

# Asset Allocation

by Arthur Childs, Chartered Financial Planner

## Introduction

Asset Allocation means deciding what proportions of your investment portfolio should be held in what:

- broad **asset classes**, eg equities, bonds, property and cash.
- **markets**, eg regions, countries, how much in the UK, how much in emerging markets
- **sectors**, eg healthcare, technology and commodities

The principles of diversification to reduce the overall volatility and therefore risk of a portfolio, suggest that **investors should aim to spread their investments**. Different types of investments react to economic and financial conditions in different ways, smoothing out the fluctuations. For example, cash retains its nominal value when equity markets fall, and fixed interest securities appreciate when interest rates drop.

"All too many investors thought they were diversified in the late 1990s because they owned 39 'different' internet stocks, or seven 'different' US growth stock funds. But that's like thinking that an all soprano chorus can handle singing 'Old Man River' better than a soprano soloist can. No matter how many sopranos you add, that chorus will never be able to nail down all those low notes until some baritones [we think he mean 'basses'] join the group. Likewise, if all your holdings go up and down together, you lack the investing harmony that true diversification brings."  
**Jason Zweig**  
 in his commentary on *The Intelligent Investor*

Various academic studies have shown that asset allocation is **the single most important factor** in determining the returns of an investment portfolio. Secondary factors like fund selection or market timing are less important when compared to being in the right asset class (or mix of asset classes) at the right time.

This is not to say that stock or fund selection cannot sometimes make a difference to the performance of portfolios. Some fund managers do add value, but unfortunately it is virtually impossible to pick **those fund managers who add value on a consistent basis**. If you pick a 'winner' this year the odds are that it will be performing below the sector average after that.

Asset allocation decisions will **dominate the performance of the fund** because the returns of the different asset classes are often weakly correlated. The original asset allocation research was conducted by Brinson, Hood and Beebower. They looked at the investment performance of institutional pension funds between 1974 and 1983. The conclusion of this particular study, which was confirmed in a follow-up study in 1991, was that **asset allocation is responsible for over 90%** of the variation in an investment portfolios return each quarter.

A more recent study by Roger Ibbotson determined that asset allocation was responsible for only 40% of the variation between portfolios. However, the Ibbotson study is controversial and Larry Elkin has published a paper explaining that the selection of 'good' funds is often cancelled out by the selection of 'bad funds', leaving the investor with an average return in each asset class.

## Asset Allocation will depend on

- **your requirements** for risk and return and the risks and returns of the different classes
- **your views on which markets** and types of securities will outperform, this depends on views on economic growth and interest rates
- the **need to diversify**
- the **aims of the portfolio**
- what assets you own **outside the investment portfolio**

Investors who rely heavily on asset allocation are described as using a **'top down'** approach.

## Asset Allocation Tool

We currently use an asset allocation tool that has been supplied by threesixty services LLP and **prepared with consulting actuaries, AKG**. What AKG has done is to design some clear definitions of risk which they believe most clients will be able to understand.

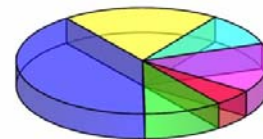
These definitions are available for clients to read and decide which most closely matches their attitude to risk for the specific investment under consideration.

Our current fact find includes the AKG risk questionnaire and clients completing it will be asked to **initial the appropriate definition**.

The questionnaire provides **two boxes** for this purpose. One is for terms of up to 10 years while the other is for more long term investments.

AKG has provided model asset allocation portfolios for each definition and each term.

## Recommended Asset Allocation for a Long Term investment with a Moderately Adventurous Attitude to Risk



The asset allocation models relating to these risk categories have been prepared by AKG consulting actuaries. Whilst every care has been taken in their preparation it is important to note that individual circumstances may differ. The precise make up of the underlying funds will also affect the efficiency of these models.

## Our Fact Find

The following section is included in our standard fact find

### Attitude to Risk

Please initial the box which combines your attitude to risk and investment term

Description of Attitude to Risk	Self		Partner		Notes
	Up to 10 years	10 years plus	Up to 10 years	10 years plus	
Generally market aware and understands and is willing to accept a higher level of risk (including small exposure to overseas markets) in return for the potential for higher returns in the longer term. Recognises that this may result in the value of the portfolio fluctuating, possibly significantly, in the short term.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Looking for a balance of risk and reward, and whilst seeking higher returns than might be obtained from a deposit account, recognises that this brings with it a higher level of risk and that the value of investment may fluctuate in the short term. Would feel uncomfortable if the overall value of investments were to fall significantly over a short period and would not be happy to see capital eroded.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Willing to accept a much higher level of risk (including a reasonable exposure to overseas markets) in return for the potential for higher returns in the longer term. Recognises that this may result in the value of the portfolio fluctuating, possibly significantly, in the short term. Aware that the risks are such that a significant percentage of the capital sum could be lost.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Looking for an investment where the value of capital should not fall in the short term and produces returns that are comparable with those from a high street deposit account, but if have the potential for some long term growth. Would feel very uncomfortable if their investment rose and fell in value very quickly.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Looking for an investment which, while giving some potential for real returns, produces returns that are at least as good as those from a high street deposit account. A high level of security of their capital is a priority. Whilst recognising that investment values will change, would feel uncomfortable if their investments rose and fell in value very rapidly.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Please answer this question separately from the above					
Would you like any social, ethical or environmental issues to be taken into account when looking at your investments? <b>Yes. No or Possibly.</b>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

### Declaration

The information given in this Fact Find will be held and processed in accordance with the Data Protection Act 1998. The information may be used by us to provide you with details of products and investment opportunities which we consider suitable to your requirements.

This information has been provided on the understanding that it will be used in strict confidence and that it places me/us under no obligation to take up any suggested recommendations. (We appreciate that if we have written 'not disclosed' in any section the advice (we receive will necessarily be more limited than it might otherwise have been if a full disclosure of information were given.

	Self	Partner
Signature	<input type="text"/>	<input type="text"/>
Date	<input type="text"/>	<input type="text"/>

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## A Plumb Line

The AGK asset allocation tool acts as a **good 'plumb line' for us when recommending funds** to form part of a client's investment portfolio.

The AGK asset allocation tool **allows us as advisers to test that a new or an existing investment portfolio is going to do the job** that is expected of it based on the client's attitude to risk requirements, the aim of their portfolio, the investment term and the other assets they hold outside of the portfolio.

Any plumb line does not, of course, build a wall for us, to continue the analogy. We as advisers will **still need to use our skills and experience to recommend country or sector splits** within the broad asset allocation suggested by the model. For example, when investing for a client who owns two or three buy to let properties, we might take the view that we can safely reduce the allocation to property suggested by the asset allocation tool.

Once we are happy with the asset allocation model for any particular client **we then need to choose single manager funds or multi manager funds** to put flesh on the skeleton of the asset allocation model.

## Multi Manager Funds

We can choose single manager funds to fit in with the asset allocation model, for example **we might choose two single manager property funds** in the above example to provide the 15% to be invested in property.

10% might be invested in a 'bricks and mortar' UK only fund and 5% in an international property fund which holds a large proportion of property shares.

However, another route would be **to choose one or more multi manager funds**. This is where **we pass over the responsibility for choosing individual funds to a professional fund manager**. We have to weigh up the additional cost involved for the client against the expected greater returns from the more active strategic asset allocation decisions that the multi manager is able to make.

Where we decide to use multi managers either for the whole of a portfolio or for a 'core' amount then **we are passing over the strategic asset allocation decisions** to a professional investment manager. Our task is to make sure that the multi manager fund(s) chosen are in line with client's objectives and attitude to risk. The asset allocation tool can still be used as a plumb line in such situations but we have to reconcile the fact that there will often be large discrepancies in this situation. This is because the multi manager will have his own strategic asset allocation model.

## Ethical Portfolios

When setting up or reviewing ethical portfolios we need to bear in mind that **the vast majority of ethically screened funds are equity funds**.

The asset allocation models call for various amounts of bonds and property. There are **some ethical bond funds but the choice is at present very limited** and for larger portfolios we might recommend the inclusion of bond funds that are not ethically screened.

At present there are no ethical **property funds** as such because **property is neutral in terms of ethical criteria** and at the present time very few properties apart from church premises restrict the types of tenant on purely ethical criteria. When advising clients with ethical objectives for their investment fund **we will usually recommend the inclusion of property funds** which have no ethical screening.

## The Importance of Reviews

Of course, once the investment portfolio has been set up it **will soon lose that 'true' line** because the assets will increase or fall in value by different amounts. It is therefore **important to review the portfolio at regular intervals**.

This is something to be agreed with each individual client but as a rough guide we would recommend the following.

Size of Portfolio	Review Interval
£200,000 plus	Half annually
£20,000 to £200,000	Annually
Less than £20,000	At the client's request

For larger portfolios with half annual reviews we would recommend **one annual face-to-face review** with an adviser and **one written review mid year**.

As a result of the reviews **the portfolio should be rebalanced**. That is the plumb line should be used to see where the asset allocation has moved from the asset allocation model, and assets sold/purchased to bring it back to the line. A multi manager will do this automatically.

## The Problem with Asset Allocation

Whilst asset allocation looks good in theory **we are our own worst enemy** when it comes to sticking to any kind of pre-determined asset allocation strategy.

We know only too well that when conducting an investment review with a client where ten investments have performed well and two badly, 80% of the time will be taken in discussing the two that have performed badly. This is human nature but it often overlooks the fact that **the poor performance of the funds in questions may be due almost entirely to the sector** of the market that they are in.

Our task is then to try to prevent the client from moving the poor performing funds out of a market sector that has performed relatively badly in recent months, into funds in a sector that has performed well, **thereby destroying the previously balanced asset allocation** of their portfolio.

"We have suggested as a fundamental guiding rule that the investor should never have less than 25% or more than 75% of his funds in common stocks, with a consequent inverse range of between 75% and 25% in bonds. There is an implication here that the standard division should be an equal one, or 50-50, between the two major investment mediums. According to tradition the sound reason for increasing the percentage in common stocks would be the appearance of the 'bargain price' levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common stock component below 50% when in the judgment of the investor the market level has become dangerously high.

These copybook maxims have always been easy to enunciate and always difficult to follow – because they go against that very human nature which produces that excesses of bull and bear markets. It is almost a contradiction in terms to suggest as a feasible policy for the *average* stockowner that he lighten his holding when the market advances beyond a certain point and add to them after a corresponding decline. It is because the average man operates, and apparently must operate, in opposite fashion that we have had the great advances and collapses of the past; and – this writer believes – we are likely to have them in the future."

**Benjamin Graham**  
*The Intelligent Investor*

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether the asset allocation of your investment portfolio is the right one for you, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

#### For Further Info

If you would like to discuss the asset allocation of your investment portfolio please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
Email: **enquiries@arch-fp.co.uk**  
Online: **www.arch-fp.co.uk**

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