Asset allocation in practice: the right mix

Strategic asset allocation and the right asset mix are essential to ensure solid portfolio performance. **Matthew Welsh** of UBS looks at how to build a robust strategy for clients.

What do clients expect from their wealth managers with regards to asset allocation? How do we begin the process in order to develop a strategy that delivers the right risk/reward balance? How can investors be encouraged to take reasonable risk? And to what extent must we tailor and refine strategies for different types of investors?

This article examines these and other challenges facing Financial Planning and wealth management professionals and highlights the importance of specialist strategic asset allocation expertise, in light of persistent market volatility and the continuing mission to reduce compliance issues and risk.

If we accept that there is no consistently best performing investment – the best this year might be the worst next year – and that achieving the 'best' performance boils down to how we mix the assets, where do we go from there? There's no easy answer to what works and what does not, but what remains clear is that the importance of strategic and tactical asset allocation continues to grow and that the models must continue to evolve in response to client needs and market forces. These range from the global liquidity crisis to unprecedented demographic change, which is having an impact on economies and asset prices.

Two decades of academic studies have shown that strategic asset allocation (SAA) is the most important factor in meeting long term investment objectives (see table below). This does not mean that selection of securities and market timing add no value, but for long term planning purposes they do not play as important a role as SAA in helping to meet financial goals.

So, how do you go about resolving the most appropriate strategy? It is safe to say that the 'one-size fits all' approach does not work and effective diversification strategies look beyond quantitative techniques. Qualitative considerations and the ability to adapt to changing circumstances are key.

Today's portfolio allocation strategies are increasingly focused on absolute return and portable alpha mandates (portable alpha refers to the return of an investment manager who has intentionally and completely eliminated his market risk, or beta), which consider the right times to choose passive over active investments, value over growth stocks and large caps versus small. Importantly, they should keep at the top of their mind 'the bigger picture'.

A strategic approach is just the first step, tactical or cyclical asset allocation is what gives the process its 'edge'. Before the actual allocation process begins, the client's profile and objectives must obviously be explored in detail, taking account of their attitude to risk, the period of time over which the portfolio will be invested, whether or not there is a requirement to make capital withdrawals (and the likely amounts) and more. In some respects, investors today are better informed and yet there is so much more that they need to be informed about than just a few years ago. With an increasing number of viable asset classes – ranging from cash to any number of commodities and real estate – a growing number of funds, including hedge funds and funds of hedge funds, and other financial instruments, this is quite a challenge. Investment managers are required to understand in detail what each of these options has to offer. Helping clients to understand what's likely to achieve the most efficient, risk-adjusted return for them is, of course, a challenge too.

Matthew Welsh: strategic asset allocation the most important factor

It is worthwhile reminding ourselves that the purpose of risk management is not to minimise risk but to monitor the levels and sources of risk to make sure that they match expectations. Risk is necessary in order to drive returns and needs to be allocated in such a way as to maximise one's expected returns, which brings us to the subject of 'risk budgeting'. Risk budgeting is the assessment of the amount of risk to be employed and where it is applied. It is considered by investment experts to be the second most important factor after asset allocation in portfolio management.

The risk profiling and risk budgeting processes define the framework for strategic asset allocation, a process which in itself requires examination of risk return characteristics for each individual asset class, security selection and market timing. In-depth risk profiling, rigorous investment research and due diligence, together with a multi-asset class approach are more likely to ensure that clients' objectives are met.

Financial Planners and wealth advisers have an important role in explaining to clients the benefits of diversification and how, for example, hedge funds, where suitable, can play a defensive role that might ultimately mean they offer less risk than equities. Delegating this complex discretionary investment management to specialists is one effective means of ensuring planners have more time to spend on relationship management.

Matthew Welsh, executive director, UBS Wealth Management.

Success Factors in Asset Allocation Strategies

Asset Allocation Policy	91.5%
Asset Allocation + Market Timing	93.3%
Asset Allocation + Market Timing + Security Selection	97.9%
Asset Allocation + Market Timing + Security Selection + Other	100%

For illustration only. Past performance should not be seen as indicative of future performance. Real results may vary

Source: ***Brinson, Hood & Beebower update May/June 1991 to 'Determinants of Portfolio Performance' Financial Analyst Journal. July/August 1986. The update analysed quarterly data from 82 large U.S. pension plans over the period 1977-1988. * Brinson, G., Hood, R., Beebower, G. 'Determinants of portfolio performance II: An update'. Financial Analyst Journal. Jul/Aug 1991 Ibbotson R. and Kaplan P.'Does asset allocation policy explain 40, 90 or 100% of Performance'. Financial Analyst Journal. Jan/Feb 2000***

Key Points:

1. **There is no** consistently best performing investment. Achieving the best performance boils down to how assets are mixed.
2. **A one-size** fits all approach to strategic asset allocation does not work.
3. **Risk profiling and risk budgeting** are essential factors in defining a framework for strategic asset allocation.