Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

The critical role of asset allocation for investors

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Key points

> While the global economy is gradually mending, returns will still be constrained and volatile relative to the long term bull market that got underway in the 1980s.
> As a result asset allocation will remain critically important for investors – particularly for those who can't take a long term approach and those looking to enhance returns.
> Improved approaches to asset allocation, in particular dynamic asset allocation, and the use of highly liquid and low cost futures and exchange traded funds (ETFs) further enhance the significance of asset allocation.

Introduction

One of the big swings in thinking around investment management relates to the perceived importance of asset allocation, ie the relative exposure to asset classes like global shares, Asian shares, Australian shares, bonds, unlisted property and cash. Through the long strong secular bull market that went from 1982 through to 2000 (or up to 2007 in Australia) the investment management industry increasingly moved away from worrying about asset allocation to focussing on manager selection at the asset class level. This partly reflected the times where most asset classes did well and so asset allocation was seen as less important and many thought it was too hard.

This all got turned on its head with the GFC and its aftermath of messy markets, coming after a decade of poor returns from global shares, providing a reminder of just how important asset allocation is. As a result asset allocation has made a comeback. This is likely to remain the case even as the global economy and financial outlook continues to heal.

What is asset allocation?

But first some technicalities. The return a traditional fund or mix of assets generates will be a function of three things:

- The fund's medium to long term allocation to each asset class and the market return they generate – traditionally referred to as the Strategic Asset Allocation (or SAA);
- any short term deviation in the asset mix from the SAA – this is known as Tactical Asset Allocation (or TAA); and
- the contribution from active management of the underlying asset portfolios. This is often referred to as security selection. It used to be done by one manager but increasingly a range of fund managers are being used.

As discussed below, newer approaches to asset allocation are tending to combine SAA and TAA into what is increasingly called Dynamic Asset Allocation or DAA. Numerous studies have shown asset allocation is the key driver of the return an investor will get.[1] In fact, if you believe active management of the individual asset classes will add no value, then asset allocation will drive 100% of the return.

New ways of doing asset allocation

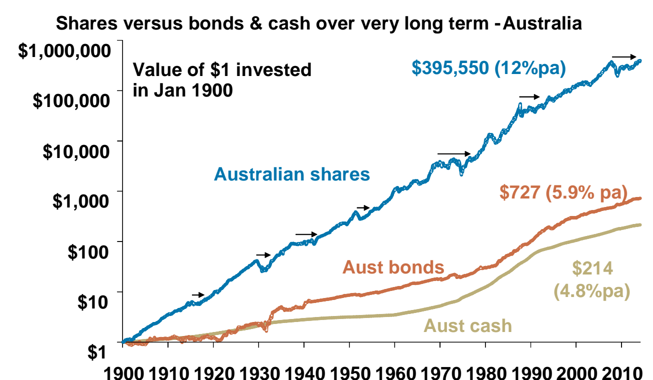
Apart from a long period of strong returns through the 1980s and 1990s during which most assets did well and bonds and equities tended to move together, another reason why asset allocation seemed to fall out of favour prior to the GFC related to the perceived mixed track record from traditional tactical asset allocation approaches. The problems with these approaches were that they were often constrained by a desire to minimise peer risk and decision making was poor, reflecting a committee based approach that was usually dominated by asset class managers who only focused on asset allocation on a part time basis and lacked the skills to assess the potential between asset classes. And whilst the TAA approach evolved into Global Tactical Asset Allocation this tended to be short term trading focussed, and ran the risk of missing out on big picture moves in markets.

After the GFC, the focus of asset allocation has shifted towards taking advantage of extreme swings in the relative performance of different asset classes through the business cycle. This approach, referred to as Dynamic Asset Allocation, sits between the short term trading focus of TAA or GTAA and the medium to long term focus of SAA. An advantage of this approach is that it can be entirely implemented via highly liquid futures, exchange traded funds or index funds, and can replicate a diversified mix of assets for a fraction of the cost but with more flexibility in varying the asset mix than in a traditional fund. Such approaches also tend to be run by dedicated teams avoiding the "committee of part timers" approach that worked poorly in the past.

But why have active asset allocation?

There are two fundamentals in investing that investors should always be aware of: the power of compound interest and that there is always a cycle. The power of compound interest is demonstrated in the next chart.

Shares versus bonds & cash over very long term - Australia



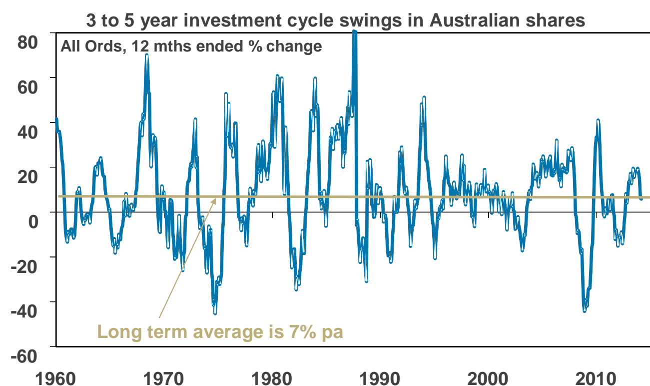
Source: Global Financial Data, AMP Capital

Whilst shares are more volatile than cash and bonds, the compounding effect of their higher returns over time results in a much higher wealth accumulation from them. The average return since 1900 from Australian shares at 12% pa is only double that of Australian bonds at 5.9% pa but over the whole period $1 invested in shares would have compounded to

[1] For articles on the importance of asset allocation see R.G. Ibbotson. "The Importance of Asset Allocation", Financial Analysts Journal. Mar/Apr 2010.

$395,550 today versus only $727 if that $1 had been invested in bonds. Over all rolling 40 year periods and virtually all 20 year periods shares trump bonds and cash. This argues for a long term approach to investing.

The problem is that there is always a cycle. Cycles encompass both secular malaises like those seen in the 1930s, 1970s and last decade for global shares that can last a decade or so before giving way to better times, and normal business cycles that result in three to five year cyclical swings in share markets. See the next chart for the latter.



Source: Bloomberg, AMP Capital

And the problem with cycles is that they can throw investors out of a well thought out investment strategy that aims to take advantage of long term returns and can cause problems for investors when they are in or close to retirement. Cycles also create opportunities for investors to enhance returns.

So for these reasons cyclical variations in asset class returns ideally need to be managed and the best approach to doing this is a rigorous dynamic asset allocation process.

How to manage cycles?

There are essentially three ways to manage cycles:

- Ignore them & adopt a set and forget approach to asset allocation. This may be okay for long term investors but not for those who are older or have a short term focus.
- Forecast them using economic forecasts – this is difficult as the track record of economists' point forecasts shows.
- Use their rhyming elements to manage them. While investment cycles do not repeat precisely they do rhyme. Each cycle has common elements – eg downswings in equities are usually preceded by overvaluation, tight monetary conditions and investor euphoria. These rhyming elements can be captured and combined to provide warning of swings in the cycle and hence are a solid foundation for a DAA process. This is our approach.

But what if the world continues to heal

An obvious issue is whether the improving global outlook will reduce the need for asset allocation. Our view remains that the cyclical bull market in equities has further to run reflecting still reasonable valuations, better earnings on the back of improving global growth, easy monetary conditions and an absence of the sort of euphoria normally seen at major market tops.[2] More importantly, after a 13 year secular bear market, a new secular bull market in global shares appears to be developing led by the US reinventing itself, aggressive reflation in Japan and structural change in Europe.[3]

However, while there will be periods of very strong returns as we have seen over the last two years, asset allocation is likely to remain critically important going forward:

- First, medium term investment returns are likely to be relatively constrained with not all asset classes doing well. The starting point for returns today is much less favourable than when long term bull markets last started in bonds and equities in 1982. The income yields are lower on all assets. Both equities and bonds won't have the combined tailwind from falling inflation, which thirty years ago benefitted both as falling inflation meant falling interest rates and yields, providing a valuation boost to returns. In fact our medium term return projections, shown in the next table, imply a 7.8% pa return from a diversified mix of assets. This is well below the 11.9% pa return that Australian diversified funds provided over the 1982-2007 period. So getting the right asset allocation will remain critically important.

Projected medium term returns, %pa, pre fees & taxes

	Current Yield #	+ Growth	= Return
World equities	4.8^	4.2	9.0
Asia ex Japan equities	3.3^	7.0	10.3
Emerging equities	1.5^	6.3	7.8
Australian equities	4.4 (5.7*)	4.7	9.1 (10.4*)
Unlisted commercial property	6.0	2.5	8.5
Australian REITS	5.6	2.5	8.1
Global REITS	5.9^	2.0	8.0
Unlisted infrastructure	6.0	3.8	9.8
Australian government bonds	3.6	0.0	3.6
Australian corporate debt	4.6	0.0	4.6
Australian cash	3.2	0.0	3.2
Diversified Growth mix			7.8

Current dividend yield for shares, distribution/net rental yields for property and 5 year bond yield for bonds. ^ Includes forward points. * With franking credits added in. Source: AMP Capital

- Second, the potential return range between the major asset classes is likely to be wide ranging as can be seen in the table. This will only add to the importance of getting the asset allocation right. Being loaded up on low yielding bonds and cash could mean very low returns.
- Third, volatility is likely to be relatively high. Public debt problems may still flaring up periodically, the world has become more reliant on naturally volatile emerging countries and extremely easy monetary policy conditions will provide a source of volatility when they start to reverse, probably led by the Fed. This will all result in bouts of volatility in relative asset class returns, providing opportunities for asset allocation to add value.
- Finally, bond and equity returns will likely remain negatively or lowly correlated, providing an opportunity for asset allocation to enhance returns by moving between the two. Through the 1980s & 90s, the two assets classes tended to move together reflecting the common driver of the adjustment to a low inflation world. But this has run its course.

Concluding comments

While the world is gradually healing and this should support equities, asset allocation will remain critical for investors reflecting likely constrained returns, a large variation in returns between major asset classes and ongoing volatility. Improved approaches to asset allocation utilising highly liquid and cheap ETFs and futures make accessing asset allocation easier and more cost effective.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital

[2] See "The risk of a correction…", Oliver's Insights, January 2014.
[3] See "The US reinvents itself, yet again", Oliver's Insights, February 2014.

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