Asset Allocation & Efficient Portfolios

Portfolio Planning

Asset allocation – getting the investment mix right

Traditionally, investment decision-making has been centred on which funds to choose. However, investment research has shown that, in most circumstances, the asset allocation choice is actually the critical factor determining investment performance over the long term.

Asset allocation does make intuitive sense though. Individual stocks in the same asset class tend to be highly correlated and tend to move together. For example, if another Enron-type scandal erupts, most of the equity market is likely to fall. So, it's the behaviour of the asset class as a whole that makes the difference.

Different assets behave in different ways:

- Cash has a very stable market value, but normally provides the lowest return
- Bonds are relatively stable, low-risk investments but tend to give a comparatively low return
- Equities are relatively volatile, higher-risk investments but tend to give a better return over the long-term
- Overseas equities add currency risk and are often even more volatile, but give the opportunity of investing in different markets

Past performance is not necessarily a guide to future performance.

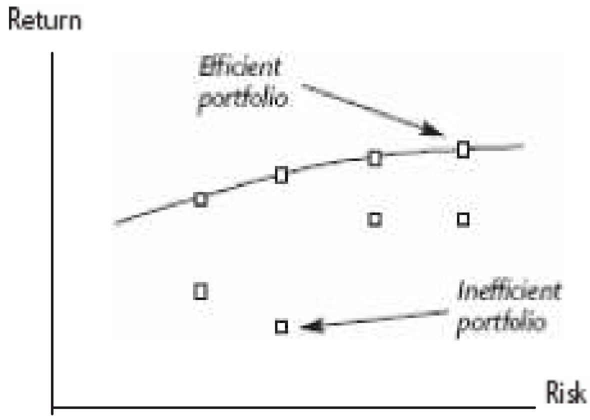
Diversification reduces risk

Again, it makes sense not to "keep all your eggs in one basket" – if you have everything invested in equities and the market falls you would lose out. But suppose you invest some in bonds and some in equities – if equities fall, bonds may well rise, helping to compensate for the loss.

So, by diversifying the investment portfolio you can reduce risk and still invest in equities aiming for good long-term returns.

Efficient frontiers – efficient portfolio diversification

For a particular investment portfolio, we can illustrate the potential return and the risk (its volatility). As you might expect, different portfolios will give different risk-return results. In fact, if you calculated all the different portfolios that gave you the same amount of risk, some portfolios would give a better return than others and one would be the highest. This portfolio giving the highest return for a particular level of risk is the most "efficient" – it gives the most return possible for the risk taken on.



The chart shows a variety of different portfolios – those on the line are the most efficient so this line defines the "efficient frontier". A portfolio planner uses efficient frontier methodology to present a range of investment portfolios ranging from low to high risk.

Getting the asset allocation right

Ultimately, the right asset allocation for an investor depends on:

- The ability to withstand market volatility (personal attitude to risk)
- Investment time-frame
- Investment goals

A Portfolio Planner combines all these factors together, to help recommend the most appropriate asset allocation for each client's needs.

Forecasting Investment returns – Stochastic Investment Modelling

A *stochastic investment model* tries to forecast how investment returns on different assets, such as equities or bonds, vary over time. This form of modeling can be used to help assess how investing in different assets could affect a client's investment value over time.

Please refer to separate article *"Stochastic Investment Models"*

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