SOCIETY OF ACTUARIES

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2014 ASSET ALLOCATION CONTEST: NAVIGATING INTERESTING TIMES

By Tom Anichini

In 2014, the Investment Section conducted its second asset allocation contest, allowing section members a chance to allocate among 10 ETFs over a six-month span from May through September. Again we awarded prizes of iPad minis (or their equivalent) in three categories: Highest Cumulative Return, Lowest Volatility, and Highest Ratio of Return to Volatility. The ETFs spanned asset classes common to U.S. investors, from Enhanced Cash to Emerging Markets Equity and Commodities.

The 2014 contest also entailed these new wrinkles different from the 2013 contest:

- No automatic rebalancing was assumed;
- Contestants were allowed to rebalance or change their allocations twice—after two months and after four months—transactions were assessed a transaction cost to better reflect real life conditions; and
- All ties were broken by a single tie-breaker score: the sum of squared ranked absolute prediction errors in all three categories.

More than 130 section members submitted entries. For the first five months of the contest the rankings were largely static as risk asset returns were mostly stable and somewhat positive (except for commodities).

Then, in late September, risk assets began to falter. Rankings shifted, and at least one of the winners navigated the contest's rebalance opportunities deftly.

CUMULATIVE RETURN PRIZE: RON BARLIN (6.27%)

Ron took advantage of the second of two rebalance opportunities to switch his allocation from 100 percent iShares MSCI Emerging Markets Index (EEM) to 100 percent iShares MSCI ACWI Index Fund (ACWI). Despite his cumulative return taking a maximum hit from the transaction cost, when risk assets fell at the end of September his cumulative return fell less than it would have had Ron allowed his initial allocation simply to drift. His final return, 6.27 percent, exceeded the cumulative return of any single one of the ETFs available.

LOW VOLATILITY PRIZE: CHILIK LEE (2.0669%)

Chilik was one of six entrants who submitted an initial allocation of 20 percent Guggenheim Enhanced Short Dur ETF (GSY)/80 percent Vanguard Total Bond Market ETF (BND), an obvious attempt at winning the Low Volatility category (or perhaps a reflection of a conservative utility function). All six finished tied for the lead. Chilik won the tie-breaker with the lowest prediction error score in the contest, based on the data listed below:

Measure	Result	Prediction
Cumulative Return	1.86%	2.50%
Volatility	2.07%	2.40%
Return/Volatility ratio	0.898	1.0

I asked about Chilik's method for estimating the eventual return and volatility so accurately:

"I estimated the predicted volatility straight from the historical data, but the predicted return I adjusted downwards from the average of past historical data of the bond funds. I didn't expect bonds to experience another significant yield drop (or even a yield spike) over the six-month horizon, thus I predicted the performance of the bond funds would not be as good as they were in 2009-2012." Well done, Chilik.

RETURN/VOLATILITY PRIZE: MARY PAT CAMPBELL (0.898)

This category was the most closely contested in the contest. The same group who submitted 20 GSY/80 BND allocations ranked at the top of this category. Since Chilik was ineligible to win two prizes, Mary Pat won with the 8th best prediction error score in the contest. When I notified her

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about winning a prize, she said this category was the one she had hoped to win.

CONCENTRATED PORTFOLIOS

Participants learned from the 2013 contest that a concentrated portfolio offers a strong chance of winning the Cumulative Return category, if they could guess the best-performing ETF. While in the 2013 contest only a handful of submissions entailed a single holding, in 2014 over two dozen entrants allocated 100 percent to a single ETF. (Your correspondent allocated 100 percent to PowerShares DB Commodity Tracking ETF (DBC), the worst-performing ETF available.) Unfortunately most of these concentrated portfolios endured sharp losses in September, highlighting the timeliness of Ron Barlin's tactical shift to ACWI.

PARTICIPATE IN 2015

Watch for an invitation during Q1 2015 to participate in the next iteration of the contest!

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IN THE NEWS

In an article by Lawrence Bader titled, "Question: How Does Investment Return Affect Pension Cost?" Bader answers that in economic terms—"It doesn't." So, pension fund investment policy should be designed not to minimize pension contributions, but rather to fit the plan sponsor's overall business and risk management policies. This article was a guest editorial published in the September/ October 2014 edition of the *Financial Analysts Journal.*