and a greater reliance on exports, and are thus exposed to foreign markets. Growth companies are most likely to expand and increase their exposure to the rest of the world.