How important is the asset allocation decision?

- Generally recognised as the most important determinant of both risk and return for an investor
- Major impact on long term funding cost
- Significant impact on short term regulatory and accounting risk
- One of the most important decisions the fiduciaries are obliged to make
The Asset Allocation Planning Process

Mission and Objectives

Monitoring

The Fiduciary

Manager Selection

Management Structure

Asset Allocation

Need to reconcile multiple objectives of multiple beneficiaries

- Trustees vs Sponsor
- Long Term vs Short Term
- Security vs Cost
- Pension Fund vs Company

Governance framework of the pension plan is also of great importance
The Asset Allocation process in a ‘nutshell’

- Decide on the Equity/Bond split
- Refine the Equity/Bond split by geographical region and/or sub-class (e.g. sector, style or risk level)
- Consider alternative investments, including real estate, private equity and hedge funds

The strategic asset allocation can be arrived at by

- Ad-hoc methods (often adopting a peer group benchmark)
- Simple analysis, general reasoning (e.g. modified regulatory benchmark)
- More structured, analytical approaches, e.g. ALM or AM

Key advantages of ALM

- Identification of benchmarks fiduciaries can agree upon
- Policies more aligned with fund’s risk/return tolerance
- Policies with explicit allowance for objectives, liability profiles and regulatory/accounting constraints
- Greater confidence for allocation to alternative asset classes
Some problems of ALM

- Dependence on assumptions and models used
- Difficulties in modelling of new asset classes
- Optimisation tend to magnify noise and anomalies
- Statistical procedures to validate models have low resolution
- Significant behavioural influences on:
  - the model and assumptions
  - interpretation of results
  - the final decision itself

Behavioural Finance and Fiduciary Decision Making

- Growing recognition that investment management decisions are not driven purely by financial risk/return trade-off
- The utility needs to incorporate some non-financial factors: Comfort and Compatibility
- Categorise these under headings
  - Sleep Well
  - Seems Good
Sleep Well Payoff

- Utility derived from minimisation of 'regret risk'
- Disappointing results do occur
- Fiduciaries decisions are subject to scrutiny
- Need to justify and defend the decisions even in adverse conditions
- Risk that chance bad outcome will be judged negligent
- We believe that Sleep Well is a valid component in fiduciaries decision making
- In asset allocation this aligns with 'peer group' practice

Seems Good Payoff

- Driven by biased evaluation of facts, 'conventional wisdom' and simplistic theories
- We believe that Seems Good payoffs do not provide financial payoffs in aggregate and therefore are undesirable
- In asset allocation examples are the capitalisation weighted approach to setting policy, relying on market efficiency of pricing capital or the adoption of some other recognised benchmark, e.g. Minimum Funding Requirement matching policy
Asset allocation based on utility theory

- Use relative-to-objective return:
  Fund Return - Liability(Inflation) Growth
- Define risk as the volatility (standard deviation) of the relative-to-objective return
- Efficiency measure
  \[ \text{Information Ratio} = \frac{\mathbb{E}[\text{relative-to-objective return}]}{\text{Volatility}} \]

Consulting Issues/Challenges

- Explanation of results - clear communication of complex process
- Accountability and performance measurement
- Adding value through helping to solve client's problems rather than 'reporting numbers'
- Take holistic view - try to place results in the context of firm wide risk management
The Structured Alpha™ Model

- Use skill-focused strategies as complements to other styles
- Use satellite managers to produce higher returns
- Use active core for long-term governance-friendly returns
- Use passive core to balance asset allocation and limit overall costs and risks

Structured Alpha™ incorporates high diversification across and within the layers