

Technical Update

This issue: Asset Allocation

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Asset Allocation – is it an art or a science or just plain common investment sense?

In this issue of Technical Update Michael Lally, director of Thesis, looks at asset allocation and asks whether it is an art, science or just common sense.

Writing after the turmoil seen in all asset classes in 2008, Mr Lally says one could be forgiven for thinking that conventional wisdom offered little help in protecting clients' portfolios. He cites the Irish writer Flann O'Brien as a betting man "who devised a system, entirely from his own head, which enabled him to lose money much faster than ordinary bad luck would ensure."

Mr Lally suspects that corporate bankers have honed this methodology into a fine art, and paid the price in spectacular fashion as evidenced by recent

market turbulence. The investment management industry is generally a cautious sector and yet even the best-known names have struggled to perform recently. Mr Lally considers what went wrong, where we go from here, risk and volatility, correlation and timing.

Unlike many asset managers, Mr Lally says Thesis insists that all its individual fund managers contribute to the investment selection process through participation in one or more of its investment committees, that is asset allocation, fixed interest, UK equities, pooled vehicles/international (unit/investment trusts, structured products, etc) and absolute return (alternative assets, derivatives and so on).

Financial and statistical

data, research and comment, is collated from a wide variety of sources including stockbrokers, independent economists and the media backed by regular contact with fund managers and analysts.

Any new idea must first go through a strict due diligence process and is then subject to challenge and finally majority approval. This means everyone buys into some part of the decision making process rather than slavishly following an anonymous buy/sell list from head office. It also enables managers to discuss clients' portfolios with them in greater detail and with more confidence and conviction, he says. Mr Lally says back-testing, also called performance attribution analysis, is a vital part of the process.

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Michael Lally, director at Thesis, looks at asset allocation, unravels the process and looks at how it works in practice. He looks at whether slavishly following conventional wisdom has offered any benefits for clients' portfolios. He explains what's gone wrong with traditional asset allocation techniques and strategies and how Financial Planners can use recent experience to develop new strategies.

Financial Planner's Technical Update section welcomes submissions or suggested topics for this section from planners and other expert contributors. Write to Financial Planner Editor Kevin O'Donnell.

Asset Allocation – understanding its potential and pitfalls

After the exceptional turmoil seen in all asset classes in 2008 one could be forgiven for thinking conventional wisdom offered little protection for clients' portfolios.

Flann O'Brien, the great Irish writer, on the subject of betting on the horses, recalled meeting a man "who had devised a system, entirely from his own head, which enabled him to lose money much faster than ordinary bad luck would ensure." While corporate bankers seem to have honed this methodology into a fine art, and paid the price in spectacular fashion, the investment management industry is generally a more cautious beast and yet even the best-known names have struggled to perform.

To understand what went wrong we have to return to basics, that is what is the function of asset allocation? Firstly it is to achieve longer term protection of capital and income by >

The Asset Universe Risk-Return Characteristics



Source: Thesis

diversifying risk, either through active or passive (that is, index tracking) management. Ideally this is achieved by diversifying portfolios across a range of asset classes some of which do not usually directly correlate with others. Various models are then developed to complement the specific investment objectives and risk profile of the individual client. Typically, the lower the risk profile then the higher the percentage allocation is given to assets, which have historically demonstrated lower volatility. The position can be complicated with institutional mandates - which often dictate that the manager must not deviate by more than a fixed percentage from the benchmark - meaning you are forced to track irrespective of your views on a specific asset class. The Unilever v Merrill court case is testament to those who ignore this.

The main problem over the last 18 months is that the yield gap (or risk premium) between higher and lower risk (or income producing) assets had narrowed to unsustainable levels thanks to unprecedented demand fuelled, among other things, by cheap money and a benign economic backdrop. This gave an aura of respectability to a myriad of intrinsically unstable assets, while over-inflating values of their less volatile peers (for example, commercial property and investment grade corporate bonds).

So where do we go from here? Before you can begin asset allocating you must have a clear understanding of where different assets classes stand in relation to their innate and probable risk and volatility and their correlation (if any) with other asset classes. Then the hard bit is assessing their current relative value and likely behaviour under different actual or assumed scenarios - because this influences the timing of purchases and sales. Combining all these factors should help determine the most appropriate asset allocation weightings for specific investment objectives, risk tolerance and timescale of your client.

So what about risk and volatility? Many believe they are one and the same thing, that is risk being the potential (or probability) to deviate from the norm (or benchmark) and volatility by how much and how often. As far as risk is concerned I come from the old school, which defines risk as the level of probability that you may

lose a significant proportion (or all) of your investment. In other words you need to understand the innate risk of any investment - irrespective of how little volatility it may have exhibited previously - before deciding which risk category it should be allocated to. Once you have done this then historic volatility is a good indicator (but not a guarantee) of how likely it is to perform within a given time period. Two contrasting examples of this are hedge funds and gilts.

Hedge funds - notably larger, longer established multi-strategy and funds of hedge funds - had, until mid-2008, demonstrated track records (discreet monthly and annual), which indicated a lower volatility moderate risk investment. But the tidal wave of risk aversion, and sudden illiquidity of many of the underlying asset classes in which they invest, stifled their ability to trade and left an increasing queue of distressed sellers. Hence some quoted funds of hedge funds lost around half their value in a few short months while NAVs widened to unprecedented levels.

Gilts, barring government default (the last time was in 1594) are of course a virtually risk free asset. However they have exhibited

extreme volatility (rises and falls of 10 per cent in one year have been the norm over the last few years and swings of 30 per cent or more, although rarer, are not that unusual). This is an important factor to take into consideration, particularly if your client has a short time horizon.

Few would disagree with the fact that all equities are high-risk investments but some (particularly clients) still believe a portfolio of good "blue chip" UK equities represents in itself a defensive strategy. The increasing list of high profile corporate casualties is proof of the folly of this argument.

Let's look now at correlation. One of the biggest problems for asset allocators in 2008 (particularly H2) was the fact that, contrary to perceived wisdom, there was a general correlation of virtually every asset class - that is they all fell in value - equities, property (commercial and residential), commodities, bonds, most hedge funds, currencies (mainly sterling) and even fine art! Cash is the lowest risk asset shown on the chart above but even this was not necessarily king if it was deposited in the wrong place (Iceland now the first country to turn itself into a highly

geared long-only hedge fund!).

So, does this signify a fundamental change in forecasting future correlation of asset classes? Well, probably not, but certainly it merits a critical review. Part of the problem is the best data on asset correlation goes back up to 100 years, which is great for equities, government bonds and cash, but many asset classes, such as corporate bonds, hedge and private equity funds, life settlement funds, overseas property and infrastructure, are all relatively recent components of portfolio structures so have yet to stand the test of time. These factors alone, I believe, will ensure there is now much greater probability of shorter term periods of deviation from the accepted norm.

Another crucial factor is market timing. Given no one continually buys at the bottom and sells at the top, timing is probably most relevant for the virgin investor starting out with cash. In these cases a policy of drip-feeding into the market (or cost averaging) is usually the most sensible and indeed successful.

Unlike hedge funds, where timing is critical, most mature portfolios tend to take a longer-term view and ride out the peaks and troughs. Many asset managers, like ourselves, allocate weightings not only to asset classes but also individual stocks. Therefore - particularly on winners - the timing of potential sales (or top slicing) is often triggered by virtue of performance, irrespective of the perceived investment merits. This discipline ensures that no individual stock, sector or asset class becomes too influential in relation to the whole portfolio, and therefore protects your clients if or when the unexpected occurs.

The tables show the duration and magnitude of the bull and bear markets in the UK over the last 40 years. The most telling point is how rapidly they change and, in the case of bull markets, the average lengths and scale of rises. Given also that far more bear markets are predicted than ever happen, this indicates that sensible asset allocation disciplines are far more important than timing - although the latter is certainly an essential attribute (alongside successful stock/fund selection) in achieving benchmark outperformance.

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A Recent History Of UK Bear Markets

	Months	Change %
31st January 1969 - 27th May 1970	16	-37
1st May 1972 - 13th December 1974	32	-73
30th January 1976 - 27th October 1976	9	-33
4th May 1979 - 15th November 1979	6	-23
17th August 1981 - 28th September 1981	1	-22
16th July 1987 - 10th November 1987	4	-37
3rd January 1990 - 24th September 1990	9	-22
11th May 1992 - 25th August 1992	3	-22
2nd February 1994 - 24th June 1994	5	-18
20th July 1998 - 5th October 1998	2	-25
4th September 2000 - 12th March 2003	30	-52
Average	10.6	-33

A Recent History Of UK Bull Markets

	Months	Change %
9th November 1966 - 31st January 1969	27	106
27th May 1970 - 1st May 1972	23	100
13th December 1974 - 30th January 1976	13	179
27th October 1976 - 4th May 1979	30	145
15th November 1979 - 17th August 1981	22	55
28th September 1981 - 16th July 1987	69	365
10th November 1987 - 3rd January 1990	26	56
24th September 1990 - 11th May 1992	19	38
25th August 1992 - 2nd February 1994	17	70
24th June 1994 - 20th July 1998	49	99
5th October 1998 - 4th September 2000	23	48
12th March 2003 - 31st December 2007	57	83
Average	31	112

Source: Thesis/Investment data providers