How the Big Picture Completes the Picture

Nearly 500 advisors complete self-assessment tool to measure what they know/don’t know about macro diversification
Portfolios should be diversified—everyone knows that. Less well known is that the source of the diversification makes a difference.

For years, financial advisors believed that bottom-up management alone would sufficiently diversify their clients’ portfolios. Unfortunately, that approach is not enough. Exposures to macroeconomic risk—and benefits of those exposures—are not the residual outcome of individual security selection. They need to be planned for.

Every portfolio needs both top-down and bottom-up portfolio management. The absence of top-down diversification results in a portfolio whose diversification is incomplete.

TAKE THE MACRO CHALLENGE!

The “Do You Know Macro?” quiz was opened to all financial advisors starting July 8, 2015, and remains available at williamblairfunds.com/macroquiz.

These results report on advisors who responded in July and early August to an email invitation distributed to the Advisor Perspectives mailing list, the William Blair advisor email list, and online advertising.
The good news is that advisors have begun to appreciate the need for macro diversification. That’s a high-level finding of “Do You Know Macro?”, an online challenge that 482 financial advisors completed from the first week of July to the first week of August 2015. William Blair prepared the self-assessment quiz to help advisors evaluate themselves on the macro learning curve and surface any knowledge gaps to be addressed.

Would their responses reveal them to be a:

**Captain Macro**
in full command of how fundamental valuations, dynamic risk capital allocations, and active currency management provide diversification to an investment portfolio

**Macro Explorer**
on his or her way to understanding the benefits of macro diversification

**Macro Scout**
a newcomer to macro diversification

**DISTRIBUTION OF QUIZ RESULTS**
The shape of the quiz results followed a bell curve. While 35% came in at the top of the class, earning a (virtual) Captain Macro badge, the majority of advisors (49%) scored a Macro Explorer badge with their answers. The scores of 16% of the advisors suggest they are at the Macro Scout level, early in their exploration.

The six-question quiz sought to help the quiz-taker measure his or her understanding of three themes relevant to macro diversification:

- **Macro diversification and portfolio performance** ......................... pages 2-3
- **Fundamental-based currency management** ............................... pages 4-5
- **Dynamic risk management** ................................. pages 6-7

Overall, advisors were strongest in understanding macro diversification’s contribution to portfolio performance. The results show that there’s more to learn about the opportunities to be gained from discrepancies between fundamental value and price and how currency management provides a diversifying source of return.

We explore the results in detail on the following pages.
Part of evaluating an investment portfolio is identifying its source of return. What are the drivers of return variation in an investment portfolio?

Correct Answer

- 50% asset allocation + 50% security selection: 7%
- 10% asset allocation + 90% security selection: 4%
- 70% asset allocation + 30% security selection: 17%
- 90% asset allocation + 10% security selection: 72%

Nine out of 10 financial advisors know that asset allocation has a greater influence on a portfolio than security selection. About three-quarters are familiar with the exact contribution made by each. Most of those who answered incorrectly underestimated only the dominance of asset selection.

The finding that, historically, over 90% of portfolio return variation has been attributable to top-down (macro) allocation decisions is relatively recent. It was confirmed in “Determinants of Portfolio Performance II: An Update,” a landmark update to one of the pioneering studies on asset allocation.1 A co-author of the work, in fact, was Brian Singer, head of William Blair’s Dynamic Allocation Strategies team and co-portfolio manager of the William Blair Macro Allocation Fund.

MORE:
“Determinants of Portfolio Performance II: An Update” (PDF)

What are the characteristics of a top-down portfolio that invests directly in asset classes, markets, sectors, credit categories, and currencies? (Check all that apply.)

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Correct Answers</th>
</tr>
</thead>
<tbody>
<tr>
<td>The ability to determine fundamental value/price discrepancies</td>
<td>45%</td>
</tr>
<tr>
<td>Smart beta*</td>
<td>24%</td>
</tr>
<tr>
<td>Flexibility—the ability to both initiate and unwind out of positions</td>
<td>88%</td>
</tr>
<tr>
<td>Stock picking expertise</td>
<td>10%</td>
</tr>
</tbody>
</table>

The flexibility to determine fundamental value/price discrepancies—the most intuitive of the provided answers—was selected by 88% of the quiz-takers. Indeed, top-down investing is widely understood to complement bottom-up investing because it views available information from a different perspective and helps to provide diversification within the portfolio.

However, about half of the advisors overlooked two additional important characteristics of a top-down portfolio:

- The ability to determine discrepancies between fundamental value and price in both markets and currencies.

  *Fundamental analysis identifies where prices deviate from fundamental values. But understanding why these discrepancies exist is key to effectively pursuing unexploited opportunities. Macro-thematic analysis, geopolitical analysis (game theory), and conventional wisdom all are brought to bear on this determination.*

- The flexibility to quickly initiate and unwind portfolio positions.

  *The ability to use liquid instruments to implement investments in individual markets and currencies around the world provides flexibility to move quickly—whether for risk management or to capture an opportunity.*

*Smart Beta*: Investment strategy that seeks to passively follow indices that use alternative index construction rules versus traditional market capitalization-based indices.

**MORE:** William Blair offers several two-minute videos to deepen your understanding, including:

- **Bottom-up vs. top-down portfolios**
- **Is fundamental analysis enough?**
- **Multi-asset strategies**

Watch our alternative investing videos at williamblairfunds.com/alternatives or download the transcripts of the videos (PDF).
Here’s how Brian Singer, CFA, partner, head of William Blair’s Dynamic Allocation Strategies team and co-portfolio manager of the William Blair Macro Allocation Fund, explains the relationship between fundamental value and price:

“Think of fundamental value as what something is intrinsically worth, and that is a powerful gravitational force that draws price toward it over time. You always want to be on the right side of the tide. If the tide is going up, you want to own the asset. If the tide is going down, you don’t want to own that asset.

Fundamental value remains the inexorable tide that pulls price toward it over the course of a number of years. It’s no longer, however, necessary and sufficient to think of that as an investment tool. Now we need to think about it as necessary—always being on the right side of the tide—but not sufficient.

Sufficiency comes from understanding different disciplines that help us navigate a geopolitically unstable world. So fundamental value is the foundation of investing, but geopolitics and other macro developments sometimes create very significant waves that can buffet the boats. And a good investor needs to navigate those waves while capturing the inexorable pull of the tide.”

Dynamic Allocation Strategies team members pictured from left, Tom Clarke, Guy Bloomfield, Brian Singer, Aaron Balsam
Opportunities arise when prices deviate from fundamental value. On average, how long does it take for price to revert to fundamental value?

- 8 years for equities, bonds and currencies: 7%
- 8-10 years for equities, 5-8 for bonds, 4-5 for currencies: 34%
- 1-2 years for equities, 3-4 for bonds, 5-8 for currencies: 40%
- 8 years for equities, 8 for bonds, it’s not possible to determine fundamental value for currencies: 19%

The most difficult question on the quiz stumped quiz-takers—all but one Macro Scout, two-thirds of the Macro Explorers, and even 36% of the Captain Macros.

The favored (but incorrect) answer suggests that equities revert to value in less than two years while bonds take longer and currencies the longest.

In fact, prices converge on fundamental value for currencies faster than for equities and for bonds. That means that fundamental value can be a very powerful tool for currency management. This shorter reversion to fundamental value provides the opportunity to quickly exploit value/price discrepancies for currencies.

**MORE:**
Watch this “How do you determine fundamental value?” two-minute video. Or download the transcript (PDF).

A more technical explanation is provided in William Blair’s “Currency Management: The Case for Value Investing” (PDF).
Every investment portfolio has currency exposure. Which of the following statements best summarizes the view of fundamental-based currency management?

- Currencies can’t be managed. Focusing on equities and bonds is sufficient. 2%
- Currencies can be managed as a means of diversifying the portfolio and enhancing return. 62%
- Currencies can be managed by seeking to anticipate where the exchange rate will move over short-term periods. 9%
- Currencies can be managed as a means of diversifying the portfolio. 27%

Nine out of 10 advisors are aware of currencies’ effectiveness as a portfolio diversifier. It’s true that the uncorrelated return stream versus equities and bonds should reduce portfolio volatility over time. And, investment managers can pursue currency opportunities independently of market concerns.

But more than one-quarter of the quiz-takers overlooked the ability for currencies to enhance return, as well.

There is a difference between a fundamental approach to currency management, which focuses on longer-term valuations, and momentum-driven currency management, alluded to in one of the provided (but incorrect) responses to this question.

Given that fundamental value is a powerful draw on price over time, diversified source of alpha (a measure of a portfolio’s return in excess of the market return, after both have been adjusted for risk) can be a significant benefit of fundamental-based currency management.

MORE:
Watch this “What’s the role that currency management plays?” two-minute video. Or download the transcript (PDF).
Macro diversification includes geopolitical analysis. Fortunately, the environment today is more geopolitically stable than it was during the heightened tensions of the Cold War. True or False?

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

True 13%
False 87%

As a whole, quiz-takers recognized this as a false statement.

A closer look at the results, however, reveals that the realization that the world today is geopolitically unstable separates those who performed well on the quiz and those who didn’t. Nine out of 10 Macro Scouts (those least familiar with macro diversification) found the statement to be true.

But, it was during the Cold War when the world was more stable. At that time there were just two main players—the United States and the Soviet Union. Both had nuclear missiles and were bounded by mutually assured destruction (MAD). Both nations knew that just one mistake would have had a costly consequence, which resulted in stability around the world.

In contrast, today there are multiple players, information is incomplete, and the analysis required is much more complex. The impact of this on building investment portfolios? Fundamental analysis alone is no longer sufficient.

MORE:
For more on the application of game theory to investing, download the William Blair Game Theory and Macro Investing Playbook (PDF). Or view more white papers and commentaries.

Watch this “How do you leverage game theory in macro investing?” two-minute video. Or download the transcript (PDF).
Risk management is a key consideration in an investment portfolio. Which of the following is a recommended approach to actively managing risk?

- Set a 2% volatility target: 4%
- Closely monitor the markets, always prepared to move to cash during market crises: 7%
- Take an amount of risk that is commensurate with the size of the opportunity: 80%
- Take a constant amount of risk at all times: 9%

Eight out of 10 quiz-takers (and nine out of 10 Captain Macros) appreciate the value of a dynamic approach to risk management, which involves taking less risk if there are few opportunities and more risk when there are many opportunities. Dynamic risk management—as opposed to taking a constant amount of risk at all times—is a superior way to position a portfolio.

MORE:
The interactive motion chart at williamblairfunds.com/macro will give you an idea of the dynamic, opportunistic nature of the William Blair Macro Allocation Fund and the decisions the team makes and why.
How To Access Macro Diversification

The William Blair Macro Allocation Fund invests opportunistically with a focused risk management style.

DOWNLOAD

Download the Fund 101 introduction (PDF) and Fund Overview (PDF) or go to to Fund web profile.

SUBSCRIBE

Financial Advisors Only: For more on macro diversification, subscribe to our twice-monthly email newsletter with macro investing insights from William Blair’s Dynamic Allocation Strategies team. The e-newsletter includes conference call highlights and insights on fundamental valuations and geopolitical risks.

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WATCH

Watch our “How Would You Describe the Macro Allocation Fund?” two-minute video introducing the Fund or download the transcript (PDF).
RISK DISCLOSURES

The Fund involves a high level of risk and may not be appropriate for everyone. You could lose money by investing in the Fund. There can be no assurance that the Fund's investment objective will be achieved. The Fund is not a complete investment program and you should only consider the Fund for the alternative portion of your portfolio. Separate accounts managed by the Advisor may invest in the Fund and, therefore, the Advisor at times may have discretionary authority over a significant portion of the assets invested in the Fund. In such instances, the Advisor's decision to make changes to or rebalance its clients' allocations in the separate accounts may substantially impact the Fund's performance. The Fund is designed for long-term investors.

The Fund may use investment techniques and financial instruments that may be considered aggressive—including but not limited to the use of futures contracts, options on futures contracts, securities and indices, forward contracts, swap agreements and similar instruments. Such techniques may also include short sales or other techniques that are intended to provide inverse exposure to a particular market or other asset class, as well as leverage. These techniques may expose the Fund to potentially dramatic changes (losses) in the value of certain of its portfolio holdings.

Investments are subject to a number of other different types of risk, including market risk, asset allocation risk, credit risk, commodity risk, counterparty and contractual default risk, currency risk, and derivatives risk. For a more detailed explanation and discussion of these risks, please read the Fund's Prospectus.

Please carefully consider the Funds’ investment objectives, risks, charges, and expenses before investing. This and other information is contained in the Funds’ prospectus, which you may obtain by calling +1 800 742 7272. Read it carefully before you invest or send money.


William Blair Investment Management, LLC and the investment management division of William Blair & Company, L.L.C. are collectively referred to as “William Blair.”