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Consultant: Demand for dynamic asset allocation strategies on the rise

By Aniket Das 7 October 2014

Most pension funds are implementing some form of dynamic asset allocation strategy with a view to managing downside risk and protect funding levels. To this end, risk-focused asset allocation approaches, whether implemented in a discretionary or systematic fashion, will garner the most interest going forward, says Aniket Das, vice president, manager research team at Redington.

Security selection, as in stockpicking, has been traditionally recognised as a source of added value within investments. However, for decades it has also been noted that asset allocation is a large driver of returns.

A commonly-quoted yet widely misunderstood study* attributes over 90 per cent of returns to asset allocation rather than security selection and market timing. Although more robust analysis** yields a less remarkable finding for asset allocation (more like 50/50), it is undeniable that dynamic asset allocation can prove to be a source of valuable return with most pension schemes implementing this in some form.

The growth of DAA strategies has meant more and more pension funds are able to outsource the dynamic part of the asset allocation process to investment managers.

Given that most pension schemes have limited governance resources and many non-investment items on their agenda, outsourcing allows them to respond more quickly to market opportunities with the ability to react daily if necessary. This means they are no longer locked into a monthly or quarterly cycle of decision-making and can take advantage of opportunities as they arise.

Managing downside risk

With a greater focus on pension deficits by regulators and equity analysts, pension schemes are increasingly interested in managing downside risk in order to protect their funding levels.

If implemented well, DAA can limit losses and make pension funds' path to full funding a much smoother ride.

DAA is useful for a pension scheme as the volatility of asset classes varies over time. Hence, asset allocations also need to be dynamic in order to maintain a similar risk profile through time.

Many fund managers believe that asset classes exhibit time-varying valuations, which they can correctly calculate, and hence managers may also be able to add value from a return perspective by timing entry into asset classes.

There are a couple of options available to investors. Discretionary DAA strategies have a more qualitative input driving the investment process and shifts in allocations will be determined by people and committees.

Systematic strategies have quantitative input behind the investment process, so computer models determine shifts in asset allocation (although human judgement will have gone into shaping the models).

While each type of DAA strategy comes with its own pros and cons, it is important that both show evidence of a strong risk management process and also manager skill where it is claimed.

Use of DAA strategies

Most pension funds have exposure to some sort of DAA, although where and how this occurs may vary. Many schemes will perform DAA at the internal investment committee or in-house investments team level.

Alternatively, a large proportion of pension funds have allocated externally to diversified growth fund managers who perform DAA within their funds on a discretionary basis.

A smaller number of schemes have allocated to risk parity strategies which follow a systematic risk-based asset allocation approach. They may also have some exposure to DAA through holdings in global macro hedge funds. In addition, for those managing their funds via a fiduciary manager, the manager may perform or advise on DAA as part of their mandate.

We continue to see interest in DGF strategies, particularly within the segment that uses a risk-based approach to allocations. As investors increasingly look to allocate assets on a risk-based rather than capital-based approach, we believe that interest in risk parity strategies will also continue to grow among UK pension schemes.

More generally, risk-focused allocation approaches, whether implemented in a discretionary or systematic fashion, will see the most interest.

Governance burden

For those pension funds running DAA internally, there is a high governance cost and requirement. They must also consider management fees when allocating externally or being advised by a fiduciary manager.

Choosing which way is right for the pension fund and how to optimise usage is also a concern. They wish to avoid DAA being disjointed because there are a number of opposing views at different levels, for example the internal investment committee may be bearish on equities while a fund manager is very bullish.

* “Determinants of Portfolio Performance”, Brinson, Hood & Beebower, Financial Analysts Journal, 1986

** For example, see “The Equal Importance of Asset Allocation and Active Management,” Xiong, Ibbotson, Idzorek & Chen, Financial Analysts Journal, March/April 2010