

# Importance of Asset Allocation

Social Insurance and Pension Systems

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## Why is it Important

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### **Asset Allocation:**

The distribution of a Fund investment among various assets,

### **Why is it so important ?**

- 91% of the variability to portfolio performance can be attributed to Asset Allocation, remaining is due to Security (Active Managers) Selection, market timing and other factors.
- Different asset classes perform differently under the same market conditions,
- Diversifying investments among various asset classes and different regions soften the blow of losses, creating a smoother path to the ultimate financial goal.
- The less concentrated a portfolio is to any one area, the more protection you have from market volatility.

## Advantages of Diversification

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- Adding asset classes that are not highly correlated can boost portfolio returns while reducing its volatility.
- Portfolios with single currency assets, stocks and bonds, are unlikely to outperform a multi currency diversified portfolio as:
  - International equities performance differ due to different economic cycles;
  - Currency fluctuations produce different influences on world equity and bond markets;
- Role of Alternative investment:
  - As standard alone assets such as hedge fund and private equity are risky, however,
  - As a part of a larger diversified portfolio, Alternatives may help investors reduce overall portfolio volatility and increase potential returns as;
  - Alternative investments are often less effected by macro-economic and financial market forces.

# Advantages of Diversification

## Wisdom of Diversification

Best

Performance

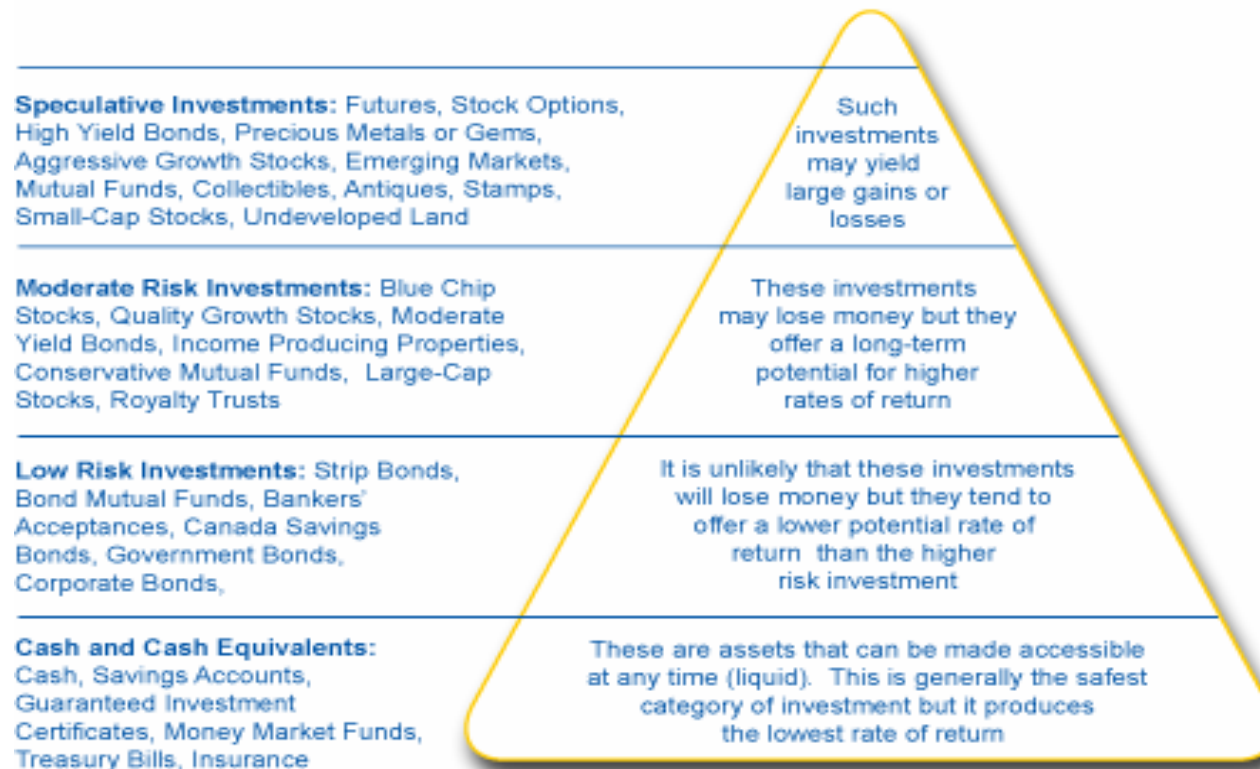
Worst

	1997	1998	1999	2000	2001	2002	2003	2004	2005
	Large Cap Growth	Large Cap Growth	Emerging Market	Municipal Intermed	Gold	Gold	China Equity	Energy	Energy
	Energy	Mid Cap Growth	China Equity	Energy	Municipal ST	Municipal Intermed	Gold	Emerging Market	Emerging Market
	Small Cap Growth	Small Cap Growth	Small Cap Growth	MM Gov Only	Municipal Intermed	Municipal ST	Emerging Market	Intl Equity	Gold
	Mid Cap Growth	Municipal Intermed	Mid Cap Growth	Municipal ST	MM Gov Only	MM Gov Only	Small Cap Growth	Mid Cap Growth	Intl Equity
	Municipal Intermed	MM Gov Only	Intl Equity	Mid Cap Growth	Emerging Market	Emerging Market	Intl Equity	Small Cap Growth	Mid Cap Growth
	MM Gov Only	Intl Equity	Large Cap Growth	Small Cap Growth	Energy	Energy	Mid Cap Growth	China Equity	China Equity
	Municipal ST	Municipal ST	Energy	Large Cap Growth	China Equity	Intl Equity	Energy	Large Cap Growth	Small Cap Growth
	Intl Equity	Energy	Gold	China Equity	Small Cap Growth	China Equity	Large Cap Growth	Municipal Intermed	Large Cap Growth
	Emerging Market	Gold	MM Gov Only	Gold	Intl Equity	Large Cap Growth	Municipal Intermed	Municipal ST	MM Gov Only
	China Equity	China Equity	Municipal ST	Intl Equity	Mid Cap Growth	Mid Cap Growth	Municipal ST	MM Gov Only	Municipal Intermed
	Gold	Emerging Market	Municipal Intermed	Emerging Market	Large Cap Growth	Small Cap Growth	MM Gov Only	Gold	Municipal ST

## Critical Factors influencing Allocation Decisions

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- Risk tolerance,
  - The amount of potential loss a fund is willing to accept in exchange for potential gains.
  - Which zone of the pyramid you are comfortable with



## Critical Factors influencing Allocation-continued

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- Required Return,
- Time Frame
  - Longer time frames provide the fund more comfort in investing in high risk asset classes as it has more time to recover from any downturns.
- Liquidity and income needs

## Issues to be considered

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During Asset Allocation Process:

- Have realistic expectations given today's market conditions by understanding how the economic climate may effect your investments,
- Look ahead, not back, when creating your investment strategy.
  - Historical returns only provide limited insight into the future
  - Future performance often differs substantially from historical averages
- Project returns by assessing future economic conditions:
  - Changes in the world economy and financial markets can present different long-term opportunities and risks for each asset class
  - Employ a building- block method using forecast of fundamental economic variables such as interest rates and earnings growth, that drive returns for each asset class.

## What after determining Strategic Asset Allocation

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The Strategic Asset Allocation takes account of the funds liability and longer term return objective-and main determinant of the fund's performance.but,

- Tactical Asset Allocation is necessary thereafter;
  - Add value through taking advantage of valuation anomalies
  - Market fluctuations can cause the asset mix to fluctuate considerably and the portfolio becomes misaligned with the strategy.
- Ignoring Tactical Asset Allocation completely removes a potential value source for additional return,
  - A balanced portfolio of different asset classes is expected to achieve 25% of alpha from this Tactical Asset Allocation.

**TAA is taken more seriously as it is a potential source of alpha generation as "Buy and hold" has been often been mocked as "Buy and Hope".**

## Pension Funds - The Choice between Asset Classes

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- The debate over an optimal asset allocation for a pension fund has two extreme views:
  - One view states that bonds are the only way to match asset with liabilities
  - while the contradicting view recommends equity exposure
- According to Chernoff(2003), a pension fund cannot just maximize its return by using traditional frontier method. The correct way is to match pension assets against liabilities, while;
- Ito (1995) argues that the aim of Pension Fund asset management is to provide funding for the pension liabilities, but a fund sponsor has also a goal of achieving an earnings spread (the positive gap between assets and liabilities) to cover for future contributions.
- Campbell and Viceira(2002), provided extensive theoretical analysis on strategic asset allocation and found that long term inflation-indexed bonds are riskless assets for long-term investors and equities can be safer assets for long-term than for short term investors.

## Empirical Findings of Pension Funds allocations in US and UK

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- Healy and Rozenov (2004) studied the 200 largest defined pension funds in the United States and found that
  - Equity allocation increased its share from 48 percent in 1991 to 57 percent in 2001.
  - Funds were increasingly allocating to alternative investments, real estate, enhanced indexed equities and bonds.
- Blake et al. (1998) report asset allocation and performance of more than 300 UK pension funds and his observations were:
  - - Allocation practices of funds have remained rather steady from 1986 to 1994.
    - High allocation to equities (78 percent) with only 14 percent to fixed income.
- Optimal Allocation for every pension fund could be unique depending on issues such as
  - regulatory environment, view of the fund liability, and its funded status.

**Hence, it is difficult to provide a definitive set of allocation rules for Funds**

## Evolution of Fund Management Structures

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- Balanced fund mandates, with a target return of the peer group were the norm for institutional pension funds; still available but popularity is declining to specialised mandates
- Since 80's a huge influx into index fund management specially in UK pension funds driven primarily by:
  - Low cost management fees of the product;
  - Lack of the value added by active managers
- Pension Funds tendency is towards schemes using their:
  - Passive exposure as their core investments;
  - A number of specialist or satellite managers are appointed to manage a percentage of assets aggressively targeting alpha through alternative asset classes such as Private equity hedge funds, real estate and commodities .

**Separation of Alpha and Beta is the theme,... Beta comes from traditional passive mandate and Alpha from active mandates and**

**Alternatives.**

## Conclusion

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**Asset Allocation is the most critical process in portfolio management.**

**Its ultimate goal is to build an efficient portfolio-providing the greatest possible returns for the lowest risk based on goals, risk tolerance and time frame.**

**Over 90% of a Fund total performance is attributable to Asset Allocation, while the remaining is explained by stock selection and market timing.**

**Tactical Asset Allocation is thereafter essential to rebalance the portfolio to align with the Fund's strategy and capture opportunities created by valuation anomalies, which could enhance the return by around a quarter.**

**Diversification by adding asset classes that are not highly correlated can boost portfolio returns while reducing its volatility.**

**No single allocation fits all, it depends on each Fund regulatory environment, fund liability and funded status.**