Can a Leopard Change Its Shorts?

Asset Allocation, Valuation, and Long-Term Investing on a Personal Scale[1]

EXECUTIVE SUMMARY

Asset allocation is crucial in determining the success or failure for a client's financial goals. While the traditional 60/40 portfolio structure is ubiquitous, we believe more and more investors and advisors are recognizing the importance of an active asset allocation approach based on long-term valuation analysis, which we wholeheartedly support. Moving beyond the 60/40 model is essential for achieving clients' financial goals. Personalized, scalable portfolios are the future of financial planning, but the industry struggles with creating efficient, individualized solutions. Nebo Wealth addresses this by integrating clients' financial plans with customized portfolios, offering a systematic, repeatable process that enhances both efficiency and personalization, thus solving the core issues clients care most about: having the financial resources they need, when they need them.

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Asset Allocation

The importance of asset allocation in determining investment outcomes is really not up for debate. We may quibble with Brinson's original 90% estimate and there are a number of academics who have weighed in,[2] but the point remains: getting the asset allocation right is really important. We don't think that statement is going to win us any Nobel prizes. However, it is a critical reminder given the omnipresence of the traditional, moderate 60% stocks/40% bonds portfolio structure. It is with increasing interest we have

1. For those who don't get the reference, it comes from the wonderful Discworld novels of Terry Pratchett…if you haven't read any of them, I deeply envy you for the joy you have in store.

2. Jahnke, "The Asset Allocation Hoax," *Journal of Financial Planning* (Feb 1997); Ibbotson and Kaplan, "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" *Financial Analysts Journal* (Jan 2001); James Xiong, Ibbotson et al., "The Equal Importance of Asset Allocation and Active Management," *Financial Analysts Journal* (Apr 2010).

seen a greater focus on an active approach to asset allocation based on long-term valuation analysis. Now that is something we can get behind!

Moving past a traditional 60/40 approach is critical in delivering the investment results clients need to fulfill their financial goals. Perhaps the holy grail in the current financial planning industry is the concept of delivering personalized portfolios in a scalable manner. Thanks to a great deal of progress in goals-based investment planning, advisors now have tools on their desktop to build customized financial plans for clients. It is a big step forward in the industry. However, when it comes to building personalized portfolios, most face a significant stumbling block – creating spreadsheets based on bespoke analysis of each client is simply not scalable and leaves the advisor in spreadsheet hell. Here we are referring to personalization for real, economic reasons, not marketing reasons (though we see plenty of that). As Eric Clarke, the former CEO of Orion, commented in 2021, "As an industry, we need to focus on solving the investor problem, and move beyond focusing so much on the investment problem."

That is to say, we need to solve the problems clients care most about: building a portfolio that makes sense given the client's financial goals. The investment management industry is not completely tone deaf, so we are seeing more and more references to goals-based financial planning, but very little in the way of real, goals-based investment management. To date, there hasn't been a way to build portfolios directly in concert with the financial plan advisors and clients spend so much time on. Often times, the financial plans are created only for clients to end up in cookie-cutter model portfolios (most often the "moderate" portfolio) or, worse yet, owning a portfolio solely based on a very flawed risk scoring methodology. [3] Understanding the impact valuation can have on a portfolio is critical, but understanding the client's needs is arguably more critical to getting the asset allocation correct. It seems the vast majority of firms are still missing the plot.

3. See "The Perils of Outsourcing Asset Allocation to a Risk Score" (Montier, Kadnar and Tarlie, 2024).

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A Leopard Changes Its Shorts

Reflecting on our multiple decades in the investment management industry (damn that makes us feel old), one observation, among many, comes to mind: investors rarely change their philosophy. Perhaps when young they are exposed to different types of investment thoughts, but over time, a natural tendency seems to settle in and calcify. Value investors want to own what is cheap. Growth investors stick with their growth biases (particularly after growth's run over the last decade or so…). The momentum crowd is continually on the lookout for the next epic "head and shoulders" or "golden cross" pattern. Of course, there are exceptions to this rule – Buffett's eschewing of tech stocks before eventually making Apple his biggest position comes close. Although, to be fair to Warren here, this was more an evolution of thinking, aided by the late, great Charlie Munger, as opposed to a wholesale change in philosophy. John Maynard Keynes is a good example of a shifting investment philosophy. Originally a momentum investor, after the Great Crash of 1929 and coming close to personal bankruptcy, Keynes saw the light and converted to a valuation focus.[4] The endowment of King's College Cambridge was a significant beneficiary of this change in sentiment. However, as in many things, Lord Keynes was unique in this pattern of behavior.

Despite the seemingly inexorable rise of passive implementation by investors, it is with great surprise that we have seen increasing interest in active asset allocation. Both investors and asset managers are more commonly advocating for a dynamic approach to asset allocation using long-term expected returns for investors with longer-term goals. We can only see "Amen" to this trend! As regular readers will know, GMO has long held a valuation-sensitive framework at the heart of our approach. Indeed, long ago, following up on an idea from Jason Zweig of the Wall Street Journal, one of our colleagues asked us to write down our investment philosophy in 10 words or less. James came up with the following:

1. Valuation matters
2. Risk isn't a number
3. Be patient

Seeing more investors adopt a long-term approach is heart-warming indeed. I don't think we've converted the CNBC "Fast-Money" crowd, but one step at a time works nicely enough!

Of course, any process built on long-term valuation will have "model risk" as a key risk factor, i.e., if you get your valuation model wrong, what you thought was cheap may turn out not to be so, or vice versa.

4. Written in 1936, Chapter 12 of Keynes' "General Theory of Employment Interest and Money" remains vital reading for any serious investor.

We certainly don't argue with this viewpoint, and we spend a large amount of our time wondering and researching where we might be wrong.

We would also emphasize career risk as a critical factor if you are managing money for another (and perhaps the key reason why more people don't try to follow a long-term approach to asset allocation). Our best explanation of career risk comes from GMO's own Jeremy Grantham:

> "The central truth of the investment business is that investment behavior is driven by career risk. In the professional investment business, we are all agents managing other peoples' money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity...the great majority 'go with the flow,'...There are many other inefficiencies in market pricing, but this is by far the largest. It is this career risk phenomenon, the fear of not keeping up with your peers or the benchmark within the short time frames that professional investors are inevitably measured, that can ultimately lead to asset bubbles."[5]

Anyone espousing the virtues of a long-term, actively managed, valuation-based approach to investing are friends, indeed! It is great to see this type of anti-career risk strategy being embraced by others. Now they are joining the likes of GMO in the anti-passive strategy of long-term, valuation-based investing. Jump on in, the water's warm!

Of course, there are some important details that need to be explored. For example, "long term" can often focus on more recent history. We, of course, would argue that there is a whole lot more history that we should be paying attention to. The "probability of success" is often a key criterion in its evaluation, which we would argue is a very blunt measure–you either run out of money or you do not. It does not distinguish between small misses and large misses. Our approach would be much more of a mosaic in determining the success of an investment strategy.

Part of the probability of success evaluation also involves a Monte Carlo analysis, but there are also key assumptions in that Monte Carlo model which need to be understood and correctly modeled.[6] We have seen time and again the importance of these details in our own work.[7] But, any process focused on getting the overall plot correct, i.e., what you pay for an asset will largely determine the returns you achieve, is an improvement over a passive 60/40 portfolio.

5. "My Sister's Pension Assets and Agency Problems: The Tension between Protecting Your Job or Your Clients' Money" (Grantham 2012).

6. If you are implementing a valuation-sensitive investment framework, this necessarily implies a Monte Carlo framework that takes into account mean reversion as opposed to the more common (and we would argue incorrect) "Random Walk" approach. Otherwise, you have a massive internal inconsistency by assuming different return-generating processes in this critical part of the process.

7. Monte Carlo simulations that utilize the Random Walk in generating their equity return and volatility profiles underestimate the volatility of bonds relative to history and overestimate the volatility of stocks relative to history. Thus, Monte Carlos that utilize the Random Walk will have an artificially wide and distorted distribution of outcomes relative to history. And if the Random Walk is used in portfolio optimization, it will result in a bond-heavy and stock-lite portfolio. See "Investing for Retirement II: Modeling Your Assets & Correcting the Flaws in Monte Carlos" (Montier and Tarlie, 2022).

Close, but No Cigar

However, moving away from the passive 60/40 portfolio and taking steps toward customizing a portfolio for a client's specific objectives using valuation as a key metric, in our view, this does not go nearly far enough. Central to this approach is academic finance's definition of risk: volatility. While volatility is an easy portfolio characteristic to calculate, it isn't necessarily a wonderful proxy for true portfolio risk. This is particularly true when a portfolio exists for a long-term objective like funding retirement. We believe a better definition of risk for clients is: will they have the financial resources they need, when they need them? This is a much more intuitive definition of risk, one that any client can easily grasp. I am not sure if a client has ever walked into an advisor's office with a clear understanding of their "risk aversion parameter." Yet, this is a key tenet in many approaches, breaching the second component of the investment philosophy outlined above.

A (Much) Better Way

One of Nebo's core investment principles is to always make sure we are focusing on the "right" question. It is basic, but so powerful. It is with this in mind that 10 years ago, when we were trying to understand how Defined Contribution glidepaths were being built,[8] we asked the critical question: what is the primary risk someone saving for retirement (or any other financial objective) faces? The answer, quite simply, is not having the financial resources you need when you need them. Thus began the decade-long odyssey in building Nebo Wealth to operationalize a goals-based investment platform for investment advisors to build truly customized portfolios that seek to minimize the critical risk of not having the financial resources you want when you want them.

With Nebo Wealth, an advisor can take the output from financial planning software (or use Nebo's "Fast-Track Financial Planning") and integrate the client's cash flow needs directly into Nebo. Nebo will then build a portfolio, customized to the client's specific time horizon, needs, and circumstances, designed to minimize the risk of falling short of the client's financial goals.[9] This applies just as much to someone who is mass affluent and worried about having enough money in retirement as it does to the ultra-high net worth individual whose goals are related to their legacy or eleemosynary pursuits. One systematic, repeatable process for all your clients.

Philosophically, the only concept the advisor needs to adopt with Nebo is our definition of risk: not having the financial resources you want when you want them. This new and better definition of risk allows us to customize

8. We were asked by one of our corporate clients about our thoughts on glidepaths. Martin Tarlie researched the major glidepath providers but could not find a clear, definitive methodology for how glidepaths were being built beyond the old investment maxim that your weight in equity should be 110 less your age.

9. Nebo's optimization minimizes both the probability and magnitude of falling short of your goals. After all, missing by $100 is very different than missing by $1,000,000.

portfolios in an efficient and systematic fashion. After all, what you want, when you want it is inherently personal. And portfolios built to minimize this risk are by definition customized to the individual. Nebo, however, can do this through a systematic and repeatable process which allows the advisor to scale their business in a more efficient and profitable way.

While more are focusing on a valuation-sensitive approach (something we obviously have great sympathy for), Nebo is agnostic to investment philosophy. We take your investment philosophy and approach and build Nebo around it so we can operationalize our multi-period optimizations and next-generation Monte Carlo engine.

Furthermore, Nebo is a completely open architecture platform customized to each firm’s unique approach to portfolio design. Capital Market Assumptions used in Nebo’s proprietary shortfall optimization, portfolio components, or building blocks (including illiquid assets such as private equity/credit or even privately held small businesses) and ultimate implementation (mutual funds, ETFs or individual securities/direct indexes) are all determined by the advisory firm.

Finally, target portfolios are easily exported to a rebalancer or can be traded by Nebo Wealth directly. Rather than putting your clients into one-size-fits-all models, you can efficiently build a custom model for each client in the same amount of time needed to allocate to the cookie-cutter models. Efficiency and customization.

Conclusion

We welcome anyone and everyone who believes in a dynamic, long-term, valuation-sensitive approach to investing. This is something that GMO has been doing since 1986, when we launched our first asset allocation strategy. While we welcome these new entrants, we have thought deeply about these ideas for almost forty years. Nebo Wealth is a direct output of decades of these investment thoughts and insights.

Continuing the trend of a more personalized experience for each client, Nebo Wealth offers unparalleled customization. Customization to the specific goals, objectives, and time horizons for each client with a more accurate and intuitive definition of risk. Customization for the advisory firm’s investment philosophy and approach from their investment building blocks, Capital Market Assumptions to direct implementation. It does not get any more personal than that.

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