

Strategic & tactical asset allocation

Your guide



PENSION & INVESTMENT ADVISERS
PLANNING FOR THE PEOPLE

Introduction

As an investor, nothing is more important than determining your financial goals. After all, aiming to achieve your aspirations is the reason you invest.

The next logical step is to assess how much risk you are willing and able to take to achieve your goals. A good understanding of the fundamentals of investing and guidance from a Financial Adviser will help you establish a clear goal-driven financial plan.

Once your plan is in place, you need to consider the right mix of investments in order to achieve your ambitions with the minimum risk of loss. This will involve creating an optimum blend of assets. These generally include cash, bonds, property, equities and perhaps some alternative assets, such as commodities.

Achieving the right asset allocation is crucial to fulfilling your financial plans. It's the map that will guide you to your goals. When establishing your asset allocation, professional investment managers tend to adopt one of two investment strategies: strategic or tactical. Each has its merits. So which strategy or mix of approaches you adopt is a decision for you and your Adviser to agree on. This document aims to help you choose wisely, providing an unbiased view of each strategy based on what we believe are generally accepted opinions.

Strategic asset allocation

Strategic asset allocation involves defining portfolio asset allocations from the outset, based on historical performance and volatility data over a representative period. This strategy follows the principles of Modern Portfolio Theory: a pioneering work that saw Harry Markowitz win a Nobel Prize in 1990.

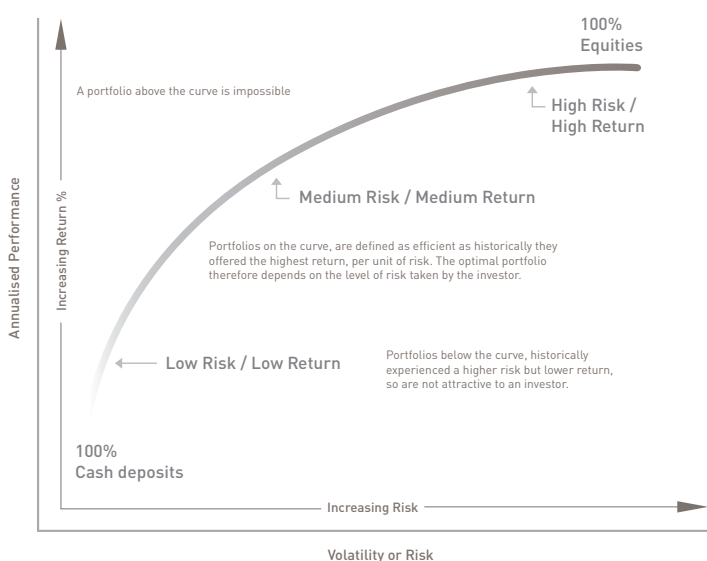
When creating the portfolio, managers establish an asset mix based on the expected risk and return dynamics of each asset class. A wealth of historical statistical data shows how asset classes have performed during a variety of social, political and economic conditions. Managers use significant resources to review this data, focusing on the long-term returns and risks within each asset class.

Using this analysis, it is possible to create portfolios that provide the best balance of risk and reward. Graphically this is known as the Efficient Frontier.

Portfolios fitting tightly to the Efficient Frontier are termed 'efficient' because they aim to achieve the highest possible expected rate of return for the specified level of risk.

Figure 1 (below) shows the relationship between risk and return as you move along the Efficient Frontier. While a portfolio above the Efficient Frontier is mathematically impossible, a portfolio below the curve is not. In fact, it is common in many do-it-yourself portfolios.

Figure 1: The Efficient Frontier



Source: Modern Portfolio Theory, Harry Markowitz (1952).

Holding a portfolio not professionally mapped to the Efficient Frontier could mean you inadvertently take a higher degree of risk than the potential return warrants. A rational person would prefer to take the minimum possible risk in pursuit of a particular level of return.

An almost infinite number of strategic portfolios are available to investment managers. So they will provide each investor with portfolios tightly mapped to the Efficient Frontier. This offers the best chance of achieving a desired return at the lowest possible risk.

Managers adopting this approach do not focus on exploiting short-term valuation opportunities caused by a change in sentiment towards different asset classes. Instead, they analyse the performance of different assets over the long term and build portfolios with a mix of assets that could deliver the best possible outcome for a given level of risk. When following this approach, asset allocations will only be changed where there is a significant shift in the long-term outlook of any particular asset class.

To preserve the portfolio's risk and return characteristics, asset class mixes are typically rebalanced to the target weights at regular intervals, such as quarterly or half yearly. The process of rebalancing involves selling those assets that have outperformed and reinvesting the proceeds into assets that have under-performed, thereby retaining the original asset allocation.

Tactical asset allocation

In its most simple form, tactical asset allocation adopts the long term asset class weightings of a strategic portfolio. However, it gives investment managers the flexibility to vary those weightings according to market conditions, within a risk-controlled framework.

Investment managers normally evaluate the relative attractiveness of cash, bonds, property and equity markets through financial valuation, growth and sentiment measures. They then often use a systematic process to assess the current attractiveness of those asset classes and alter the portfolio weightings accordingly.

Professional investment managers seek to create an additional source of return by adjusting the weightings between asset classes. They aim to take advantage of short to medium term market inefficiencies by managing investors' exposure to the different asset classes within an appropriate risk framework. The resulting additional trading costs must be recovered in additional gains in order for the tactical manager to outperform relative to a strategic portfolio.

Tactical strategies are usually based on the belief that markets are not efficient. Investor psychology and market forces can lead to periods of incorrect asset class valuations. Tactical asset allocation attempts to capture these inconsistencies to generate a higher risk-adjusted return. Asset allocations are dynamic by nature, and a portfolio's risk level may change according to the views of the investment manager.

Which strategy is best?

This is hotly debated between the advocates of each strategy. Both sides accept that your overall strategic asset allocation significantly affects the variability of your returns over the long term.

However, they diverge on how to manage that allocation in the short term. Advocates of strategic asset allocation argue that, over the long term, the performance and volatility of each asset class will remain relatively constant and that adjusting asset weightings in the short to medium term is equally as likely to end in failure as in success.

They therefore promote keeping the asset mix in-line with the investor's long-term goals and striving to retain this blend through rebalancing. Changes should therefore only be made, where it is believed that the historic long-term performance and volatility of any asset class, is no longer a useful proxy for likely future performance and volatility due to some fundamental change.

The debate focuses on the tactical manager's ability to identify short to medium term inconsistencies in asset prices and exploit them for the investor's benefit. This could mean reducing a weighting in an asset class they believe is overvalued – and buying into an asset class they think is undervalued or attractively valued. The aim is to provide a risk-adjusted return above that of a strategic asset allocation.

However, while the manager has the flexibility to generate outperformance, choosing incorrectly could lead to underperformance. Tactical managers strive to identify market inefficiencies and make judgements that provide opportunities to outperform. However, this strategy involves significant ongoing research, trading and other associated costs. These costs must be recovered through additional portfolio gains before the tactical manager can demonstrate outperformance against a strategic portfolio.

Managers structure a series of strategic and tactical portfolios to achieve returns for varying levels of risk. One style will not necessarily offer a better return or less volatility than the other over the longer term. Either approach can be appropriate for an investor, as part of a disciplined, goal-oriented, structured financial plan as agreed with your Financial Adviser.

In summary

Ultimately it comes down to what extent you believe markets are efficient and if it is possible to forecast relative asset class movements over the short to medium term.

Strategic asset allocation may be right for you if you like to keep things simple. It may also be appropriate if you don't feel comfortable with the additional costs of tactical asset allocation, given there is no guarantee of outperformance versus a strategic asset allocation.

However, tactical asset allocation may appeal because you prefer to adopt a more active asset allocation in your portfolio. Each approach has its merits. No two investors are the same. So the choice between strategic and tactical asset allocation is something to be discussed and agreed with your Financial Adviser.

This document provides information about investing and explains some of the different approaches available to you. It is a statement of opinion, not advice, and you should not take it as an indication of likely future returns. Seeking professional advice will help you make informed decisions that are right for you.



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