TACTICAL ASSET ALLOCATION:
A CORNERSTONE OF ACTIVE PORTFOLIO MANAGEMENT

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Asset Allocation is possibly the largest piece of the active management pie, and arguably offers the largest means of generating 'alpha'

Active Portfolio Management

When most investors think of active portfolio management, they think of the concept of picking shares that they believe will outperform the return level of the general market. With such a practice, by picking correctly an investor will generate excess returns, known as "alpha", over and above the market return, thus generating a better investment outcome.

Stock picking takes advantage of inefficiencies within an asset class (such as Australian Shares) and focuses on increasing exposure to individual companies that may be undervalued, and decreasing exposure to individual companies that may be overvalued.

Active stock picking is undoubtedly a potential way to generate alpha from Australian shares, but research indicates it is in fact only a relatively small part of the overall investment value-add.

What is Asset Allocation? Widening the Opportunity Set

Asset Allocation is possibly the largest piece of the active management pie, and arguably offers the largest means of generating "alpha".

Asset Allocation is the practice of investing not just in one asset class (eg. Australian shares), but in several such as cash, international shares, bonds, currencies, commodities and alternative assets such as infrastructure and hedge funds.

Asset Allocation enables active management for "alpha" not just by trading WITHIN an asset class like Australian shares, but also by trading BETWEEN asset classes. It provides a dual source of alpha that is complementary to, but even more important than, stock picking alone.

It is essentially stock picking on a broader scale and with greater potential to generate "alpha". At its simplest, it is a process that involves dynamically increasing exposure to undervalued asset classes and decreasing exposure to overvalued asset classes.

Play to your strengths

Asset Allocation is a portfolio management technique that provides investors with the potential to add value above and beyond any individual fund manager.

Most funds are constrained to a narrow asset class benchmark and do not have the ability to engage in asset allocation. Thus the investor who does use Asset Allocation has a KEY advantage through greater alpha generating opportunities than an institution who is asset class constrained.

Benefits of Asset Allocation

Asset Allocation can provide several benefits to portfolios that cannot be achieved through investing in only one asset class. These benefits may include:

- **Absolute Return**: Different asset classes perform differently in various types of markets. As such, the asset allocator has an ability to outperform in both rising and falling markets. For example, an investor could have used asset allocation to potentially reduce losses in the GFC by overweighting cash or bonds, our could have enhanced returns in the rally from March 2009 by overweighting international equities such as the US (See Figure 2 and Figure 3).
- **Increased Alpha**: Stock valuations within an asset class are traditionally far more efficient than asset class valuations as stocks are often over-researched and "over-broked", reducing the alpha generation opportunities in stocks relative to asset classes.
- **Diversification and Risk Reduction**: Adding uncorrelated or low-correlated assets diversifies portfolios, potentially reducing risk and volatility.

Quantifying the Asset Allocation Value Add

An investment paper written in 2000 by Ibbotson and Kaplan asked and answered several specific questions regarding asset allocation, one of which was:

"What portion of the return level is explained by asset allocation policy?"

i.e. If a portfolio returned 10% in a year, how much of that 10% return could be explained by the asset allocation of the portfolio rather than the stock/bond picking of the portfolio? Is it 50%? 70%? The answer they arrived at was actually closer to 100%!!

FIGURE 1 : RANGE OF PERCENTAGE TOTAL RETURN LEVEL EXPLAINED BY ASSET ALLOCATION POLICY

Percentile	Mutual Funds	Pension Funds
5 (best)	82%	86%
25	94	96
50	100	99
75	112	102
95 (worst)	132	113

Source: "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance", Ibbotson & Kaplan, 2000. This research studied US mutual and pension funds between 1988 and 1998.

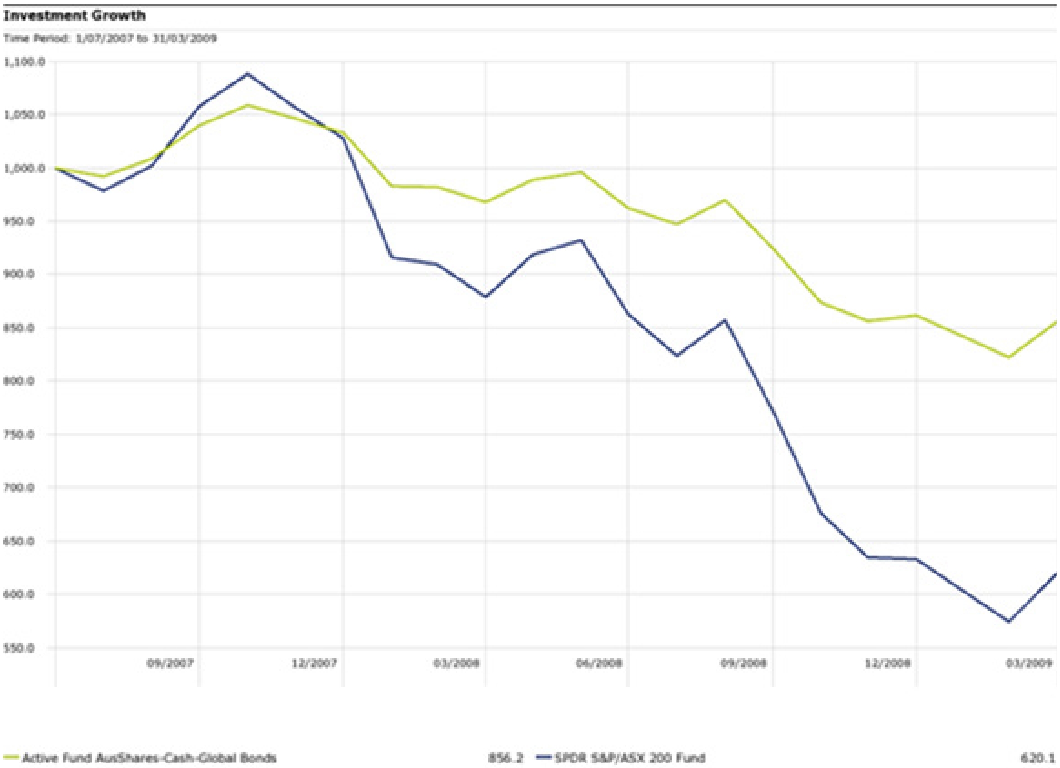
As you can see in Figure 1, asset allocation is tremendously important to overall return, a finding that is consistent with numerous academic studies. For the top 5% of Mutual Fund portfolio managers, asset allocation explained 82% of their portfolio return, with stock/bond picking therefore accounting for ~18% of the total return. So if the return for that year was say 10%, asset allocation provided 8.2% return and stock/bond picking a further 1.8% of return. So clearly stock picking CAN add value, but this research shows it is not the MAIN source of a portfolio's return. For a 50th Percentile manager, asset allocation explained 100% of the return. This means that this manager effectively gave back any gains from picking winners by picking a loser at some other point over the year, leaving only their asset allocation decisions to add value.

For the 95% Percentile manager (bottom 5% of managers), the asset allocation explained 132% of the portfolio return. This means that if the manager in this example returned 10% for the year, they effectively made 13.2% return from asset allocation and lost 3.2% from bad stock/bond picks to give a total return of 10%.

Implementing Asset Allocation in Clients' Portfolios

Many investors already use asset allocation to some extent, perhaps without ever even realising it! Have you ever sold down shares and moved to cash because you thought markets were toppy? That's asset allocation!

FIGURE 2 : PERFORMANCE OF S&P/ASX 200 V. 50% S&P/ASX 200 + 25% GLOBAL BONDS + 25% CASH: JULY 2007 - MARCH 2009

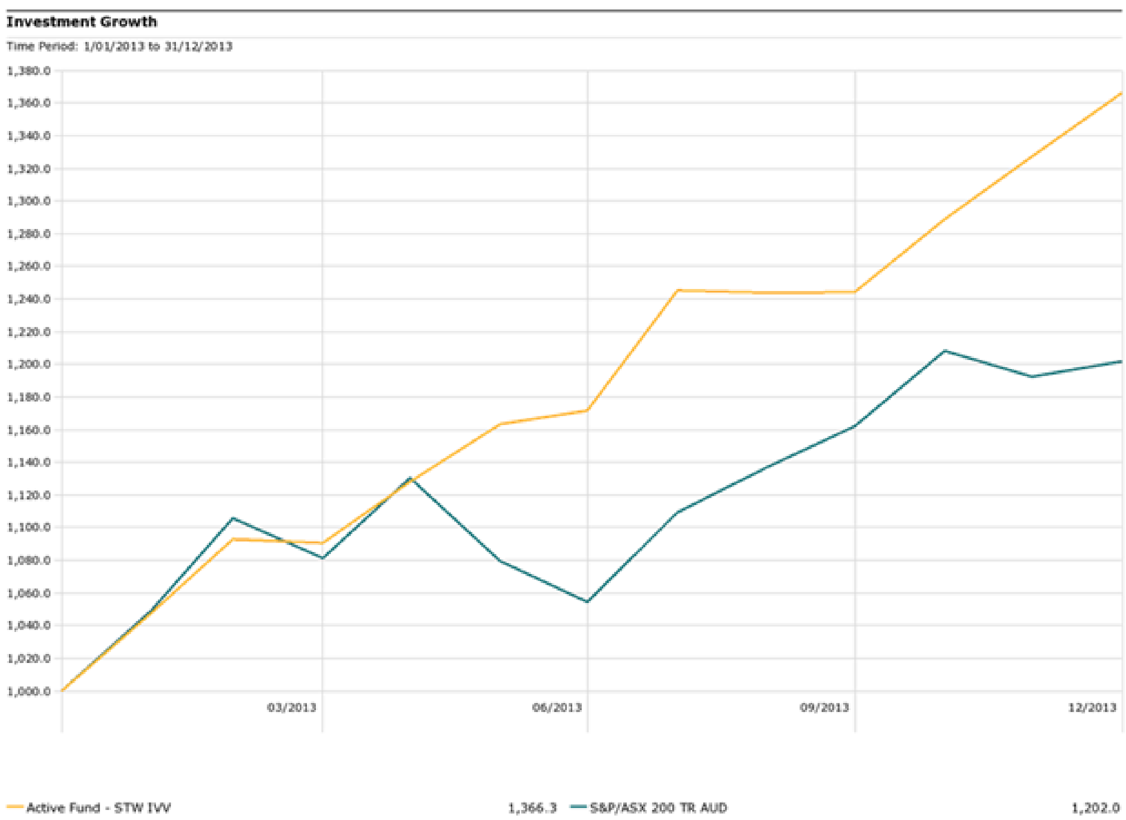


Source: Morningstar Direct. Past performance is not an indication of future performance.

The benefit of such an approach can be seen above in the outperformance of a portfolio of 50% ASX 200/ 25% Global Bonds / 25% Cash (Green line), compared to just an ASX 200 Portfolio (Blue Line). The Green asset allocation portfolio outperformed by ~36% in total during the GFC! That is real alpha on top of any alpha from ASX 200 stock picks.

Similarly, have you ever bought international equity exposure for your client because you felt that perhaps the US market would outperform the Australian market? That's asset allocation!

FIGURE 3 : PERFORMANCE OF S&P/ASX 200 V. 50% S&P/ASX 200 + 50% S&P 500: JANUARY 2013 TO DECEMBER 2013



Source: Morningstar Direct. Past performance is not an indication of future performance.

You can see above the outperformance of a 50%ASX 200/50% S&P 500 Portfolio (orange line) vs a pure ASX 200 Portfolio over the 12 months to end December 2013. The blended domestic and international exposure outperformed by ~13% during this period.

If you are already using asset allocation to some extent, it is really a very simple alpha generating step to broaden its use further into other asset classes that may fit the current investment landscape. Indeed, perhaps one way to "get started" is just to make sure you focus on the decisions you are already making from an asset allocation standpoint.

Accessing Asset Class Exposures

Once you decide you want to implement asset allocation, the next question becomes "How do I implement this?". There is no right or wrong answer here - there are a number of ways to implement asset allocation for clients and it will be up to you to determine which works best for you, your client base and the specific asset class you are trying to gain exposure to. Some common methods might include:

1. Buying direct shares, bonds or commodities in an overseas or domestic market
2. Buying ETFs on the ASX that provide exposure to different domestic and global asset classes
3. Investing in unlisted active or passive fund managers for exposure to different domestic and global asset classes

The other point here is that these implementation methodologies are not mutually exclusive in any way. You can easily use direct shares for say Australian equities and ETFs or managed funds for bonds and international exposure.

Or, alternatively, you could blend a broad market Australian and US ETF for diversified exposure with a few high conviction direct shares both here and in the US for some additional “stock picking alpha”.

Why ETFs may be useful to you in implementing Asset Allocation

As mentioned previously, we would not expect, nor suggest, you use ETFs exclusively for your asset allocation, but we should highlight the benefits they can provide that make them attractive asset allocation tools. There is a reason that ETFs are so heavily used by offshore wealth managers and often comprise more than 35% of all value traded on the NYSE on a given day. Benefits include:

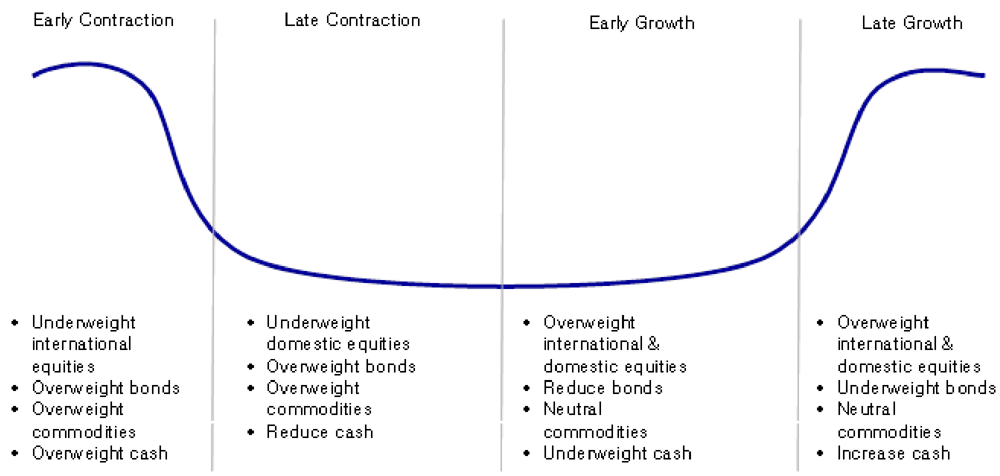
1. They are quoted on the ASX like a share meaning that, irrespective of their asset class exposure, they can be purchased as simply as an Australian equity.
2. They provide instant access to many asset classes including:
   a. Domestic and international equities (including country specific exposures)
   b. Domestic and global bonds
   c. Cash
   d. Currencies
   e. Commodities
3. They are highly liquid, allowing potentially sizable transactions into and out of an asset class with ease.
4. They can provide instant diversification to an asset class or geographic region (although you may also choose to add some high conviction single stock positions for additional potential alpha).
5. They are amongst the lowest cost investment tools available.
6. They are vanilla instruments that are easily explained to clients and require no additional documentation over and above a standard equity account.
7. They are highly transparent – Holdings are typically disclosed daily providing certainty over what exposure you hold. This benefit is shared by direct equity holdings but not my most unlisted managed funds which may run opaque portfolios with holdings only reported quarterly in arrears.

Knowing when to move between asset classes

The simplest way to add value through asset allocation is to be in the right asset class at the right point in the business cycle. Many asset classes move inversely or in a non-correlated manner to each other. The key is picking the right asset class for the current (or approaching) economic environment.After sustained periods of rising prices, investors are often lulled into taking risk for ever-diminishing reward within a given asset class. Conversely, after sustained pullbacks, assets can become cheap and priced to deliver strong future rewards.

Here is a broad idea of which asset classes suit which business cycles:

FIGURE 4 : ILLUSTRATIVE ASSET CLASS EXPOSURE OVER THE ECONOMIC CYCLE



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The on-going assessment of asset class values and resulting portfolio adjustments is the key tenet of asset allocation.

Since 1990, no single asset class has outperformed on a consistent basis. It is clearly evident in Figure 5 that yesterday's winner is often tomorrow's loser, and vice versa. You need to be active between asset classes to capture this alpha.

FIGURE 5 : PERFORMANCE OF MAJOR ASSET CLASSES - 1990-2015

Calendar Year	Cash	Australian Bonds	Global Bonds	Australian Equities	Global Developed	Emerging Markets	Australian REITs	Global REITs	Inflation
1990	16.3%	19.1%	14.1%	-17.5%	-15.1%		8.7%		6.9%
1991	11.2%	24.8%	18.9%	34.2%	20.0%		20.1%		1.5%
1992	6.9%	10.4%	10.1%	-2.3%	4.6%		3.5%		0.3%
1993	5.4%	16.3%	13.5%	45.4%	24.2%		30.0%		1.8%
1994	5.3%	-4.7%	-2.5%	-8.7%	-8.1%		-6.3%		2.6%
1995	8.0%	18.6%	20.6%	20.2%	26.1%		14.3%		5.1%
1996	7.6%	11.9%	9.5%	14.6%	6.2%		14.2%		1.5%
1997	5.6%	12.2%	10.7%	12.2%	41.6%		21.8%		-0.3%
1998	5.1%	9.5%	10.1%	11.6%	32.3%		18.4%		1.5%
1999	5.0%	-1.2%	0.3%	16.1%	17.2%		-4.2%		1.9%
2000	6.2%	12.0%	11.7%	4.8%	2.2%		18.9%		5.8%
2001	5.3%	5.5%	8.3%	10.5%	-10.0%	5.7%	14.8%		3.2%
2002	4.8%	8.8%	11.6%	-8.6%	-27.4%	-14.7%	11.8%		2.9%
2003	4.9%	3.1%	6.6%	15.0%	-0.8%	16.5%	8.8%		2.5%
2004	5.6%	7.0%	8.9%	27.9%	9.9%	20.7%	32.2%		2.5%
2005	5.7%	5.8%	3.8%	22.5%	16.8%	43.2%	12.7%	18.3%	2.8%
2006	6.0%	3.1%	5.4%	24.5%	11.5%	23.0%	34.1%	39.3%	3.3%
2007	6.8%	3.5%	6.6%	16.2%	-2.6%	25.1%	-8.4%	-15.6%	2.9%
2008	7.6%	15.0%	9.2%	-38.9%	-24.9%	-41.2%	-55.3%	-45.0%	3.7%
2009	3.5%	1.7%	8.0%	37.6%	-0.3%	38.4%	9.6%	29.1%	2.1%
2010	4.7%	6.0%	9.3%	1.9%	-2.0%	4.3%	-0.7%	23.8%	2.8%
2011	5.0%	11.4%	10.5%	-11.0%	-5.3%	-18.4%	-1.6%	2.5%	3.0%
2012	4.0%	7.7%	9.7%	19.7%	14.1%	16.7%	32.8%	28.0%	2.2%
2013	2.9%	2.0%	2.3%	19.7%	48.0%	13.0%	7.3%	6.8%	2.8%
2014	2.7%	9.8%	10.4%	5.3%	15.0%	6.9%	26.8%	30.4%	1.7%
2015	2.3%	2.6%	3.3%	2.8%	11.8%	-4.3%	14.4%	4.9%	1.7%

Source: Bloomberg and BetaShares. Past performance is not an indicator of future performance.

By avoiding overpriced assets and buying underpriced assets you can potentially achieve higher returns and lower risk over the course of a full business cycle.

Conclusion

Whilst following the investment decisions of the market may be comfortable, it is rarely profitable.

Asset class valuations may from time to time be at odds with the market's "herd" mentality, but this should be a reminder that often what seem the "riskiest" assets offer the best valuations and potential for future reward, whereas the "safer" assets are often crowded and thus fully valued with lower prospects for future reward.

But by staying true to the asset allocation through whichever implementation means deemed most appropriate, an investor may be able to add value to portfolios by:

- Actively managing portfolios to increase reward and reduce risk
- Partially smoothing the volatility of the business cycle
- Potentially increasing the total amount of alpha available for capture through multiple asset classes
- Providing the potential to perform in both rising and falling markets

Whilst by no means the only method of implementing asset allocation, ETFs offer important benefits that make them attractive tools for implementing simple asset allocation decisions.

About BetaShares

BetaShares Capital Ltd ("BetaShares") is a leading manager of exchange traded products ("ETPs") which are traded on the Australian Securities Exchange. BetaShares offers a range of ETPs which cover Australian and international equities, cash, currencies, commodities and alternative strategies. As at 31 December 2015, BetaShares has approximately $2.6 billion in assets under management.

BetaShares is a member of the Mirae Asset Global Investments Group, one of Asia's largest asset management firms. Mirae currently manages in excess of US$75B, including over US$10B in ETFs

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