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The Case for Flexible Allocation
August 2009

Alternative thinking.

Agenda

- Evolution of Strategic Asset Allocation (SAA)
- Flaws in SAA
- Tactical Asset Allocation (TAA) explored
- Other approaches
- Towards a better approach
- Implications for risk profiling and planners
- Asset allocation challenges looking forward

Evolution of SAA

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- Efficient Market Hypothesis (EMH) – belief that assets fairly priced drove much of thinking on asset allocation from early 70s
- MPT/CAPM assumed efficient markets and normal distributions
- Fixed SAA – natural outcome of MPT approach
- SAA and consultants – from performance benchmark to asset allocation driver
- Development of Risk Profiling systems using fixed SAA

Flaws in SAA approach

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- In an inefficiently priced world - long term returns, risks and correlations vary widely
- Therefore there is no fixed asset allocation certain to meet risk/return objectives even over the long term - risks of fixed SAA fluctuates
- Starting valuations – a key driver in long term returns is ignored in many long term SAA determinations
- Changes in asset class structure can dramatically change risk/return profile
- Focused on mainstream assets only (reliance on LT history)
- Emphasises major asset classes only (not sub classes)

History often a poor guide to future investment markets (even over the long term)

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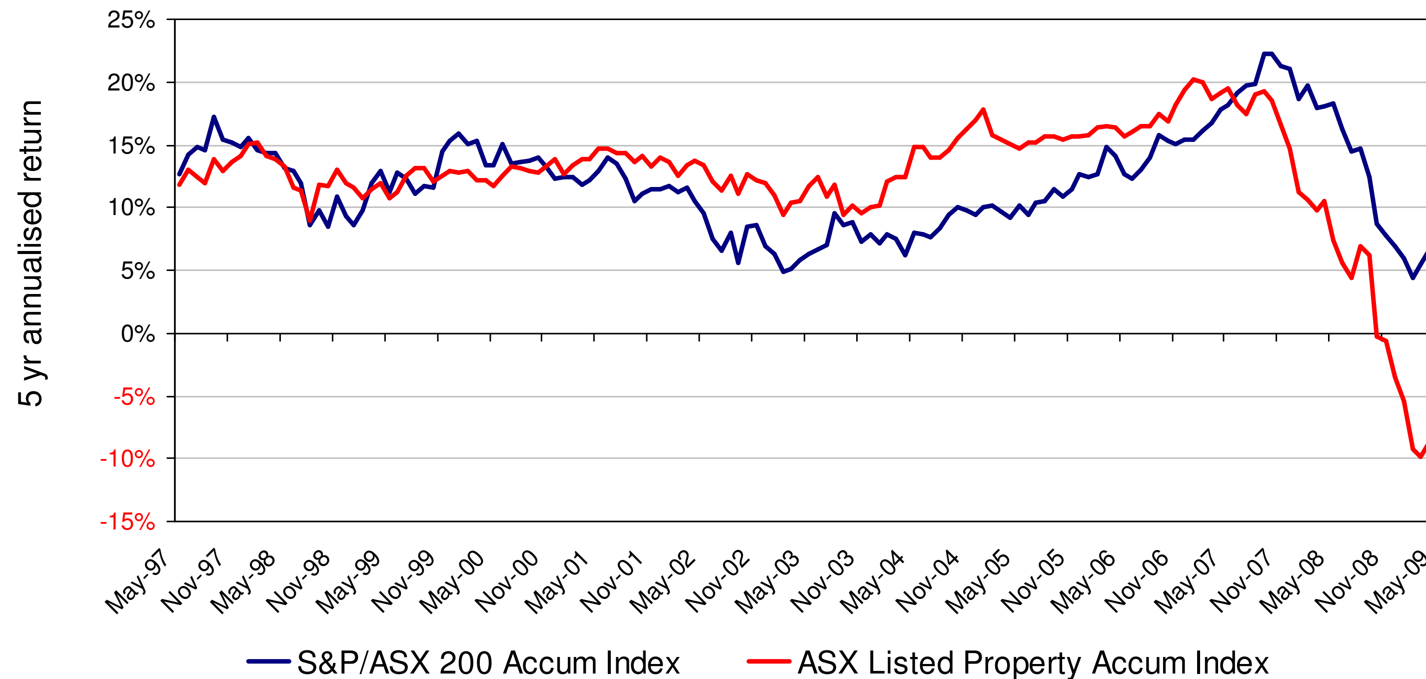

Source: Standard and Poor's, ASX. May 1997 to May 2009. Listed Property is represented by the S&P/ASX LPT Accumulation Index. Prior to March 2000 data used is the ASX Cumulative Property Trust Index.

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Market volatility can be unstable as well

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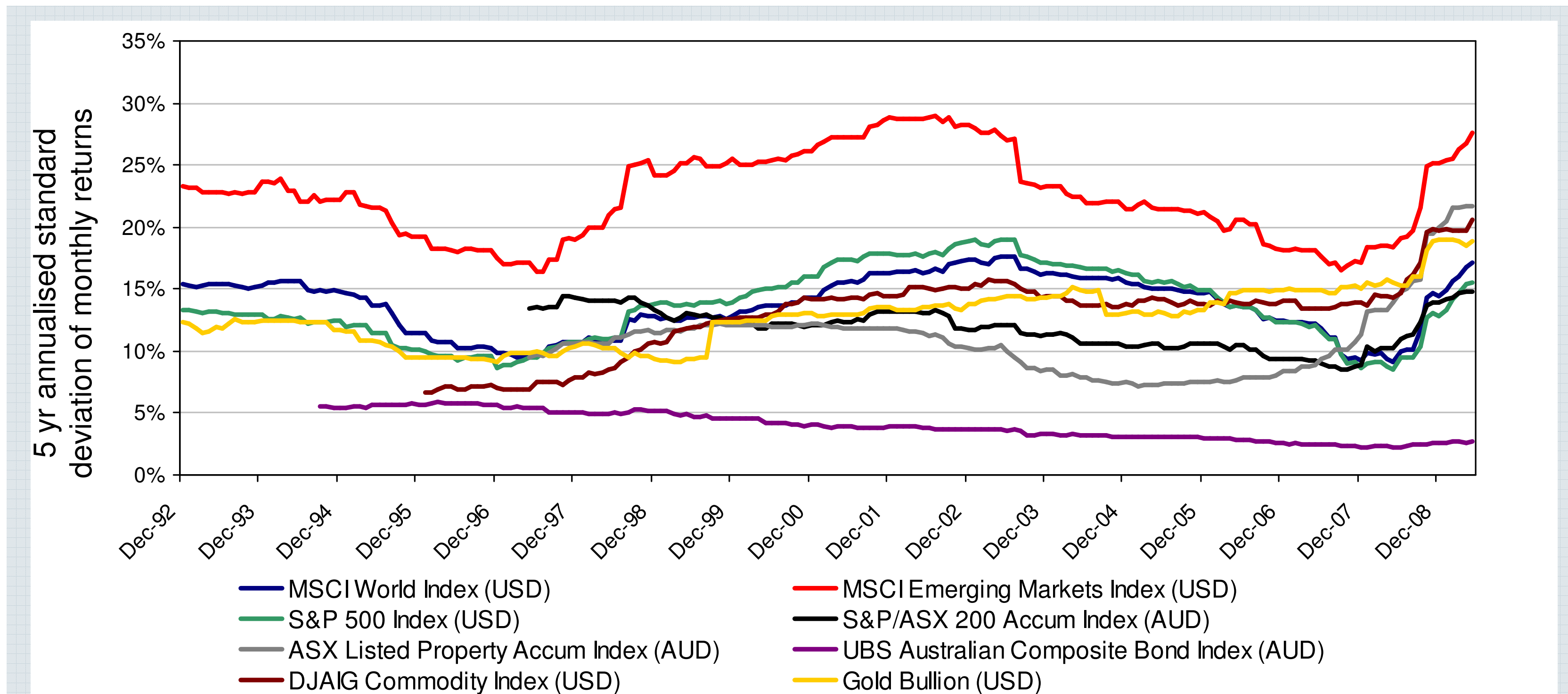

Source: Morgan Stanley Capital International, Standard and Poor's, UBS, Dow Jones, Bloomberg. December 1992 to May 2009 (where data available, otherwise shorter periods). Listed Property is represented by the S&P/ASX LPT Accumulation Index. Prior to March 2000 data used is the ASX Cumulative Property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

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Correlations also unstable

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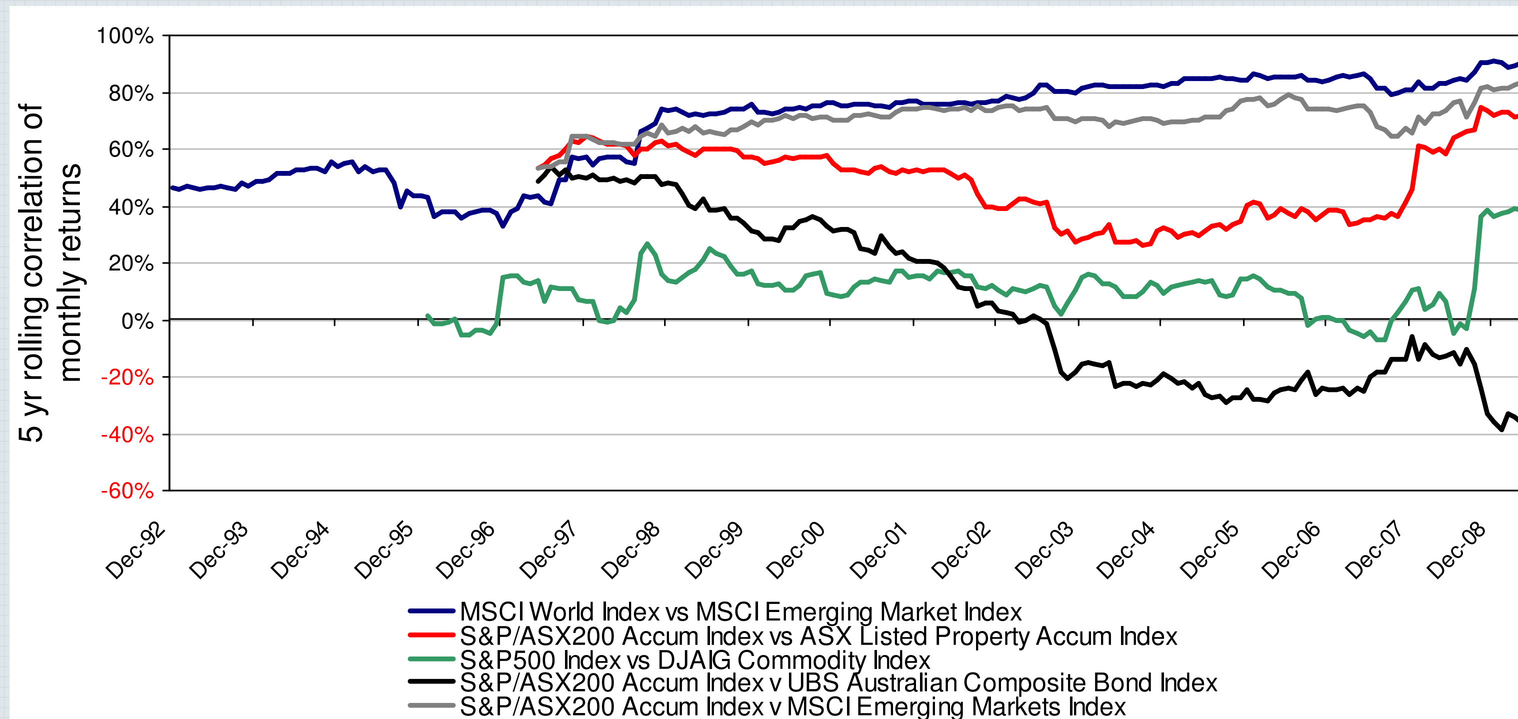

Source: Morgan Stanley Capital International, Standard and Poor's, UBS, Dow Jones, Bloomberg. January 1993 to May 2009 (where data available, otherwise shorter periods). All data is stated in local currency terms with the exception of the JP Morgan Global Bond Index which is stated in hedged AUD terms 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.

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Starting valuations are a key driver for future returns and risks

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S&P 500 Index,

20 year periods ending 1919-2008 (90 periods)

	Net total returns by decile range		S&P500 decile	Average begin	Average end
Decile	From	To	Average	P/E	P/E
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). Note: P/E ratio is based on the Schiller methodology

Asset class structures can change dramatically over time

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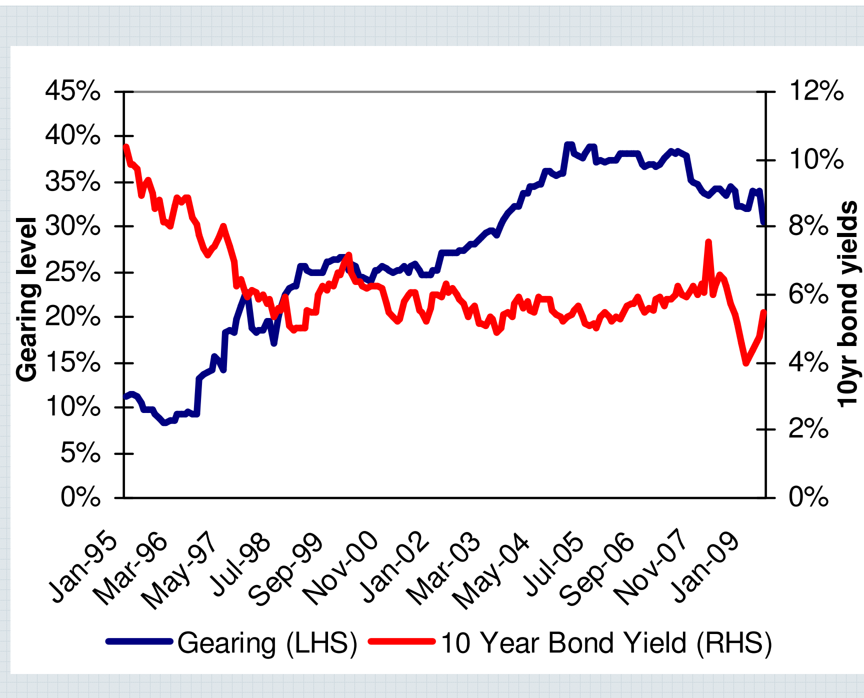
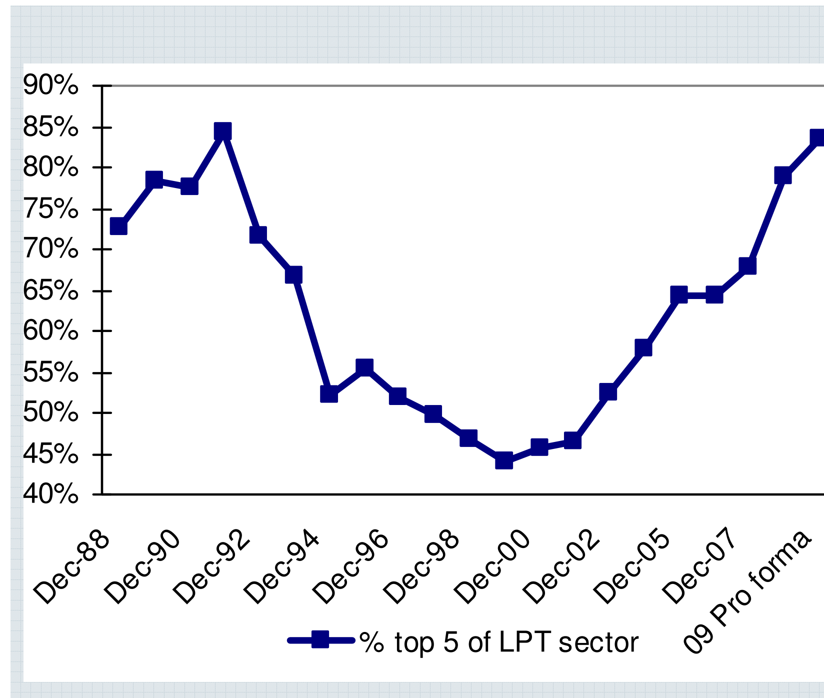
Australian LPT sector – gearing versus 10 year bond yields, 1995 to 2009



Percentage of top 5 Australian LPTs as proportion of the sector, 1988 to 2009



Source: UBS

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Composition of major asset classes can change – fixed interest

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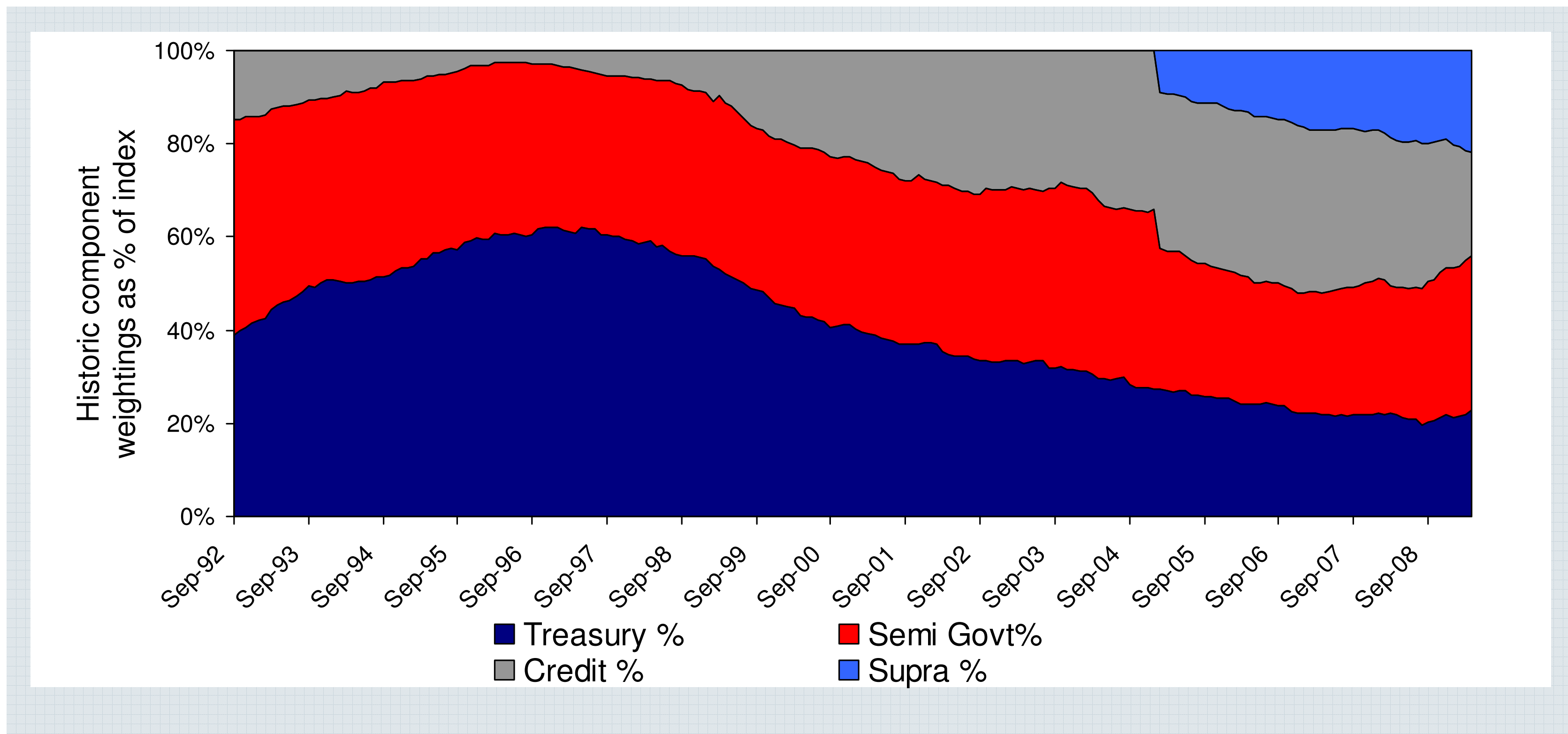

Source: UBS, Kapstream. 31 May 2009

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Asset class structures can change dramatically over time – Hedge Funds

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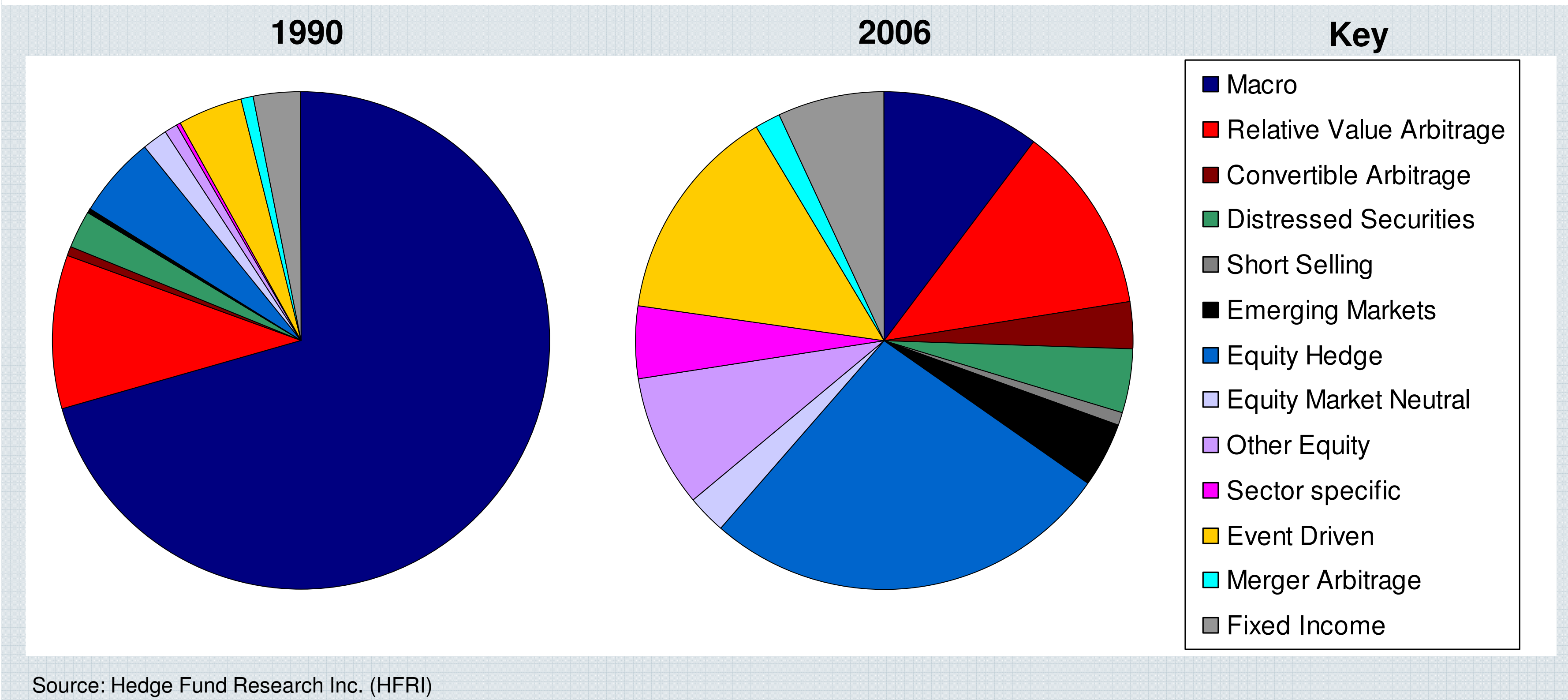

TAA explored?

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- Constraints of SAA – narrow ranges, anchor effect
- Very narrow breadth (few possible bets)
- Often too short term focused – valuation drivers work mostly long term
- Peer pressure to follow markets (hard to be contrarian)
- Doesn’t take sufficient account of sentiment & momentum which impact short/medium term
- Under these constraints no surprise evidence suggests it is difficult to add value

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Alternativethinking.

- Wide ranges across broad (global) asset classes (no SAA)
- Flexibility to allocate to sub asset classes/styles (and alternatives)
- Valuation framework – focused on longer term returns
- Understand how asset classes are changing
- Consider various investment scenarios – true diversification
- Recognize role of sentiment & momentum
- Recognise it is as much art as science

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e.g. Flexible and wide investment mandates

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Asset Allocation	Typical Balanced			More flexible Balanced Portfolio	
	Minimum	Strategic	Maximum	Minimum	Maximum
Cash and Fixed Interest	20%	30%	40%	15%	60%
Property and Infrastructure	5%	7.5%	10%	5%	25%
Australian Equities	30%	40%	50%	25%	65%
Global Equities	10%	20%	30%		
Alternative Investments	0%	2.5%	5%	**10%**	**35%**

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A more flexible asset allocation/investment process

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Asset/Sector/ Theme Selection

Scenario Analysis
Core/Alternative

Valuation Analysis
Major Asset Classes/Sectors

Momentum/Sentiment

Investment Implementation

Manager Due Diligence

Manager Screening

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Role of sentiment and momentum

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- Valuation measures useful for longer term – poor guide short term
- Sentiment measures can help determine (contrarian) medium term asset allocation positioning (e.g. investor attitudes, retail and institutional fund flows, option pricing)
- But recognise sentiment can feed on itself for extended periods helping create momentum on both upside and downside
- Simple asset allocation model using momentum can improve risk outcomes without impacting returns (*eg Faber, M, Spring 2007 Journal of Wealth Management– "A quantitative Approach to TacticaL Asset Allocation*)

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SAA versus more flexible AA

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Issues with traditional SAA approach:

- Long run returns, risks and correlations are not reliable over time
- The structure of asset classes can change dramatically over time (e.g. Property Trusts)
- Starting valuations are a key driver for future returns and risks
- Leads to excessive exposure to equities
- Passive rebalancing can be dangerous
- It enshrines cultural factors (e.g. home country bias) that have nothing to do with intelligent investing
- Business risk focus

***Flexible* approach:**

- Operate within wide asset allocation ranges
- Look within asset classes for added value and how asset classes themselves are changing
- Consider alternative assets and strategies to express asset allocation views
- Global approach to asset classes and not constrained by cultural biases with little investment merit
- Valuation framework as the basis for forecasting long term returns and risks
- Consider how the asset mix will perform in a range of investment/economic scenarios
- Consider the role of sentiment and momentum in current asset targets
- Client risk focus

Part Art, part Science

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- Dynamic SAA/SAA tilting
- Review SAA on more frequent basis (yearly?)
- Use managed futures/macro funds/active AA fund as AA component
- Accept limitations of SAA but be much more diversified across assets/strategies (“endowment” approach)

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Implications for risk profiling?

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- If investment risk of fixed AA not constant then matching a risk profile to a fixed SAA is flawed
- Sometimes higher risk not equal to higher return & vice versa eg 70/30 (defensive/growth) not always conservative when bond rates low
- Risk Profiling requires match to overly simplistically approaches to asset allocation (major assets only, no active AA)
- Risk tolerance typically changes as markets change (and the wrong way!)

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How should planners respond?

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- Develop more flexible framework/implementation approach themselves
- Make their portfolios more diversified and/or conservative
- Consider outsourcing -

  1. consulting – dynamic AA advice

  2. Implemented consulting/multi-asset - active asset allocation core
- Use more managed futures/macro funds as asset allocation core
- Recognize SAA problems and use as performance benchmark only

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Challenges for asset allocation going forward

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- Extended period of sideways markets possible (within large ranges)
  - continued de-leveraging
  - Greater aversion to risky assets
  - Slow global economic/earnings growth
- Interest rates more likely to rise than fall from record lows
- Constraints of/approach to less liquid assets
- Which alternative investments and how to achieve exposure

Conclusion/Summary

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- The theoretical and practical framework behind SAA is fraying
- Fixed SAA does not escape valuation judgments (i.e. is still as active decision)
- Flexible asset allocation is necessary to manage risk and meet return objectives
- Risk profiling to fixed SAA is dangerous
- Next decade likely to be more challenging for AA than last two
- Art and science required!

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