

**THE CASE FOR A FLEXIBLE APPROACH TO ASSET ALLOCATION**

Dominic McCormick, CIO, Select Asset Management

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*The difficulties in investment markets in recent years have decimated many portfolios and raised questions regarding conventional approaches to asset allocation. In particular, it has highlighted the limitations of the strategic, largely “set and forget” approach to asset allocation that many in the industry adopt. This research paper highlights some flaws in the conventional approach to asset allocation and explains why a more flexible approach is appropriate for many investors, particularly in the challenging investment environment expected to continue in coming years. This paper does not provide a “magic bullet” for determining client’s asset allocation nor suggest that successful asset allocation is easy. However, it shows how value can be added over time and highlights that the decision to ignore asset allocation or simply adopt historically based, fixed, strategic allocations may be a costly approach for many clients.*

The Global Financial Crisis of 2008/2009 has focused attention on traditional approaches to asset allocation and portfolio construction. In particular, it has highlighted the limitations of the strategic, largely set-and-forget approach to asset allocation adopted by many institutions and investors.

This approach to asset allocation typically involves a fixed or strategic asset allocation (SAA) across three to six risk profiles, with a higher proportion in growth assets relative to defensive assets, as the risk profile increases. SAA models typically cover the major asset classes only, are infrequently reviewed and, in practice, appear to be heavily influenced by consensus or competitor allocations<sup>1</sup>. Some tactical asset allocation (TAA) around these SAA models may be implemented but, in practice, deviations tend to be minor and relatively ineffective<sup>2</sup>. Various degrees of regular or automatic rebalancing back to the set SAA benchmarks as a result of market movements are also commonly implemented.

Given the favourable investment environment of the last 15 to 20 years until late 2008, especially in Australia, any flaws in the SAA approach have been generally ignored. However, the Global Financial Crisis and its devastating impact on most investment portfolios raised some valid issues and concerns about an SAA approach.

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<sup>1</sup> Stracca, L., 2005, “Delegated Portfolio Management A Survey of the Theoretical Literature”, No. 520 / September 2005

<sup>2</sup> Evidenced for UK pension funds by Mercer, 2008, “Asset allocation survey and market profiles – European institutional market place overview 2008”, pages 5, 14.

## STRATEGIC ASSET ALLOCATION AND ITS LIMITATIONS

The SAA approach developed from Modern Portfolio Theory and the Capital Asset Pricing Model, as well as the Efficient Market view of the world that underpins it. Within this framework, the asset allocation starting point for any rational investor is assumed to be a fixed exposure to all available asset classes in proportion to their market capitalisation (the market portfolio). As Gibson (2008) states “Modern Portfolio Theory suggests that in an efficient market, an investor with average volatility tolerance should hold a portfolio that mirrors the proportion in which the world’s wealth is allocated among the various asset classes.”<sup>3</sup>

Since asset prices are assumed to be fairly priced in an efficient market, there is no incentive to overweight or underweight one asset class over another. Indeed, the risk of this market portfolio is assumed to be constant, with risk able to be adjusted by either allocating to the risk free rate or borrowing at that rate and investing more in the market portfolio.

However, in the real world many of these assumptions are unrealistic. Investors can’t borrow at the risk free rate, for example. But from an asset allocation perspective, the key issue is that the SAA approach fails to make sense if markets are not efficient<sup>4</sup>.

Those participants in the investment industry who appear not to have recognised the dependency between market efficiency and SAA usually follow an assessment of the long-term historical risk premiums earned across asset classes and implicitly assume that these risk premiums are reliable (albeit variable) over time, and therefore a good estimation of future risk premiums. As shown below, risk premiums are not reliable at all times.

A related concept is the belief that a SAA controls systematic risk<sup>5</sup>, allowing investors to set an optimal portfolio for a given level of risk with five years (seen as a) reasonable minimum reference point<sup>6</sup>. As shown below, however, in an inefficient world, a specific SAA will not provide a given level of systematic risk but rather a widely varying level of risk for the fixed asset portfolio, using either standard measures of risk (e.g. volatility) or more sophisticated ones dealing with drawdowns. In a world where bubbles and busts occur, an investor relying on fixed SAA is potentially abandoning the management of systematic risk.

If instead, SAA model is derived from expected medium-long term forward returns (and risks) then it is obvious that in an inefficient world these will change as market prices and valuations change

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<sup>3</sup> Gibson, R., 2008 (4th Edition), “Asset Allocation, Balancing Financial Risk”, p13

<sup>4</sup> This paper does not intend to debate the efficient market hypothesis (EMH). Roger Gibson’s “Asset Allocation, Balancing Financial Risk” (refer footnote 3) states that “Most research evidence, however supports the notion that markets are reasonably efficient.” This sentiment probably partly explains why SAA is so widely accepted but in 2009 the vast majority of the academic and professional investment world now seem to agree that the EMH is a poor description of the real world (refer Fox, J., 2008 “The Myth of the Rational Market”). Professor Robert Schiller has called the EMH “the greatest mistake in the history of economic thought” (refer Fox above).

<sup>5</sup> Systematic risk, also called market risk, is risk that is characteristic of an entire market, a specific asset class, or a portfolio invested in that asset class. Source: Dictionary of Financial Terms, 2008.

<sup>6</sup> Sharpe, W.F., Chen, P., Pinto, J.E. and McLeavey, D.W., 2007, “Managing Investment Portfolios: A Dynamic Process, 3<sup>rd</sup> Edition.

(amongst other elements). In such a world, the idea of a fixed SAA is illogical. Further, if the SAA is changed regularly in response to valuation changes, it effectively ceases to be strategic.

Another “definition” of SAA is the asset allocation investors’ expect to average over time or, as Sharpe et al suggest, “the appropriate asset mix to be held under long-term or “normal” conditions”<sup>7</sup>. This definition tells you nothing about where asset allocation should be when conditions are “abnormal”. Based on this view, the obvious question is “what is long term and normal in practice?”.

None of these definitions of SAA make much sense unless markets are efficient. It can therefore be contended that there is no pre-determined fixed set and forget asset allocation that investors can rely on to meet their risk and return objectives going forward, simply because the risk and reward profile of any fixed asset allocation will change (often significantly) over time.

What usually happens in practice is that SAA models are developed based largely on how other investors are positioned. This consensus or herding approach (as outlined by Maug and Naik (1996)<sup>8</sup>) obviously lacks rigor and has a range of inherent problems, some of which are addressed below. A careless practical implementation applied from a flawed theoretical framework is hardly well placed to deliver for investors.

SAA may have some role in assessing long term returns (which was a major focus when first it became more popular). But it is dangerous as the anchor for asset allocation as shown below.

#### WHAT ABOUT TACTICAL ASSET ALLOCATION?

Some argue that flaws in SAA are negated through Tactical Asset Allocation (TAA) around benchmark SAA models. TAA involves deviations from the SAA within defined ranges, usually based on valuation judgements that assume asset values will mean revert. TAA, as it is commonly practiced, also has problems, not the least that it is anchored to a flawed premise (SAA) in the first instance.

Some argue that no one can add value in active asset allocation, so a non-active approach to asset allocation makes sense<sup>9</sup>. However, even if this view was correct, it provides no guide as to what the asset allocation should be (apart from the idea of investing in every possible asset in proportion to its market capitalisation).

This is not to suggest that TAA is easy. Even adopting a specific SAA is an active allocation decision, which will ultimately be judged by investors as a success or a failure. Blaming the market for poor returns may be justified in the short or medium term, however, in the long term, failing to meet targeted return objectives as a result of asset allocation decisions means that either the approach to asset allocation or the asset allocator has failed, neither of which will be appreciated by investors.

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<sup>7</sup> Ibid

<sup>8</sup> Maug, E.G. and Naik, N.Y., 1996, “Herding and delegated portfolio management: the impact of relative performance evaluation on asset allocation”, IFA working paper number 223/1996

<sup>9</sup> As summarised in “Sources of Portfolio Performance: The Enduring Importance of Asset Allocation”, The Vanguard Group, July 2003: [https://institutional.vanguard.com/iip/pdf/icr\\_asset\\_allocation.pdf](https://institutional.vanguard.com/iip/pdf/icr_asset_allocation.pdf)

Avoiding this disappointment should be the major focus for those involved in asset allocation decisions.

## WHY THE CONVENTIONAL SAA APPROACH IS FLAWED

Below are six reasons why SAA is flawed. They do not cover all the issues regarding SAA, however, collectively they build a strong case that the SAA approach has significant flaws in theory and practice.

1. Long run returns, risks and correlations are not reliable over time;
2. The structure of asset classes can change dramatically over time;
3. Starting valuations are a key driver for future returns and risks;
4. SAA leads to excessive exposure to equities;
5. Passive rebalancing can be dangerous; and
6. SAA enshrines cultural factors that have nothing to do with intelligent investing.

### 1. Long run returns, volatility and correlations are not reliable over time

Most literature covering asset class risk premiums implies that they are consistent over time, and that historical risk premiums are a good estimation of the future. For example, Gibson<sup>10</sup> shows that the risk premium for US large company stocks was 6.0% per annum from 1926-2005 (that is, total return of 9.7% per annum less the 3.7% per annum return from US Treasury bills). Gibson follows this by stating that “If we assume that the volatility inherent in large company stocks will not be materially different in the future from what it has been in the past, and if we further assume that the market will price large company stocks such that the compensation for bearing this volatility is the same in the future, as it has been historically, then 6.0% will be a reasonable estimate of the equity risk premium in the future.”

Such long-term historic risk premiums and historic volatility are often used as the starting inputs for determining SAA models. The reality is, however, that such risk premiums are notoriously volatile even over the five, 10 or even 20 year time frames that constitute the long-term investment horizon of most investors. Gibson<sup>11</sup> alludes to this by showing a graph of the widely varying equity risk premium over rolling five-year periods showing a negative equity risk premium for much of the 1930s and 1970s.

Relying on this approach in the real world is dangerous. Take the example of Japanese equities or US equities over the last decade. In the decade to 30 May 2009, US equities had returned a negative risk premium of -3.7% (and -4.1% the five-year period ending that date)<sup>12</sup>, much lower than any number than would have been projected under Gibson’s model. Rolling five-year returns were extremely variable as shown in Figure 1.

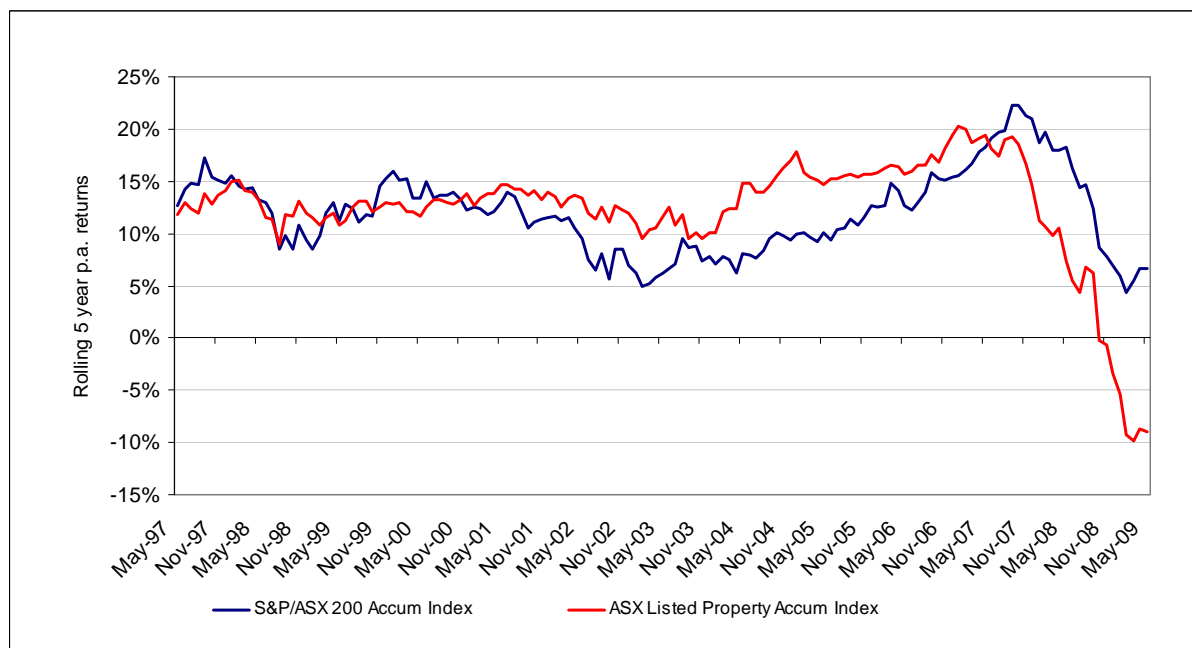
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<sup>10</sup> Gibson, R., 2008 (4<sup>th</sup> Edition), “Asset Allocation, Balancing Financial Risk”, p51-56, exhibit 3.2 p 56

<sup>11</sup> ibid

<sup>12</sup> French, K.R., 2009: <http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html>

Figure 1: Rolling five-year returns for Australian equities and listed property May 1997 to May 2009



Source: Standard and Poor's, ASX. Listed Property is represented by the S&P/ASX LPT Accumulation Index. Prior to March 2000, data used is the ASX Cumulative Property Trust Index.

### Volatility

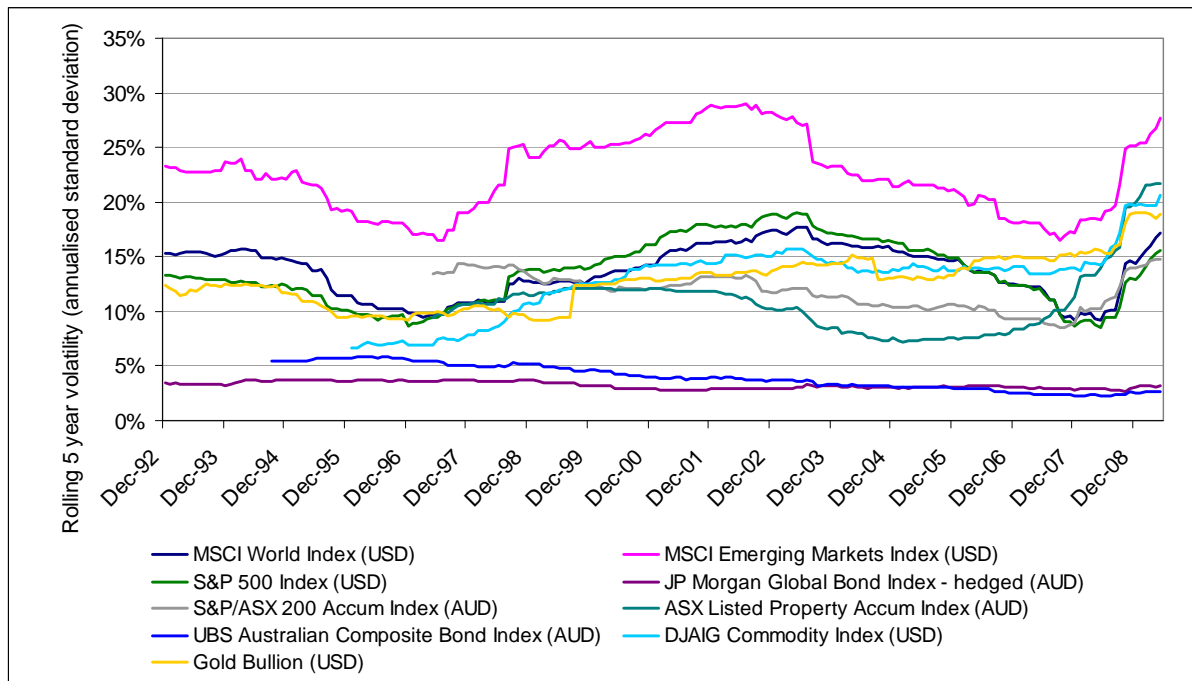
Gibson's assumption that historical volatility is a reliable guide to the future is supposed to provide investors with the comfort that a specific fixed asset allocation will provide them with a constant risk over time<sup>13</sup>. The problem is volatility itself varies dramatically. Figure 2 below shows this for a range of asset classes over recent decades, with the exception being Australian and global bonds.

Even if other measures of risk are adopted (e.g. shortfall risk<sup>14</sup>), the answer is much the same. The risk of a fixed asset allocation is widely variable even over the long term.

<sup>13</sup> Volatility has flaws as a measure of risk. No investor is really concerned about upside volatility, for example. Nevertheless as a proxy for risk it has become widely accepted.

<sup>14</sup> Shortfall risk is the risk of falling short of any investment target. Dictionary of Financial Terms, 2008.

Figure 2: Rolling five-year volatility, major markets/indices



Source: Morgan Stanley Capital International, Standard and Poor's, UBS, Dow Jones, Bloomberg. December 1992 to May 2009 (where data available, otherwise shorter periods). Listed Property is represented by the S&P/ASX LPT Accumulation Index. Prior to March 2000 data used is the ASX Cumulative Property Trust Index.

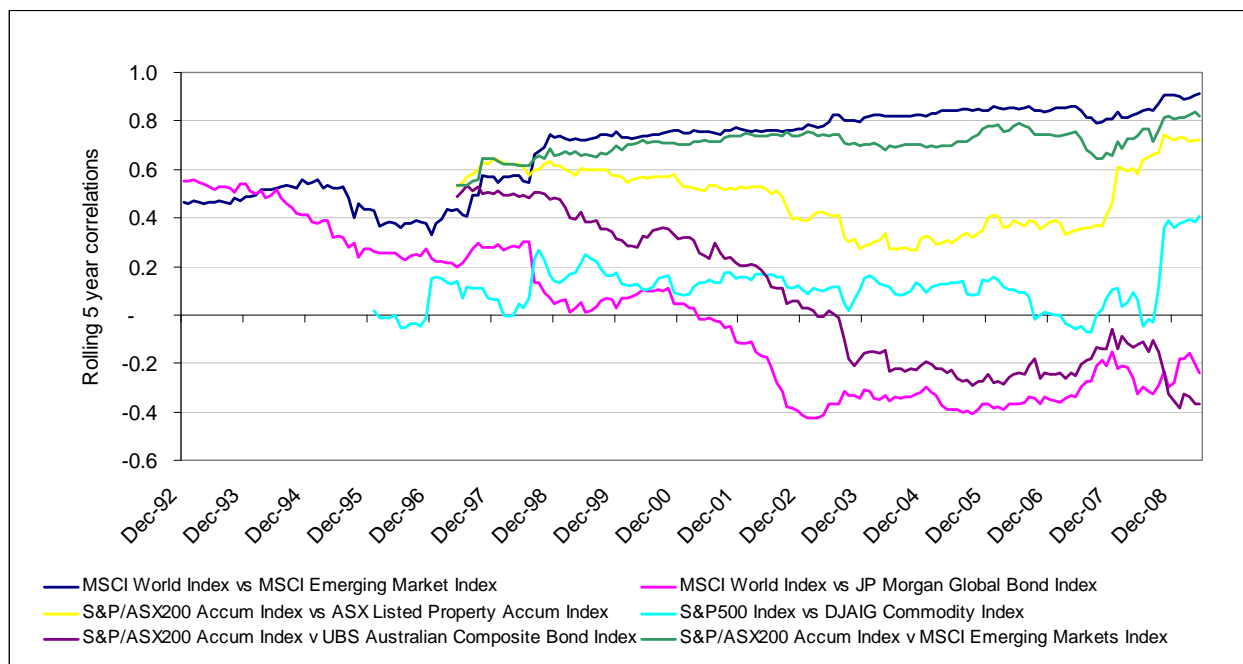
### Correlations

The basis of a well diversified portfolio is finding and then combining assets that are lowly or negatively correlated to each other. The problem is that, just like with returns and volatility, historical correlations can be an extremely poor guide to the future, as the dislocation of markets in 2008 showed (refer Figure 3). Historical correlations completely broke down in some cases. Thus, any fixed asset allocation that is heavily reliant on historical correlation relationships is potentially flawed.

There is a strong case for combining quantitative analysis with a subjective assessment of current fundamentals to assess the relationship between asset classes. This is not easy but as Warren Buffet said "It is better to be approximately right than precisely wrong"<sup>15</sup>.

<sup>15</sup> Buffet, W.E., 1 March 1994, Chairman's Letter to Berkshire Hathaway Shareholders: <http://www.berkshirehathaway.com/letters/1993.html>

Figure 3: Rolling 5 year correlations, major markets / indices



Source: Morgan Stanley Capital International, Standard and Poor's, UBS, Dow Jones, JP Morgan, Bloomberg. January 1988 to May 2009 (where data available, otherwise shorter periods). All data is stated in local currency terms with the exception of the JP Morgan Global Bond Index which is stated in hedged AUD terms. Listed Property is represented by the S&P/ASX LPT Accumulation Index. Prior to March 2000 data used is the ASX Cumulative Property Trust Index.

## 2. The structure of asset classes can change dramatically over time

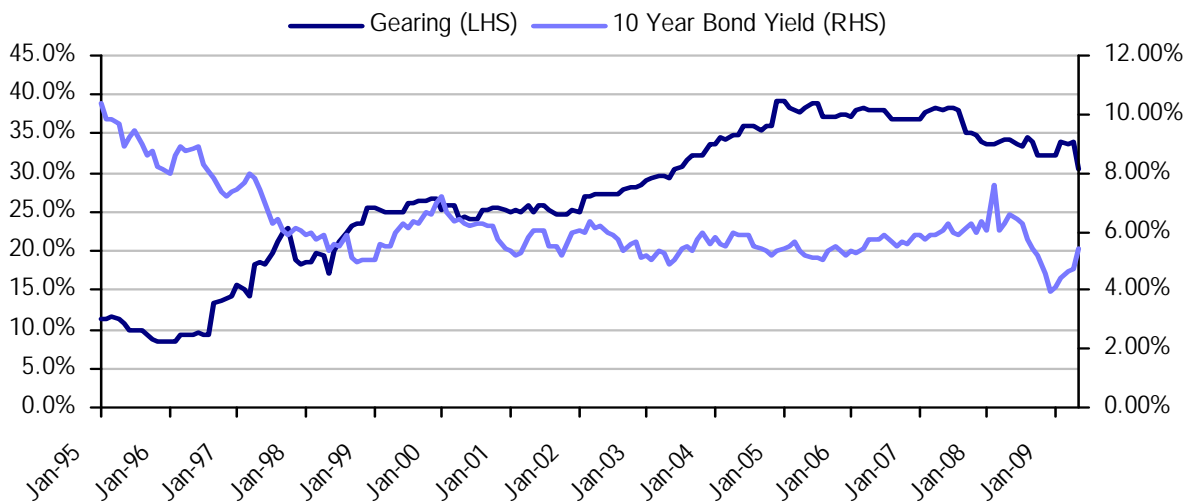
It does not make sense to treat a particular asset class as a coherent and consistent basket through time when the underlying makeup of the asset class is changing, sometimes dramatically as discussed below. This is not referring to normal changes in the constituents of an index but rather the fundamental changes in asset classes that change their risk-return prospects and diversification benefits. Such changes may be one off factors driving the widely varying returns, volatilities and correlations, as illustrated in Figure 3. However, some drastic changes in the structure of the asset class can be understood as they occur and therefore adjustments made accordingly at the overall portfolio level. Examples include the levels of gearing within the sector, currency, or exposure to credit as discussed below.

### Listed Property Trusts

For much of the mid 2000s, Australian Listed Property Trusts (LPTs) were priced to deliver very low returns. Despite this, most investors anchored around SAA (even if they were underweight on a TAA

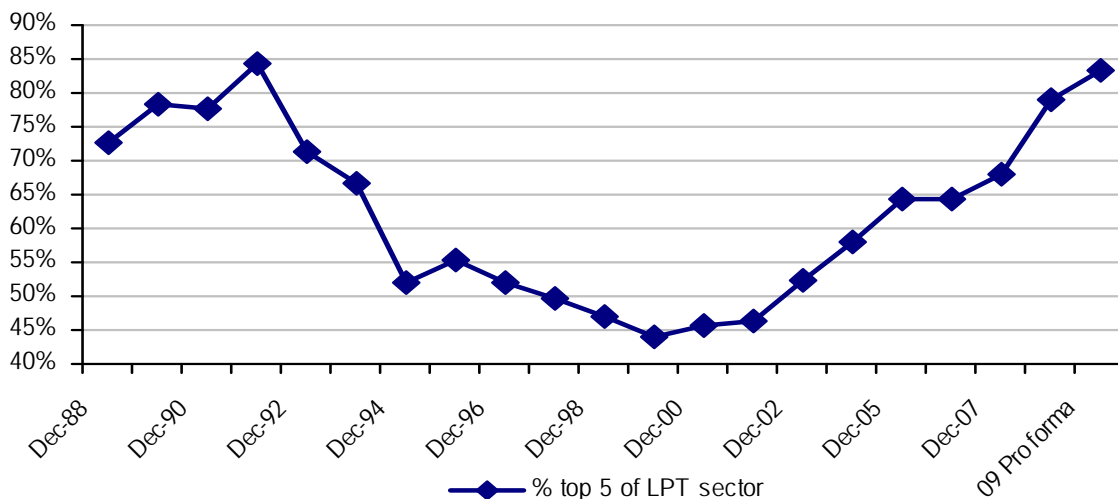
basis) were holding meaningful exposure to LPTs<sup>16</sup>, even as gearing levels (Figure 4) and sector concentration (Figure 5) increased considerably.

**Figure 4: Australian LPT sector gearing versus 10 year bond yields Jan-95 to May-09**



Source: UBS

**Figure 5: Concentration of Australian LPT sector – % top 5 Dec-88 to May-09**



Source: UBS

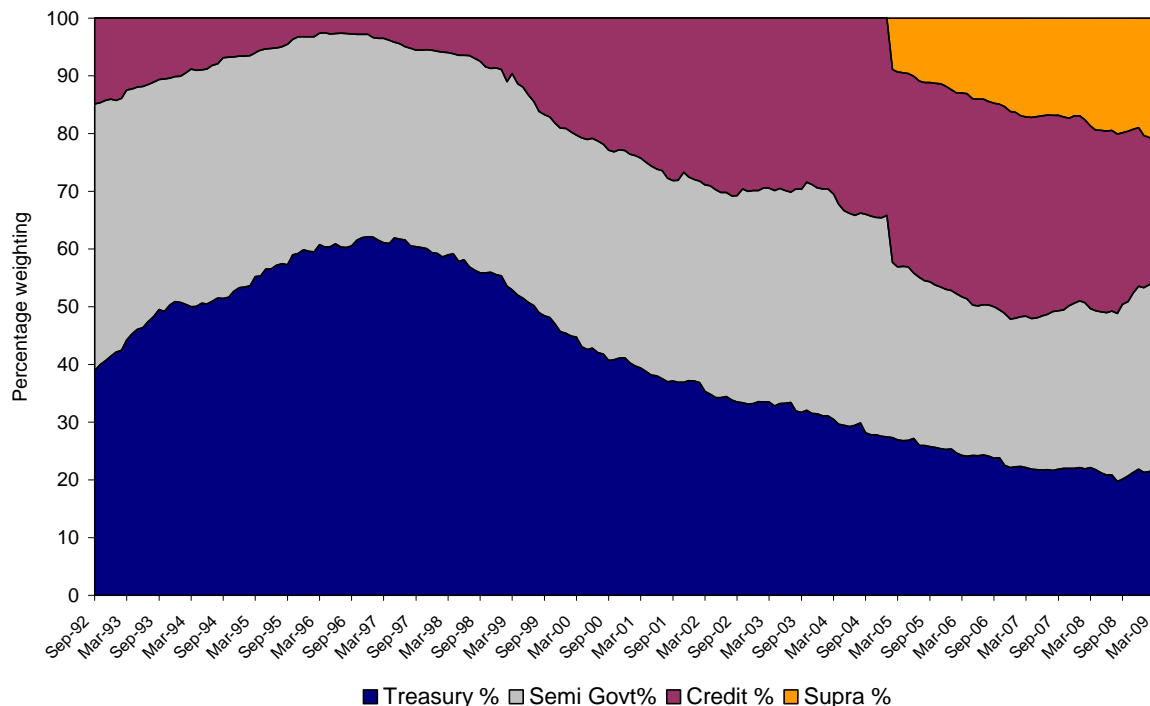
<sup>16</sup> Mercer Australian Pooled Fund Asset Allocation Survey 31 October 2007. Average allocation to LPTs in balanced funds was 7.2% and in growth funds was 7.8%.



### Australian Fixed Interest

From a low of around 2.5% in 1996, credit securities as a percentage of the UBS Composite Bond Index rose to a high of almost 36% by 2006. At the same time, Australian government and semi-government securities fell from a weighting of 97.5% to just below 50%, and we saw the emergence of supra-national issuers into the local index (Figure 6). Investors need to be aware of the changing nature of the index and in particular the increase in credit securities and the introduction of the risk of downgrades and default which may not be apparent when looking solely at historical volatility statistics to determine the risk of an allocation to Australian Fixed Interest.

Figure 6: Composition of the UBS Composite Bond Index Sep-92 to Apr-09



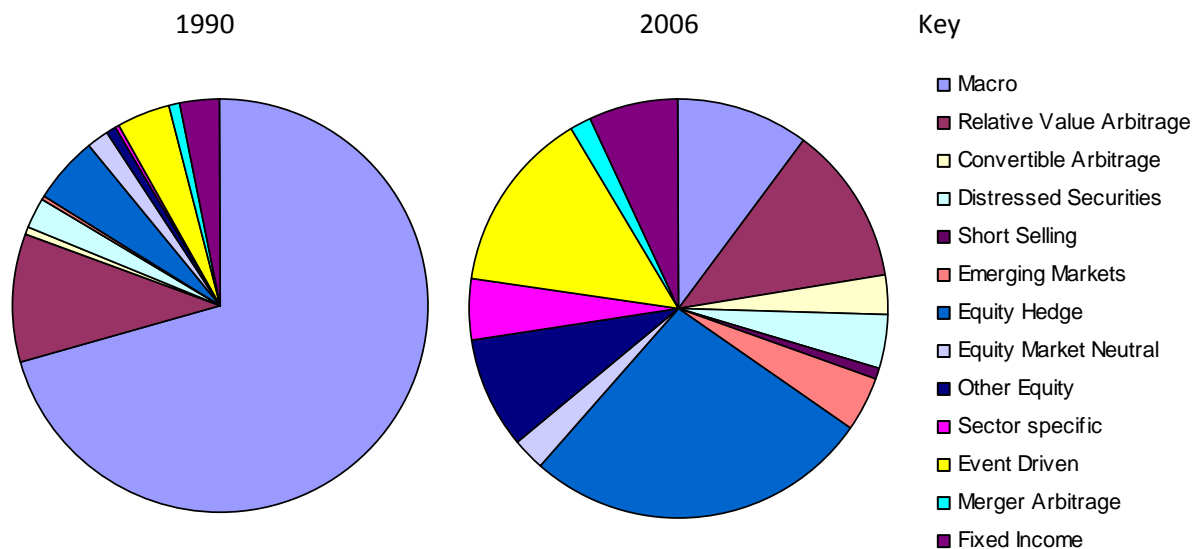
Source: UBS, Kapstream

### Hedge Funds

Hedge funds are another asset category that has changed dramatically in recent times. Global Macro strategies, which dominated in 1990 at 71% of all hedge fund assets were just 11% in 2006 (Figure 7). Not only do such dramatic changes have significant implications for risk, return and diversification benefits of hedge funds if treated as one asset class, they also have significant implications for the liquidity of these investments (particularly the growth of less liquid strategies such as some relative

value arbitrage assets, distressed securities and emerging markets as a percentage of the industry), an issue which became a major focus during 2008<sup>17</sup>.

Figure 7: Hedge fund industry asset composition Dec-90 versus Dec-06



Source: Hedge Fund Research Inc. (HFRI)

### 3. Starting valuations are a key driver for future returns and risks

If the efficient market view of the world doesn't hold and asset classes become over or undervalued at times (often significantly), then it makes sense that the starting valuation for an asset class will be a key factor in determining its return over the long term. SAA models based on historical risk premiums do not recognise this, and nor does TAA because it is focused on the short or medium term.

Valuation (and hence the entry point of an investment) matters for long term return as shown in Figure 8 below. Using the S&P 500 Index as an example, it shows that the higher the PE ratio at which you'd invested, the lower the subsequent 20-year return, and vice versa. For example, the first decile is characterised by a higher average starting P/E ratio and lower returns than in the 10<sup>th</sup> decile where the opposite is true, illustrating that historically, the cheaper the valuation point at entry, the higher the subsequent 20-year returns.

<sup>17</sup> There is a strong argument that hedge funds are not an asset class in the traditional sense. Nevertheless, hedge funds as a group are often treated as an asset class for SAA purposes. .

Figure 8: S&P 500 Index net total returns 20- year periods ending 1919-2008 (90 periods)

Decile	----- Net Total Return -----			----- P/E -----	
	From	To	Avg	Avg Start	Avg end
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	6.0%	5.6%	13	12
5	6.2%	7.9%	7.0%	15	15
6	8.0%	9.0%	8.6%	16	19
7	9.0%	9.6%	9.3%	15	19
8	9.7%	11.0%	10.4%	11	20
9	11.5%	11.9%	11.7%	12	22
10	12.1%	15.0%	13.4%	10	29

Source: Crestmont Research, 2009 ([www.CrestmontResearch.com](http://www.CrestmontResearch.com)).  
P/E ratio is calculated based on the Shiller methodology

Given that market prices and valuations move, a fixed SAA results in investors receiving widely varying levels of risk and return expectations over time. Indeed, the only way to produce anything approaching a constant risk/return outcome is to be willing to adjust allocations over time, generally in a contrarian fashion.

Some investors do incorporate valuation judgments into setting SAA. However, there is no point incorporating valuation into the determination of a SAA today, and then failing to change it for many years if there are significant changes in valuation within that time. The events of 2008 showed how quickly changes to asset prices can occur over short periods of time. If, on the other hand, investors adjust their SAA more often to reflect moves in valuations, it ceases to be strategic.

#### 4. SAA leads to excessive exposure to equities

Because long-only equities are the dominant liquid asset class (and perhaps the one with the longest/cleanest data history), they tend to be the largest asset exposure in most SAA<sup>18</sup>. However, as one of the most volatile asset classes, equities tend to become the key driver of returns in an investors portfolio as shown in Figure 9 below.

Moreover, because SAAs are often driven by their heavy reliance on long-term history, newer asset classes or strategies that don't have that history have a harder time being considered, even if the fundamental case for inclusion in a portfolio is strong. Of further concern is that newer asset classes tend to be added to portfolio SAAs after a period where the asset class has performed exceptionally

<sup>18</sup> Mercer, 2008, "Asset allocation survey and market profiles – European institutional market place overview 2008" page 3. Mercer Australian Pooled Fund Asset Allocation Survey June 2008..

well, because more data is available on which to model the SAA. From a valuation perspective, this is the time to be careful about adding exposures.

Figure 9: Most multi sector funds are correlated to local or global equity markets

Index	S&P/ASX 200 Accum		MSCI World (\$, unhedged)	
	Correlation	Beta	Correlation	Beta
Mstar Multisector Aggressive Index	0.94	0.77	0.77	0.63
Mstar Multisector Growth Index	0.95	0.58	0.75	0.46
Mstar Multisector Balanced Index	0.93	0.45	0.72	0.35
Mstar Multisector Moderate Index	0.89	0.25	0.66	0.19
Mstar Multisector Conservative Index	0.78	0.12	0.59	0.09

Source: Morningstar Australasia Pty Ltd., Standard and Poor's, Morgan Stanley Capital International. Data is for the period January 2000 to May 2009. Constitution of growth assets: Aggressive > 80%, Growth 61% to 80%, Balanced 41% to 60%, Moderate 21% to 40%, Conservative < 20%, where growth asserts are typically defined as equity and property asset classes. Source: Morningstar Australasia Pty Ltd.

## 5. Passive rebalancing can be dangerous

Rebalancing can be a useful contrarian strategy that takes profits from asset classes that have done well (and are possibly overvalued) while adding to asset classes that have done poorly (and are possibly undervalued). Problems can arise, however, because the SAA approach suggests that investors do this blindly and regularly, without considering the valuation or structural elements discussed above. This approach would have resulted in portfolios having high weightings in asset classes that had developed some fundamental flaws, with Australian Listed Property Trusts the obvious example. It also creates enormous issues for funds with high exposures to illiquid assets. In practice, the mechanisms used to rebalance portfolios vary but many still appear to be relatively mechanistic rather than opportunistic<sup>19</sup>.

## 7. SAA enshrines some cultural factors that have nothing to do with good investing

This is less a theoretical criticism than a recognition of how SAA is normally implemented in practice. There is a tendency for investors to be influenced heavily by the SAA of other investors because it is generally known<sup>20</sup>. In practice, there are some elements of asset allocation that become heavily enshrined across most investors without necessarily having significant investment merit. For

<sup>19</sup> Ibid, page 14. The survey illustrates that amongst survey participants comprising 1,104 funds with assets totalling €538 billion, of the preferred means of managing asset re-weighting between formal reviews, 33% was mechanistic versus objective-related, opportunistic or 'other'.

<sup>20</sup> Stracca, L., 2005, "Delegated Portfolio Management A Survey of the Theoretical Literature", No. 520 / September 2005

example, a significant home country bias applies to many developed countries<sup>21</sup>. Australian balanced superannuation funds still typically have around half of their equity exposure in Australian equities<sup>22</sup> despite Australian shares making up around 2.5% of developed world equity market capitalisation<sup>23</sup>. There are some taxation benefits which support this bias. However, these decisions can be made to the detriment of diversification. This bias is also evident in the allocation to property (listed and direct) within Australian balanced superannuation funds. In the US for example, property is considered an alternative asset with low representation in many portfolios.

This is not to suggest that these are poor asset allocation decisions but rather to point out that they are often made for non investment reasons.

### IS TACTICAL ASSET ALLOCATION THE ANSWER?

Many professional investors have relied on TAA within ranges around SAA benchmarks to add value and to overcome the limitations of SAA. However, the track record of this approach is poor. In a study of the performance of balanced, growth and capital stable funds with regard to asset allocation activity between December 1989 and February 2001, Faff, Gallagher and Wu (2005) concluded that “active managers have been unable to deliver investors with superior returns through tactical asset allocation”<sup>24</sup>. This is no real surprise given the study included the overall result of all managers who were no doubt approaching TAA differently. Given the dominance of SAA and the relatively small ranges around these benchmarks, TAA does not appear to have been given the highest priority of the managers. For example, in the Mercer June 2008 Pooled Fund Asset Allocation Survey<sup>25</sup>, only four of the 21 managers within the Balanced Fund category deviated from their benchmark by more than 5% for Australian equities. In terms of international shares, only two of 21 managers had an active tilt of more than 5%.

Further, there may have been a number of factors weighing on the ability to add value with TAA over recent decades even amongst specialist TAA managers. These include:

1. They were trying to add value in an environment where the medium-term dispersion between asset classes was not significant (that is, most major asset classes were in extended bull markets over the relevant period)<sup>26</sup>; and

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<sup>21</sup> Evidenced in Mercer, 2008, “Asset allocation survey and market profiles – European institutional market place overview 2008” and IMF, 2008 “Changes in the International Investor Base and Implications for Financial Stability”, Chapter II, page 71.

<sup>22</sup> Ibid

<sup>23</sup> Morgan Stanley Capital International, MSCI World Index

<sup>24</sup> Faff, R., Gallagher, D.R. & Wu, E., December 2005, “Tactical Asset Allocation: Australian Evidence”, Australian Journal of Management

<sup>25</sup> Source: Mercer Australian Pooled Fund Asset Allocation (Balanced Funds) as at 30 June 2008

<sup>26</sup> Supported by the performance of the Morningstar Multi-sector Growth Index for the years 1995 to 2008. Calendar year returns over this period averaged +13.5% and there were only two negative calendar years of performance during this time (-6.7% in 1994 and -8.2% in 2002) compared to the return of -25.7% for the 2008 calendar year. Source: Morningstar Australasia Pty Ltd

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2. They were focused on a few major asset classes only, thereby neglecting the large opportunity set within asset classes including some alternative investment asset classes.

Ultimately, TAA is heavily constrained because it is based on a flawed construct - that of SAA.

**A DIFFERENT APPROACH TO ASSET ALLOCATION**

If an investor accepts the flaws of the conventional SAA/TAA approaches what approach to asset allocation should they adopt?

Firstly, it is essential to forget the terms Strategic and Tactical. Ultimately, the only asset allocation that matters is the current target asset allocation and how it was achieved. Secondly, in throwing out the crutch of SAA, the framework adopted needs to be flexible yet disciplined, and aim to utilise the full range of opportunities to add value in asset allocation. Some vital elements of this approach are:

1. Operate within wide asset allocation ranges, not SAA benchmarks;
2. Look within asset classes for added value and how asset classes themselves are changing;
3. Consider new/alternative asset classes for diversification
4. Take a global approach to asset classes and don't be constrained by cultural biases with little investment merit;
5. Develop a valuation framework as the basis for forecasting long term returns and risks;
6. Consider how the asset mix will perform in a range of investment/economic scenarios;
7. Consider the role of sentiment and momentum in current asset targets; and
8. Use the full range of available vehicles to express asset allocation views.

**Operate within wide asset allocation ranges, not SAA benchmarks**

The purpose of wide asset ranges without SAA benchmarks is to avoid the anchor effect – that is, the tendency to stay very close to those benchmarks – that develops when specific SAA benchmarks are employed. Wide asset ranges without SAA benchmarks allow the flexibility to build allocations to areas which the asset allocation holds a strong view will produce attractive returns relative to risk taken over an acceptable time frame, rather than to focus on over/underweighting and relative performance. Essentially, if an asset class is not expected to produce attractive absolute returns then it should have minimal weighting in a portfolio. Of course, this flexibility comes with some limits as it still remains important to differentiate broadly between different portfolios (for example, defensive, balanced and growth diversified portfolio options).

**Look within asset classes for added value and how asset classes themselves are changing**

Increasingly, not only is the data on performance and valuations of assets available but there is a huge arrange of specialist vehicles (sector funds, ETFs, derivatives) that allow the expression of asset allocation views. For example, why does it make sense to make a five to 10 year fixed commitment to an asset class that itself is changing dramatically? Simply looking at the top level is not enough.

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Many conventional funds invest either via broad market indices (a passive approach) or employ managers who benchmark against such broad market indices. While such vehicles or managers may sometimes be appropriate for part of that overall asset exposure, there are benefits in having the flexibility to allocate toward different themes or sub sectors which this approach precludes. As such, the make up of the overall asset class allocation could look extremely different to the broad index, in turn creating additional scope to add value and reduce risk. An obvious example is the large portion of the S&P/ASX 200 Index which comprises resources and financial stocks to which, by default, benchmark aware managers have a large exposure<sup>27</sup>.

**Consider new/alternative asset classes for diversification**

There is some debate that alternative investments failed in 2008, however much of this simplifies the situation. Some areas of alternatives delivered negative returns<sup>28</sup>, but should they be judged over the short term? Other areas of alternatives produced positive returns during this period, for example, managed futures and volatility funds<sup>29</sup>. The case for diversification using alternatives remains strong. However this is more difficult for the average retail investor due to access and research constraints. Alternatives should not be regarded necessarily as the panacea but rather one element of building and managing properly diversified portfolios.

**Take a global approach to asset classes and don't be constrained by cultural biases with little investment merit**

By having specific asset allocation benchmarks covering domestic versus foreign assets many traditional portfolios cement a home country bias that has much to do with tradition and very little to do with optimal investment strategy as discussed above. There is merit in considering the asset class at the broadest (global) level with no pre-determined biases towards domestic versus foreign assets, judging each geographic region on its relative qualities. There may well be very good reasons to have a higher weighting in local versus overseas assets (for example, dividend imputation/taxation) but these need to be assessed rationally as part of a target allocation not as part of a simple comparison with competitors or what is accepted generally.

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<sup>27</sup> Financials and resource stocks represent 36.6% and 25.8% of the ASX200 Index by market capitalisation at 31 May 2009. Additionally, the top 10 companies comprise 51.2% of the ASX 200 by market capitalisation as at May 2009. Source: Australian Stock Exchange.

<sup>28</sup> For example Commodities (DJ AIG Commodity Index) -36.6% return in USD terms & Hedge Funds (HFRI Fund Weighted Composite Index) -19.0% return in USD terms (both for the 2008 calendar year). Sources: Dow Jones, Hedge Fund Research Inc (HFRI).

<sup>29</sup> Managed Futures (BarclayHedge CTA Index) +14.1% return in USD terms and Volatility Funds (NewEdge Volatility Trading Index) +3.2% in USD terms (both for 2008 calendar year). Sources: BarclayHedge & NewEdge.

**Develop a valuation framework as the basis for forecasting long-term returns and risks**

In a world where bubbles and busts do occur, there is no predetermined asset mix that will surely meet all return and risk objectives. As discussed above, future long-term returns depend heavily on starting valuation so asset allocation needs to be flexible to adjust to that.

Of course, valuation analysis is not just a science. Having a sense of long-term value is crucial in determining positioning within asset ranges. For example, those who were allocated 10% to 15% to listed property trusts during 2007 are going to find that it is extremely unlikely to make decent returns, even over the long term. The mathematics is against investors. From a loss in excess of -50% in the 12 months to 31 May 2009<sup>30</sup> even a return of 20% per annum over the next subsequent four years won't return those investors to a positive return over a five-year period (long term for many).

**Consider how the asset mix will perform in a range of investment/economic scenarios**

The assumption implicit in the SAA approach is that the world is unpredictable in the short/medium term but will provide predictable risk premiums in the long term. Yet predicting the future with any precision is extremely difficult. However, it is possible to gain a reasonable view of how a particular asset mix will perform in a range of different investment/economic scenarios. Developing a number of such scenarios allows the production of an asset allocation that is robust and well diversified. This is not about relying heavily on historical correlations but rather subjective and intelligent assessment of asset behaviour.

The asset allocation may be skewed towards a core scenario, subject to valuation and momentum/sentiment analysis that determines core target positions held at any point in time. A number of alternative scenarios highlighting key risks can be developed. This may temper the target weightings suggested by the core scenario or occasionally may suggest holding assets that will perform in a range of the alternative scenarios – essentially as a hedge against the core scenario being wrong. The aim is to focus on assets that represent attractive value in the core scenario and, ideally, that are undervalued such that there is a margin of safety if the core scenario does not play out or the assumptions underlying valuations prove incorrect. Conversely, assets that are overvalued on such a basis would be avoided. In general terms, the medium to longer term returns expected from asset class valuations should be consistent with the favoured and unfavoured areas developed in the core and alternative scenario analysis.

**Consider the role of sentiment and momentum in current asset targets**

While valuation is clearly a key factor in longer-term returns, it may not be that useful in the short to medium term. Valuation is useful starting point but assets can stay undervalued or overvalued for extensive periods of time. There are no magic indicators that help out in terms of short/medium term asset allocation, although occasionally sentiment and momentum can be useful in both

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<sup>30</sup> The return of the S&P Listed Property Accumulation Index for the period 1 June 2008 to 31 May 2009 is -54.8%



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enhancing returns and reducing risk. The idea is not to become too wedded to any particular indicator but to use them as tools to help with asset allocation decisions. For example, the best time to add exposure to equities may well be when sentiment is negative, when there are outflows from managed funds, for example. The Dalbar Survey shows that retail investors tend to get it very wrong<sup>31</sup>. The corollary of this is that it is possible to add value when you go against retail investor sentiment. Many trends develop their own momentum and it can make sense to scale into and out of positions gradually. Faber (2009)<sup>32</sup> demonstrated, using a moving average timing model for major equity, commodity, listed real estate and bond markets since 1973, that a simple momentum-based approach can significantly reduce risk without impacting return.

**Use the full range of available vehicles to express asset allocation views**

In today's complex world it makes sense to be agnostic about the best way to gain exposure to assets, sectors or themes in terms of investment structure, whether it is via active fund managers, passive funds, CEFs, ETFs, baskets of stocks or derivatives.

**WHY THE NEXT DECADE MAY BE MORE CHALLENGING FOR ASSET ALLOCATION THAN THE PAST**

If investors had a view that the next five to 10 year period is going to be largely a rerun of the 1990s or early to mid 2000s, the SAA debate is largely academic. Over those periods, fixed allocations to virtually any combination of major asset class performed well. Indeed, in most of the last 25 years, a static approach to asset allocation worked well<sup>33</sup>.

The problem is there is a strong case that the Global Financial Crisis represents the end game for some of the underlying forces that helped create the benign environment of recent decades that favoured most asset classes and the fixed SAA approach. In particular, the growth in credit in developed economies over 30 years to unsustainable levels is unwinding. It is likely that this de-leveraging cycle will extend over a number of years with uncertain implications for financial markets. Even with the better value on offer in a range of asset classes following the falls in markets in 2008/9, there is a strong case that this de-leveraging cycle will weigh on markets and valuations, particularly equities and property, preventing or limiting broad based major bull markets across these areas looking forward. These limiting factors include:

- The effect of asset sales as corporates and households sell assets to reduce debt;
- Ongoing risk aversion as investors react to large losses that will inhibit risk taking that would otherwise drive up asset prices;

<sup>31</sup> Dalbar Inc., 2009, "Quantitative Analysis of Investor Behavior – 2009"

<sup>32</sup> Faber, M.T., Spring 2007 *Journal of Wealth Management* (updated February 2009), "A Quantitative Approach to Tactical Asset Allocation".

<sup>33</sup> Illustrated by the performance of the Morningstar Multi-sector Growth Index for the years 1995 to 2008 in which irrespective of how active managers were around their strategic asset allocations, they generated positive returns for much of this period. Calendar year returns over this period averaged 13.5% and there were only two negative calendar years during this time (-6.7% in 1994 and -8.2% in 2002) compared to the return of -25.7% for the 2008 calendar year. Source: Morningstar Australasia Pty Ltd

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- Rising long-term interest rates given low starting levels and high fiscal deficits (with inflationary implications); and,
- Subdued economic and corporate profit growth as household and corporate expenditure reduces in response to de-leveraging.

Equities in particular may be cheaper than they have been for many years, but the above forces may keep them cheap for some time. Other asset classes are also vulnerable. For example, government bond yields reached record lows at the end of 2008<sup>34</sup> and despite interest rate rises since (and negative returns for holders), yields are still at the low end of historic ranges and vulnerable to further rate rises. Unprecedented monetary stimulus by governments and central banks has uncertain implications for inflation and interest rates going forward.

Of course, the cynic will say that these things are totally unpredictable and no one has any idea what the future holds. We can put our heads in the sand and hope that things will be ok or we can recognise that things might be different and prepare for them.

If the above factors prevent or inhibit the development of broad-based bull markets in a range of asset classes, the result may be a period where asset classes still move significantly and quickly but within wide ranges, potentially not making much progress in terms of total return even over the medium to longer term, and with returns heavily dependent on underlying cash flow/income characteristics.

The year to mid 2009 has given a taste for such markets. US and Australian equity markets fell -47% and -42% respectively in a period of little more than six months from 19 May 2008 to 20 November 2008 then rallied 35% and 21% respectively in a period of little more than two months from 9 March 2009 to 29 May 2009, before giving back some of these gains. If the long-term buy-and-hold approach is questionable, the key is to being able to act quickly to take advantage of these moves.

**CONCLUSIONS**

The market difficulties of 2008/2009 have resulted in increased scrutiny of many aspects of portfolio construction and asset allocation. It is no surprise that the traditional set-and-forget SAA approach is a major target of such scrutiny. It is natural to question a framework which, while having worked reasonably through a benign period for markets, is arguably not well placed for current and future challenges. A more flexible yet still disciplined framework is arguably necessary, particularly given the challenges currently facing investors.

This is not just because a strict SAA approach has resulted in losses recently. Many active approaches to asset allocation did not avoid losses either. More concerning is that even long-term SAA results are increasingly disappointing and the groundswell against the rational market that underpins the SAA approach has grown rapidly.

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<sup>34</sup> Reference: US 30 year Treasury yields - 18<sup>th</sup> December, low of 2.522%. Source: Bloomberg

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Investors are realising that what is important in asset allocation is not the strategic or tactical mix. Rather, what is important at each and every point in time is the current asset allocation, and how it changes will determine portfolio returns and risk over time. In an inefficient world where bubbles and busts do happen and deep overvaluation and undervaluation of asset classes are possible (indeed to be expected), there is no preset asset mix that investors can expect will deliver on their return and risk expectations over the long term. This Holy Grail doesn't exist and investors need to start thinking about what makes sense from a practical perspective, remembering that there is as much art as science involved in deciding an appropriate asset allocation.

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