

# Asset Allocation

# SUCCESS

## **Don't Limit Your Options.**

The critical variable in meeting an investment goal is the distribution of assets between classes. This is no secret. But achieving success in asset allocation is easier said than done. Within the Private Client Group at Lazard, we believe that we have a better framework for asset allocation than most other investment firms can offer. Why? In short, where other plans tend to be rigid, we're flexible. Where other plans limit your choices, we take nothing off the table, while at the same time giving you the best framework in which to make your decisions. Every investment plan is set up so that you come out ahead. But at

Lazard we ask: "Can you do better than just come out ahead?"

## **We think you can.**

Of course, like other firms, we recognize that investments are made to meet client goals and lifestyle needs – and not necessarily to beat industry benchmarks. But, we also understand that navigating through the various investment opportunities around the world requires a logical framework that clearly lays out all of the choices available for investors. Making an allocation decision between equities and bonds or large- and small-cap stocks requires not just a return assumption, but a conviction in the likelihood of success. That's why our asset-allocation process is probability based.



## Likelihood of success

# results

**H**istorical data may provide guidance on understanding future returns (though no guarantee).<sup>1</sup> But risks change, and valuation and timing matter. How will a change in real interest rates affect small-cap stocks? If taxes and governmental regulation rise, what does that mean for bonds? A forward-looking view that can tie together such important variables is critical to the asset-allocation process.

The Lazard Investment Advisory Board, with over 100 cumulative years of direct capital-markets experience, looks to formulate the probabilities of asset-class returns. We then apply those probabilities to an investor's long-term goals, producing a recommended asset allocation. This allocation is run through a quantitative framework which reflects the Board's opinions by overweighting opportunistic sectors and underweighting overvalued sectors. This ensures that there are no unintended bets made in a portfolio.

But Lazard differentiates itself in asset allocation in two additional ways. The first is in the versatility of our framework. The second is in the active use of passive vehicles (a.k.a. index funds).

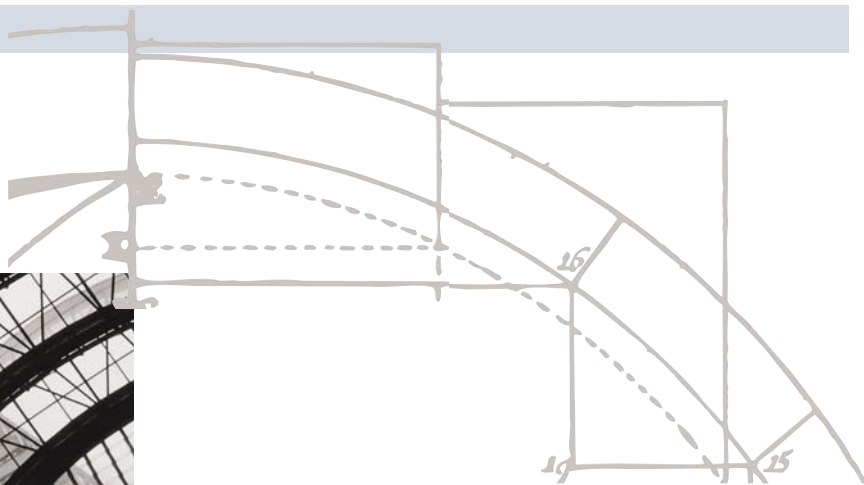
Whether it be for client considerations or market opportunities, the asset-allocation model can be changed to find opportunity. That's what we mean when we talk about the versatility of the framework. For example, we do not view the non-traditional sector exclusively as the domain of hedge funds. To us, the non-traditional sector is a place for any investment decision that does not correlate with traditional capital-market indices yet does have value. This sector could include hedge funds but may also include investments in discounted closed-

end funds and industry-sector funds or specific securities that represent good long-term value.

Our second differentiating feature is the active use of passive vehicles. You may have noticed a debate today over whether to "index" or go "active." This is conducted in the context of strategic asset allocation, which requires an active manager to consistently outperform the market over the long run. But what if a manager regularly outperforms the market during certain cycles and underperforms the rest of the time? It's quite possible that the long-run performance of the manager will not be much different than that of the index.

This argument suggests that indexing is indeed the superior strategy for strategic asset allocation. However, strategic asset allocation may produce inferior results to a strategy that focuses on taking advantage of the relative performance of different asset classes during cycles. We are not talking here of a traditional tactical allocation, but of a somewhat intermediate step between tactical and strategic allocation — call it cyclical asset allocation.

Such a strategy emphasizes different asset classes, as well as active-versus-passive management, as cycles dictate. When markets do not provide much in terms of selection opportunities for securities, the index fund is a cost-efficient tool in which to access broad market moves. But market efficiency has cycles too. Correspondingly, reallocating index funds is another source of value that we add through our asset-allocation process. Such a strategy requires a nimble management structure, such as the one in place at Lazard.



## Thinking In Cycles

There is a time for everything. There is a time for active management and a time for passive management; a time for value stocks and a time for growth stocks; and a time for large-caps as well as for small-caps.

The construction of major stock indices provides an excellent illustration of this. In general, stock indices are capitalization weighted, meaning that larger stocks tend to get more weight in an index. For example, during the mid 1990s the 10 largest holdings of the S&P 500 accounted for roughly 50 percent of that index's capitalization. Thus, when the top 10 holdings outperformed the index, the 490 stocks accounting for the bottom 50 percent on average underperformed.<sup>2</sup> Hence, the odds of an active manager outperforming during this period would have been low. The implication is that an index strategy during a large-cap cycle can be superior.

On the other hand, during a small cap cycle, those 490 S&P stocks would have outperformed on average. In this example even a monkey throwing darts at a stock board would have a good chance of beating the market. So, during a small-cap cycle, an active strategy is most likely the desirable approach.

Size and weighting schemes alter the odds that an active management strategy will outperform an index. But when the odds are in your favor to outperform, we believe that you should consider that option. Again, this is based on a conviction in the likelihood of your success.

Style differences also count. Take any index, such as the S&P 500, S&P 400, or S&P 600. In each of these, the number of value stocks is much larger than the number of growth stocks. That said, there are numerous studies showing how value

stocks on average tend to beat their respective broad-based indices. However, even if this result holds true, it may not be advisable to pursue an active value strategy. Here's why: an active management strategy invariably leads to a concentrated portfolio in relation to the universe of value stocks. Second and equally important is the fact that by the nature of the value-selection criteria, when misses occur they can be disastrous to a portfolio.

A simple example illustrates this point: A stock is undervalued at \$15 and its price declines to \$12. Is it now even more undervalued? Should you increase your exposure to this stock? Not so fast. The value approach may in some cases induce you to double-up on a loser. On the other hand, growth investors have a natural way to preserve their gains: When growth slows down, they get out of a stock.

Again, there's a time for everything.

At Lazard we take the view that on a risk-adjusted basis and over the long-term, no one asset-allocation strategy should dominate another. Sometimes an active approach works, other times passive is the way to go. Sometimes it's large-caps, other times small. As cycles persist there will be times when each of the strategies will outperform.

Why should a plan act as if it has one hand tied behind its back? A plan should have all of the alternatives at its disposal. And when it does, it should be administered by an advisor who can identify the relative attractiveness of different strategies over time. That's where the Private Client Group at Lazard comes in.

## A Logical Framework

There is a broad range of advice to be found in the investment community today. Some of it is good, if limited in scope, and some of it is poor in quality. For instance, an overdependence on historical data and quick-fix universal solutions have not always served investors well.

As a wealthy individual you have capital market risk. Managing that risk, evaluating opportunities in the context of your goals, and accessing specific investments efficiently requires broad, objective, close-to-the-capital-markets thinking.

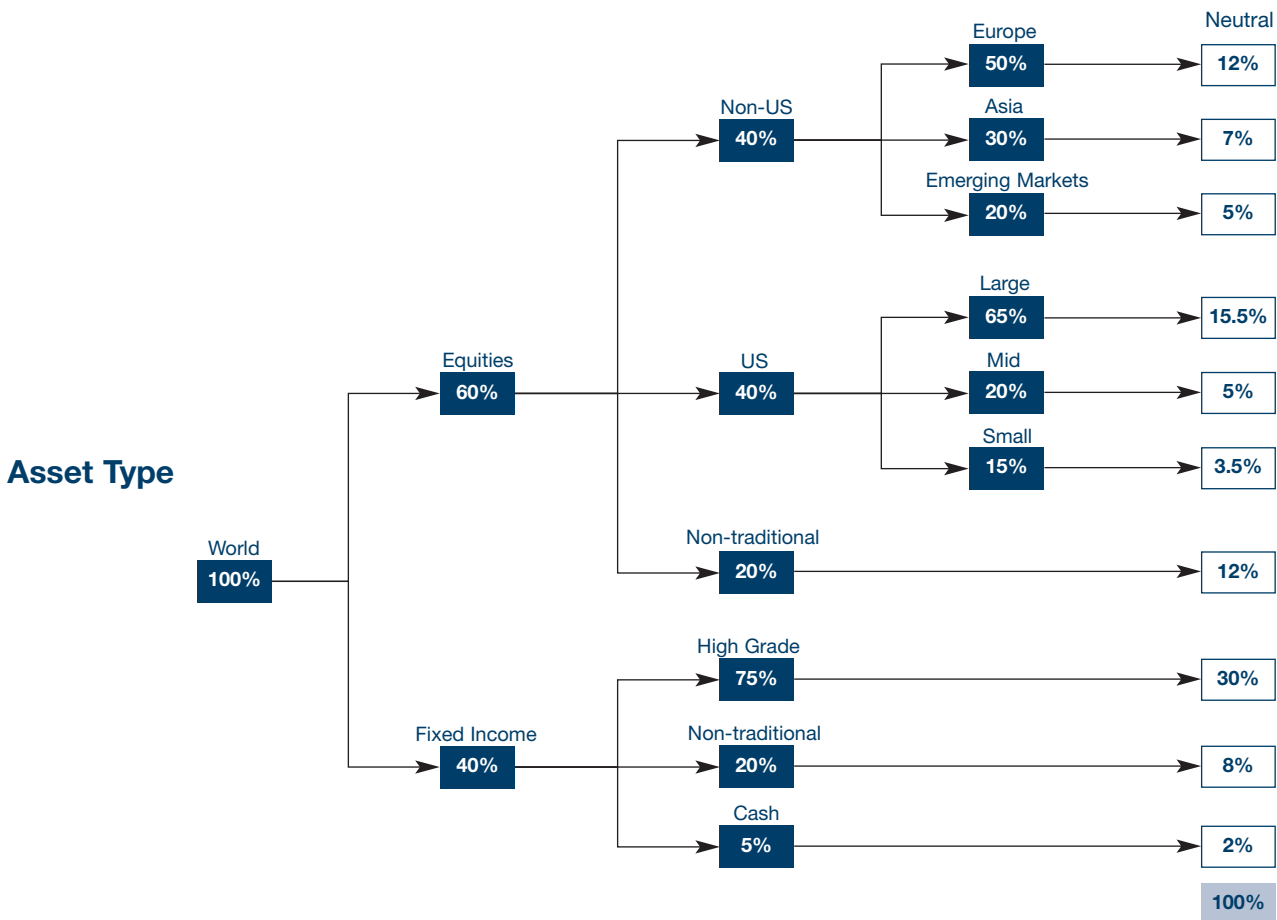
At Lazard we believe that historical relationships combined with various market insights provide us with the signals to develop a forward-looking view of the world that on average will correctly anticipate the turning points in various return cycles. More, a top-down global view that focuses on policy changes at the government level and a range of geopolitical events is also useful in identifying and anticipating some of the

secular and cyclical changes in relative performance both domestically and across countries.

Armed with such information, we develop decision rules for determining how and when to choose a style, location, and/or size of an investment, and whether to do so in a passive or active mode. We call this whole process the value-timing approach to asset allocation.

Lazard's asset-allocation framework is not a black box that processes a large number of statistical variables and spits out an investment plan. It's a logical framework that lays out the choices for investors. Stocks or bonds? Domestic or international? Large or small? Index or active? Traditional or non-traditional?

Committing to a single strategy may only provide mediocrity in the long run. Don't limit your options. We think you can do better.



1 Past performance does not guarantee future results.

2 Source: Standard & Poors.