Available online at www.sciencedirect.com
ScienceDirect
Journal of Empirical Finance 15 (2008) 363–386
Journal of EMPIRICAL FINANCE
www.elsevier.com/locate/jempfin

Benchmarking the performance of recommended allocations to equities, bonds, and cash by international investment houses ☆

Mary M. Bange [a], Kenneth Khang [b], Thomas W. Miller Jr. [c,*]

[a] *Houston, TX 77007, United States*
[b] *College of Business Idaho State University Pocatello, ID 83209, United States*
[c] *John Cook School of Business, Saint Louis University, 3674 Lindell Boulevard, St. Louis, MO 63108, United States*

Accepted 17 July 2007
Available online 17 October 2007

Abstract

We conduct performance tests of the recommended asset allocations made by a panel of international investment houses (the "Houses") from 1982 through 2005. We compare the returns and Sharpe Ratios from the recommended-weight portfolio against those of several benchmark portfolios and to a set of 10,000 returns and Sharpe Ratios from randomly shuffled-weight and shuffled-weight change portfolios. We find that the Houses generally fail to outperform the benchmarks. The shuffled-weight change benchmark exhibits a robust "style-preserving" property in that the average portfolio standard deviation is nearly equal to the portfolio standard deviation from the actual recommended weights.

JEL classification: G12; G14; G23
Keywords: Asset allocation; Portfolio performance measurement; Benchmark portfolio; Conditional performance; International investment houses

1. Introduction

Perhaps the most fundamental investment decision is how best to allocate portfolio dollars among equities, bonds, and cash. However, there is little published research concerning advice on this basic investment decision. By contrast, many studies examine the ability of investors to make superior decisions about market timing and security selection.

☆ We thank Mike Alderson, Chris Anderson, Andrew Ang, Brian Betker, Geert Bekaert, Matthew Billet, Werner De Bondt, Wayne Ferson, Shingo Goto, Jim Granato, Mike Hemler, Robert Hodrick, Alok Kumar, Bob Miller, Carolyn Moore, David Myers, Greg Niehaus, Ľuboš Pástor, Dave Rapach, Rudi Schadt, Sandra Sizer, Jack Strauss, Jonathan Taylor, Zhenyu Wang, Bonnie Wilson, and Guofu Zhou. We are especially grateful to Heber Farnsworth for his many insights and comments concerning this paper. We acknowledge the helpful suggestions from anonymous referees as well as seminar participants at Northern Illinois University, Saint Louis University, the University of Kansas, the University of South Carolina, and Washington State University. In addition, we received valuable comments from participants at the 2004 AFA Conference, the 2003 FMA Conference, and the 2003 Global Investment Conference in Banff, Alberta, Canada. We are grateful to Leigh Riddick, who provided valuable data. We also thank Chullawach Darongkamas and David Shrider for their high-quality research assistance. Of course, we are responsible for any remaining errors.
* Corresponding author. Tel.: +1 314 977 2476.
E-mail address: millertw@slu.edu (T.W. Miller).

0927-5398/$ - see front matter © 2007 Elsevier B.V. All rights reserved.
doi:10.1016/j.jempfin.2007.07.005

Blake et al. (1999) underscore the importance of asset allocation when they show that potential gains to investors from asset allocation dwarf potential gains from market timing and security selection.[1]

A motivating question we address in this paper is how best to measure the performance of asset allocation recommendations in the face of differing investment "styles" and their associated ex-ante risks. We introduce two new performance measures that use randomization to generate a benchmark return distribution. In these randomization methods, the recommended portfolio weights, as well as the recommended portfolio weight changes, are repeatedly shuffled to generate two distributions of portfolio returns. We can then compare the actual performance to these distributions and calculate significance levels.

In our study, we examine the long-horizon performance of recommended asset allocation strategies made by a panel of international investment houses between April 1982 and July 2005. These investment houses (the "Houses") provide recommended asset weights to equities, bonds, and cash. The recommendations come from surveys published in the *Financial Report*, a confidential newsletter that was purchased by The *Economist Newspaper, Ltd.*, in 1989. In these surveys, money managers in different countries are asked to provide asset allocation recommendations for a hypothetical investor who has "no existing investments, no overriding currency considerations, and the investment objective of long-term capital growth." These criteria give us a sample that is well-suited to a detailed examination of the performance of asset allocation recommendations over a long horizon.

We look for performance attributable to style by separating the Houses into "equity champions" (Houses that recommend equity holdings that are greater than the average equity holding), "fixed-income champions" (Houses that recommend equity holdings that are less than the average equity holding), and by examining individual House performance. We find that the shuffled-weight change benchmark portfolio exhibits a robust "style-preserving" property. That is, the average portfolio return standard deviation is nearly equal to the portfolio return standard deviation from the actual recommended weights. This property is robust across time periods and return series. It is also robust as to whether the recommendations come from equity champions, fixed-income champions, individual Houses, or an overall consensus.

In our sample, as a group or individually, the Houses do not exhibit much, if any, skill in shifting asset allocations among equities, bonds, and cash. Independent and simultaneous research by Annaert et al. (2005) also concludes that recommendations from these Houses are unable to outperform passive portfolio benchmarks. However, our study differs in significant ways.

First, Annaert et al. (2005) do not incorporate transaction costs. In our study, we account for transaction costs using a method we develop to rebalance a portfolio to target weights when transaction costs differ among asset classes. Annaert et al. (2005) only use unconditional performance tests. In addition to the randomization methods, we measure portfolio performance using unconditional Sharpe Ratios and the Ferson and Khang (2002) conditional weight measure. We find that the Ferson and Khang (2002) conditional weight measure confirms the basic conclusion of this study. That is, the Houses exhibit little, if any, ability to make timely asset allocation shifts among equities, bonds, and cash.

Our findings have important implications for investors who rely on basic asset allocation advice. The scale of their collective decisions is colossal. Mutual fund investments in particular are vast. As of the second quarter of 2006, world-wide mutual fund assets totaled $19.4 trillion, distributed among 59,385 funds across 41 countries (www.ici.org, November 6, 2006). It is possible that this enormous investment pool has benefited from knowledgeable asset allocation recommendations over time. However, asset allocation recommendations that are highly correlated with those in our sample would have had little value for investors.

The paper proceeds as follows. In Sections 2 and 3, we describe the return and weight data, respectively. In Section 4, we detail how we incorporate transaction costs into portfolio rebalancing. In Section 5, we summarize the unconditional portfolio performance results, and in Section 6, we present two robustness inquiries. Section 7 contains conditional portfolio performance and Section 8 concludes.

[1] For example, from April 1982 through October 2005, an investment of $1 million would have grown to over $2.1 billion if, at the beginning of each month, the investor placed their growing portfolio into the asset class (i.e., equities, bonds, or cash) that will perform best over the month (with transaction costs of 50 basis points per month, the portfolio still would have grown to over $940 million). Three other studies on fundamental asset allocation are those by Brinson et al. (1986, 1991), and Annaert et al. (2005).