



The Asset Allocation Process. Strategic and Tactical Asset Allocation.

Portfolio Management
for Financial Advisers

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Asset Allocation Process

- The asset class selection process depends on limiting the risk for a given amount of return based on long-term capital market expectation
 - **Private investors** tend to use a less formal approach to asset allocation, making benchmarks less important than the return on portfolio
 - **Intitutional investors** tend to make the distinction between strategic and tactical asset allocation
- They evaluate the managers basing on manager deviations from a benchmark rather than the return from manager's portfolio



Asset Allocation Process

Global asset allocation process consists of four steps:

STEP 1: Research and market analysis

STEP 2: Asset allocation optimization

STEP 3: Portfolio construction

STEP 4: Portfolio monitoring



Asset Allocation Process

Research and Market Analysis

Formulating capital market expectations can be the most rewarding, yet most difficult part of research process.

There are 3 steps to developing expectations:

1. Defining asset classes
2. Developing long-term expectations
3. Developing short-term expectations



Asset Allocation Process

Research and Market Analysis – Defining Asset Classes

- An asset class is a **set of securities** that have very similar characteristics with regards to the factor that influence their prices

- They are usually segmented based on:
 - type
 - geography
 - sector
 - style

- The client's size and time horizon affect asset class selection



Asset Allocation Process

Research and Market Analysis – Developing Long-Term Expectations

Long-term expectations can be developed on the basis of:

- 1. Historical returns:** past returns, volatility and correlations are simply projected into the future.

DRAWBACKS:

- 1) Past relationships may not hold in the future
- 2) Specific event driven relationships may disappear with the occurrence of the event
- 3) The historical data can be unavailable or of poor quality

2. Forward- looking returns



Asset Allocation Process

Research and Market Analysis – Developing Long-Term Expectations

Forward – Looking Returns

Developing long-term expectations that are consistent with market equilibrium.

An approach based on **CAPM** and applied to international markets follows **3 steps**:

- 1) Calculate covariance matrix
- 2) Develop expected returns for each asset class based on CAPM
- 3) Adjust the returns for segmentation and liquidity

Asset Allocation Process

Research and Market Analysis – Developing Long-Term Expectations

Forward – Looking Returns

As world markets lack full integration, certain investments require premiums to be adjusted from the required return calculated using CAPM:

- 1) **Risk premium:** the expected return for each asset class is the risk-free rate plus a risk premium proportional to its beta with the world market.

Risk premium for asset class	=	The beta of asset class with respect to the world market	*	The equity risk premium for the world
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- 2) **Segmentation premium:** world markets are not fully integrated. As local investors cannot diversify away all the risk of local assets class, they will demand a higher risk premium.
- 3) **Illiquidity premium:** if the asset class suffers from lack of liquidity, investors will want to be compensated for the inability to quickly sell it. Because CAPM assumes liquidity the illiquidity premium is added to risk premium



Asset Allocation Process

Research and Market Analysis – Developing Short-Term Expectations

- **Short - term opportunities** arise when asset prices become over - or undervalued in the time span of less than a few years.
- **Tactical asset allocation** decisions, which deviate from strategic allocation, exploit these mispricing opportunities.

A vertical image on the left side of the slide shows a white globe with a grid of latitude and longitude lines. Below the globe, there are several financial charts and documents, including one with a jagged line graph and another with the word 'NOW' visible. The background is a light, neutral color.

Asset Allocation Process

Asset Allocation Optimization

Different methods can be used to develop optimal asset allocation:

1. **Mean-Variance Optimization:** it is based on optimizing the risk for given levels of expected returns, which are derived from capital market expectations. The main disadvantage of this method is its assumption of normal distribution of returns
2. **VAR approach:** managers set a given loss probability and structure the portfolio not to exceed that loss. The implementation of this method is more complicated than in case of previous one
3. **Inverse optimization:** it starts with the assumption that world market is in equilibrium. This approach works backwards from the allocation, which is given by the proportion of each market cap group observed at equilibrium, back to the expected returns that investors require for holding assets in market-cap proportions

A vertical image on the left side of the slide shows a white globe with a grid of latitude and longitude lines. Below the globe, there are several financial charts and documents, including a line graph with a jagged peak and the word 'NOW' written on it. The background is a light, neutral color.

Asset Allocation Process

Portfolio Construction

1. **A strong research department** should perform necessary analysis in order to provide managers with list of securities together with their **risk characteristics and sensitivities**
2. **The manager**, using multi-factor models based on the data provided by research department, **constructs portfolios that meet client's objectives**
3. **Each portfolio** should be periodically or contemporaneously **rebalanced based on the allocations in the IPS**, while minimizing the impact on return imparted by transactions costs and taxes.



Asset Allocation Process

Portfolio Monitoring

The final and ongoing step is to monitor the portfolio, constantly watching its risk/return performance and deviations from the approved allocation

Components of Global Performance Analysis should include:

- The total return for specified period
- The components of return (capital gains, income, exchange rate returns)
- The contributions from allocation, security selection, currency selection and market timing
- How return compares to the chosen benchmark
- Alpha calculations for asset classes and market allocations to determine particular areas of expertise

Once the performance attributes have been calculated and analyzed, they should be interpreted according to the global investor's individual situation:

- An analysis of whether the risk-diversification objectives were achieved
- An analysis of the manager's strategy compared to client objectives

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2. Strategic and Tactical Asset Allocation



Strategic and Tactical Asset Allocation

Strategic Asset Allocation (SAA) refers to the long-term risk/return investment policy **based on capital market expectations**. When the market environment presents certain risks or opportunities, the asset allocation may be adjusted through process called **Tactical Asset Allocation (TAA)**



Strategic Asset Allocation

- For individuals the investment policy statement plays a large role in the SAA
- For institutions, the SAA generally specifies benchmark against which the plan sponsor will measure the investment manager performance

A globe is positioned on the left side of the slide, partially overlapping a background of financial charts and documents. The globe shows the Americas. The charts include a line graph with a peak and a trough, and some text like 'NOW' and '1992'.

Strategic Asset Allocation

There are some important issues regarding how to select an appropriate benchmark:

- 1. Scope of the benchmark:** a truly global investor should consider all available asset classes and assign a sub-benchmark for each of them. Unfortunately, foreign and domestic assets are often treated to different asset classes. When the global asset allocation for entire portfolio, heavily reflects domestic assets, it may not mirror the natural allocation for a global strategy
- 2. Weights in the benchmark:**
 - The most common weighting scheme uses relative market capitalizations from a published global market index
 - Some investors have switched to GDP country weights, which accounts for each country's economic strength
 - Separate benchmarks may be used for each asset class, what leads to customized portfolio benchmarks



Tactical Asset Allocation

Tactical asset allocation (TAA) is the process by which active managers adjust their strategic allocations in the short-term.

- TAA seeks to add additional return by exploiting perceived short-term dislocations in the value of an asset class
- They are deviations from SAA and are conditional on new information the manager believes will affect asset's price
- How manager exploit these opportunities depends on the techniques available to him. Some managers use a disciplined risk/return optimization process, while others rely on fundamental data, and still others use subjective analysis



THANK YOU!