Charting your Financial Future

A Guide to Asset Allocation

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Investing

This example shows how returns translate into different amounts:

Investing

There is no such thing as a sure-fire way to investment success. However, if you have money in funds you will need to pursue some form of strategy.

The strategy matters, because differences in return can be significant. Especially over time.

A strategy that works and produces decent returns versus one that fails and produces poor returns, could mean a difference of tens of thousands of pounds.

It really is worth the effort, if you have money in funds, such as pensions, ISAs or general fund holdings to strive to maximise those returns.

Consider two investors who both started with £50,000, in total in funds, 10 years ago.

One invested in a range of funds which obtained 3% per year (1) ("Investor A"), the other invested and achieved 6% per year (1) ("Investor B").

The sums each would have now are:

Investor A: £67,195

Investor B: £89,542

Investor B has over **£22,000 MORE.**

The difference in returns are magnified if you run the same comparison over 20 years, £50,000 invested 20 years ago would be worth today:

Investor A: £90,305

Investor B: £160,356

Investor B has over **£70,000 MORE.**

This is extra money investor B has available compared to investor A.

In other words, the prize of striving to improve or maximise returns, if you can successfully achieve this, is meaningful.

This money could enhance retirement income, help family members with a house purchase or educational costs, fund a cruise or pay health costs.

Do such differences and variations in performance exist in the real world? Yes!

Research shows that fund performance does vary – even within the same sectors – and often by big percentage amounts. (2)

However, whilst this is true, it is only ever evident with the benefit of hindsight.

To access the higher return, one would need prior knowledge of future performance and an idea which investments or funds were going to be the 'good' ones.

There is no reliable or consistent formula or mechanism for making such predictions.

This means that trying to get higher future returns by picking 'winners' is unlikely to succeed.

As a strategy towards investing - fund selection, on its own, is flawed because of the absence of a crystal ball which provides this information.

There is, though, another strategic approach to investing, which research shows, is also very important in differentiating future returns and, in this case, is also a workable strategy.

Asset Allocation

The strategy is to use an asset allocation approach.

Asset Allocation

Asset allocation describes the process of dividing your investment between different assets, such as cash, bonds, shares, and property.

The decision how much of your investment portfolio to put in any asset class is likely to have the most significant impact on your long-term results, of any investment decision you make.

If you consider the short list above: cash, bonds, shares and property, then it is quite simple to show why this is the case.

If you decide to put 100% of your investment capital into cash and hold it there for 10 years, you are likely to have a very different outcome than if you elected to put 100% into shares.

Evidence shows that this decision is more important than choosing which shares or funds or cash accounts to use.

The 'top-level' asset allocation decision is incredibly important.

For example, if you chose to put 100% of your investment capital into cash 10 years ago and to focus hard on finding the best cash account (i.e. paying the highest rate of interest) each year, to maximise your return, you would have substantially less capital today, than if you had elected to put 100% of your capital into shares (e.g. UK shares) and had selected a fund that had slightly below average performance. (3)

The percentage amounts you choose to allocate to different asset classes is the key factor.

That is just a snapshot of two assets against each other over one isolated ten-year period, in that way proving nothing. However, the fact is that if you take this sort of snapshot over many different periods and compare various asset areas, this will be the case time and time again.

Asset Classes and Sectors

An asset class describes a broad group of investments that have similar financial characteristics. The four types, mentioned above, are generally considered the main asset classes.

However, the position becomes a little more complex if one brings in other types of assets, for example commodities, and then, separately sub-divisions of the main assets, for example small company shares and large company shares. Then, there is the added element of geography: UK shares, US shares, European shares etc. In this regard the total number of asset areas starts to escalate considerably.

Finding the Most Suitable Percentage Split

The term ‘sector’ is therefore often used to segregate the various asset classes, their geographical spread and sub-divisions. The sectors also include the minor asset areas and some non-standard investment categories, for example hedge funds.

Asset allocation is the method of dividing up your entire investment capital amongst these various categories.

It is how you decide to do this, both at outset and ongoing, that determines your asset allocation strategy.

This strategy is likely to be the single biggest contributory factor to the long-term results you achieve.

The challenge is to work out what constitutes the most suitable percentage split of assets to use in any situation.

In some ways this is like the earlier position of trying to pick winners amongst funds or individual shares. No-one has a crystal ball and just as there is no way of knowing which funds will perform best in the future, no-one can know how different asset classes will perform.

To deal with this, and to provide a reasonable prospect of achieving good results in the future, there are various tactical approaches that can be employed:

1. Diversify

Diversification is an aspect of asset allocation which does two things at once: it opens the possibility of obtaining good returns by capturing some of the best gains, whilst simultaneously acting as a way of managing risk. We will cover diversification in full in the next section.

2. Constantly keep the asset allocation active

The word ‘active’ is often used to describe active funds, those that are managed by fund managers who move money around within the funds seeking out the best returns from individual stocks or bonds, the underlying ‘instruments’ within the fund. This is not the context we are using here. An active asset allocation approach describes the process of not leaving your assets always lined up in the same way. To use an example, you may have 50% of your portfolio invested in UK shares in 2019, and then 30% in 2024. Active asset allocation means reviewing and adjusting your split of assets regularly.

3. Seek out expert help on the asset areas

There is evidence that asset areas, as opposed to individual funds or shares or bonds, can be selected with some degree of accuracy. Whilst there is no crystal ball to predict future markets and, certainly, no certainty of anything, there are firms that specialise in looking at macro-economic trends and conditions and carefully appraising where value may lie – in terms of having a strong view on where things are likely to go.

Combining these tactical factors can hopefully lead to a successful application of an asset allocation strategy.

Diversification

Diversification is the process of using different asset classes and mixing the percentages in each in such a way that you diversify the risk and return.

This is best explained by way of an illustration. Whatever sum you have available to invest; you could plump to hold it all in cash. That would be described as 100% cash. Or you could plump to put it all in shares, which would be 100% shares.

In the former case, 100% cash, it is fair to say that you are taking little risk, possibly no risk at all, in terms of how much money you may lose. As cash accounts have no risk of capital loss.

However, you are sacrificing the potential return, as cash accounts tend to pay very low interest rates and – longer-term, based on historical statistics - lose money in comparison to using assets such as shares.

In most real-world situations, where as outlined earlier, there are dozens of asset classes, sub-asset areas and sectors, the process of diversification becomes dynamic because it is the skilled application of spreading between all these possible areas – including the percentage applied to each – which can make a big difference to the risk/reward equation.

In the latter case, 100% shares, you have a real and significant risk, as you could invest and then encounter a bear market in shares, and their value could drop. You would lose capital value.

The trade-off here is the opposite could happen and you invest, and the shares rise in value and way above cash interest rates. You invest in shares to hopefully capture these higher returns.

If, instead of either selecting 100% cash or 100% shares, you select a 50/50 split, you have quite simply reduced the risk compared to the 100% shares option and increased the potential for a good return compared to the 100% cash option.

You have diversified if you select 50/50 – because you have spread between different assets aiming to get a more balanced position.

Diversification continued

In terms of completing the background explanation around diversification it is important to understand that diversification only ‘works’ properly if you diversify amongst non-correlated asset areas.

“Non-corelated” means that the movements in the value of an asset area are independent of another area. Some areas are closely correlated, so the general direction of UK shares tends to be roughly in line with US shares. There is a clear correlation in their performance, certainly in terms of direction.

Heavily investing most – or all – of your invested capital into correlated areas, even if those areas are notionally separate categories is not proper diversification.

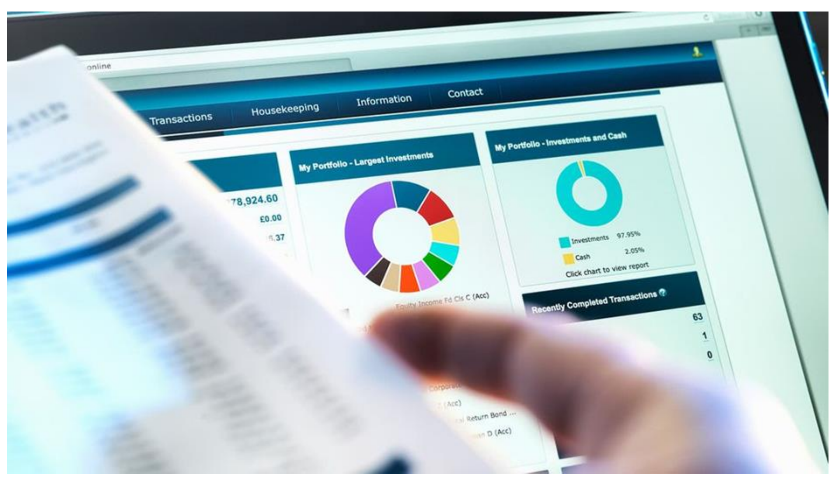
However, where there is very limited or no correlation the process can legitimately be spreading the risk, and by implication changing the risk and reward ratio.

The performance of certain sectors, for example Japanese shares and UK Gilts are likely to be non-correlated.

This should radically increase the chances of divergent performance at different points in time, when one area is ‘doing well’ another may not, and then at another point in time vice-versa.

This leads to a smoothing in the risk position, the task is to try and achieve this whilst reducing the reward by as little as possible.

A dynamic asset allocation strategy is the application of this approach.



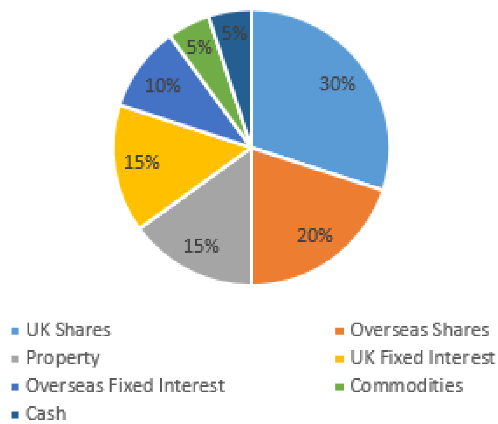
Managing an Investment Position

There are two parts to an asset allocation strategy. One is selecting the asset split at the outset. The other is managing it ongoing, over the years. The split that is selected at outset is a skilled assessment – how best is this done?

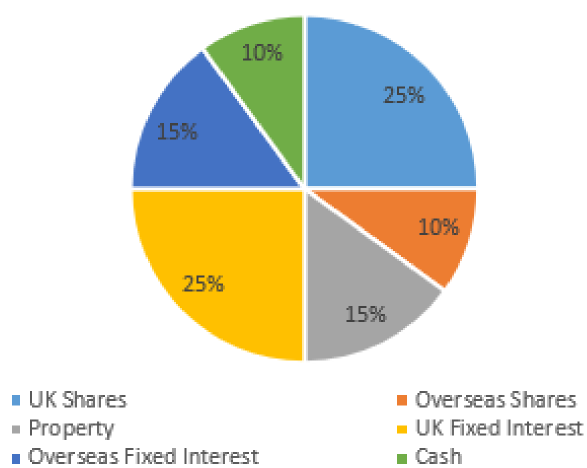
There is no right or wrong answer to this, but classically the asset allocation that is chosen is determined by a combination of two factors.

The first is based on the investor's risk position. The asset mix needs to align with a risk level which will be relevant to the investor's own risk position.

A higher risk investor will have more of their invested capital in asset areas which carry higher risk, put another way a higher chance of losing money, and a lower proportion in low risk areas, those assets that have limited loss potential. The skew will be towards higher risk assets, for example an investment portfolio mix which could like this:



A lower risk investor will skew in the other direction. Less in high risk assets, more in low risk assets. Their portfolio could like this:



This is partly down to their attitude to risk and party to their propensity for risk. The propensity means the amount an investor can afford to lose.

The starting position is therefore determined by an assessment of an investor's own risk.

The risk assessment is, as a stand-alone exercise, an important task and one that requires a skilled appraisal. Getting this right provides the basis for the asset allocation decisions to be taken and for an appropriate portfolio mix to be created.

Once done, the portfolio should be lined up with the investor's position and requirement. However, that cannot be left alone to work for ever and a day, because it is easy for the portfolio to fall out of line with the original alignment. Therefore, the asset allocation strategy needs to be managed on an ongoing basis.

The alignment can be broken down in three ways, all of which can apply alongside side each other:

1. The investor's own circumstances could change, and their risk position may change;
2. The portfolio performance can change the percentages held in different asset areas, simply through variations in performance (see below for further explanation);
3. Macro-economic conditions may change which suggests certain asset areas have different risks or prospects than at outset.

The middle one of these is particularly relevant. The 'natural' variations in performance of any portfolio can take it out of line. Think of an extreme example where an investor plumps for a portfolio consisting of 50% UK Shares and 50% in Commodities.

The shares double in value over the next two years, the value of the commodities halves.

After two years the portfolio mix has changed from 50/50 (at outset) to 80% UK Shares, 20% Commodities. It is a different portfolio mix than the one determined at the outset by the original risk assessment and asset allocation decision. The mix has changed merely because of the performance.

At this juncture the investor could sensibly decide that this new mix is not right for their risk position and readjust back to the 50/50 basis by selling some of the UK shares and buying more Commodities.

You may notice that in doing this the investor has taken 'profits' from the Shares and reinvested back into the struggling Commodities sector, maybe increasing their chances of buying low, selling high. Simply through the adjustment.

Rebalancing

This exercise is known as rebalancing, and whilst the illustrated example above is not especially realistic to most people's portfolios of investments, the principle stands across the board.

Regular reviews are integral to the asset allocation process.

Reviews

One of the keys to a successful asset allocation strategy and approach is to maintain some form of dynamism towards it. For the reasons outlined above this can include making regular changes, even if these are small, to the portfolio mix.

Such changes require regular reviews; how often such a review takes place is open to debate, but annually at the very least seems to be sensible.

Naturally, reviews of this type can always include 'no change' and maintaining the position as it stands.

A review can include checks to see if anything has changed which would alter the investor's own risk position, whether the portfolio mix has altered due to investment performance variations and to look at the wider world picture.

Notes:

(1) 3% and 6% per year are illustrated assuming these returns are the net returns after the investor had paid charges.

(2) "The Importance of Good Investment Performance on your Pension" Our previous guide published in January 2020.

(3) As at 28 February 2019.

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Advising Professionals Every Step of the Way