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By Frank Sortino, Mark Kordonsky and Hal Forsey

Imagine you go to your doctor and he says, “I see by your chart you are 45 years old. I am going to recommend an appendectomy.” When you ask why, he says, “The last patient I had who was your age had an appendectomy and he is doing fine now. Would you prefer arthroscopic surgery, the less expensive scalpel cutting, or psychic surgery?”

Absurd? But isn't that similar to what are becoming the most popular investment options in 401(k) plans? We mean, of course, the lifestyle, lifecycle and target-date fund options.

Where is the evidence these options work as an appropriate way to direct asset allocation?

These types of funds make asset allocations based on age and preferences rather than needs. This allocation methodology might well protect sponsors from liability based on Department of Labor guidelines, but how could anyone be so naive as to think, say, a top executive of a company and a janitor should have the same portfolio because they are the same age and claim to have the same risk tolerance?

Their lifestyles are not the same because they are the same age. Their needs are not the same because they are the same age. Their financial abilities are not the same. So why on earth should they have the same portfolio?

This is an example of ill-founded practice trumping evidence.

Divergence between inferior practice and evidence is examined in a different but applicable context by Jeffrey Pfeffer and Robert Sutton, professors at Stanford University. Their recently published book, “Evidenced-Based Management,” while directed to CEOs for corporate guidance, has important application to portfolio management. Investment professionals would be wise to seek its counsel. The basic idea is that managers should look at evidence to see if it supports what they are doing or supports the philosophy that underlies their actions.

However, that is not the way of the world. Messrs. Pfeffer and Sutton point out the difficulty of overcoming ideas that become part of the bedrock belief system of mainstream practitioners. They claim “ideology is one of the most widespread and potent impediments to using evidenced-based management. People believe their theories so fervently they are incapable of learning from new evidence. People see what they believe and ignore evidence that contradicts their most precious beliefs.”

For example, the asset allocation decision is generally accepted to be the most important investment decision. Yet fiduciaries spend most of their time selecting managers to fit an asset allocation. Furthermore, the way managers are selected guarantees the asset allocation will be changed in some indeterminate manner. That is due to the false assumption that each manager can be compared to a single index, when in fact almost all managers are a blend of styles. Failure to recognize this fact, supported by years of empirical research, ensures the most important

investment decision will be corrupted beyond comprehension. Amazingly, the same companies that sell this flawed advice also make use of the style analyzer that identifies each manager's style blend. So, why do they sell flawed advice when they have the technology to do better? In their observation, Messrs. Pfeffer and Sutton note, "Consultants are always rewarded for getting work and seldom rewarded for advice that actually enhances performance."

A better proposed approach would replace the capital asset pricing model for managing a portfolio. Instead, it would look at an investor's needs and evaluate assets in light of future liabilities. CAPM ignores liabilities.

The goal is retirement, not beating the market. However, if the goal is not to beat the market, doesn't that mean performance should therefore be measured relative to the goal of retirement? This would require new performance measures to replace the alpha return and beta risk variables in CAPM.

While we applaud those who recognize the limitations of CAPM and welcome their new approaches, we ask, "Where is the evidence?" Until there is some evidence these new models work, we recommend revisiting the approach of Peter C. Fishburn, former professor of economics at the University of Pennsylvania: find out what the investor needs to accomplish his or her goal and measure risk and reward relative to the target return that will accomplish the goal. We have published a considerable amount of evidence for the past two decades on the efficacy of downside risk and upside potential as alternatives for alpha and beta.

In the words of Messrs. Pfeffer and Sutton, "We should be committed to doing the best we can with what we have at the time while taking steps to gather new and possibly more useful information."