AN INTRODUCTION TO ASSET ALLOCATION

The correct asset allocation of a client's investment portfolio is the bedrock of the Swallow Financial Planning investment process. This note is designed to explain how asset allocation works and why it is so important to the future success of your investment performance. Within these notes we will cover:

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1. INTRODUCTION

Asset allocation is at the heart of our fund management philosophy. These notes are designed to explain the background behind asset allocation and the reasons why so much of our report recommendations are concerned with your asset allocation. We recommend you also review "Our Approach to Investments" and "Investment Cycles and Factor Investing" on our website.

2. ASSET ALLOCATION PROVIDES OVER 80% OF A PORTFOLIO'S RETURNS

Asset allocation is the most important decision to be made in any portfolio.

There are legions of technical papers confirming the effect of asset allocation on portfolio returns.

Data	Term	Average Total Return	Average Asset Allocation Effect on Return
91 pension funds	1974-1983	112.00%	93.60%
82 pension funds	1978-1987	101.00%	91.50%
58 pension funds	1988-1998	99.00%	88.00%
94 US balanced mutual funds	1988-1998	104.00%	81.40%
189 US balanced mutual funds	1966-2006	108.00%	82.10%

An investment plan can have a lucky/brilliant stock selection policy but perform abysmally if the asset allocation is not right. Indeed, stock selection (and arguably stock management) is to a large extent ***irrelevant***.

It is better to be the worst performing stock in the best performing sector than the best performing stock in the worst performing sector.

It should be noted that asset allocation methodology is based on the benefits of diversification and is, therefore, essentially defensive, placing capital protection before capital growth. If one's aim is out-and-out capital growth, then as Warren Buffett has remarked, the right technique is not to diversify but to concentrate capital.

3. MODERN PORTFOLIO THEORY (MPT)

Well, now not so modern! In 1952 Harry Markowitz published his Nobel Prize winning research on how certain investments have different levels of risk, and how that risk could be reduced by diversification. In a nutshell, MPT states that for most investors the risk from holding a stock is that the returns will be lower than expected. MPT showed that by combining securities into a diversified portfolio the overall risk will be lower and reduce the variability of future returns.

When a portfolio contains more than one asset class (i.e. equities and bonds) the performance of the asset classes determines the return of the portfolio. The fund choice has very little additional value. This is one of the reasons we favour passive investments.

3.1 Risk Types

The MPT highlights the following risk types:

3.1.1 Systematic Risk

Systematic risk is the market risk. This cannot be avoided and is the reason why asset backed investments generate bigger longer term returns. You accept risk and are rewarded by greater returns.

3.1.2 Unsystematic Risks

This is the risk associated with the stock (or, to a lesser extent, collective) you are buying. This can be reduced by holding a diversified range of investments. The MPT states that there is an efficient frontier of asset allocation which can match the extent of risk the investor wishes to take against the maximum return they require.

3.2 The Capital Asset Pricing Model (CAPM)

CAPM takes modern portfolio theory further by attempting to define what constitutes an acceptable return from an asset. It says that in order to invest in a riskier asset, an investor should require a return that is equal to the risk-free return (say cash) plus a risk premium for taking on the additional risk of such an asset.

There are lots of excellent books which explain these theories in greater detail, however, for the purpose of these notes it is important that you realise:

- Our premise is that investing client funds based around asset allocation will generate the maximum returns for the lowest (relative) risk.

- If you want the maximum returns you should concentrate risk (or even gear it). With the exception of the UK irrational love of housing we find this option generates an unacceptable level of risk.

4. THE BASIC ASSET CLASSES

If you hold 10 shares in the UK FTSE 100 retail sector you are diversifying your risk away from a single share, but you are not diversifying your risk away from the retail sector or the asset class of shares or the asset class of large companies or the UK itself. Generally speaking, in our relatively simplistic approach we talk of diversification by holding different asset classes and further by holding different geographical and factor sectors within the asset classes. The basic asset classes the industry considers are:

4.1 Cash

Bank and building society deposits.

4.2 Fixed Interest

UK & foreign fixed interest investments which include gilts, preference shares, corporate bonds and related fixed interest implements.

4.3 Equities

Shares (collective or specific) within the UK and throughout the globe.

5. ADDITIONAL ASSET CLASSES WE INCLUDE IN CLIENT PORTFOLIOS

5.1 Property

Property is always a difficult asset class for investment advisers. Many clients have a substantial percentage of their overall wealth tied up in their homes. Likewise, many clients have “buy to let” residential property. These 2 assets combined usually skew the property element of asset allocation planning over the (typically) 25% maximum for property in an investment portfolio.

For the purpose of our platform investments, property would be commercial property held as both shares (Real Estate Investment Trusts) and bricks and mortar (PAIFS). In the past commercial property has not been correlated exactly to residential property. However, the trend towards shorter term commercial leases, particularly in secondary areas, means that the correlation has got closer in recent years. Leases which exceed 10 years tend to be less volatile than residential properties due to the long term nature of contract over the typical 6 month buy to let AST agreements.

Property also usually has a different investment cycle than equities and fixed interest so some commercial property (even where there is substantial residential property) within a portfolio does usually make sense.

From a factor investing perspective property is usually a low volatility investment.

5.2 Other Strategic and Factor Considerations

5.2.1 Commodities

Commodities are assets such as steel, oil, gold, etc. These are a separate asset class and are generally considered too specialist to be included in this type of model. Having said this, modern ETF and ETC products provide a lower risk collective investment option which we consider is a potential hedge against instability in world markets. We have many clients currently invested in commodities using this route.

5.2.2 Options and Derivatives

Options and derivatives are not an asset class in themselves. However, because they represent such a large part of the current investment world we include them (with commodities) as an option on most asset allocation statements.

This type of investment can be a hedge fund which uses put and call options, or it can be a structured product designed to provide specific returns under certain circumstances.

We usually do not include same within our recommendations, however we have done many packaged option products in the past where for instance a client wants a higher level of security than is offered by plain vanilla equities.

5.2.3 Biotechnology

We may include some Biotech in portfolios in an effort to spread risk and maximise returns. Biotech is usually a momentum factor investment. Other specialist areas may also be chosen (i.e. Robotics) where additional diversification is required.

5.2.4 Strategic Funds

Whilst we favour passive investments we have over many years come across a few fund managers and funds which have consistently warranted their additional costs. Such funds are usually more volatile (so low risk clients may not have recommended them) and as a rule they are momentum funds, but they can add a bit of colour within our overall landscape.

5.2.5 Pension Income

If you receive pension income you are in the “draw down” stage of your life. In essence the draw down stage of life is when the purpose of your investments is to generate an income for you when you are no longer able to generate same from working.

If you accept this concept then in our view you should capitalise pension income back to a capital value and add that into the asset allocation equation as a secure asset.

At this stage we are using very generous standard assumptions for pension income as follows:

Pension Type	Gross Annual Pension	Assumed Annuity Rate	Equivalent Capital Value
Level annual pensions	£10,000	4.17%	£239,684
Escalating annual pensions	£10,000	2.18%	£458,912

The current rate for a joint life level pension with both spouses being aged 65 and the survivor having a pension of 2/3rds the main annuitant is 4.17%. Better terms can be obtained if the individuals are in ill health.

Add escalation by the Retail Price Index (RPI) to the quotation and the rate drops to 2.18% (September 2021).

The rate doesn't alter hugely for single life due to the new unisex annuity rates.

We would always take into account pensions when considering your asset and factor allocation. However, this is not the industry norm so within your presentation we usually include two sets of recommendations, i.e. one assuming we take account of guaranteed pensions and one ignoring them.

6. CORRELATION

The key to reducing risk is the correlation of investment growth between asset classes. To reduce risk one really wants investments where the returns differ in the same market. For instance, it is generally accepted that interest rates and the capital value of fixed interest stock move in the opposite direction (i.e. are uncorrelated). If interest rates on your cash deposits double, the actual value of your long term fixed rate investments will fall substantially, otherwise no one would buy them.

On the other hand, if the world economies are booming then UK share values will rise and one would expect international shares to do so at the same time. In simple terms, therefore, domestic and international equities are "correlated". In many cases, however, different classes of equity are not correlated to each other. In times of boom, advertising and media do well. When the bust comes utilities and basic retailers (i.e. supermarkets) tend to ride the storm better. Likewise, over the longer term smaller companies will grow quicker than larger companies, but larger companies are less badly affected by market down turns.

To reduce risk the adviser needs to look at different asset classes which will compensate for the shortcomings of others. As we do not possess a crystal ball, we tend to stick to a client's optimum asset mix for their risk profile rather than make big calls on what may or may not transpire during the next 12 months.

2008 saw an unprecedented collapse in all asset classes. This is very unusual and difficult to explain this in terms of the Modern Portfolio Theory, except that historically the collapse of the banking system only seems to occur every 150 years so is perhaps the exception that proves the rule!

7. WHAT IS RISK?

Risk is the premium you pay in order to try and generate a real return on your money. All investment involves risk of some form or another.

Invariably clients think of risk as the risk of the actual value of their investment tomorrow, being less than it is today. So if I invest £1,000 today and the market falls by 20% I only have £800 tomorrow. Investment professionals invariably think of risk as how often and how much an investment goes below or above its mean expected growth pattern.

It is not possible to guarantee any investment in actual terms. Even governments default so whilst the chances of your premium bonds not repaying their capital are very small, there is still a risk. We have a more comprehensive paper on risk and client risk profiles available upon request.

7.1 Volatility

In simple terms volatility is the extent to which the returns on an investment might vary from what we expect.

What we expect each year is usually calculated as a "standard deviation". In statistical terms standard deviation is a "mean of means". In other words, in any set of data you can simply calculate a mean average but will include data at extremes of the statistical table.

Standard deviation aims to only take the mainstream data (i.e. using 70% of the data ignoring the other 30% positive and negative spikes) thus creating (hopefully!) a better predictive assessment.

From the Dimensional database the volatility of assets for the 20 years to July 2021:

Data Series	Annualised Return	Standard Deviation	In About 70% Of Time Periods Minimum Return	Maximum Return
Cash	1.94%	0.59%	0.00%	5.78%
RPI	2.88%	1.36%	(1.57%)	5.59%
Global Bonds	4.84%	2.82%	(1.64%)	12.93%
FTSE 100	4.97%	13.77%	(32.30%)	50.42%
UK Equities	5.70%	13.21%	(32.86%)	51.42%
International Equities	8.34%	14.29%	(31.55%)	45.17%
Global Property	9.16%	17.79%	(59.34%)	85.59%
UK Small	9.44%	18.50%	(46.71%)	75.22%
UK Value	9.95%	22.44%	(61.84%)	91.38%
World Small Cap	10.24%	16.61%	(30.11%)	63.62%
Emerging Markets	10.55%	19.26%	(43.71%)	79.89%

Remember this is the return before taxes and charges. Cash has therefore returned an average of 1.94% in the range 0.0% to 5.78%. Emerging Markets produced the best returns but with much wilder gyrations in short term rewards, i.e. in 70% of years the return varied between -43.71% and + 79.89%.

In investment terms the adviser wants to invest your money and achieve the best gains he can for you, however, you have to be comfortable with the volatility of the investments chosen. In this example for a high risk investor smaller companies are the way forward. Someone more cautious, however, may be quite happy to accept larger companies knowing that their investment is still beating inflation.

As can be seen cash and bonds are now producing returns which will guarantee a loss of value in real terms.

7.2 Time

Time and risks are inextricably linked. In 90% of all known 10 year periods the best returns have been from equities. This drops to 15% of all known two year periods. If you have short term essential objectives keep the money in cash but longer term it has to be assets.

7.3 Objectives

If you are a cautious investor who does not want high volatility then you may have to manage your expectations. Quite often objectives cannot be met without the funds being invested into asset backed investments so you are left with the stark choice of accepting risk or reducing your objectives.

8. RISK TOLERANCE

To advise you correctly we need to combine the volatility of the asset classes based on their past history and your attitude to risk. Please refer to our notes on risk profiling for further information. For these notes we can state that the allocation you choose depends critically on your emotional ability to accept big swings in the market value of your portfolio. If you choose to go for asset backed investments then you must accept there will be times when the value of your investments will fall substantially.

9. TARGET BASED ASSET ALLOCATION

If your objectives require your investments to generate above inflation returns then regardless of your personal preferences the asset allocation needs to reflect the type of assets needed to generate the required returns in the longer term (or your objectives need to be adjusted accordingly).

Other factors that affect the generic asset allocation model would be:

- Time
- The need for income from a portfolio
- The need for liquidity

10. STRATEGIC ASSET ALLOCATION

Having looked at the building blocks of asset selection (i.e. based around your risk tolerance and objective needs) we can then “add value” by trying to tilt your portfolio towards assets we consider will out or under perform. For instance, in 2015 it seemed obvious that in the next 5 years interest rates would rise. If interest rates rise fixed interest stock prices fall. Despite the preference for fixed interest holdings as a hedge against risk, therefore, it seemed unlikely that fixed interest holdings would represent a good capital investment. This has led us to hold very little fixed interest stock within our portfolios. We tend to stick to cash or (for the more risk tolerant) commercial property.

11. KEEPING YOUR ASSET ALLOCATION UP TO DATE

It is fair to say that at different times in the market cycle the different asset classes are likely to perform better than their counterparts. This being the case, ***it is essential*** that we regularly review your asset allocation to ensure it still matches your risk profile. By asset allocating properly we are trying to insulate you (to some extent) from market fluctuations. For instance, if a cautious portfolio has not been reviewed during an equity boom, it will be far too heavily invested in equities when the inevitable market correction occurs. On the other hand, if a high risk portfolio is not reviewed after market falls it will not be sufficiently geared to growth assets to generate the rewards the high risk investor wishes.

We recommend a minimum review of your asset allocations once a year or when you are considering additional investments or asset sales. Put simply, it is a waste of time undertaking asset allocation if you are not then going to review and realign the assets regularly thereafter.

Another good reason to review your asset allocation is stock risk, i.e. where a particular fund has performed well and now represents too high a proportion of your overall holdings. Finally, of course, it is worth using your annual capital gains tax (CGT) allowance to achieve tax free growth.

12. SUMMARY

Hopefully, these notes have explained the good intentions behind trying to assess and then alter asset allocation structures to achieve the highest level of returns based on your desired level of risk and objectives (the so called “efficient frontier”).

We know that getting the asset mix right has far more effect on your long term returns than choosing the right stock or collective fund. If we can achieve “constancy of purpose” over the longer term then we are certain we can add substantial value to your investments.

13. FURTHER EXPLANATIONS

We have an extensive library of notes similar to this document on our website under "Library, Personal Investments".

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 09.2021 An Introduction To Asset Allocation and was last updated in September 2021. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

Investments are subject to market risk, including the possible loss of the money you invest. Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. Diversification does not ensure a profit or protect against a loss in a declining market. Performance data shown represent past performance, which is not a guarantee of future results. Note that hypothetical illustrations are not exact representations of any particular investment, as you cannot invest directly in an index or fund-group average.

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