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AMP CAPITAL

Asset allocation is critical for investors – even as the world mends

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Key points

- The GFC and the low and volatile returns seen in subsequent years highlighted the importance of asset allocation in determining returns and managing volatility.
- While a mending global economy will result in better returns, asset allocation will remain critical for investors as returns will likely remain constrained, volatile and lowly correlated.
- Improved approaches to asset allocation, in particular dynamic asset allocation, and the use of highly liquid and low cost futures and exchange traded funds (ETFs) further enhance the significance of asset allocation.

Introduction

A critical lesson of the global financial crisis (GFC) and its aftermath is that asset allocation is critically important. The period of poor returns and high volatility that characterised the GFC and subsequent years clearly demonstrated that asset allocation, by far, swamps the impact of active security selection or manager selection as a driver of investor returns.

However, will this remain the case if the global economic and financial outlook continues to improve in the years ahead? Before this is addressed, it is worth putting asset allocation in context.

What is asset allocation?

The return generated by a diversified fund or mix of assets will essentially be a function of three things:

- The fund's medium to long term allocation to each asset class (e.g. 30% in Australian shares, 25% in bonds, 10% in property etc.) and hence the market return they generate – technically this is referred to as the fund's Strategic Asset Allocation (or SAA);
- Any short term deviation in the asset mix away from the SAA – this is technically referred to as Tactical Asset Allocation (or TAA); and
- The contribution from active management of the underlying asset classes, often referred to as security selection. In the past this was largely undertaken by just one manager but it has become common to use a multi-manager approach in each asset class.

Numerous studies have shown that asset allocation is the key driver of the return an investor will get.[1] In fact, if you believe active management of the individual asset classes will add no value, or the fund only invests in indexed funds, then asset allocation will drive 100% of the return. This is just common sense. If a fund is skewed towards shares over bonds or cash, then it will do well when shares outperform and vice versa.

However, in an environment of strong returns from all asset classes and where returns between the two main asset classes of shares and bonds invariably move together, the benefits of asset allocation tends to be masked as buy and hold strategies work very well. This is effectively what applied through much of the 1980s and 1990s, which turned out to be an environment where asset allocation faded in perceived importance relative to manager selection.

This begs the obvious question: if we are heading into a new secular bull market in shares, will this see a renewed decline in the perceived relative importance of asset allocation in favour of a return to simple buy and hold strategies?

Our view on equity markets

In our view, while shares are at risk of a further correction in the short term, in a broader context they have likely entered a new cyclical bull market.[2] Factors that support this view are discussed below:

- The risk of a meltdown in Europe is gradually receding, albeit in 'fits and starts'. This was highlighted by the relatively muted reaction to the messy bailout of Cyprus, with Spanish and Italian bond yields remaining well below crisis highs. While concern is likely to linger that losses for large depositors and bond holders in Cypriot banks sets a precedent for the rest of Europe, in reality Cyprus is likely to be a special case given its minute size, large banking sector relative to its economy and large non-Eurozone deposit base. Problems in Europe are likely to continue to flare up occasionally but growth should return late this year or the next.
- The US economy is continuing to strengthen, led by an improving housing sector, strengthening business investment, strong profits and an improving labour market.
- Growth in China looks to have bottomed. While the authorities are trying to cool the property market, inflationary pressures seem to be benign and indicators are at levels consistent with growth of around 8%.
- There are increasing signs rate cuts will help boost profits in Australia, particularly for leaner industrial companies. Consumer confidence is now well above long term average levels, business confidence is up from its lows and housing indicators are picking up – all the things that would normally be seen after a period of rate cuts.
- Global monetary conditions are highly stimulatory and there is plenty of cash on the sidelines which appears to be starting to come back into equity markets.

More significantly, after a 13-year secular, or long term bear market, a new secular bull market in global shares appears to be close, led by a rebuilding US economy but also helped by more aggressive reflation in Japan and gradual structural improvement in Europe.[3]

Asset allocation to remain critically important

While there will no doubt be periods of very strong returns as we have seen over the past year, asset allocation is likely to remain critically important going forward.

Firstly, the broad return backdrop is likely to remain constrained with not all asset classes doing well. The starting point for returns today is much less favourable than when long term bull markets last started in bonds and shares in 1982. The yields on all asset

1. For articles on the importance of asset allocation see R.G. Ibbotson. "The Importance of Asset Allocation", Financial Analysts Journal. Mar/Apr 2010.
2. See "A new bull market in shares?" Oliver's Insights, February 2013.
3. See "A new secular bull is close..." Oliver's Insights, February 2013.

classes, particularly bonds, are much lower. Shares are unlikely to have the tailwind of rising profits relative to GDP as the profit proportion is already high. And both shares and bonds won't have the combined tailwind from falling inflation which benefitted both asset classes thirty years ago as the yield structure fell, providing a huge valuation boost to returns. In fact, our medium term return projections, shown in the next table, imply a 7.5 to 8%p.a return from a diversified mix of assets. This is well below the average 11.9%p.a return that Australian diversified funds provided over the 1982-2007 period. In a world of constrained returns, getting the right asset allocation will remain critically important, compared to in a high return world where it's not as much of a focus.

Projected medium-term returns, % pa, pre fees and taxes

	Current Yield #	+ Growth	= Return
World shares, local currencies	2.7	4.2	6.9
Asia ex Japan shares	2.7	8.0	10.7
Emerging market shares	3.0	7.0	10.0
Australian shares	4.3 (5.6*)	5.2	9.5 (10.8*)
Unlisted commercial property	6.0	2.5	8.5
Australian REITS	5.3	2.5	7.8
Global REITS	6.1^	1.9	8.0
Unlisted infrastructure	6.0	3.5	9.5
Australian Government bonds	3.1	0.0	3.1
Australian corporate debt	4.5	0.0	4.5
Australian cash	3.7	0.0	3.7
Diversified growth mix			7.7

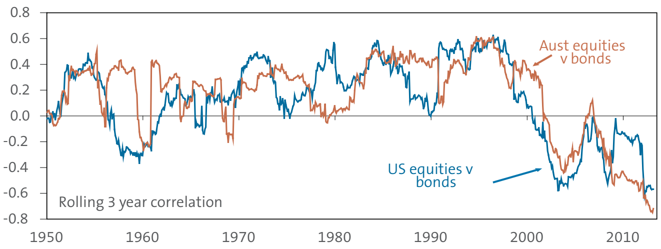
Current dividend yield for shares, distribution/net rental yields for property and five-year yield for bonds. ^ Assumes forward points averaging 2% points p.a.
* With franking credits added in. Source: AMP Capital

Secondly, the potential return range between the major asset classes is likely to be wide ranging from just 3%p.a for Australian government bonds to just over 10%p.a for Asian shares. Conceivably, given the way markets go the range could be even wider than this. This will only add to the importance of getting the asset allocation right. In particular, being loaded up on low yielding bonds and cash could end up locking investors into very low returns.

Next, while volatility is likely to be down on the extremes seen over the last few years, it is still likely to be relatively high. Public debt problems are likely to continue flaring up periodically, the world is becoming more reliant on growth from naturally volatile emerging countries and extremely easy monetary policy conditions will provide a source of volatility when they are reversed at some point. This will likely result in ongoing volatility in asset class returns, providing opportunities for asset allocation to add value to investment returns.

Finally, bond and share market returns will likely remain negatively or lowly correlated, providing an opportunity for asset allocation to enhance returns by moving between the two. This is evident in the next chart which shows the rolling three year correlation between bond and equity returns in Australia and the US since 1950.[4] Through the 1980s and 90s, return correlations between bonds and shares were mostly positive, reflecting the common driver of the adjustment to a low inflation world. But starting over a decade ago, this had run its course and so the correlation turned negative as investor sentiment swung more aggressively between "risk on" (favouring shares) and "risk off" (favouring bonds).

Correlation of monthly equity & bond returns



Source: Global Financial Data, AMP Capital

So while the world is gradually starting to heal which should result in a better environment for shares, asset allocation is likely to remain critical, reflecting the likelihood of constrained returns, a large variation in returns between major asset classes and ongoing volatility.

A different approach to asset allocation

Apart from a long period of strong returns, another reason why asset allocation seemed to fall out of favour prior to the GFC relates to the perceived mixed track record from traditional TAA approaches within diversified funds. But the problem with these approaches is that they were often constrained by a desire to minimise peer risk and decision making was poor. These outcomes reflected a committee-based approach dominated by part-timers (usually asset class managers lacking the skills to assess the relative potential between asset classes). And whilst the TAA approach evolved into global tactical asset allocation (GTAA), this tended to be very short term or almost trading focussed and ran the risk of missing out on big picture moves in markets.

Following the experience of the GFC, the focus of asset allocation has shifted more towards taking advantage of extreme swings in the relative performance of different asset classes (such as occurred around late 2008/early 2009) over the course of a business cycle. This approach, often referred to as dynamic asset allocation, sits between the short term trading focus of TAA or GTAA and the medium to long term focus of SAA. A big advantage of this approach is that it can be entirely implemented via highly liquid futures and exchange traded funds and can replicate a diversified mix of assets for a fraction of the cost but with far more flexibility in varying the asset mix than would apply to a traditional fund. This approach has seen significant growth in offshore markets, notably the US.

4. The correlation coefficient ranges between +1 (perfectly positively correlated, ie the two assets move precisely in the same direction) and -1 (or perfectly negatively correlated). A zero correlation would indicate no relationship between the two asset classes.

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