







The 70 Year History of Investment Consulting: 1950-2020

Investment consulting is 70 years new and still learning. Innovations occur every decade. Some are adopted quickly while others take decades, and some never gain acceptance. Disruptive innovations are both exciting and frightening, so some consultants are early adopters while others prefer to wait. Readers of this article can see and understand the progress of their advisor. For example, the 60/40 stock/bond “solution” remains entrenched but questionable, especially for those near retirement.

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is a pension consulting pioneer who started his career in 1972. He is currently president of Target Date Solutions and sub-advisor of the SMART Target Date Fund Index suite of collective investment funds (CIFs). He designed the patented Safe Landing Glide Path followed by SMART. He is also co-host of the Baby Boomer Investing Show on YouTube and Facebook, and CEO of Glidepath Wealth Management that manages target date portfolios.

	1952: Modern Portfolio Theory (MPT): 70 years ago Dr. Harry Markowitz won a Nobel Prize in 1990
	1964: Capital Asset Pricing Model (CAPM): 55 years ago Dr. William F. Sharpe won a Nobel Prize in 1990
	1986: Modern Investment Theory (Smart Beta): 45 years Dr. Robert A. Haugen
	1991: Post Modern Portfolio Theory (PMPT): 30 years Dr. Frank Sortino
	2006: Target Date Funds: 15 years ago Pension Protection Act of 2006
	2013: Rising Equity Glide Path in Retirement: 7 years Dr. Wade Pfau and Michael Kitces

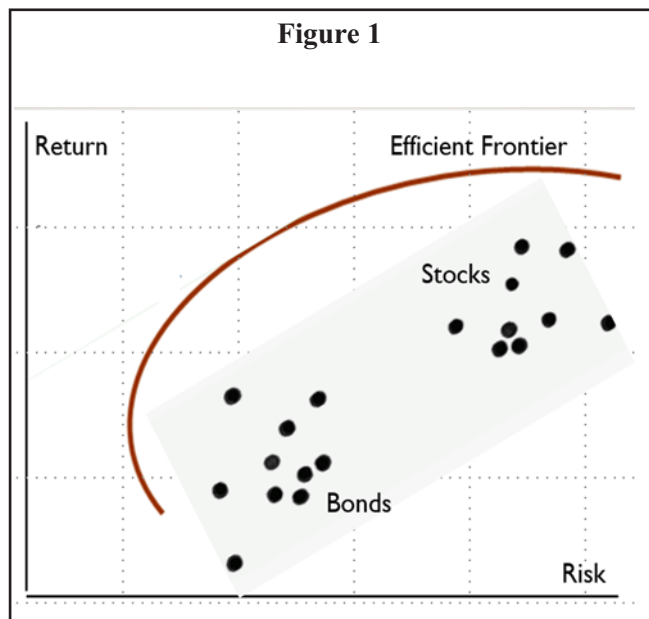
Investment consulting has a long history that has been marked by innovations occurring about every ten years. We recently broadcast a live streaming video on this topic, focused on the following innovations:

In the following article, we discuss each innovation, plus the impacts of the 1974 Employee Retirement Income Security Act (ERISA) and the 1986 groundbreaking study on the Importance of Investment Policy, “Determinants of Portfolio Performance.”

**1952: MODERN PORTFOLIO THEORY (MPT): 70 YEARS OLD
DR. HARRY MARKOWITZ WON A NOBEL PRIZE IN 1990**

It is incredible that “Modern” Portfolio Theory is about 70 years old. It has stood the tests of time and is currently embraced by many consultants. This 1952 breakthrough began to be utilized in the 1970s, and became mainstream 20 years later, demonstrating our natural resist-

ance to change. Dr. Harry Markowitz won a Nobel prize in 1990 for educating investors on the magic of diversification and the existence of an “Efficient Frontier” that maps portfolios that earn the highest expected return for a given level of risk. Figure 1 forms the basis for MPT (Modern Portfolio Theory).



Every stock and bond has risk and expected return. Risk is measured as the standard deviation of returns – volatility. Investors will only take risk if the expected return is high enough. The graph shows examples of stock and bond risk-reward. The big breakthrough is that combinations of stocks and bonds earn higher returns for the risk, shown along the Efficient Frontier. Diversification is an immensely powerful investment tool. There is a free lunch in investing; it’s called diversification.

**1964: CAPITAL ASSET PRICING MODEL (CAPM): 55 YEARS
DR. WILLIAM F. SHARPE WON A NOBEL PRIZE IN 1990**

Twelve years later, Dr. William F. Sharpe extended the work of Dr. Markowitz by introducing the Capital Asset Pricing Model (CAPM) that postulated that everyone should want to hold the most diversified portfolio because it provides the highest return-to-risk ratio, called the “Sharpe Ratio.” The most diversified portfolio is the “World Market” of all risky assets in the world, held in proportion to their market values. An integral aspect of the theory is the “Capital Market Line” that states that risk is best controlled with cash. Every investor should

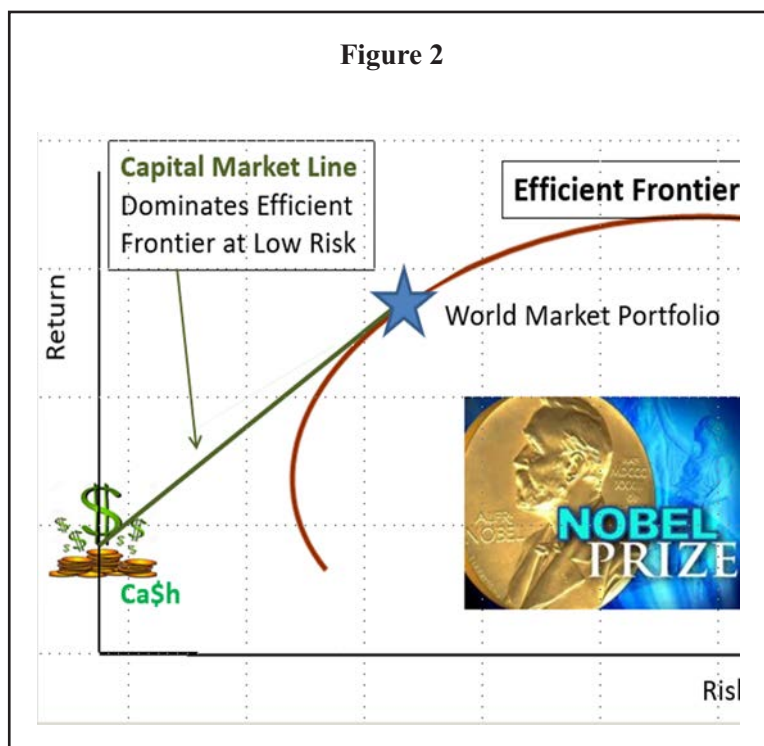
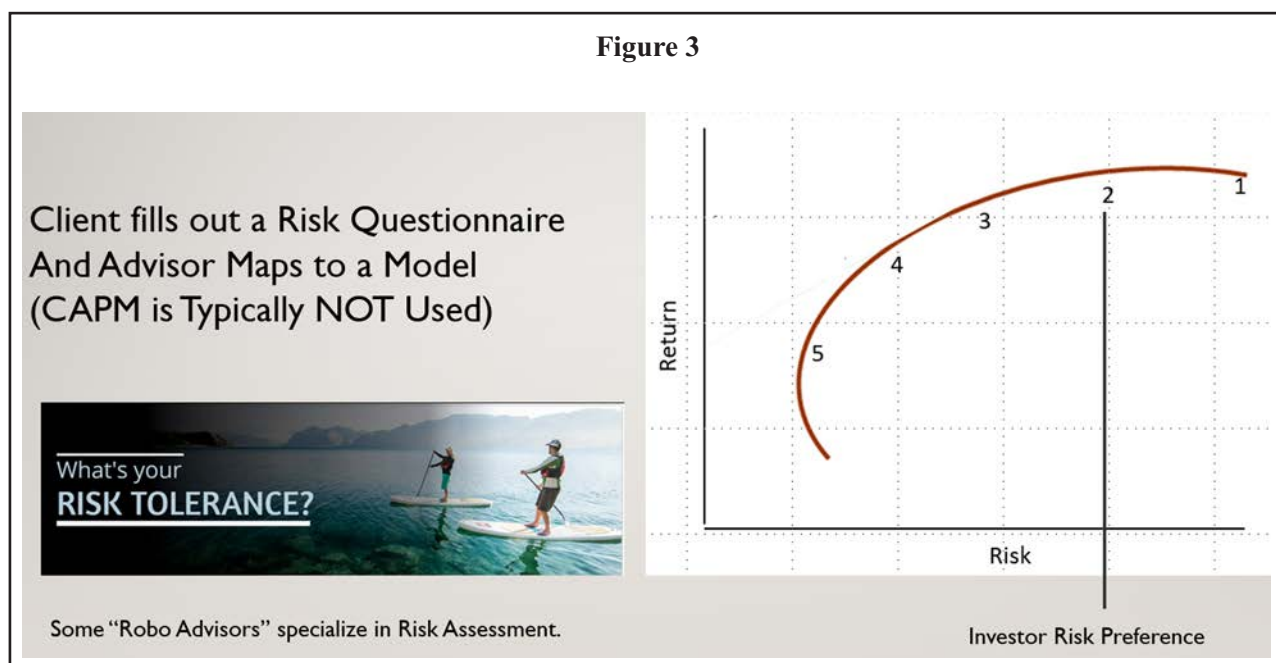


Figure 3



want to hold the Market Portfolio, and if this is too risky use cash to reduce risk. The resulting line dominates the Efficient Frontier, providing higher expected returns for the risk.

This risk management breakthrough is not used much by consultants because they prefer to not control risk with cash. However, most consultants use another aspect of the theory, namely alpha and beta. The regression statistics that everyone uses today to evaluate investment performance were first introduced by CAPM.

Mapping Risk Tolerance into Models

In the early days of consulting, MPT was used to map a client's risk tolerance into a model portfolio, as shown in Figure 3.

The original idea of "risk tolerance" is the maximum risk that the client can tolerate because high risk earns high returns. This approach changed in the 1990s with the introduction of objective-based investing, discussed below. As shown along the curve above, model portfolios are located on the Efficient Frontier. Then risk questionnaires identify investor risk tolerance that is used to find the best model. The "60/40 Rule" emerged from this practice because most mappings gravitate to the middle toward Model 3 in the graph above. The

broad use of the 60/40 rule remains entrenched today. The typical investor is 60/40 equities/bonds, so model providers and TAMPs (turnkey asset management platforms) tend to focus on this model. As I discuss below, the recent introduction of target date funds should change this practice eventually.

1974: The Employee Retirement Income Security Act

About 50 years ago Congress passed ERISA to govern the practices of fiduciaries. This law remains today as the teeth for prosecuting unethical fiduciary behavior. Importantly for consultants, parts of the law reinforce the wisdom of diversification to avoid the risk of large losses. Consequently, buying the entire market became popular as the ultimate in diversification, and index funds were born. The theory stated that you can't beat the market. But 12 years later the next innovator showed that you can beat the market by concentrating on certain stock fundamentals, and thereby not diversifying. You have to make big bets.

1986: MODERN INVESTMENT THEORY (SMART BETA): 45 YEARS DR. ROBERT A HAUGEN

Dr. Robert A. Haugen is the father of factor-based investing, although most don't know it. A prolific writer,

Dr. Haugen wrote hundreds of articles and books on identifying investment factors that produce alphas, superior returns. These factors include fundamentals like yield and capitalization, and classifications like industry sector and style. Dr. Haugen set the academic profession on its ear with the heresy that broad markets can be beaten. Interestingly, one of his biggest critics was Professor Gene Fama, who later went on to create the famous Fama-French style factors. His legacy is the fairly common use of factor-based investing today and the recent “discovery” of “Smart Beta.” Dr. Haugen proclaimed that stock markets are “inefficient,” meaning they can be beaten, and he made it his life’s work showing how.

Dr. Haugen identified the existence of a return premium in minimum variance portfolios, as shown in the next graph. Today it is called Smart Beta.

It remains unclear at the time of this writing whether factor-based investing will achieve the acceptance of previous innovations. Most factor-based approaches identify a couple factors, like small company and value, and tilt to them regardless of market conditions. The bet is on the same factors all the time. By contrast, Haugen’s factor allocations were dynamic, adjusting through time to the strength of their signals.

1986: The Determinants of Portfolio Performance

In apparent contradiction to Dr. Haugen’s work, a famous study was released in 1986 documenting that asset allocation explained most of investment performance.

The allocations to asset classes like stocks and bonds explained virtually all of the performance in pension funds. A careful read reveals that the report is actually about volatility, as measured by R-squared. Asset allocation explained about 95% of the volatility in portfolio performance. Using the same data provided in the article, we find that asset allocation actually explained 100% of performance.

How does this square with Haugen’s work? Most pension portfolios were not using factor-based investing in the 1980s, and that fact remains today. Only a few institutional investment firms utilize factor-based techniques, plus the use of dynamic factor allocations has not yet caught on, although some use factor exposures to measure and evaluate risk.

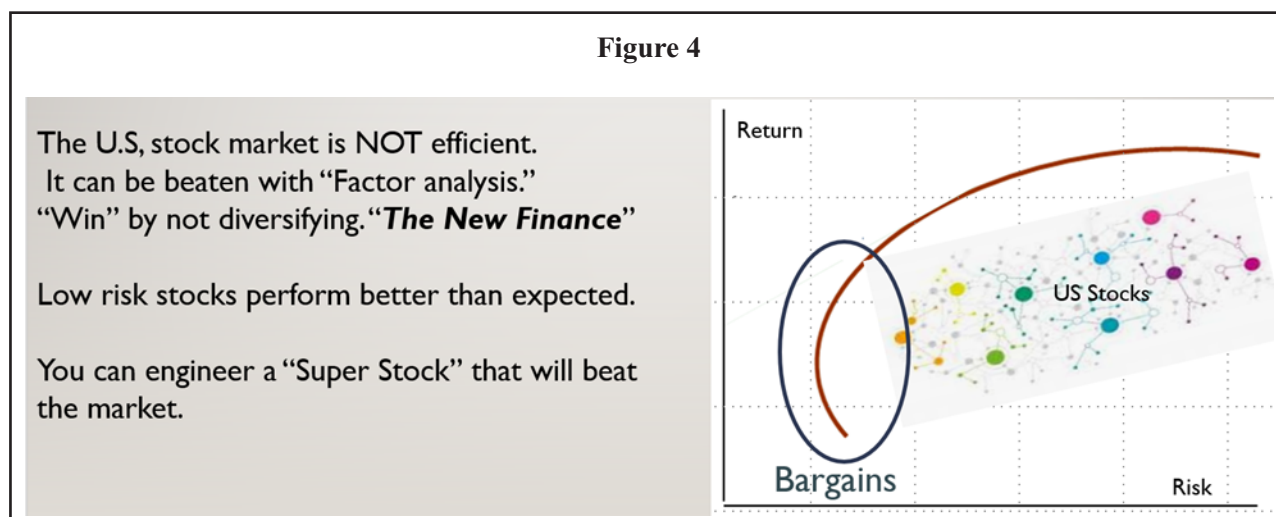
1991: POST MODERN PORTFOLIO THEORY (PMPT): 30 YEARS

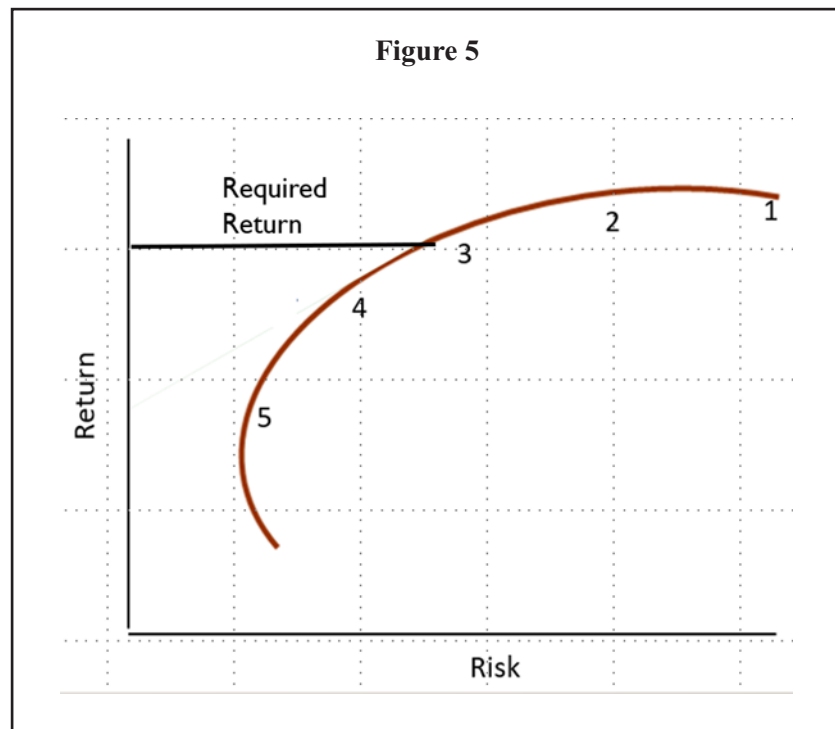
DR. FRANK SORTINO

About 30 years ago, Dr. Frank Sortino, AKA Dr. Downside, proposed a new way to define risk, and introduced PMPT – Post Modern Portfolio Theory. Risk in the PMPT world is the possibility that you will not achieve your objectives. Success in the PMPT world is not beating an index, it’s achieving your goals. Objective-based investing was born, as was the now popular Sortino Ratio.

Dr. Sortino wrote two books on portfolio construction designed to achieve objectives, and has made his software available for free, including source code. Consult-

Figure 4





ants use a simplified version that begins by solving for a rate of return that will achieve the client’s objective. Dr. Sortino calls this the Minimum Acceptable Return (MAR). The MAR is then used to locate a model on the Efficient Frontier, as shown in Figure 5.

Note the similarity between the old risk-based approach and the new objective-based process. Both use a family of models along the Efficient Frontier. Risk-based uses the horizontal scale (risk) to locate a solution, while objective-based uses the vertical scale (return) to find an answer. This reliance on a handful of models was about to change, as discussed in the next section.

2006: TARGET DATE FUNDS: 15 YEARS PENSION PROTECTION ACT OF 2006

The consulting industry had an epiphany about 15 years ago that is slowly being integrated into consulting practices. Risk is more complicated than volatility or required return. The epiphany is simple, but very important – age matters. There is a time in everyone’s life when we cannot afford to take risk. Losses sustained during the Risk Zone spanning the five to 10 years before and after retirement can ruin retirement, even if markets subsequently recover. Target date funds (TDF) are supposed to provide this protection, although most

currently do not. A properly constructed TDF should be no more than 30% in risky assets at the target date, but most are more than 80 percent.

A TDF follows a “glidepath” that begins with high risk for young investors and reduces risk through time as the target date approaches. The target date in retirement plans is the retirement date. In other situations, the target date is a date that the fund will be liquidated, like the date a student will start school in college savings plans.

TDFs were not very popular before the passage of the Pension Protection Act of 2006, which made TDFs a Qualified Default Investment Alternative (QDIA) in 401(k) plans. Subsequently, TDFs have grown to more than \$2.5 trillion. They are the biggest deal in pension plans.

The breakthrough for consultants is that a brake needs to be applied to whatever process is used to find a model. That brake is called “Risk Capacity,” defined as the limit on what an investor can afford. Investors in the Risk Zone cannot afford much risk.

The disciplines of target date funds are just beginning to be integrated into consulting practices for individual investors, and this could take a long time. The main short-

coming of target date funds is that they are one-size-fits-all. Personalized target date portfolios solve this problem, and lead to models that are simultaneously risk-and-age based, an innovation in model building.

2013: RISING EQUITY GLIDE PATH IN RETIREMENT: 7 YEARS DR. WADE PFAU AND MICHAEL KITCES

The most recent innovation is about investing for retirees. Dr. Wade Pfau and Michael Kitces have conducted extensive research on optimal investing in retirement and conclude that it is best to begin retirement cautiously with no more than 30% in risky equities and bonds, and to gradually increase risk through time. The cautious beginning is to protect in the Risk Zone, and the re-risking is to extend the life on investments. To begin retirement cautiously you need to end your working life the same way with no more than 30% in risky investments. In other words, a U-shaped lifetime glide-path is optimal, with the bottom of the U in the Risk Zone. Couple this with the importance of asset allocation, and you have the current best thinking for investment consulting.

Dr. Wade Pfau is a professor of retirement income and a Director of the New York Life Center for Retirement

Income, and Michael Kitces is a consulting industry luminary.

CONCLUSION

A lot has improved in 70 years, but not all consultants have evolved. Investment consulting is a credence good like computer technicians and car mechanics. “Trusted advisors” are usually nice people, but not all are financially skilled with the clients’ best interests at heart. The client is best advised to trust but verify. Consultants are best advised to differentiate through innovation.

to see our video on this topic.

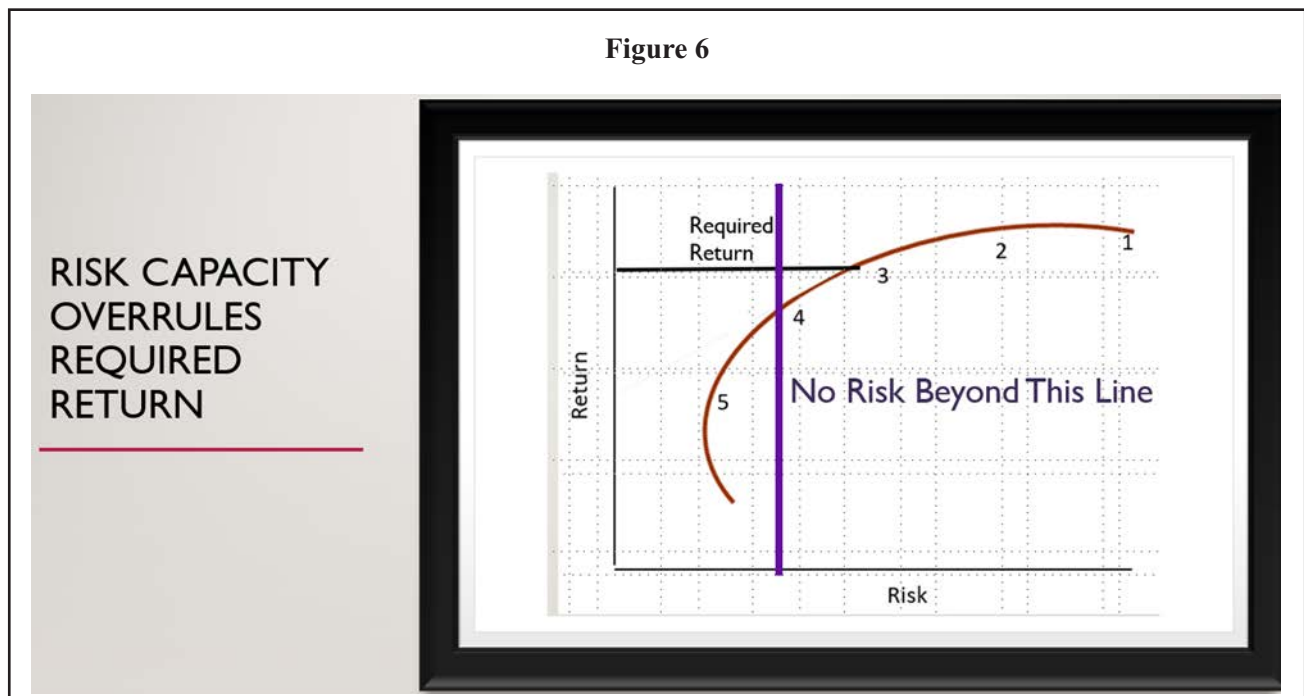
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Figure 6



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