

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



### Key points

- The perceived importance of asset allocation in driving investor returns faded during 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 from global shares over the last decade, a constrained overall return outlook, increasingly wild swings in share markets and the return of more volatile economic cycles are 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, e.g. global shares, Asian shares, Australian shares, global bonds, 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, when most asset classes did well and asset allocation was seen as less important. Many thought it was too hard anyway.

This is all changing following the global financial crisis and continuing gyrations in investment markets, coming after a decade of poor returns from traditional global shares and providing 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?

Firstly, let's address 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 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.

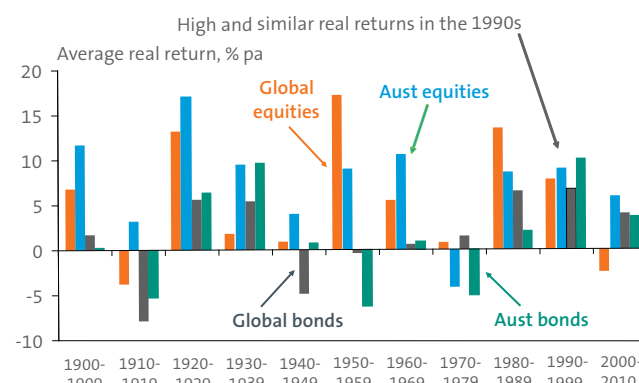
Although various studies show the last two components are of similar importance depending on the period, there is general agreement that the first component, i.e. the strategic asset

allocation of a fund, is the key driver of an investor's return. Its importance rises even higher once any tactical asset allocation is allowed for as well. In fact, if 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. 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: E.Dimson, P.Marsh & M.Staunton, Global Investment Returns Yearbook, London Business School/ABN AMRO 2003. 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 moved in line anyway. This was because they were largely 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 too hard to enhance returns by varying the asset allocation of a fund. The track record of traditional diversified funds adding value by tactical asset allocation was perceived to be poor.

This was seen to be a result of the traditional committee-based approach to asset allocation where consensus and group think led to weak decisions and committee members (usually asset class managers) lacked the skills to assess the relative return potential between asset classes. Also, it was felt that undertaking 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.

allocation over just a handful of assets meant it lacked sufficient breadth to add value.

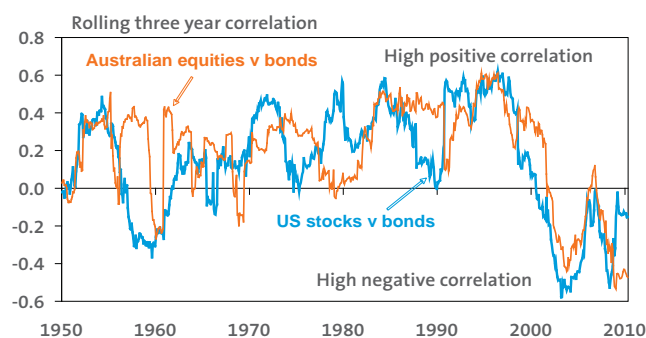
Finally, there was a general faith in the view that investment markets were efficient and that, as a result, regardless of the starting point there was some stable long-term return relationship, or risk premium, between asset classes reflecting their riskiness. In other words, whether you bought shares before or after a big fall their long-term return potential relative to bonds would 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.

- First, a more constrained investment outlook emerged after the ‘tech wreck’ bear market and has since been reinforced by the latest bear market and the constrained average returns over the last five to ten 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. Therefore, 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 Australia and the US since 1950<sup>2</sup>.

### Correlation of monthly equity and bond returns



Source: Global Financial Data, Datastream and AMP Capital Investors

2. The correlation coefficient ranges between +1 (perfectly positively correlated, i.e. 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.

The impact of these more volatile forces became noticeable in the US and Europe over the last decade. None of this was a major issue for Australia during the ‘tech wreck’ bear market as Australia wasn’t really exposed to the assets at the centre of the technology bubble. However, it is progressively becoming an issue as Australia’s exposure to commodities has grown and commodities have become more central to the global boom-bust cycle.

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.**

- Third, more asset classes are now available which has expanded the scope for asset allocators to add value (e.g. emerging market shares, emerging market debt, infrastructure and various ‘alternative’ asset classes).
- Fourth, 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.
- Finally, the enhanced availability and liquidity of futures markets along with the advent of cheap exchange-traded funds has made undertaking asset allocation very cheap.

## 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. A big advantage of this approach is that it can be undertaken relatively cheaply using exchange traded funds and futures markets.

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