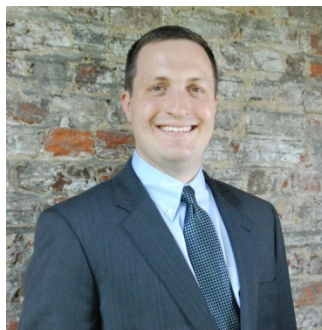

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By Definition, Asset Allocation is Active

There is no such thing as passive asset allocation. Whatever an investor chooses to do with their money is an active decision, from leaving it in a bank, to investing it, to storing it under their proverbial mattress. In our view, asset allocation should be driven by financial needs, risk tolerance, and a forward-looking assessment of the risks and rewards of asset classes. This is different for each investor; thus, it is not simply "benchmark-able." A passive strategy, by definition has to have a benchmark to follow. Once an asset allocation has been agreed upon, a custom benchmark can be created and implemented using an active or passive approach. At RiverFront we use both.

ASSET ALLOCATION STRATEGIES

Modern Portfolio Theory (MPT) is probably the most commonly used technique for asset allocation, as it has been incorporated into finance theory and taught to finance graduates for decades. It was first developed by Harry Markowitz more than 60 years ago as a way to optimize the benefits of diversification; at the time, it was just called "Portfolio Theory." The word "modern" is thus misleading. MPT is probably as close as one can get to a passive asset allocation strategy, but it still requires a very active judgment to accept its central assumptions and to believe in diversification. Modern Portfolio Theory is so pervasive in our industry that we believe people who use models and portfolios based around the theory should understand its two major assumptions:

1. Markets are efficient, and thus future expected returns are best estimated by using the historical average return, regardless of current prices.
2. Risk is best understood in terms of the standard deviation[1] of returns and the correlation between asset classes, both of which are assumed to be constant through time.

The academic appeal of MPT is that, in a world in which its assumptions hold, it is an optimal way to set asset allocation – hence its popularity. However, we believe both assumptions are flawed, and that the market regularly serves up the evidence to refute them. We will get to the return assumptions in a moment, but let's talk about risk. Standard deviations of assets class returns, especially correlations between assets, are not constant, and they are most likely to increase in unison at the exact moments that you need diversification. Thus, in our opinion, MPT provides an overly optimistic view of how assets will be protected in a downturn (as occurred in 2008). Additionally, as stated, Modern Portfolio Theory does not account for current valuations in setting expected returns. We believe history has shown that returns in five- and ten-year timeframes vary markedly with the starting valuation – Price Matters®. In our view, expected returns are best estimated with a judgment about valuations at the starting point.

Capital Preservation: You might think that keeping money in a private safe, bank vault, or government insured certificate of deposit is the ultimate form of passive investing, but we disagree. Capital preservation comes from a heightened aversion to losses, and at current interest rates, we view this strategy as an active decision to accept a loss of purchasing power. While this strategy will protect assets in a downturn, it makes the assumption that contributions from savings will be large enough to compensate for inflation – an active judgment.

[1] *Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.*

"All Tactical" Asset Allocation is a strategy that relies on timing to move into and out of asset classes using trading signals and/or judgments. Its success is predicated on being smart enough to foresee, or react to, declines and advances in price – clearly a highly active strategy. To the extent that these strategies use trading signals based on price momentum, they tend to perform well in strongly trending markets, but only after a trend is well established. To the extent that trends begin and then reverse, this strategy has historically tended to struggle.

Our issue with this strategy is not its tactical aspect – we certainly spend a lot of time refining our tactical rules. Our issue is one of degree. We are confident in the ultimate success of our strategic process, and we only use our tactical rules for opportunistic and defensive risk management.

RIVERFRONT'S APPROACH – THE PRICE MATTERS® OPTIMIZATION PROCESS, OR MEAN REVERSION OPTIMIZATION

We believe that the previous three approaches each contain virtues. The MPT approach compels market participants to think longer term about their investments. The Capital Preservation approach reflects the need for safety in uncertainty; and the All Tactical Asset Allocation approach is virtuous in that it seeks to incorporate the information in the market to make "lane changes" across asset classes as information and pricing changes. Our investment approach, most recently documented by Chief Investment Officer, Michael Jones (*The Strategic View*, February 20, 2015) seeks to build on these three virtues with the following:

1. Price Matters®: Expected returns should be based on current valuations.
2. Risk is defined as the probability of losing money and seeking to minimize the probability of loss at specific time horizons by stress-testing each of our strategies under severe historical economic and market scenarios.
3. Allocation that seeks to optimize returns in more normal market scenarios, subject to the constraints in point 2.
4. A tactical overlay for risk management and opportunistic selection.

COMBINING ACTIVE AND PASSIVE STRATEGIES TO IMPLEMENT ASSET ALLOCATION

For decades there has been a vigorous debate about whether investors are better served by "passive" investments in vehicles that track widely published indexes or by working with "active" managers who will attempt to generate excess returns. At RiverFront, we employ *both* active and passive approaches in our security selection. When we want a low-cost way to implement an asset class we follow a passive index. When we think we can outperform a passive index through a selection strategy that contains different country or sector weightings, we take a more active approach.

Important Disclosure Information

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Diversification does not ensure a profit or protect against a loss.

Mean reversion is the tendency of a variable, such as a stock price, to converge on an average value over time.

RiverFront Investment Group, LLC, is an investment advisor registered with the Securities Exchange Commission under the Investment Advisors Act of 1940. The company manages a variety of portfolios utilizing stocks, bonds, and exchange-traded funds (ETFs). Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

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