

Principles of Asset Allocation

S.D = standard deviation

1. INTRODUCTION

Two separate decisions for a diversified multi-asset class portfolio includes:

- Asset allocation decision – translating the client's goals & constraints into an appropriate portfolio.
- Implementation decision – determining specific investments

2. DEVELOPING ASSET-ONLY ASSET ALLOCATION

2.1 MVO Overview

- MVO requires 3 inputs: i) returns, ii) risks and iii) related assets' pairwise correlations.
- Risk-adjusted exp. return = $U_m = E(R_m) - 0.005 \lambda \sigma_m^2$
- *Common Constraints are 'budget constraint' & 'no negative or short position'.*
- To estimate risk aversion, determine investor's risk preference & risk capacity
- 'Global min. variance portfolio', has the lowest risk & is located at the far left of the efficient frontier.
- 'Max. expected return portfolio' is the portfolio at the far right of the frontier. If no constraints, the max. exp. return portfolio allocates 100% in the single asset with the highest expected return.
- MVO is a single-period framework

2.2 Monte Carlo Simulation

- is a statistical tool
- generates a no. of strategic asset allocations using random scenarios for variables such as: returns, inflation, time frame etc.
- delivers more realistic outcome
- helps to evaluate the strategic asset allocation for multi-period time horizon.
- incorporates effectively the effects of Δ in financial markets, trading or rebalancing costs & taxes.
- complements MVO by tackling the limitations of MVO.

2.3 Criticisms of MVO

- outcomes are sensitive to small Δ in inputs.
- highly concentrated asset classes.
- focuses on the mean and variance of returns only.
- may fail to properly diversify the sources of risk.
- does not consider the economic exposures of liabilities.
- not useful for multi-period objectives.
- does not take into account trading/rebalancing costs and taxes.

2.4 Addressing the Criticisms of MVO

Continued on Page 2

2.5 Allocating to Less Liquid Asset Classes

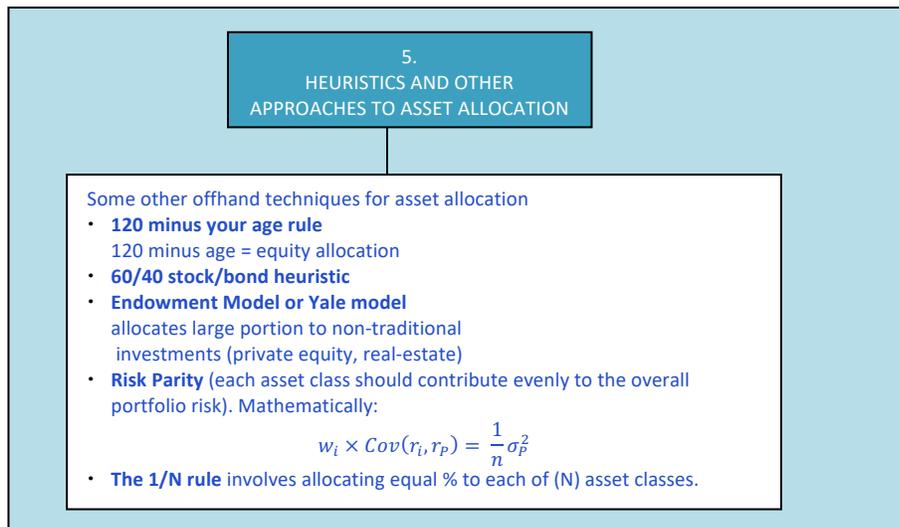
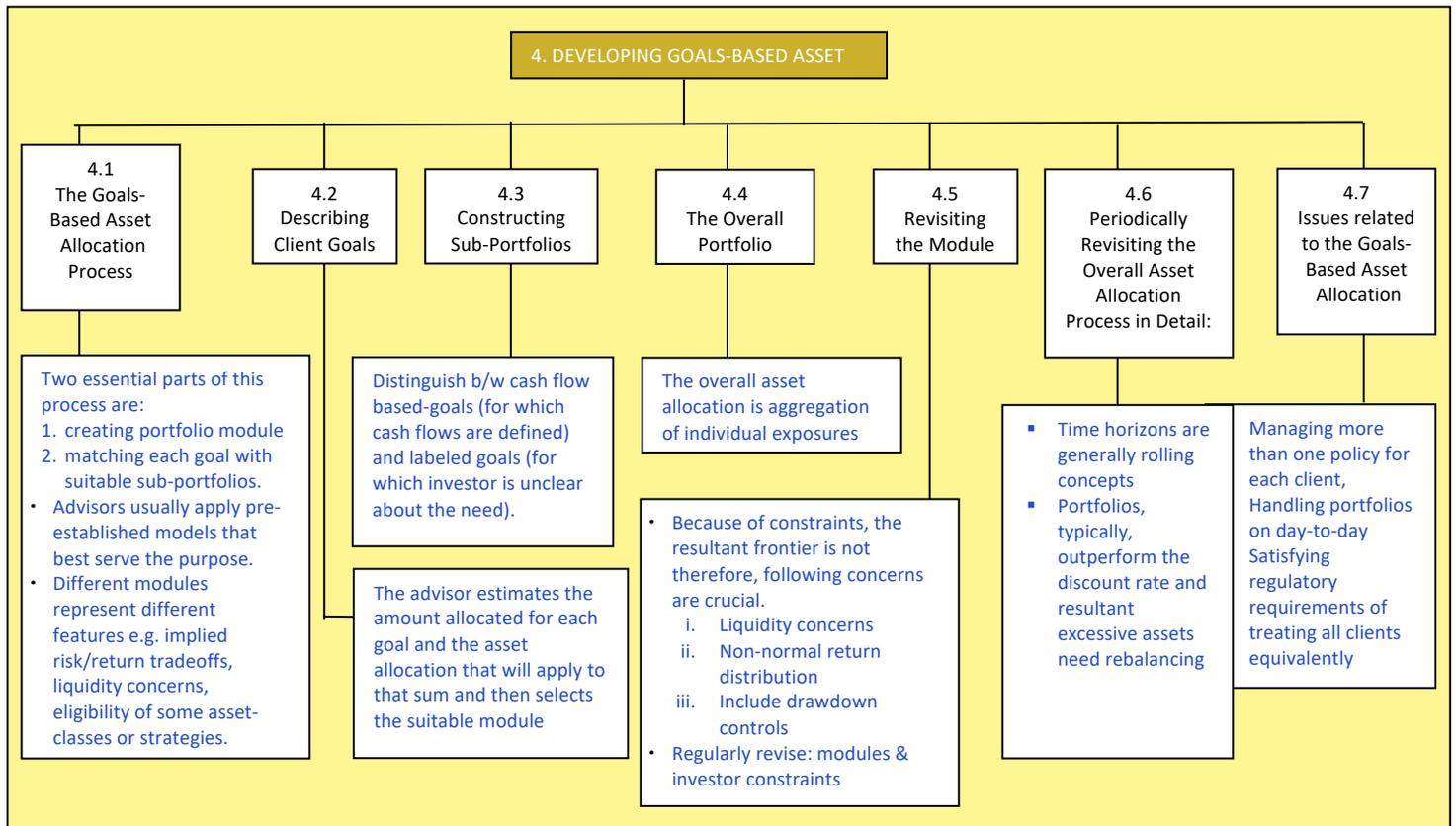
Including less liquid asset classes in the optimization is challenging as indexes fail to gauge aggregate performance of asset class: the characteristics of assets differ significantly because of idiosyncratic (co. specific) risk.

2.6 Risk Budgeting

- finding optimal risk budget to maximize return per unit of risk.
- Some key computations for risk budgeting:
 - Marginal contribution to risk ($MCTR_i$) = (Beta of Asset Class i relative to Portfolio) \times (Portfolio S.D)
 - Absolute contribution to risk ($ACTR_i$) = Asset class weight \times $MCTR_i$
 - Portfolio S.D = Sum of ACTR = $\sum_i^n ACTR$
 - % contribution to total S.D = $\frac{ACTR_i}{Portfolio\ S.D}$
 - Ratio of excess return to MCTR = $\frac{(Expected\ Return - R_f)}{MCTR}$

2.7 Factor-Based Asset Allocation

focuses on optimization to an opportunity set consisting of investment factors (fundamental or structural)



6. PORTFOLIO REBALANCING IN PRACTICE

Factors & their relation with corridor width	Effect on optimal width of corridor (all else equal)
Transaction costs +ve	↑ transaction cost, wider the corridor
Risk tolerance +ve	↑ risk tolerance, wider the corridor
Correlation with the rest of the portfolio +ve	↑ correlation, wider the corridor
Volatility of the rest of the portfolio -ve	↑ volatility, narrower the corridor