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THE RELATIONSHIP BETWEEN PORTFOLIO PERFORMANCE AND ASSET ALLOCATION POLICY

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ABSTRACT

Asset allocation is an important strategy for portfolio management. In its simplest terms, asset allocation refers to the process of adjusting the relative proportion of different asset classes in an investment portfolio. Asset allocation is based on the fact that both expected return and risk of each asset class are different. By combining asset classes in different proportions, it is possible to enhance the overall portfolio return and reduce risk. As per past research, it is believed that a portfolio return is dependent upon many important factors or strategies. The recognized strategies are a) Strategic Asset Allocation b) Sector/ Stock Selection, and c) Market Timing. The above strategies have also been recognized in the research papers of Hood, Brinson and Beebower (1986) and Singer, Beebower and Brinson (1991).

KEYWORDS

asset allocation, portfolio performance, mutual fund, portfolio optimization, investment strategies.

1. INTRODUCTION

The literature on Asset Allocation has for long been an area of interest for both theoretical and empirical research. This consists of the finding of new research, using a growing arsenal of econometric techniques for identifying new strategies to improve portfolio performance.

Creating a suitable Asset Allocation is a dynamic process, and it is the most important factor in deciding portfolio's expected Return and Risk. Portfolio's Asset Allocation should be as per individual's goals at any point in time. Following are the different Asset Allocation Strategies in Portfolio Management

Strategic Asset Allocation

Strategic Asset Allocation is the process of finding the right mix between different asset classes based on respective asset class outlook and investors willingness to take risk. Once the Asset Allocation is decided and finalized, the strategy of buy and hold is followed. The Allocation mix is not changed during the holding period of portfolio. For example, if Debt has historically given 10% per annum and Equity has given 20% then the Asset Allocation mix of 50% in Equity and 50% in Debt will give an expected return 15% per annum.

Constant-Weighting Asset Allocation

Constant Weighting Asset Allocation is also referred to as Market Timing or Reallocation.

Rebalancing is the next step after Strategic Asset Allocation. In Strategic Asset Allocation, the asset mix is not changed or disturbed during the holding period of portfolio. Because of the buy and hold strategy, the risk of the portfolio changes with time. If Equity market goes up then Equity allocation in portfolio goes up which leads to higher overall risk and if Equity market goes down then Equity allocation of portfolio comes down and leads to reduction of portfolio. This may not be good for investor because of diversion of risk of the portfolio from the long term goal. To correct this and to control the unwanted Risk in Portfolio, Rebalancing or Constant Weighting Asset Allocation is done. The deviation of asset mix is corrected and Portfolio is brought to the original mix of Strategic Asset Allocation. The deviation is corrected by selling the asset which has gone up from the pre-defined mix and buying the Asset which has gone down in percentage terms.

There are no predefined rules for timing the portfolio rebalancing or constant-weighting asset allocation. Research shows that Rebalancing at higher frequency may not add value because of higher trading cost. The commonly used rebalancing frequency is either once a year or whenever the variance is more than 5% in portfolio.

Constant-Weighting Asset Allocation is also referred as Rebalancing.

Tactical Asset Allocation

A big disadvantage of Strategic Asset Allocation is that it is rigid and not ready to take advantage of short-term opportunities which become available in market. Extra Alpha can be created in portfolio if Asset Allocation mix is changed depending upon the outlook and valuation level of Asset Class. The flexibility in Tactical Asset Allocation makes it a very powerful strategy to add value in portfolio.

Tactical Asset Allocation is also referred as Reallocation.

Tactical asset allocation is usually considered to be a moderately active strategy. The strategy may or may not give higher return. It completely depends on the accuracy of timing of the advisor or investor. If the timing is good then it may lead to higher return. Tactical Asset Allocation is recommended only when someone has good knowledge of markets.

CONSTANT-WEIGHING ASSET ALLOCATION

Rebalancing is the next step after Strategic Asset Allocation. In Strategic Asset Allocation, the asset mix is not changed or disturbed during the holding period of portfolio. Because of the buy and hold strategy, the risk of the portfolio changes with time. If Equity market goes up then Equity allocation in portfolio goes up which leads to higher overall risk and if Equity market goes down then Equity allocation of portfolio comes down and leads to reduction of portfolio. This may not be good for investor because of diversion of risk of the portfolio from the long term goal. To correct this and to control the unwanted Risk in Portfolio, Rebalancing or Constant Weighting Asset Allocation is done. The deviation of asset mix is corrected and Portfolio is brought to the original mix of Strategic Asset Allocation. The deviation is corrected by selling the asset which has gone up from the pre-defined mix and buying the Asset which has gone down in percentage terms.

There are no predefined rules for timing the portfolio rebalancing or constant-weighting asset allocation. Research shows that Rebalancing at higher frequency may not add value because of higher trading cost. The commonly used rebalancing frequency is either once a year or whenever the variance is more than 5% in portfolio.

Constant Weighting Asset Allocation is also referred to as Market Timing or Reallocation.

Research by Vanguard has shown that risk-adjusted returns don't change much whether the portfolio rebalancing is done daily, monthly, annually or at any other frequency. Cost (taxes, time, and labor) is an important angle in Rebalancing. Higher the frequency, higher is the cost. A balance between rebalancing frequency and cost should be maintained.

Costs of Rebalancing

Following is the cost associated with Rebalancing:

1. Taxes (if applicable): Capital Gain tax will be applicable if there is gain on the units sold for rebalancing.
2. Transaction costs to execute and process the trades: There is transaction cost related to Rebalancing like Exit load, Commission, Impact cost, Bid and Ask spread etc.
3. Time and labor input costs: The cost of the man hours spent on computing and executing the rebalancing is included here. The costs may include management fees, if a professional manager is hired for rebalancing exercise.

TACTICAL ASSET ALLOCATION

Tactical Asset Allocation (TAA) or Reallocation or Market Timing is a dynamic strategy that actively adjusts a portfolio's strategic Asset Allocation (SAA) based on short-term market expectation, outlook or forecast. Although the successful implementation of a Tactical Asset Allocation strategy is often considered to be simple but it is actually very difficult. Research shows some Market Timing strategies have added value, on average Market Timing strategies have not produced significant excess returns over various time periods in Developed Markets. However, enough work on the value addition by Market Timing Strategies on Emerging Markets has not been done.

The main objective of Reallocation strategy is to take advantage of inefficiencies or temporary imbalances different asset or sub asset classes. Reallocation Strategy can add (or subtract) value, if designed, evaluated and executed appropriately.

The case for Tactical Asset Allocation

Tactical Asset Allocation attempts to add value to Strategic Asset Allocation by increasing allocation to those asset classes that are expected to outperform on a relative basis and decreasing exposure in those asset classes which are expected to underperform. In Reallocation, financial and economic variables are used to predict performance and assign relative short-term asset-class weightings.

Economically, Tactical Asset Allocation is based on the assumption that returns among asset classes will diverge temporarily from equilibrium levels, allowing the opportunity for excess returns from systematic and disciplines strategies.

A good Tactical Asset Allocation strategy will recognize the imbalance from equilibrium and recommend a overweight to an underpriced asset class.

Tactical Asset Allocation Signals

Some of the commonly used signals for Tactical Asset Allocation are as under:

- Earning Yield vs Bond Yields
- Business Cycle/ Macroeconomic Signals
- Valuation Signals
- Market Capitalization vs GDP
- Momentum Signals
- Sentiments Signals
- Liquidity Signals
- Economic and Industrial Growth
- Employment and productivity Signals

STRATEGIC ASSET ALLOCATION

In Asset allocation, it is assumed that both expected return and risk of each asset class are different. By combining asset classes in different proportions, it is possible to enhance the overall portfolio return and reduce risk.

As per past research, it is believed that a portfolio return is dependent upon many important factors or strategies. The recognized strategies are a) Strategic Asset Allocation b) Sector/ Stock Selection, and c) Market Timing. The above strategies have also been recognized in the research papers of Hood, Brinson and Beebower (1986) and Singer, Beebower and Brinson (1991).

Strategic Asset allocation is defined as an investment strategy in which the investor's funds are allocated or invested across available asset classes. The allocation percentage depends on some of the following factors:

- Age of person
- Willingness to take Risk
- Ability to take Risk
- Cash outflows in future
- Cash inflows in future
- Size of existing wealth
- Volatility of expected Future Wealth.
- Past experience of investing
- Risk Profile
- Longevity Risk
- Risk and Return expectation of each asset class.
- Correlation among asset classes

The assets are spread across different asset classes such that the resulting risk and return of overall portfolio matches as per the personal requirement of investor. Strategic Asset Allocation is also known as buy and hold strategy. Once the funds are allocated, the allocation is not changed. The Asset Allocation of portfolio continues which was defined in the very beginning. Strategic Asset Allocation is the most important strategy and a wrong Asset Allocation has the potential of affecting the investor negatively. Strategic Asset Allocation is good for passive investors who don't want the portfolio to be changed or churned regularly.

2. REVIEW OF LITERATURE

The literature on Asset Allocation has for long been an area of interest for both theoretical and empirical research. This consists of the finding of new research, using a growing arsenal of econometric techniques for identifying new strategies to improve portfolio performance.

Ibbotson and Kaplan (2000) used 5 asset classes in their study "*Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?*" Ibbotson and Kaplan "examined the 10 year return of 94 US balanced mutual funds versus the corresponding indexed returns. The linear correlation between monthly index return series and the actual monthly actual return series was measured at 90.2%". Ibbotson concluded "(1) that asset allocation explained 40% of the variation of returns across funds, and (2) that it explained virtually 100% of the level of fund returns".

"Does asset allocation policy explain 40 percent, 90 percent, or 100 percent of performance? According to some well-known studies, more than 90 percent of the variability of a typical plan sponsor's performance over time is attributable to asset allocation. However, few people want to explain variability over time. Instead, an analyst might want to know how important it is in explaining the differences in return from one fund to another, or what percentage of the level of a typical fund's return is the result of asset allocation. To address these aspects of the role of asset allocation policy, they investigated these three questions".

1. How much of the variability of returns across time is explained by asset allocation policy?
2. How much of the variation of returns among funds is explained by differences in asset allocation policy?
3. What portion of the return level is explained by returns to asset allocation policy?"

"They examined 10 years of monthly returns to 94 balanced mutual funds and 5 years of quarterly returns to 58 pension funds. For the mutual funds, they used return-based style analysis for the entire 120-month period to estimate policy weights for each fund. They carried out the same type of analysis on quarterly returns of 58 pension funds for the five-year 1993-97 period. For the pension funds, rather than estimated policy weights, they used the actual policy weights and asset-class benchmarks of the pension funds".

"They answered the three questions as follows:

- 1) They regressed each fund's total returns against its policy return and recorded the RSQ value for each fund in the study. They found that, on average, about 90 percent of the variability of returns of a typical fund across time is explained by asset allocation policy. Most of a fund's ups and downs are explained by the ups and downs of the overall market.

- 2) They ran a cross-sectional regression of compound annual fund returns for the entire period on compound annual policy returns. They found that about 40 percent of the variation of returns from one fund to another is explained by policy return differences. For example, among mutual funds, if one fund's return is 13 percent and another fund's return is 8 percent, then on average, about 2 percent of the difference is explained by the difference in asset mix policy; the remaining 3 percent difference is explained by other factors, such as timing, security selection, and fee differences between the funds.
- 3) For each fund, they divided the compound annual policy return for the entire period by the compound annual fund return. They found that, on average, about 100 percent of the return level is explained by the return to asset allocation policy. Thus, the average fund's return to asset-mix policy is about the same as the return to the benchmarks for the asset classes".

Meir Statman (2000) "found that using the same parameters that explained BHB's 93.6% variance result, a hypothetical financial advisor with perfect foresight in *tactical* asset allocation performed 8.1% better per year, yet the strategic asset allocation still explained 89.4% of the variance. Thus, explaining variance does not explain performance. Statman says that strategic asset allocation is movement *along* the efficient frontier, whereas tactical asset allocation involves movement of the efficient frontier".

"A more common sense explanation of the Brinson, Hood, and Beebower study is that asset allocation explains more than 90% of the volatility of returns of an overall portfolio, but will not explain the ending results of portfolio over long periods of time. Hood notes in his review of the material over 20 years, however, that explaining performance over time is possible with the BHB approach but was not the focus of the original paper".

Wolfgang Drobetz and Friederike Kohler (2002) "found that by using the approach of Ibbotson and Kaplan (2000) on German and Swiss balanced mutual fund data they find that more than 80 percent of the variability in returns of a typical fund over time is explained by asset allocation policy, roughly 60 percent of the variation among funds is explained by policy, and more than 130 percent of the return level is explained, on average, by the policy return level".

"In this paper they analyse the contribution of asset allocation policy to the performance of 51 German and Swiss balanced mutual funds. While it is well known throughout the investment community that asset allocation policy is the major determinant of total fund performance, there is substantial disagreement about the exact magnitude. Following the approach in Ibbotson and Kaplan (2000), they demonstrate that the correct answer depends on the specific question being asked".

"They find that more than 80 percent of the variability in returns of a typical fund over time is explained by asset allocation policy, roughly 60 percent of the variation among funds is explained by policy, and more than 130 percent of the return level is explained, on average, by the policy return level. Comparing their empirical results to previous results by Brinson et al. (1986, 1991) and Ibbotson and Kaplan (2000) for U.S. pension fund and mutual fund data, they come to three conclusions".

"First, they find that the degree of active management is similar. Second, they document evidence that U.S. managers offer a more diverse range of mutual fund products, i.e., compared to their sample of German and Swiss funds, there are more pronounced differences in the asset allocation targets among funds. Finally, they report that, on average, active management (i.e., stock picking and/or timing) has not even been neutral to fund performance, but rather destroyed a significant portion of investors' value".

S. Fowdar (2008) "investigate the contribution of asset allocation policy to the performance of seven Mauritian mutual funds has being analysed. This study investigated whether asset allocation policy does contribute to the performance of Mauritian mutual funds. There is significant divergence of opinion as to the exact amount of the contribution of asset allocation. Following the method used by Ibbotson and Kaplan (2000) and Drobetz and Köhler (2002), the study revealed that the policy return explained approximately 33 percent of the variability of total fund return over time, around 22 percent of the variation across funds was explained by policy, and nearly 20.43 percent of the policy return level is incorporated in total return level on average".

"It can be inferred that the degree of active management is not similar since funds operating in more efficient markets than Mauritius, had a higher degree of active management. In addition, developed markets offer a wider range of mutual fund products".

James X. Xiong, Roger G. Ibbotson, Thomas M. Idzorek, and Peng Chen (2010) "found that considerable confusion surrounds both time-series and cross-sectional regressions and the importance of asset allocation. Cross-sectional regressions naturally remove market movements; therefore, the cross-sectional results in the literature are equivalent to analyses of excess market returns even though the regressions were performed on total returns. In contrast, time-series analyses of total returns do not naturally remove market movements. With market movements removed, asset allocation and active management are equally important in determining portfolio return differences within a peer group".

"Their study helped identify and alleviate a significant amount of the long-running confusion surrounding the importance of asset allocation. First, by decomposing a portfolio's total return into its three components—(1) the market return, (2) the asset allocation policy return in excess of the market return, and (3) the return from active portfolio management—they found that market return dominates the other two return components. Taken together, market return and asset allocation policy return in excess of market return dominate active portfolio management. This finding confirms the widely held belief that market return and asset allocation policy return in excess of market return are collectively the dominant determinant of total return variations, but it clarifies the contribution of each. More importantly, after removing the dominant market return component of total return, they answered the question, Why do portfolio returns differ from one another within a peer group? Their results show that within a peer group, asset allocation policy return in excess of market return and active portfolio management are equally important".

"Critically, this finding is not the result of a mathematical truth. In contrast to the mathematical identity that in aggregate, active management is a zero-sum game (and thus, asset allocation policy explains 100 percent of aggregate pre-fee returns), the relative importance of both asset allocation policy return in excess of market return and active portfolio management is an empirical result that is highly dependent on the fund, the peer group, and the period being analyzed".

"The key insight that ultimately enabled us to conclude that asset allocation policy return in excess of market return and active portfolio management are equally important is the realization that cross-sectional regression on *total* returns is equivalent to cross-sectional regression on *excess market* returns because cross-sectional regression naturally removes market movement from each portfolio. They believe that this critical and subtle fact has not been clearly articulated in the past and has been overlooked by many researchers, especially when interpreting cross-sectional results in relation to the overall importance of asset allocation".

"The insight that cross-sectional regression naturally removes market movement leads to the notion that removing market movement from traditional total return time-series regression is necessary should one want to put the time-series and cross-sectional approaches on an equal footing. After putting the two approaches on an equal footing, they found that the values of R^2 for the excess market time-series regressions and the cross-sectional regressions (on either type of return) are consistent".

"Finally, by examining period-by-period cross-sectional results and highlighting the sample period sensitivity of cross-sectional results, they explained why different researchers using the same regression technique can get widely different results. More specifically, cross-sectional fund dispersion variability is the primary cause of the period-by-period cross-sectional R^2 variability".

Colleen M. Jaconetti, Francis M. Kinniry Jr and Yan Zilbering (2010) "found that the primary goal of a rebalancing strategy is to minimize risk relative to a target asset allocation, rather than to maximize returns. There is no optimal frequency or threshold when selecting a rebalancing strategy. This paper demonstrates that the risk-adjusted returns are not meaningfully different whether a portfolio is rebalanced daily, monthly, quarterly, or annually".

"The primary goal of a rebalancing strategy is to minimize risk relative to a target asset allocation, rather than to maximize returns. A portfolio's asset allocation is the major determinant of a portfolio's risk-and-return characteristics.¹ Yet, over time, asset classes produce different returns, so the portfolio's asset allocation changes. Therefore, to recapture the portfolio's original risk-and-return characteristics, the portfolio should be rebalanced. In theory, investors select a rebalancing strategy that weighs their willingness to assume risk against expected returns net of the cost of rebalancing. Their findings indicate that there is no optimal frequency or threshold when selecting a rebalancing strategy. This paper demonstrates that the risk-adjusted returns are not meaningfully different whether a portfolio is rebalanced monthly, quarterly, or annually; however, the number of rebalancing events and resulting costs (taxes, time, and labor) increase significantly. (For instance, monthly rebalancing with no threshold would require 1,008 rebalancing events, while annual rebalancing with a 10% threshold would require only 15 rebalancing events.) As a result, they conclude that for most broadly diversified stock and bond fund portfolios (assuming reasonable expectations regarding return patterns, average returns, and risk), annual or semi-annual monitoring, with rebalancing at 5% thresholds, is likely to produce a reasonable

balance between risk control and cost minimization for most investors. Annual rebalancing is likely to be preferred when taxes or substantial time/costs are involved”.

“Just as there is no universally optimal asset allocation, there is no universally optimal rebalancing strategy. The only clear advantage as far as maintaining a portfolio’s risk-and-return characteristics is that a rebalanced portfolio more closely aligns with the characteristics of the target asset allocation than with a never-rebalanced portfolio. As their analysis shows, the risk-adjusted returns are not meaningfully different whether a portfolio is rebalanced monthly, quarterly, or annually; however, the number of rebalancing events and resulting costs increase significantly. As a result, they conclude that a rebalancing strategy based on reasonable monitoring frequencies (such as annual or semi-annual) and reasonable allocation thresholds (variations of 5% or so) is likely to provide sufficient risk control relative to the target asset allocation for most portfolios with broadly diversified stock and bond holdings”.

Daniel, Julieann, Christos and Joanne of Vanguard’s (2012) “research for U.S., Canadian, U.K., and Australian funds were proportionately much the same in terms of the degree to which asset allocation was found to explain return variability over time and dispersion of returns across funds. In addition, they found that indexed policy portfolios provided, on average, higher returns and lower volatility than actively managed funds. Also, the Sharpe Ratio of Active funds were less than the Policy Asset Allocation Portfolio”.

“The importance of choosing a strategic asset allocation is now common knowledge to those in the investment advisory community. For general investors the question remains, however: How does asset allocation affect their risk-and-return expectation?”

CONCLUDING OBSERVATIONS

Globally lots of research has been done to understand the importance of Asset Allocation in Portfolio Performance. Majority of the work has been done in Developed Markets and limited research is available for Emerging Markets. In Developed Markets, the markets are assumed to be efficient which also gets reflected in higher contribution of Asset Allocation strategy to Portfolio Performance. The emerging markets which has weak or semi strong level of efficiency may have less contribution by Asset Allocation in Portfolio Performance. This study tries to investigate this difference in contribution.

Asset allocation is based on the fact that both expected return and risk of each asset class are different. By combining asset classes in different proportions, it is possible to enhance the overall portfolio return and reduce risk.

As per past research, it is believed that a portfolio return is dependent upon many important factors or strategies. The recognized strategies are a) Strategic Asset Allocation b) Sector/ Stock Selection, and c) Market Timing. The above strategies have also been recognized in the research papers of Hood, Brinson and Beebower (1986) and Singer, Beebower and Brinson (1991).

Evaluation of the contribution of strategies in portfolio Return and Risk across time is done for Balanced Funds and Income Funds. The past research work has shown the importance of Strategic Asset Allocation in Portfolio Performance. This study enhances the work by seeing the importance of portfolio strategy on different asset classes, holding periods, Risk and Asset Allocation Strategies.

This research contributes to the Asset Allocation Literature. Research also gives new directions & information on Asset Allocation Strategies and Portfolio Performance to Policy makers, Wealth Managers, Financial Advisors, Fund Managers, Asset Management Companies, Researchers and Credit Rating Agencies.

Further research on the subject is recommended given its economic as well as academic importance.

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