# THE ALLOCATOR'S EDGE

# THE ALLOCATOR'S EDGE

## A modern guide to alternative investments and the future of diversification

**Phil Huber, CFA, CFP®**

Harriman House

HARRIMAN HOUSE LTD
3 Viceroy Court
Bedford Road
Petersfield
Hampshire
GU32 3LJ
GREAT BRITAIN
Tel: +44 (0)1730 233870

Email: enquiries@harriman-house.com
Website: harriman.house

First published in 2021.


Hardback ISBN: 978-0-85719-793-1
eBook ISBN: 978-0-85719-794-8

British Library Cataloguing in Publication Data
A CIP catalogue record for this book can be obtained from the British Library.



Harriman House

*"If everyone is thinking alike, then no one is thinking."*

***— Benjamin Franklin***

*"We cannot solve our problems with the same thinking we used when we created them."*

***— Albert Einstein***

*For my wife, Christie,*
*and our daughter, Hannah.*

*You are my world.*

*To that, there is no alternative.*

# ABOUT THE AUTHOR

Phil Huber, CFA, CFP®, as both a wealth management practitioner and an investment industry thought leader, is uniquely qualified in understanding the merits of alternative investments as well as the myriad challenges that accompany their use in the portfolios of wealthy individuals and families.

Phil is the Chief Investment Officer for Savant Wealth Management, where he helps oversee the firm's investment and portfolio-management related functions. As co-chair of the firm's Investment Committee, Phil leads the research efforts that he and his team perform on asset managers, investment strategies and portfolio construction techniques.

Phil has been featured in a number of notable media outlets, including *The Wall Street Journal*, *The New York Times*, *InvestmentNews*, *CityWire RIA Magazine*, and Bloomberg TV. In 2018, 2019, and 2020, he was named one of Investopedia's Top Financial Advisors. He also produces his own investing blog, *bps and pieces* (bpsandpieces.com).

He has been involved in the financial services industry since 2007. Phil joined Savant as part of a merger with his prior firm, Huber Financial Advisors, where he worked for twelve years and last served as the firm's Chief Investment Officer. Prior to his days at Huber Financial, Phil was employed at a global asset management company where he worked closely with financial advisors to develop investment strategies for their clients.

He holds a bachelor's degree in finance from the Kelley School of Business at Indiana University and is a CERTIFIED FINANCIAL PLANNER™ professional. Phil also is a CFA® charter holder and a member of the CFA society of Chicago.

Phil and his wife Christie live in the northwest suburbs of Chicago where they enjoy reading, yoga, and spending time with their daughter Hannah. He is also a lifelong, diehard professional wrestling fan.

# CONTENTS

# FOREWORD BY CLIFF ASNESS

It is hard to write an unbiased non-self-serving foreword to a book when a) you already think quite highly of the author, b) you think the author thinks quite highly of you, and c) the author's recommendations line up fairly well with your own (with an admitted nod to Upton Sinclair). Luckily for me "unbiased" is not a requirement for a foreword and I will thus make no attempt to temper my praise with manufactured critique added solely for credibility. Be forewarned.

My summary of Phil's wonderful book can be broken into three parts.[1]

1. What's the situation?
2. What do you do?
3. Why is doing it hard and how might we make it less hard?

So, what's the situation? Well, I won't rehash all the evidence Phil presents (or people like me have been screaming about for a while!) but valuations on both stocks and bonds are very expensive today. That means (almost but not quite by definition[2]) that they have done really well for a while, but sit at substantially lower expected medium- to long-term expected returns right now. That doesn't mean it's a certainty they'll underperform

---

1 By the way, Phil starts each chapter with a great set of quotes, all implicitly about investment but rarely explicitly about investing. Please make sure you glance at them as you read the book as they are both fun and informative.

2 It doesn't have to be so for stocks. For example, you can get to a very high P/E by price going up or earnings falling through the floor. So it's theoretically possible to be at very expensive valuations without having had abnormally high returns. But that's not the case today. Stocks are very expensive versus history and have indeed done very well.

their historical norms going forward. Expectations are just that—they aren't ex post realizations. And it's not without controversy. I have colleagues who've written papers on the difficulty in statistically "proving"[3] this as you just don't get enough non-overlapping long-term periods.[4] But, the point estimates (i.e., if you had to make one guess from the data) go the way intuition would suggest. That is, more expensive starting valuations lead to lower expectations of future return and vice versa. Again, it's difficult to prove that beyond a reasonable statistical doubt, but it has been historically true and fits our economic intuition (at least mine)—two things that are enough for me to give it serious consideration.

What's more, one thing that makes today fairly unique is *both* stock and bond markets are very expensive versus history at the same time. That means that *portfolios* (e.g., like the classic 60/40 stock/bond portfolio) of U.S. or global stocks and bonds taken together are actually more expensive than their component parts. In the past when one of these was quite expensive (e.g., stocks in the 1999–2000 technology bubble) the other (e.g., bonds in the 1999–2000 technology bubble) was often cheap, and thus the portfolio, even without any tilts or timing towards the cheaper one, was not as extreme as today. Today, both major asset classes have done very well versus history for quite a long time, leaving both of them quite expensive, and thus the portfolio of stocks and bonds even more expensive vs. history. As a result, at least in Phil's and my opinion, the expected going forward return on this diversified portfolio of stocks and bonds is extremely low versus history.

Phil then shows that it doesn't seem that most real-world investors actually believe this! Rather, their estimates for the future currently seem higher than historical experience. To those seduced by Phil's (and my) reasoning, that may appear backwards (and we think it is!). However, for many, having experienced at least a decade of superb returns on both stocks and bonds (with some big bumps along the way of course) the intuition runs the exact opposite way. They expect the good times to continue to roll on and on.

So, what do you do? Well, I really should say "what do you do if you believe Phil and Cliff?" but let's consider that implied from now on. Well,

---

3 "Proving" here means a really small chance you're wrong. Sadly, you never really prove anything in statistics you just reduce the chance you are mistaken.

4 For one paper on this statistical difficulty see J. Boudoukh, R. Israel and M. Richardson, *Financial Analysts Journal* 75:1 (2019).

you're faced with substantially lower expected return on traditional assets today vs. history. Many organizations and individuals have return goals, and financial obligations, that makes this a real problem looking ahead. One thing you could do is just accept it. Stay the course, realize you'll likely make less than-hoped-for for a while, perhaps quite a long while (the alternative is making a ton less for a little while but that's kind of scary), but not make any big errors. Not a crazy plan but Phil (and I) are interested in how we can perhaps do better.

One option is to stay with traditional stocks and bonds but add a ton more alpha than you used to assume you could, either through security selection or market timing. Nice work if you can get it! This isn't a screed about perfect efficient markets and the impossibility of either of these attempts. That would be pretty hypocritic of me. But it is a warning that both of these are a zero-sum game that you were, I assume, already engaged in if you believe in it. Why anyone can suddenly get much better at this now that traditional assets are offering less is anyone's guess but it doesn't seem like the best plan to us.[5]

So, Phil lands on the recommendation to diversify away from traditional stocks and bonds. OK, that sounds great. But into what? Phil goes through multiple options that all can fall under the rubric of "alternative." Some have done even better than traditional markets (e.g., crypto), some have kept up, but many (e.g., liquid alts that put significant weight on the "value factor"—something I know a bit about) have lagged what seems like an ever upwards, ever anti-cheap assets stock and bond market. Phil is non-partisan across these. If they pass a basic reasonableness test, including that they are getting more investable for more people all the time, he likes them, at least for a small part of the whole. He advocates a broad portfolio of many different types of alternatives, and taking a slice of what's normally allocated to traditional stocks and bonds and allocating it to that alternative portfolio. We all might do it slightly differently. I for one am more cynical than Phil about privates (e.g., the dampened reported volatility might make them look better than the really are), more clueless about crypto (I'm kind of cynical, but not in a knowledgeable way, more in an old-man harrumphing kind of way), even more clueless about farmland (like House Greyjoy my family

5 Admittedly, some of Phil's suggestions to come, like liquid alts, are a form of indeed pursuing more alpha going forward.

sigil might be "we don't sow"[6]), and even more bullish than he on liquid alts which have taken a pounding for a while leaving many of them the rare things that look cheap not expensive today versus their history (massive Upton Sinclair alert). No matter. As a whole, it's hard to argue with Phil's non-denominational diversified portfolio of diversifiers. I'll leave the details to Phil (you do have to read the book!) but he shows that such a portfolio of diversifiers has great potential to help the situation that investors in a more traditional portfolio find themselves in.

So, it's simple right? No it ain't. In fact it's ridiculously hard. Phil discusses why it is so hard and how might you make it less hard.

Here I picture Phil as Colonel Nathan R. Jessup screaming at us all "You can't handle diversification!" OK, more accurately, though not as pithy, he's (not screaming but politely explaining) that diversification, particularly away from assets that have (note the tense, people assume "have" is the same as "will" way too much in investing!) done great, is in fact much harder to handle than those in an ivory tower might think. Of course, he has some concrete ideas how to help get there (and stick there which is also very hard!).

At one point Phil says "Most allocators intuitively like the idea of uncorrelated returns, but most balk at the actual experience of owning uncorrelated return streams." This certainly fits my experience! As Phil discusses, diversification is, by definition, being different than the norm. When the norm does very well, being different will, also mostly by definition, hurt you, at least relative to your "norm"ish peers. That's not easy to live through! It's not easy even if you're doing it precisely because you strongly believe it will lead to doing better than the norm long term. When it doesn't work it's going to hurt, and hurt more than many anticipate when and if they allocate to these alternatives to begin with. Diversifying away from the norm means almost by definition you'll be trailing when most people you know are doing great. You'll have your moments, including hopefully the most important one (the long term). But, it's really hard to stick with through the lean years. And I do mean years with a plural. Everything in investing seems to go on longer than we all expect, and it seems (and this is probably a tautology in some equilibrium fashion) many of us throw in the towel at exactly the wrong time. We suffer for years and then can't take it, leaving

6 Actually my family did officially vote on a motto about 15 years ago. For those curious it was "are you going to finish that?"

(in my case sometimes within minutes of the low!) at the near exact point it finally starts to work and work and work. If that's going to be the case it is truly better not to have diversified at all but, rather, have simply accepted the lower expected returns on traditional assets and held the line there.[7]

Of course Phil is not without suggestions on how allocators can weather these difficulties and actually see diversification through. I won't spend a lot of time on them here. Again, you have to read the book! But one thing Phil says that I particularly love is "Great investments (and by extension great portfolios) are nothing if not paired with equally great investors." I think that's just staggeringly true.[8] An example (where the portfolio creator and the investor are one and the same) is Warren Buffett (isn't he an example of everything?). My colleagues wrote a paper on Buffett's investing success.[9] They found his success came a large part from picking the "right" investing styles over his career (for those keeping score at home it's buying cheap, high quality, low volatility/beta stocks) and, taking advantage of the lower volatility/beta, applying modest leverage. But they also found one other thing that's really neat. A big part of his success came from not backing off during some periods of tremendous relative or absolute difficult performance. And he did that when he was plain old Warren Buffett not the WARREN FREAKING BUFFETT THE GOAT we know today. It's just one example where doing something ex ante good, like the styles Buffett tilts towards, must be paired with staying power. I can't promise you Phil will turn all us readers into Warren Buffett but if you read his book I think it helps you at least move in that direction.

In summary, Phil tells us stocks and bonds have done great, but are now poised to do less great over the next X years, just when people now expect them to do even greater. He tells us we should diversify into some alternatives and makes a very reasonable recommendation about which to include. Perhaps most importantly, he coaches us about how hard it's going to be, how important it is to stick with it, and offers some concrete ideas

---

7 Phil notes in the book that alternatives also often get a shorter leash than other investments. First, I'm here to testify that is true! Second, while true, it's perhaps also why there's the most to gain here. Doing things that are easy rarely leads to a long-term edge. For instance, "easy" makes them easy to arbitrage away. Doing things that are hard is not sufficient for generating such an edge (there can indeed be hard but stupid things) but does seem necessary.

8 And it makes me a very thankful man for the investors I've (mostly) encountered in my career.

9 A. Frazzini, D. Kabiller and L. H. Pederson, *Financial Analysts Journal* 74:4 (2018).

how to make it happen. He offers a mantra for the whole project—SHARP. It stands for sensible + humble + autonomous + resolute + persevering. Personally, I think he's forcing it a bit with resolute and persevering being pretty similar, and he wussed out on adding an "E" to make it "SHARPE," but it's really great stuff![10]

Phil tells us diversifying properly is vital, today more than ever. But, that sticking with it is a harder battle than you might think, yet a battle worth waging, and when it comes to waging it he's got your six.

Read the book.

**Cliff Asness**
Managing and Founding Principal,
AQR Capital Management

10 This coming from me who prefers my own acronym MAGFANTs (Microsoft, Apple, Google, Facebook, Amazon, Netflix, and Tesla) to the more well know FANGs. It's my foreword and I'll be a hypocrite if I want to be.

# INTRODUCTION

## Trade-Offs All the Way Down

For as long as I can remember, I have been fascinated—nay, obsessed—with asset allocation.

I know what you're thinking—this guy needs more hobbies.

And you'd be right, but that's neither here nor there…

My infatuation with asset allocation stems from my strong conviction that diversification—true diversification—is indistinguishable from magic. I mean, think about it. To put different investment ingredients together in a blender and have the resulting smoothie taste great *and* be less filling than the sum of the parts?

The direct parallels between asset allocation and our everyday lives captivate me. Whether in markets or in life, we continually walk a tightrope of trade-offs in the decisions that we make. Want to be physically fit? You need to balance the trade-offs between a healthy diet and exercise against your desire to watch TV and eat the things you enjoy. Want to have a successful career? You need to balance the trade-offs of a higher salary and recognition from your peers against your willingness to work long hours and spend time away from your loved ones.

This brings us to the myriad trade-offs we must make as investors: return objectives, risk tolerance, income needs, liquidity preferences, tax considerations, and so on and so forth. The deeper you go, the more you realize that it's trade-offs all the way down.

For the last several decades, traditional asset allocation techniques have proved sufficient in helping investors achieve their most important financial goals. It is my belief that while the conventional core building blocks of portfolios—stocks and bonds—will still be necessary going forward, they are no longer sufficient.

To that end, I have spent an inordinate amount of time over the last decade-plus of my career researching modern approaches to asset allocation and leading-edge portfolio construction techniques. I believe that most investors have historically been limited in terms of the types of diversification they can access, but that is changing.

My raison d'être with *The Allocator's Edge* is to reach other forward-thinking financial advisors and investment professionals involved in the asset allocation process who believe we can do better than the status quo. Some will be resistant to change, while others will keep an open mind. Either way, I'm confident those who bring an unwavering commitment to doing what's necessary to improve their clients' odds of achieving their most important financial goals will walk away from this book more confident than before in that very possibility.

The road to success in this new era will not be paved with the familiar and comfortable. It is no secret that old habits die hard. But excellence in asset allocation requires a continuous evolution of ideas. We now live in an era where alternatives can stand on equal footing with stocks and bonds as a third pillar of diversified portfolios. The evidence and rationale are too compelling to ignore.

Writing instructor David Perell encourages authors to write at the intersection of what they know, what excites them, and what others want. I'm confident I've got the first two covered and it is my hope that in picking up *The Allocator's Edge* you possess the third intersection of this Venn diagram.

When I set out to write this book, I had four main priorities with the end reader in mind. I wanted it to be:

- Interesting
- Accessible
- Comprehensive
- Actionable

If after reading *The Allocator's Edge* you feel that all four of those boxes have been checked, that's about the best compliment I could receive.

# A Two-Asset World

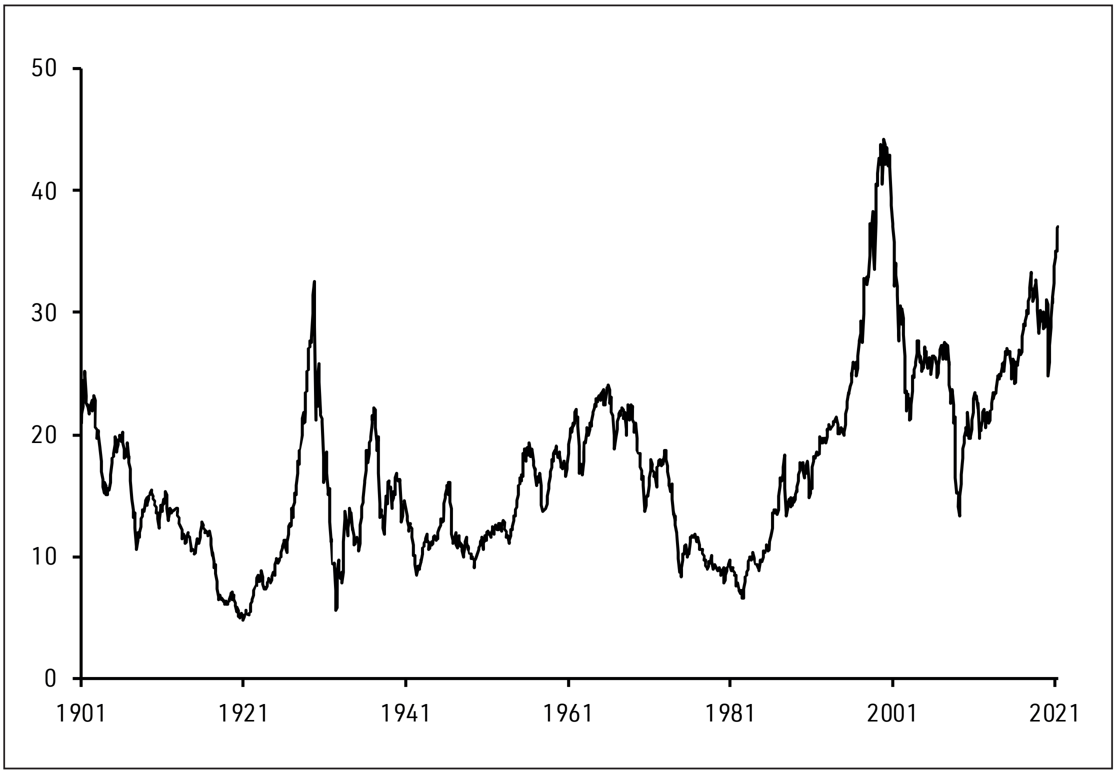
Most investors live in a two-asset world. You want the prospect of high returns with commensurate risk? Buy stocks. You want safety and income with the accompanying lower expected returns? Buy bonds. Find yourself stuck somewhere in the middle? Buy some combination of the two. It is impossible to pinpoint exactly when and how it happened, but somewhere along the way, the specific combination of 60% stocks and 40% bonds became the de facto standard in asset allocation.

The last thirty-plus years have been defined by a secular decline in interest rates, providing a once-in-a-generation tailwind for fixed income investors coming off the heels of the inflationary environment of the 1970s. Or, as writer Morgan Housel puts it, "The most underrated investing traits are patience and having your career coincide with a 30-year record decline in interest rates."

There's good news and there is bad news. Let's just rip off the Band-Aid and get the bad news out of the way first. There is a high probability that the 60/40 portfolio that worked tremendously in the past will ultimately fall short in meeting the return targets and objectives of investors in the decades ahead. There are two main culprits to blame here: high valuations of the "60" and paltry interest rates on the "40."

Let's start with equities. There is a wealth of evidence supporting the notion that starting valuations matter a great deal to long-term returns. The mean-reverting nature of valuations links high (low) starting multiples with lower (higher) than average returns. For U.S.-domiciled investors with an embedded home bias, this challenge is particularly acute as our domestic stock market in 2021 ranges from slightly rich to obscenely expensive, depending on your preferred valuation metric. Figure A shows the cyclically adjusted price-to-earnings ratio (CAPE) for the S&P 500 throughout history. It has recently reached levels seldom seen in its history.

**Figure A: S&P 500 Shiller CAPE Ratio (1901–2021)**




Source: Author.

This tells you nothing about what might happen in the next year or two, as valuations alone are a blunt timing tool. But it certainly doesn't paint a pretty picture for the next seven to ten years. The story in international markets is not nearly as bad, but market multiples abroad are by no means a screaming buy.

Let's move on to fixed income now. As of March 2021, the 10-year Treasury rate sits at around 1.5%. That is materially higher than the low of 0.52% reached in 2020, but still historically low. Assuming realized inflation of roughly 2%, investors are set up for negative expected real returns from an asset that has historically acted as ballast against equity volatility and generated mid-single digit returns in the process. One doesn't have to make an interest rate forecast to confidently declare that the halcyon days of fixed income are all but over.

Figure B shows the 10-year Treasury rate from 1962 to 2020. You can see that the rate in 2020 is historically low and that the rate has been on a downward trend since the 1980s.

**Figure B: Historical 10-Year U.S. Treasury Rate (1962–2020)**


Source: Author.

The result of these two forces colliding is dramatically lower expected real returns for traditional 60/40 portfolios. According to AQR, the expected medium-term real returns for a U.S. 60/40 portfolio is a measly 1.4%—less than one-third of its long-term average since 1900.

Don't get me wrong. I think almost all investors should own stocks. I also think most investors should own *some* bonds. These core portfolio pillars are not going anywhere anytime soon and both serve valuable roles in a portfolio. But we can do better. The goal is not to replace stocks and bonds, but to augment them.

## Three Choices

With conventional portfolios stuck between a rock and a hard place, allocators can choose one of three paths to confront today's challenges on behalf of their clients:

### 1. Do Nothing

This is the path of least resistance. And it is likely the road that most will take, as inertia is a force to be reckoned with. Maintaining the status quo will feel comfortable, but the price of admission for that comfort will come in the form of falling short of investors' objectives. Return targets are unreasonably high, yet capital market expectations are stubbornly low. Something's got to give.

### 2. Take More Equity Risk

This choice might solve the return side of the equation but requires a very long horizon and will incur some bumps along the way. Investors will likely have to incur cringeworthy levels of volatility and drawdowns that will keep them from sleeping well at night. And we must remember the equity risk premium is promised to no one—that's why it's a risk premium. History has demonstrated several lengthy dry spells. In theory, this approach might work. In practice, the odds are slim.

### 3. Think and Act Differently

Investing differently than others is easier said than done. There is peer risk, career risk, and a whole host of other considerations to factor in. Choosing this path takes courage, but it is where the opportunity lies ahead.

## The Opportunity

*What do I mean when I say we need to think and act differently?*

I promised there was good news as well. A net positive for investors is that the investable universe has grown by leaps and bounds, providing a more diverse toolkit with which to build portfolios.

The solution to the dilemma facing traditional asset allocation is to embrace additional sources of return that lie outside the conventional orthodoxy. A wide range of exposures once considered un-investable are now increasingly democratized thanks to the confluence of technological advancements and financial innovation. From niche asset classes to strategies designed to intelligently exploit structural market inefficiencies and behavioral biases, investors today can enhance their portfolios by including valuable, diversifying return streams sourced from non-traditional risk premia.

The effective implementation of alternative investments in the context of a diversified portfolio is simultaneously the biggest opportunity and the biggest challenge facing financial advisors, asset allocators and other sophisticated investors today.

---

There are no easy answers to the dilemma we face as asset allocators. But there are worthwhile solutions. And as we all know, nothing worthwhile is ever easy.

If you have been on board conceptually with alternatives, but have struggled with implementation and client adoption, worry no more.

If you are a natural skeptic—and you absolutely should be—then this is an opportunity to objectively reassess the portfolios of the families and institutions you serve.

The new paradigm suggested in this book involves a sizable and wholesale shift, both in dollars and in mindset. Succeeding unconventionally is unnatural and challenging for all of us, but I am confident that the long-term outcome is one of more robust and rewarding portfolios that can deliver across a wider spectrum of goals and objectives.

It's time to stop being complacent.

It's time to start getting creative.

It's time for us to sharpen the Allocator's Edge.