YourQ&A

What Pitfalls Trip Up Core/Satellite Model?

January 17, 2012

Q: What are some common mistakes that can trip up core/satellite investing strategies?

A: Now that we have been through the eras of individual stocks and bonds, retail funds and separately managed accounts, the core/satellite approach seems to be gaining steam. In theory, the approach holds the promise of lower downside risk while delivering more consistent returns. However, some common misreads and missed opportunities can trip up the approach and dampen overall returns.

Source of risk. Here’s one: the illusion that capital allocation results in proportional risk allocation. When caught in this illusion, we can look at a hypothetical 70/30 equity/fixed income portfolio. We can calculate its historical volatility of, let’s say, 13%, and we can even display the wisdom to recognize that while the mix is 70/30, fully 97% of that volatility is explained by the risky assets in that portfolio, according to research from Goldman Sachs Asset Management. But it is here that the illusion deceives, because it is that 3% that could kill the portfolio.

For example, going into the Great Recession, as of year-end 2007, low volatility assets such as ultra-short bonds and bank loans had five-year standard deviations of 0.76% and 2.21%, respectively. But in 2008, they returned -7.89% and -29.72%, respectively, according to BlackRock and Morningstar. It wasn’t the 97% of the volatility that did more damage; it was the remaining 3%. To avoid this incomplete view of the source of risk, those constructing core/satellite portfolios need to have a wide-angle view on risk, looking at factors such as interest rate, inflation, credit, market, liquidity, currency, political and constraint risk. Core/satellite can tempt us into a portfolio construction based simply on asset and sub-asset classes, but a more holistic view of risk will lead you to more “constructive” portfolios.

Myths of the pure alpha/beta approach. A core/satellite approach is often associated with Yale University and David Swenson’s endowment approach. As the approach has gained a following, it has become fashionable to simply equate it to alpha and beta. Though sophisticated on the surface, this interpretation could lead to disappointing performance in the portfolio. The endowment model argues that since in efficient segments of the market, which by definition are
the most liquid, it is very difficult to outperform the indicies, there may be no sense in looking for outperforming managers in a portfolio’s core; one might as well simply use inexpensive exchange-traded funds (ETFs) and index funds. Then, for the satellites, one would use active managers.

In other words, this school of thought suggests that the beta of the portfolio comes from ETFs and index funds, while the alpha comes from active managers. I would argue, instead, that this is another illusion, implying that all active managers underperform in liquid areas but somehow outperform in illiquid areas. This is, of course, not always the case, and when one accepts this illusion, one may leave some performance on the table.

Witness the Standard & Poor’s Indices Versus Active scorecard from mid-year 2011. It shows that over a five-year period, 38% of managers in the large-cap category outperformed the S&P 500, according to Standard & Poor’s and Fortigent. It is a trap to assume that one cannot find that 38%. Yes, the majority of managers underperform benchmarks over longer periods of time, but there are high-quality active managers that deliver consistent returns with good upside and limited downside, and they are not hiding. Consultants can find them with disciplined research, and they may very well endow an institutional investor’s portfolio in a way that makes it well worth the search.

**More correlation must mean more satellites.** In order for a core/satellite approach to yield desired results, one must recognize that correlations are the driver. Over time, correlations have increased among asset classes, making it more difficult to diversify the risk away. For the period between 1980 and 1989, correlation between U.S. and international stocks, as measured by the S&P 500 and MSCI EAFE, was 0.47. That increased to 0.54 for the period between 1990 and 1999. For the period from 2000 to 2009, the correlation increased to 0.88, according to Informa Investment Solutions and BlackRock. Furthermore, during crises, correlations converge and work against the investors. A common mistake with the core/satellite approach is that not enough satellite strategies are utilized, and there are not enough risk-diversifiers when correlations are high. The satellite universe must be broad.

In addition, the traditional equity and fixed income buckets should be expanded to include enhanced equity and enhanced fixed income. Consider market neutral, long/short, event-driven, short bias, relative value, private equity and venture capital strategies. In the enhanced fixed income bucket, consider including absolute return, long/short, arbitrage and relative value strategies.

If a portfolio’s satellites either use no alternatives, only a narrow universe of satellites or have a very low satellite allocation, chances are the core/satellite approach will deliver mediocre results. This is the case unless, of course, the asset allocation is dictated by the investor’s liquidity requirements.

**Don’t downplay the tactical.** The final common mistake is this: Because core/satellite is a solid strategic approach, it lulls some into being less-than-ambitious on the tactical side. Instead, the strategic and tactical components must go hand-in-hand. If the environment warrants a more bullish stance, the portfolio weights should be adjusted in such a fashion that core, beta-seeking, passive components are dialed up. If the stance is bearish, then the satellite, alpha-seeking, active components should be dialed up.