EMPIRICAL
ASSET MANAGEMENT

SPECIAL COMMENTARY

EAM's Asset Allocation Template and Non-Normal Risk Orientation

- Modern Portfolio Theory (MPT) and Markowitz are dead – actually MPT is flawed and never worked to begin with, but, it didn't get exposed in the last 38 years because of persistently falling interest rates.
- You must account for non-normal risks, especially now that rates are close to zero %
- Flaws with MPT:
  - Standard deviations and correlations are not static but MPT relies on them to be so in order for the theory to work.
  - Humans are emotional and social so non-normal events happen way more than frequently than MPT and the Efficient Market Hypothesis would suggest.
  - MPT does not consider future return potential, solely relying historical risk and return
  - Most investors are on the same side of the boat, many using MPT and ETFs to invest in Asset Allocation models creating the likelihood of an outsized overreaction to a regime change shift.
- What needs to be considered:
  1. Change of correlations overtime especially in extreme market environments (the left tail).
  2. The fact that more left tail events happen then should be expected.
  3. That prior returns influence current returns so therefore build up and amplify risk over time.
  4. Current risk and return of investment categories and vehicles not just historic risk and return.
- What needs to be done:
  1. Change of correlations – assess joint risk returns in left tail (Copulas)
  2. Fat tails – utilize Extreme Value (EV) analysis using Current Value at Risk (CVAR) not Standard Deviation as the risk measure
  3. Serial Correlations – unsmooth returns
  4. Current risk and return – moderate and amplify asset category use
- The next Asset Allocation frontier is Tactical Asset Allocation done right
  - Valuations are like seagulls, they can be great indicators of where or where not to fish, but you need to know where and when to use their activity as a true signal.
  - Bond rates are close to Zero % and have persistently gone down for 40 years.
  - Acute changes in markets affecting strategic (long-term) asset allocation require more immediate and more sizeable adjustments.
  - Avoid all in bets which has destroyed many investment firms - use smaller incremental changes such as 20% changes.
  - Empirical Asset Management has a 13-part Rules Based Tactical Market Signal that may help

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