Alternative Approaches to Asset Allocation

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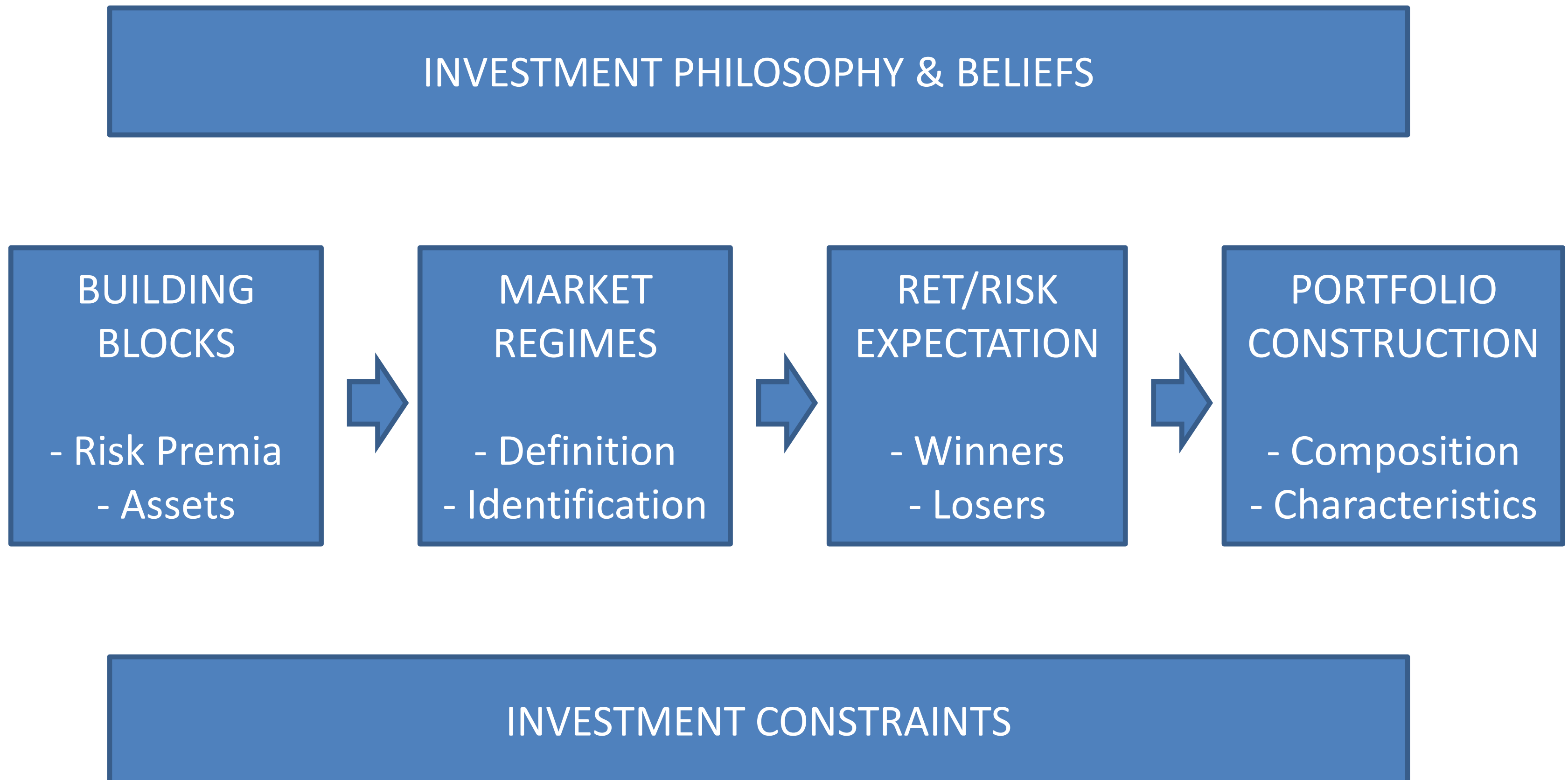
Introduction

- Traditional asset allocation model rests on equilibrium risk & return assumptions resulting in stable allocation aided by systematic rebalancing over time
- Explicit or implicit recognition of time varying risk premia gives rise to alternative approaches to asset allocation
- We will look at 3 such approaches based on different beliefs on how portfolios should be constructed in the face of changing market environment:
  - Valuation-driven - Liquidity cycle-driven
  - Risk parity
- These are illustrated with traditional asset classes here but can be readily extended to include other risk premia

Stylised Asset Allocation Process

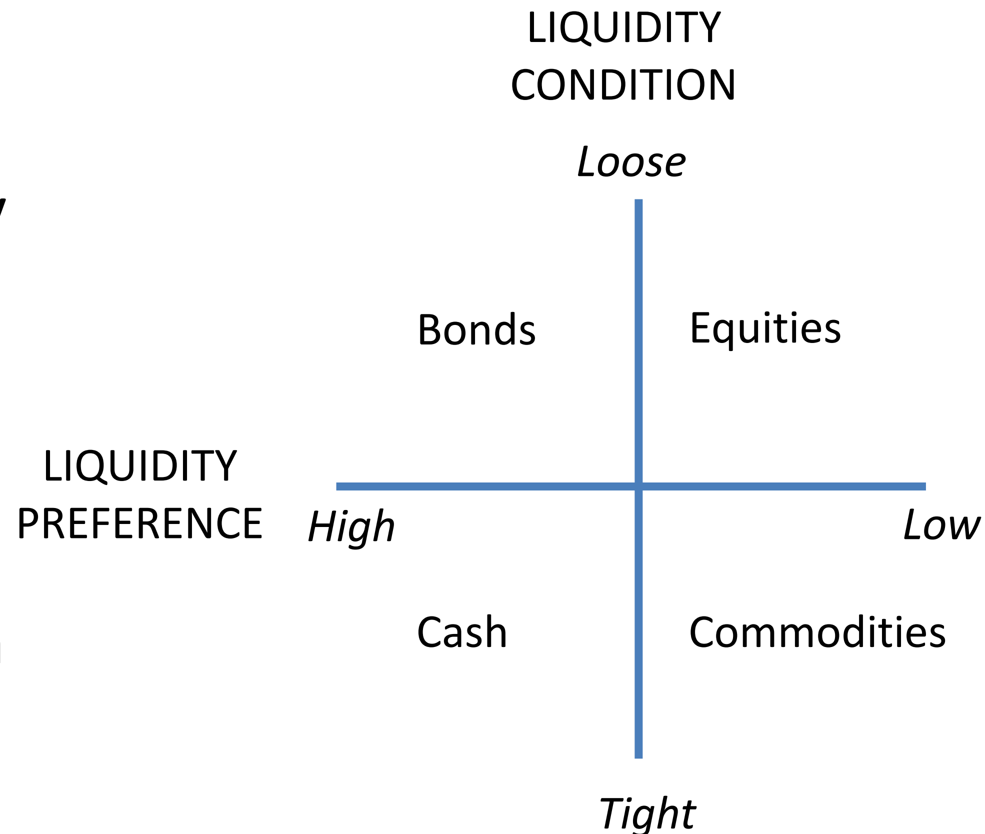


Valuation-based Approach

- Well-chosen value indicators exhibit mean reversion against historical norms or fair value estimates over reasonably long time horizon
- Examples: earning yield for equities; yield-to-maturity for bonds; rental yield for real estate; and variants
- Value indicators also carry varying degrees of predictability for future returns
- Thus the idea is to identify assets in valuation extremes: buy/over-weight cheap assets and sell/under-weight expensive ones
- If nothing stands out, stay neutral
- Be prepared to endure pain for being too early!

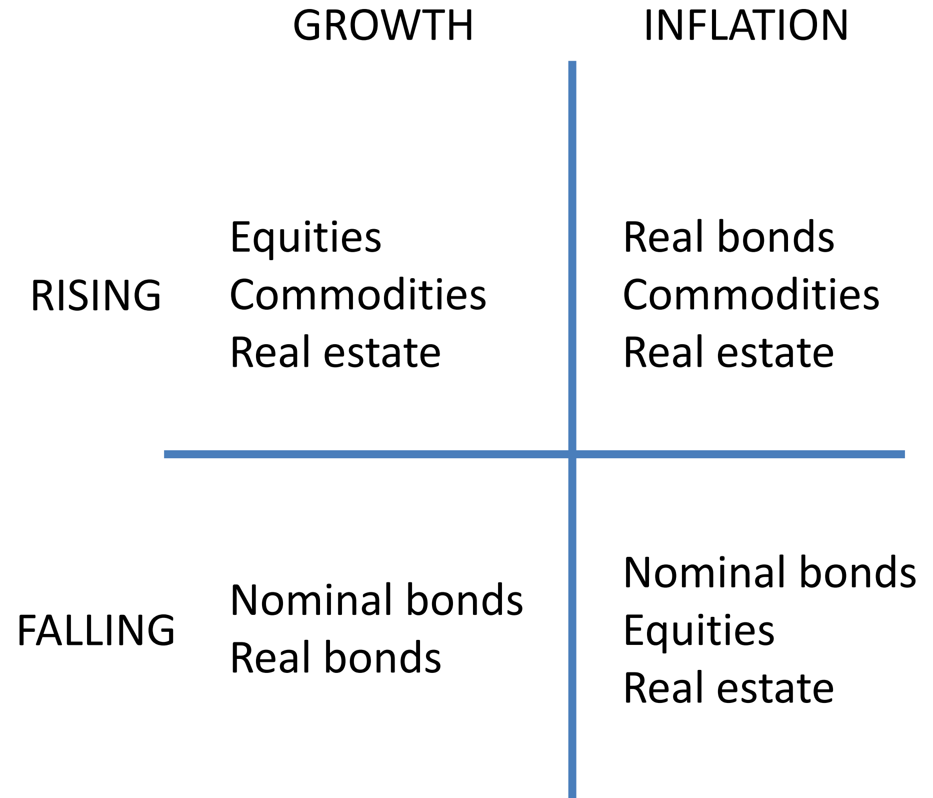
Liquidity Cycle Approach

- Market cycle is driven by liquidity cycle
- Liquidity cycle is defined by combination of liquidity condition (*loose*/*tight*) and investors' liquidity preference (*low/high*)
- Market thus cycles through 4 phases in clock-like fashion but not at uniform speed, favouring different asset classes in turn



Risk Parity Approach

- Major asset classes have comparable risk-adjusted returns
- Correlations across asset classes are unstable/hard to forecast
- More balanced portfolio risk by leveraging low-volatility asset classes
- Pick (leveraged) asset classes across multiple market regimes & sit tight



Relevance to GPFG

- Before adopting a new asset allocation regime for GPFG, there are a few things we need to think hard about:
  - How scalable are these strategies?
  - How much leverage is involved?
  - Are these strategies sufficiently contrarian?
  - Is MOF in the business of endorsing dynamic or discretionary strategies?
  - If it comes under NBIM's purview, how big an active risk budget is required and still deemed acceptable?
  - Can the current division of labour between MOF and NBIM still stand if allocation covers both betas and alphas?