

Asset allocation strategies



There are a number of different aspects to consider when making your asset allocation. These include, risk and volatility, correlation and timing, writes Michael Lally of Thesis Asset Management.



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Writing on stock markets for a legal magazine seems rather akin to making the last presentation of the day, at a partners' meeting, on the subject of time recording or Health and Safety. Deviating somewhat from the articles by my illustrious predecessors, I would, instead, like to summarise a few home truths about the whole process of allocating investment assets.

Whether you are acting as an attorney, trustee or just a legal adviser to a client with investments, and given also the current more litigious environment, there is now a much greater burden of responsibility on lawyers to ensure that the investments are being responsibly and appropriately managed.

Therefore, before you can begin asset allocating, I believe that you must have a clear understanding of where different asset classes stand in relation to their innate and probable risk and volatility and their correlation. You then get to the hard bit – 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 the specific investment objectives, risk tolerance and

timescale of your client.

Risk and Volatility

Many believe these are one and the same thing, i.e., risk being the potential (or probability) to deviate from the norm or benchmark and volatility – by how much and how often. 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 any previously low volatility, before allocating its risk category. 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 or economic scenario.

Correlation

One of the biggest problems for asset allocators last year was the fact that, contrary to perceived wisdom, there was a general correlation of virtually every asset class – i.e., they all fell in value – equities, property (commercial and residential), commodities, non-government bonds, most hedge funds, currencies (mainly sterling) and even fine art!

So, does this signify a fundamental change in forecasting the future correlation of asset classes? Well, probably not, but certainly it merits a critical review. Part of the problem is that the best data (i.e., the Barclay's Gilt/Equity Study) on asset correlation goes back just over 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 construction, so have yet to stand the test of time.

Money flows are greater and globally coordinated, investors' time horizons shorter and derivative/hedging tools more influential than ever before. These factors alone, I believe, will ensure that there is now much greater probability of shorter term periods of deviation from the accepted norm.

Timing

Given that 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. To wait for a bull market to implode or a bear market to correct, before committing the whole lot in one go, borders on speculation.

Most mature portfolios tend to take a longer term view and ride out the peaks and troughs. Unfortunately, this does often lead to a propensity to hang on to both higher risk winners and losers for too long. Some asset managers, like us, allocate maximum 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 relative 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 thus protects your clients if or when the unexpected occurs.

We will continue to review and stress test our policies, as the current environment is not exactly conducive to conventional longer term planning. Like a ship sailing through rough seas, it is important to check regularly that all the lifeboats are in good working order! 