

## **Asset Allocation (top down)**

**Dominic Sheehan – October 2009**

The main purpose of this article is to explain what asset allocation is and how it is applied to the construction of a portfolio. This is carried out prior to stock/fund selection and therefore is a critical part of a portfolio manager's job when applying this approach, especially as it can have a significant impact on performance. I hope you find the information useful as an initial starting point.

Asset allocation is defined as the process of spreading your assets (diversification) across different types of investments in suitable amounts. Examples of assets are Cash, Gilts, Corporate Bonds, Domestic/Overseas Equities, Hedge funds, Property and Structured Products.

The aim is to maximise the return for any given level of risk or reduce the risk for any given level of return. Different asset classes do not have similar patterns of return or price volatility over long periods of time (i.e. are not highly correlated) and thus can be mixed to provide a more efficient structure. Asset allocation has become a hot topic in recent times as a large number of asset classes e.g. Equities, Commodities, Property and Hedge funds have become more highly correlated (i.e. moving in the same direction) thus increasing risk.

The percentage of the total that you place into each area is usually determined by an asset allocation model. There are a variety of models that you can choose from ranging from very conservative to growth, where each have a different amount invested across the debt/equity spectrum. For example a growth model may have 15% in cash/Bonds and 85% in Equities with further subdivisions into the regional choices.

The model chosen will, among other things, be based on your objectives/needs (growth or income/combination), time scale and attitude to risk. This means that prior to investing you will have to spend time, for example, looking at your income/expenditure and assets/liabilities in detail. From this information you will be able to understand your needs and then start to build objectives. You need then to try and quantify the amount of risk you are willing to take over a particular time period. This can be achieved via tools such as risk profiling, which aim to understand your risk appetite. You are then in a position to adopt a core strategic asset allocation i.e. the model. This is called strategic as it is based on the long-term outlook for each asset class. This is usually fixed in terms of weightings for each model and only needs to be rebalanced when component parts of it move relative to one another e.g. Equities move up substantially relative to Bonds or vice versa.

It is also possible to adopt a shorter or tactical asset allocation whereby investors can deviate from the strategic asset allocation by under weighting or over weighting particular asset class(es). An investor could adjust the UK Equity position by say 5% in favour of over-weighting Global Equities by a similar amount if they felt for example that the £ was over valued and if they believed prospects were better in another parts of the world. If they are right and take profits and revert to the original position they have added value to the strategic position and vice versa. The risk is that a series of wrong moves will detract from the long term goal that the strategic asset allocation was designed to produce.

Once the asset allocation is in place you can start to research the markets/sectors and then the stocks/funds that you will put in each asset class and also the style (large, medium or small companies), which will ultimately lead to the creation of the final portfolio.

In summary asset allocation can be viewed as a risk control mechanism and it also provides a platform for a structured and diversified way of investing.

Please contact a suitably qualified portfolio manager / IFA prior to making any asset allocation / investment decisions.

For further information please contact Dominic Sheehan on 01279 658304.