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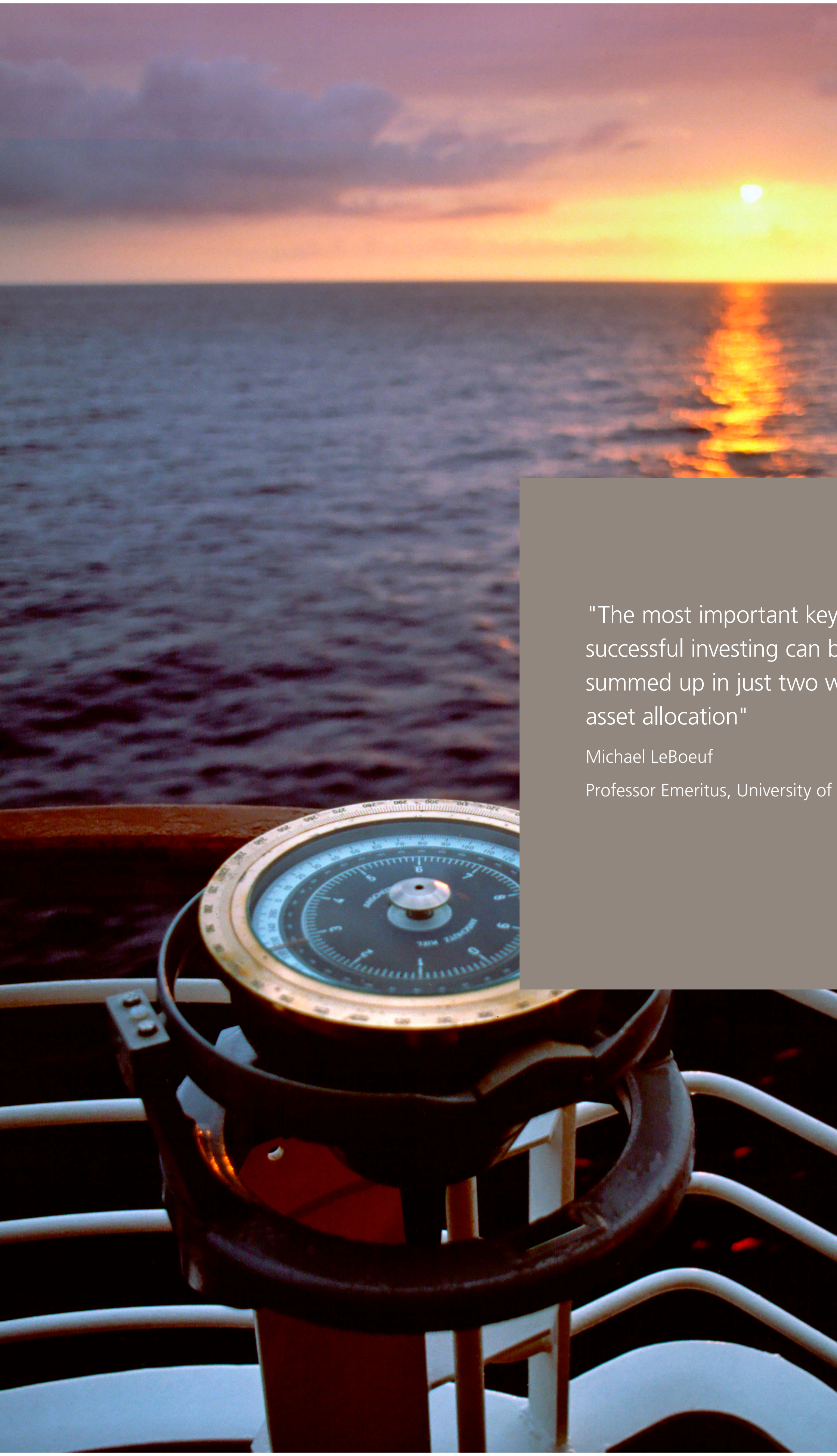
The key to long-term investment success

An introduction to asset allocation



"The most important key to successful investing can be summed up in just two words: asset allocation"

Michael LeBoeuf

Professor Emeritus, University of New Orleans

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Start with the big picture, not the details

What is asset allocation?

Asset allocation is one of the most important elements of investing. Put simply, it provides a framework for optimising the risk and reward of your investment portfolio over a medium to long-term time frame. This involves identifying and allocating to the right mix of asset classes to reflect your investment goals, risk tolerance and investment horizon.

Asset allocation is also important in helping to remove emotion from investment decisions. Emotions can be detrimental when it comes to investing as human biases can negatively impact decision-making at inopportune times. Having a strategic asset allocation, and sticking to it, can help you take the emotion out of investing.

The biggest driver of investment success

Asset allocation decisions are typically considered over two time frames—the long term, which is approximately five to seven years, and the short term, which incorporates the next three to six months.

Strategic asset allocation is focused on a long-term investment horizon and provides the foundation upon which well-constructed portfolios are built. It is one of the most important elements of wealth management. Academic research has shown that strategic asset allocation is responsible for the majority of overall investment return variation over the long term. In *A framework for institutional portfolio construction* (February 2016), Vanguard Research found that asset allocation policy accounts for 91.4% and 89.9% of return variation for balanced funds in the United States and Australia respectively.

Navigating the ups and downs of market cycles

Tactical asset allocation is focused on a short-term horizon and involves positioning portfolios to take advantage of near-term market conditions. While these short-term portfolio tilts are important, and are designed to add to return, the long-term impact of tactical asset allocation on performance is less pronounced than strategic asset allocation.

As mentioned earlier, Vanguard Research found that asset allocation policy accounts for 89.9% of return variation for balanced funds in Australia. Tactical asset allocation and security selection explain the remaining 10.1% of return variation.

At LGT Crestone, our tactical asset allocation positioning is considered over a three to six-month period and expressed relative to our long-term strategic asset allocations. For example, if an asset class has a favourable outlook for the next three to six months, then an overweight position may be implemented, increasing its relative weight within the portfolio.

The investor's emotional rollercoaster

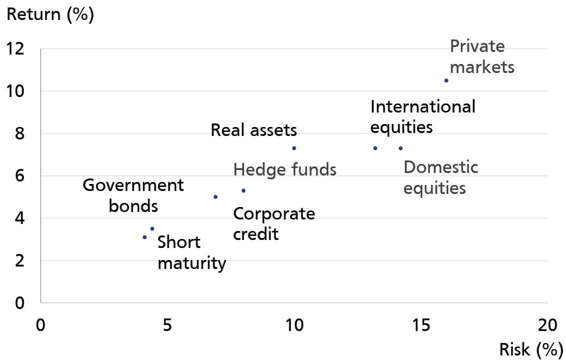
Source: LGT Crestone.

The link between risk and return

The relationship between risk and return

The relationship between risk and return is one of the most important concepts of investing. The basic tenet is that if you want a higher investment return, then you must be willing to accept higher risk. For example, cash is the asset class with the lowest risk profile, but it is also expected to generate the lowest investment return. Equities, on the other hand, have the highest expected investment return, but they are expected to be more volatile.

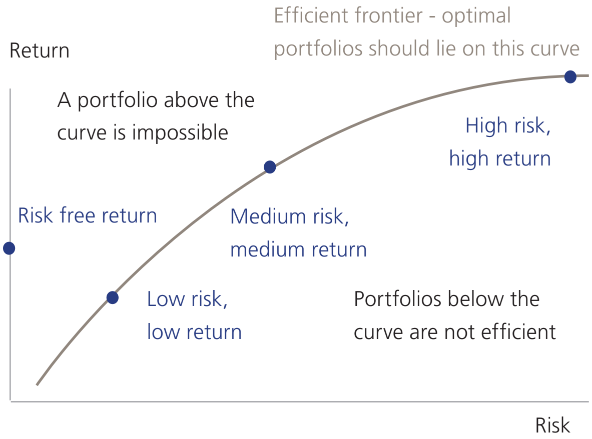
The link between risk and return for asset classes



Maximising the trade-off

Common sense suggests that, as a rational investor, you should want to maximise the return you are getting for the risk you are taking—in other words, you want to get the most 'bang for your buck'. This can be graphically represented by a curve known as the efficient frontier. The aim of the efficient frontier is to demonstrate which combinations of asset classes will generate the maximum return for a given level of risk. Portfolios on the efficient frontier have a better risk-return trade-off than any other portfolio and, therefore, generate the maximum return for a given level of risk—or, alternatively, the minimum risk for a specific level of return.

The efficient frontier

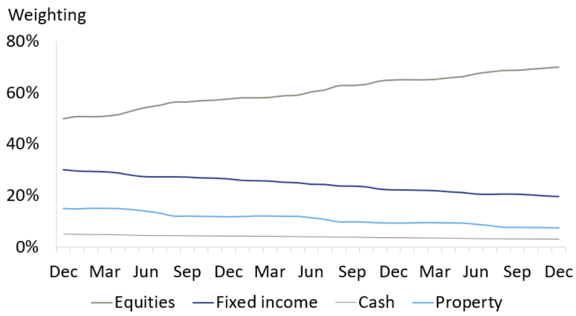


The need to monitor and rebalance

Once your asset allocation has been set and your portfolio built, it's important that you and your investment adviser monitor your portfolio. This is because asset class returns can vary over time, causing the relative weights of your investments to change. This can ultimately result in your portfolio moving away from its intended strategic asset allocation.

The following chart shows a theoretical portfolio, which hasn't been rebalanced over a three-year period. The initial weighting of the portfolio to equities is 50%, but this increases to 70% as the asset class outperforms other markets. This asset allocation drift, caused by market movements alone, has significantly altered the composition of the portfolio and its expected risk-return characteristics. The result is a sub-optimal portfolio which sits below the efficient frontier and its stated risk profile.

The relative weights of your investments can change over time



To avoid this asset allocation drift, the portfolio must be rebalanced back to its intended weightings. While rebalancing the portfolio on a frequent basis will eliminate any asset allocation drift, this isn't necessarily the best solution. It can result in higher trading costs and outweigh any benefit gained from maintaining the original asset allocation.

A more practical approach is for the portfolio to be monitored frequently and rebalanced either on a fixed-time basis or if the allocation moves beyond a pre-determined trigger level. A common strategy involves quarterly rebalancing with trigger levels in place to manage risk in between rebalancing dates. How often rebalancing occurs, and what these trigger levels are, will depend on the type of assets held (which dictates the trading costs) and upon your individual needs as an investor.

Source: LGT Crestone.

You need a diversified portfolio

If you could look into the future and know which asset class was going to perform the strongest, there would be no need for a diversified portfolio or to allocate between asset classes—you would simply allocate all your capital to the best performer.

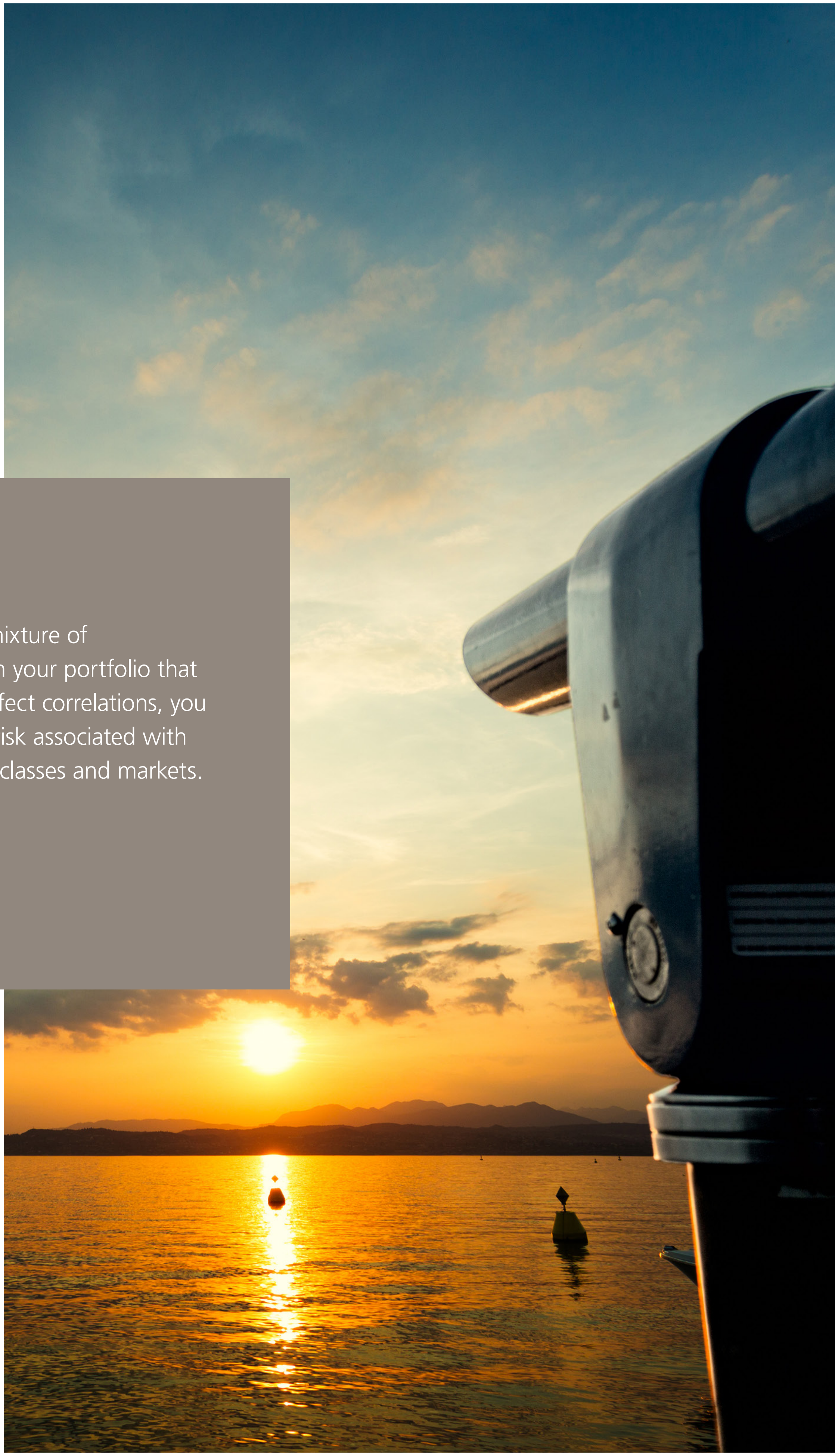
Nobody has a crystal ball, however, and each asset class has different return drivers so will perform differently depending on the market environment. In other words, asset classes are not perfectly correlated. As investing requires allocating capital in an uncertain future, it's important to come up with a strategy to adequately manage risk and return. The following image shows returns for the main asset classes since 2009, and demonstrates how difficult it can be to predict the winners and losers each year in markets.

By having a mixture of investments in your portfolio that have non-perfect correlations, you can diversify risk associated with specific asset classes and markets. This reduction of non-systematic risk increases the efficiency of your portfolio and should provide you with more consistent returns across the business cycle.

Asset class returns in Australian dollars (%)

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Dom fixed income 11.4	Domestic equities 20.3	Intl equities 48.0	Intl equities 15.0	Intl equities 11.8	Domestic equities 11.8	Intl equities 13.4	Intl hedge funds 5.6	Intl equities 28.0	Intl equities 5.7	Intl equities 29.6	Intl hedge funds 4.2
Intl fixed income 10.5	Intl equities 14.1	Intl hedge funds 26.9	Intl hedge funds 12.6	Intl hedge funds 10.7	Intl equities 7.9	Domestic equities 11.8	Dom fixed income 4.5	Domestic equities 23.4	Intl fixed income 5.1	Domestic equities 17.2	Domestic cash 3.1
Domestic cash 4.7	Intl fixed income 9.7	Domestic equities 20.2	Intl fixed income 10.4	Intl fixed income 3.3	Intl hedge funds 6.5	Intl fixed income 3.7	Intl fixed income 1.6	Intl hedge funds 10.7	Dom fixed income 4.5	Intl hedge funds 14.6	Domestic equities -1.1
Intl equities -5.3	Dom fixed income 7.7	Domestic cash 2.7	Dom fixed income 9.8	Dom fixed income 2.6	Intl fixed income 5.2	Dom fixed income 3.7	Domestic cash 1.5	Dom fixed income 7.3	Domestic equities 1.4	Domestic cash 0.1	Dom fixed income -9.7
Intl hedge funds -5.5	Intl hedge funds 5.0	Intl fixed income 2.3	Domestic equities 5.6	Domestic equities 2.6	Dom fixed income 2.9	Domestic cash 1.5	Intl equities 1.5	Intl fixed income 7.2	Domestic cash 0.3	Dom fixed income 0.0	Intl fixed income -12.3
Domestic equities -10.5	Domestic cash 3.7	Dom fixed income 2.0	Domestic cash 2.5	Domestic cash 2.1	Domestic cash 1.7	Intl hedge funds 0.3	Domestic equities -2.8	Domestic cash 1.2	Intl hedge funds -2.4	Intl fixed income -1.5	Intl equities -12.5

Source: Morningstar, Bloomberg, LGT Crestone. Calendar year returns relate to total returns in Australian dollars for the S&P/ASX 200 Accumulation index, Bloomberg Aus Bond Composite 0+Y TR index, Barclays Global Aggregate TR AUD Hedged index, MSCI World ex-Australia NR index AUD and the HFRI Fund Weighted Composite index AUD. Data as at 31 December 2022.

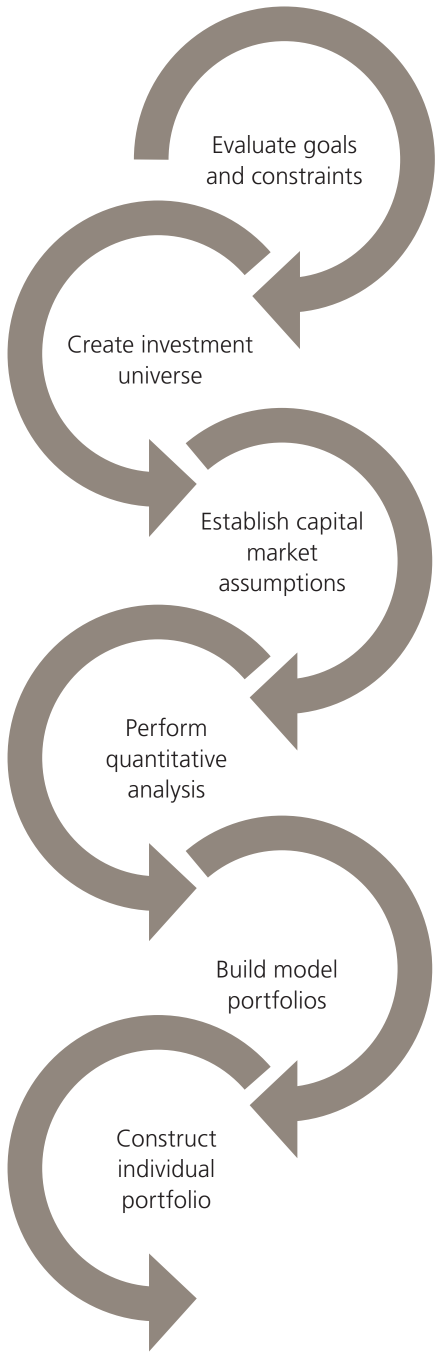


By having a mixture of investments in your portfolio that have non-perfect correlations, you can diversify risk associated with specific asset classes and markets.

Our approach to asset allocation

The beauty of the link between risk and return, diversification and portfolio optimisation is that several portfolios can be created for varying levels of risk.

At LGT Crestone, we do exactly this—we analyse the universe of asset classes and establish forward-looking capital market assumptions of risk and return to generate a range of portfolios. This results in strategic asset allocations that cater for a range of risk tolerances.



Evaluate your goals and constraints

Your goals and constraints are assessed quantitatively via a questionnaire and qualitatively through discussions with your investment adviser.

Create an investment universe

Our investment universe includes a broad range of domestic and international asset classes so you can rest assured your portfolio is sufficiently diversified. These include a range of sub-asset classes within equities, fixed income and alternatives, as well as cash. We regularly review these asset classes to ensure they remain appropriate and relevant.

Establish capital market assumptions

Establishing assumptions for the expected performance of various asset classes is one of the most complex and important parts of the asset allocation process.
To derive forward-looking capital market assumptions, we use a combination of research from our strategic partners, as well as input from our team of internal asset class specialists.

Perform quantitative analysis

How individual asset classes interact with each other within a diversified portfolio, and how they contribute to risk, is a complicated process. We use forward-looking risk and return estimates together with historical correlations to produce an efficient frontier of asset class combinations.

Build model portfolios

With the creation of the efficient frontier there are now thousands of possible portfolio combinations that would be considered efficient. We offer five model portfolios that cater for a broad range of needs.

Construct individual portfolio

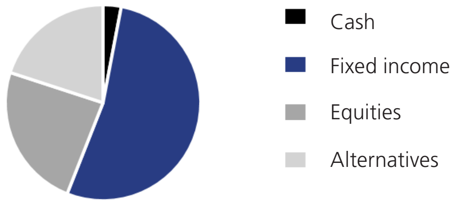
We then design an individual portfolio based on your particular needs for return, as well as your tolerance for risk.

The outcome is a portfolio that's right for you

At LGT Crestone, we offer a range of strategic asset allocations, or risk classifications, that cater for a broad range of needs. We offer four base strategic asset allocations, but can tailor these to suit your specific requirements.

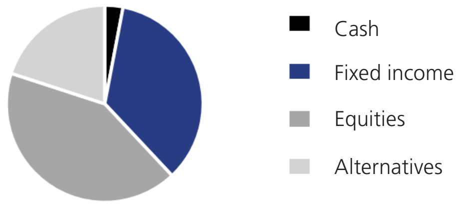
Yield

Suits investors with a conservative to medium risk tolerance who favour income generation over capital growth. The overall portfolio is tilted towards cash flow.



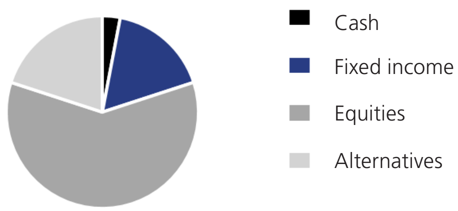
Balanced

Suits investors with a moderate risk tolerance and who are willing to accept short-term price fluctuations in return for a return comprising capital growth and income. The portfolio is well diversified and allocated almost equally between income and growth-orientated assets.



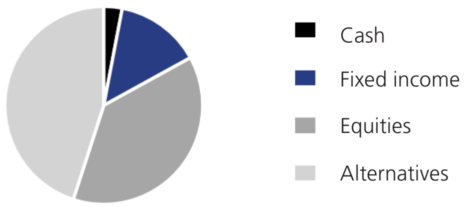
Growth

Suits investors with a high risk tolerance and who are willing to accept potentially larger short-term price fluctuations in the pursuit of maximising long-term capital growth.

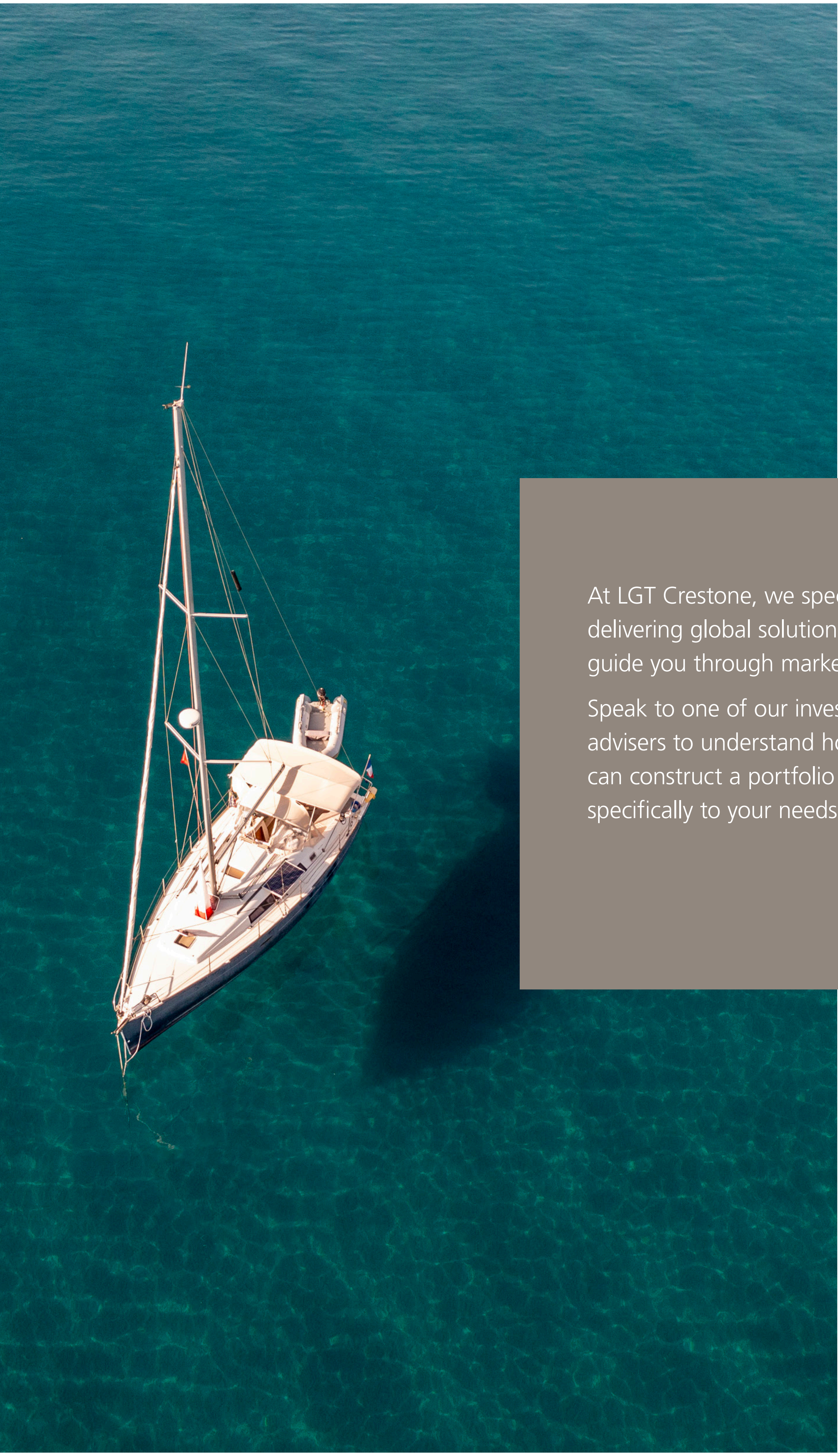


Endowment

Suits investors with a high risk tolerance, very long investment horizon, limited liquidity needs, and who are willing to accept potentially larger short-term price fluctuations in the pursuit of maximising long-term capital growth. Generally, these investors will have a larger capital base.



Source: LGT Crestone as at 31 December 2022.



At LGT Crestone, we specialise in delivering global solutions to help guide you through market cycles.

Speak to one of our investment advisers to understand how we can construct a portfolio tailored specifically to your needs.

Contact us

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