

# Asset allocation isn't everything, but it nearly is

## Investment insights

### Key points

- The perceived importance of asset allocation in driving investor returns faded from the 1990s as a result of high overall returns from most asset classes and relatively high correlations between bonds and shares.
- However, the dismal returns of the last decade from global shares, a relatively constrained overall return outlook, increasingly wild swings in share markets and the return to more volatile economic cycles is serving to highlight the importance of asset allocation.

### Introduction

Everything comes in cycles, and one of the big swings in investment management relates to the perceived importance of asset allocation, i.e. the exposure an individual or fund has to individual asset classes, eg, global shares, Asian shares, New Zealand shares, global bonds, listed/unlisted property, cash, etc. Through the 1990s and into the last decade the investment management industry increasingly moved away from worrying about asset allocation to focusing on manager selection at the asset class level. This partly reflected the experience of the 1980s and 1990s - where most asset classes did well so asset allocation was seen as less important and many thought it was too hard anyway.

This is all changing with the global financial crisis and continuing gyrations in investment markets. Coming on the back of a decade of poor returns from traditional global shares, it provides a reminder of just how important asset allocation is. As a result asset allocation looks to be making a big comeback.

### What is asset allocation?

First some technicalities. The return a diversified fund or mix of assets generates will essentially be a function of three things:

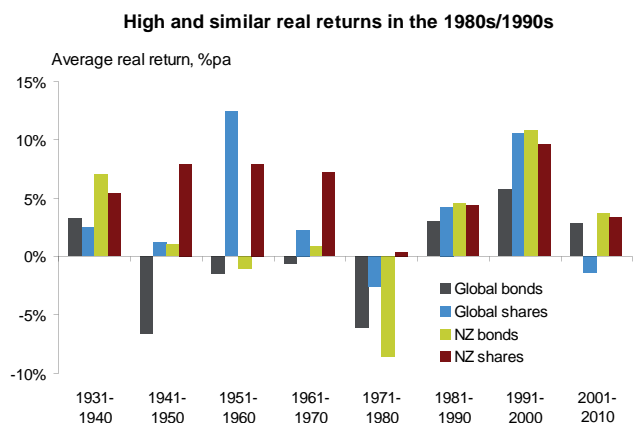
- The fund's medium to long term allocation to each asset class (i.e. shares, bonds, etc) and hence the market return they generate – this is usually referred to as the fund's Strategic Asset Allocation (or SAA);
- Any short term deviation in the asset mix away from the SAA – this is traditionally referred to as Tactical Asset Allocation (or TAA); and
- The contribution from active management of the underlying asset class portfolios. This is often referred to as security selection. In the past this was largely undertaken by just one manager but over the last decade a range of fund managers have increasingly been used in each asset class.

While various studies show the last two components are of similar importance depending on the period, there is general agreement that the first component – i.e. the strategic asset allocation of a fund – is the key driver of the return an investor will get. And of course its importance will rise even higher once any tactical asset allocation is allowed for as well. In fact, if you believe active management will add no value, or the fund only invests in indexed funds, then asset allocation will drive 100% of the return<sup>1</sup>.

### Asset allocation took a back seat from the 1990s

During the 1990s and into the last decade asset allocation seemed to fade in importance relative to security selection and picking managers. There were several reasons for this.

First, real returns from shares, bonds and most other asset classes were very high during the 1980s and 1990s, reflecting the powerful tailwinds of falling inflation, deregulation and globalisation. Against this backdrop there seemed to be little need to worry about asset allocation. Buy and hold – virtually anything – worked very well. “Time in, not timing” became the mantra because it worked seemingly easily.



Global returns are in \$US. Source: Global Financial Data, AMP Capital Investors.

Second, there was thought to be little scope for asset allocation to enhance returns because the main asset classes of bonds and shares seemed to move pretty much together anyway. This was because they were largely being driven by a common factor which was the fall in inflation and inflationary expectations that occurred from the early 1980s. This drove a fall in bond yields (and hence high returns from bonds) and a rise in price to earnings multiples (which boosted equity returns) and as a result the returns of equities and bonds were positively correlated through much of the 1980s and 1990s (see the next chart).

Third, there was a perception that it was just too hard to enhance returns by varying the asset allocation of a fund. The track record of traditional diversified funds being able to add value by tactical

<sup>1</sup> For articles on the importance of asset allocation see R.G. Ibbotson. “The Importance of Asset Allocation”, Financial Analysts Journal. Mar/Apr 2010.

asset allocation was perceived to be poor. This was seen to be a reflection of the traditional committee based approach to asset allocation, where consensus and group think led to weak decisions and committee members were part-timers (usually asset class managers) and lacked the skills to assess the relative return potential between asset classes. Also, it was felt that undertaking asset allocation over just a handful of assets meant it lacked sufficient breadth to be able to add value. Finally, there was a general faith in the view that investment markets were efficient and that, as a result, regardless of the starting point there is some stable long term return relationship, or risk premium, between asset classes reflecting their riskiness. In other words, whether you buy shares before or after a big fall their long term return potential relative to bonds will be the same!

## Asset allocation back in the front seat

However, the investment management landscape is changing again as over the past few years a number of challenges to the downgraded view of asset allocation have emerged. These include the following.

- The first is the more constrained investment outlook. This initially started to emerge after the “tech wreck” bear market but has since been reinforced by the latest bear market and the constrained average returns over the last five to 10 years. With the tailwinds of falling inflation, deregulation and globalisation now behind us, and problems now flowing from both high household and public sector debt, it’s likely that the medium term return outlook will remain constrained. This means anything that can improve returns – including asset allocation - will be far more valuable than when average returns were much higher.
- Second, cyclical swings in asset classes are becoming more evident as favourable secular forces have faded and the combination of poor household balance sheets, high public sector debt levels and extreme swings in monetary policy in some advanced countries are resulting in a return to a more pronounced economic cycle. This has seen the correlation between equity and bond returns fall to negative levels in recent times after being positive through the 1980s and 1990s. This is evident in the next chart which shows the rolling three year correlation between bond and equity returns in New Zealand and the US since 1973<sup>2</sup>.

<sup>2</sup> 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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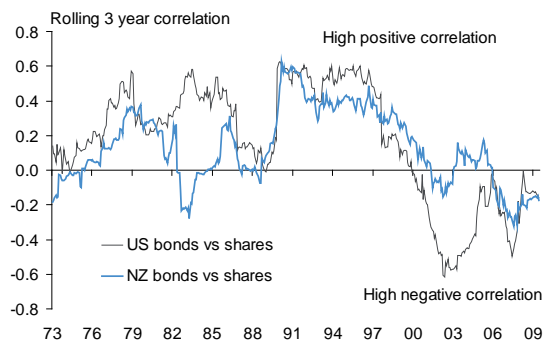
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Correlation of monthly bond and equity returns



Source: Global Financial Data, Datastream and AMP Capital Investors

Against this backdrop, a 1990s style “buy and hold” strategy won’t work so well. Rather if economic and investment cycles are becoming shorter and more extreme, correlations between equities and bonds remain negative and medium term investment returns are more constrained, then this will provide more opportunities for shifts in the allocation between key assets to enhance the returns investors receive.

- Thirdly, more asset classes are now available which has expanded the scope for asset allocators to add value, eg, emerging market shares, commodities and infrastructure. That said, while there is a role for alternative and more exotic investments in portfolios, their diversification benefits should not be exaggerated. After all, one of the lessons learnt from the global financial crisis is that there is a lot of value in the rather simplistic yet old fashioned approach to risk control – government bonds and cash did provide good diversification through the crisis. Assets such as REITs, hedge funds and credit have proven to be too risky in times of greatest need for diversification
- Finally, the tech wreck and the global financial crisis have shaken belief in the view that financial markets are efficient and it is now commonly accepted that irrational investors can drive wild swings in asset classes which alter their relative return potential.

## Concluding comments

As a result of all these considerations the role of asset allocation is on the rise again. However, rather than just resulting in a swing back to short term market timing, as undertaken by traditional Tactical Asset Allocation, the focus is likely to be on taking advantage of the opportunities provided by extreme swings in share markets (such as occurred around late 2008/early 2009) over a one to three year time horizon. For want of a better term, some have taken to calling this Dynamic Asset Allocation as it’s somewhere between the shorter term focus of Tactical Asset Allocation and the medium term focus of Strategic Asset Allocation.