

Technical Update

This issue: Strategic Asset Allocation

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This Issue: Special on Strategic Asset Allocation and low-correlated assets

In this issue of Technical Update we focus exclusively on a key topic for Financial Planners; strategic asset allocation. We've invited Henrik Lind-Grønbaek to discuss how the strategic asset allocation fund he manages works and its use of non-correlated investment cycles and assets.

Henrik Lind-Grønbaek, portfolio manager at Sparinvest's Strategic Asset Allocation funds, expounds on the theory that asset allocation is the key to providing superior returns for investors. He says we must disregard short-term market behaviour and continue to allocate portfolios strategically and in doing so must seek out assets with divergent

behaviour patterns at different stages of the economic cycle. Recession, Mr Lind-Grønbaek argues, like wars, coups d'état and interest-rate movements - is a source of unavoidable, 'systematic' risk to securities markets. Systematic risks can only be avoided by being out of the system or mitigated by hedging. Unfortunately, the global markets are currently demonstrating (with remarkable synchronicity) the precise meaning of 'systematic' risk - particularly to those investors who have been forced to realise capital losses.

Financial Planners, he says, cannot be held accountable if their clients have opted to take on board

systematic risk by being invested in securities markets. But it could be argued that it is their job is to ensure that clients are exposed to as little non-systematic risk as possible. Asset allocation is the key to achieving this, he believes.

Mr Lind-Grønbaek concludes that, as Benjamin Graham, once said: "The investor's chief problem - and even his worst enemy - is likely to be himself."

Financial Planner's Technical Update sector welcomes submissions or suggested topics for this section. Write to Financial Planner Group Editor Kevin O'Donnell at kevin.odonnell@portfoliopublishing.co.uk

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Henrik Lind-Grønbaek, portfolio manager at Sparinvest's Strategic Asset Allocation funds, looks at how the company's strategic asset allocation fund works and its use of low-correlated investment cycles and assets. Outlining the theory that asset allocation is the key to providing superior returns for investors, Mr Lind-Grønbaek says we must disregard short-term market behaviour and continue to allocate portfolios strategically and in doing so must seek out assets with divergent behaviour patterns at different stages of the cycle.

Investment: how strategic asset allocation works in practice and how low-correlated assets can be used to reduce risk

In 2001 the Financial Services Authority concluded in a report that past performance of a managed fund is a poor guide to its future returns. Yet seven years later the retail finance industry still uses this approach as its main method of selecting funds for recommendation to clients.

Asset allocation is the key to providing superior returns for investors. Therefore, we must disregard short-term market behaviour and continue to allocate portfolios strategically. In doing so, we must seek out assets with divergent behaviour patterns at different stages of the cycle.

Recession - like wars, coups d'état and interest-rate movements - is a source of unavoidable, 'systematic' risk to securities markets. Systematic risks can only be avoided by being out of the system or mitigated by hedging. Unfortunately, the global markets are currently demonstrating

(with remarkable synchronicity) the precise meaning of 'systematic' risk - particularly to those investors who have been forced to realise capital losses. As Financial Planners, you cannot be held accountable if your clients have opted to take the systematic risk of being invested in securities markets. But it could be argued that it is your job to ensure that they are exposed to as little non-systematic risk as possible. Asset allocation is the key to achieving this.

Asset allocation is the process of dividing a portfolio among the major asset classes in order to reduce non-systematic risk and optimise long-term returns through diversification. The concept began with

the American academic, Harry Markowitz, whose work in the 1950s looked at the then ground-breaking idea of using asset diversification to reduce portfolio risk. Taking his 'Modern Portfolio Theory' a stage further, Markowitz discovered that by strategically blending together non-correlated assets (that would perform entirely differently in different

economic conditions); he could optimise the risk/return relationship within a portfolio. Once a portfolio had reached the stage where no asset could be added or removed to improve its performance, it was considered an 'optimal'; it had reached Markowitz' 'Efficient Frontier'.

William Sharpe developed Markowitz' Portfolio Theory further. He invented the 'Capital Asset Pricing Model' (CAPM), a pricing theory which helps measure a portfolio's systematic risk (beta) and the compensation - or returns - an investor can expect from it. In 1990, Markowitz and Sharpe were awarded Nobel Prizes for their

