Asset allocation is a crucial aspect of fund management which adds gravely to the weight of responsibility carried by trustees. Where do they turn for help — to managers or consultants? That depends, says Charles Macek, on how the trustees see the trade-off between risk and return.

Who should take responsibility for a superannuation fund’s asset allocation? There are four candidates: the members, the trustees, the fund managers and the asset consultants.

Determining which should have the task entails analysing four issues:
- whether the superannuation industry supervision (SIS) legislation which came into effect on 1 July 1994 has any bearing on the answer;
- whether attribution analysis, one of the necessary tools in arriving at the answer, represents the holy grail or a poisoned chalice;
- the relevant advantages and disadvantages of using balanced or specialist managers;
- the distinction between strategic and tactical asset allocation and the alternative approaches to each.

The only “constant” in this debate and its effect on investment fashion is the undisputed role of asset allocation in determining a fund’s investment return.

The SIS legislation
The main effect of SIS is to codify the responsibility of trustees towards fund members. For example, the legislation spells out some of the obligations of trustees to communicate with members, although trustees are free to delegate these functions to organisations or individuals they judge as having appropriate abilities.

However, trustees cannot abdicate responsibility, for they are ultimately accountable. This aspect of trust law paradoxically implies that members cannot be the party with ultimate responsibility for asset allocation decisions. Indeed, this interpretation would appear to be consistent with the trend towards so-called “political correctness” over the past two decades. This trend has significantly diluted the notion that individuals should be held responsible for their own actions, while conferring on them considerable rights against other entities. This perspective would make member choice a risky approach for trustees of a fund to adopt. An extensive and costly process of communication and education of members would appear to be a prerequisite for such an approach. Further, this education process should start in the classroom, before people enter the workforce.

Given their fiduciary responsibility, trustees must be involved in the asset allocation process of the fund. At the very least, they have the responsibility for establishing the investment objectives of the fund and communicating these to members. Prudence suggests that in undertaking this responsibility most will choose to engage professional assistance.

However, there appears to be nothing in SIS that should cause a bias towards the appointment of consultants to set the strategic asset allocation or towards the appointment of specialist managers — two recent trends attributable to the enactment of the legislation.

Attribution analysis
Attribution analysis has the worthy aim of accurately measuring the contributions from various sources to a fund’s added value. In practice, however the results and conclusions

Charles Macek ASIA is the founding chief executive of County NatWest Australia Investment Management Limited. This article is adapted from his address to an AIC investment management conference in Sydney in May 1994.
drawn are flawed for a number of reasons.

First, the methodology used is inadequate. This is especially true for derivatives, particularly for options where the hedge ratio is extremely volatile. Another problem area is the averaging of cashflow for the purpose of performance calculation. Both problems could be overcome by a move to daily attribution analysis. However, this solution has several significant drawbacks. For example, the cost would be prohibitive. Further, daily pricing is not necessarily accurate, as quick and dirty pricing is often done in the interests of speed, whereas precise valuations are more likely to be made at the end of an accepted accounting period such as a month.

Daily analysis would also present the problem of comparing chain-linked data (a geometric series) with arithmetic returns. The difference between actual fund returns and the benchmark return is simply arithmetic. However, the attribution of this difference to asset allocation, stock selection and the interaction between them is a geometric series. A further measurement problem occurs with multi-currency portfolios, where some of these problems are exacerbated because of the proliferation of asset categories.

Second, there is insufficient information to permit statistically significant analysis. Suppose an attribution analysis is done of a balanced fund. Assume asset allocation changes occur on average each quarter. There are basically two decisions – equity/debt and domestic/international. If three years of data is analysed, there are 24 observations (3 years x 4 quarters per year x 2 decisions). This number of observations is insufficient to draw any conclusion. If the number of observations is insufficient for a statistician to draw any conclusions, then a qualitative assessment of the results is needed.

Third, attribution analysis brings the danger of over-engineering. We assume that the objective of the fund manager is simple and unambiguous: to add value to an agreed benchmark. However, attribution analysis could result in barriers being placed along the road to this goal.

This could occur where the fund manager is restricted from investing in an asset class because of apparent underperformance within that sector. Any good manager will naturally evaluate its own strengths and weaknesses and seek to overcome weaknesses. Where a weakness in a sector persists, a better solution from the fund’s viewpoint would be to require the manager to index that sector.

Ultimately, the value of attribution analysis is limited by the inability to determine precisely the added return attributable to skill, as distinct from luck. It is well understood that higher returns can often be achieved by taking higher risks. This necessitates the returns to be risk-adjusted before performance can be evaluated. However, risk has many dimensions which, with the exception of volatility, do not lend themselves to precise measurement. Not all losing bets are stupid. They can only be evaluated in the context of the aim of the decision and whether it was efficiently implemented.

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The specialist case
Arguments advanced by advocates of specialist fund management include:

- No single manager will excel in every asset class. Therefore you should use specialists who have demonstrated excellence in each field.
- Asset allocation is too important to delegate to external managers, who may be more concerned about their position on industry league tables than about the client’s risk profile.
- On an industry-wide level, balanced managers may be moving funds in opposite directions at the same time, thereby wasting transaction costs by effectively trading between themselves.
- To these objections, proponents of balanced fund management respond:
  - A well-run balanced manager should not have any serious weaknesses which are not already in the process of being corrected.
  - The manager’s accountability for meeting its client’s individual objectives is ensured by the proper use of benchmarks and sector ranges, which control the risk level and prescribe the limits of the manager’s discretion.
  - The question of wasted transaction costs is rarely an issue in practice. Asset allocation is often adjusted through derivative instruments, which incur very low transaction costs. In any event, managers are often moving in the same direction, responding to the same changes in the economic environment.

The balanced case
Apart from defending themselves against specific objections raised by advocates of specialist management, the proponents of balanced fund management also argue:

- Active asset allocation (ie, making short-term “tactical” shifts in the fund’s asset mix) is one of the main sources of added value in an investment portfolio.
- Strategic asset allocation (ie, the long-term asset mix of a fund) itself needs to be reviewed and updated in response to changing economic or regulatory conditions.

Again, the other side of the debate counters these criticisms, maintaining:

- Those who use specialist managers
can still enjoy the benefits of active asset allocation by engaging a “tactical overlay” manager.

- Where specialist managers are used, an asset consultant can be engaged to focus on strategic asset allocation.

In weighing up the merits of each side of this debate, cost is an important factor.

Use of specialist managers can involve significant costs for consultants to assist the trustees in monitoring complex structures. There may be additional costs of employing a tactical overlay manager. These costs may to some extent be offset by the fact that specialist management in the fixed-interest and cash areas is usually cheaper than balanced or equity management. Cost considerations and increased complexity mean that usually only larger funds use specialists.

The debate over balanced versus specialist fund management is by no means black and white; we believe there is a place for both styles of management in Australia’s growing managed funds industry.

**Tactical asset allocation**

There is widespread agreement that tactical asset allocation (TAA) should be the responsibility of the fund manager. There are two main types of TAA strategies: model-driven and active. TAA is usually implemented through an overlay portfolio. (There are two other common overlay strategies. One has a passive control function – managing cashflow and ensuring that a portfolio is fully invested at all times or rebalancing back to a benchmark. The other is a protective strategy to ensure a minimum outcome, such as portfolio insurance.)

A model-driven TAA approach relies on the belief that a fundamental valuation relationship exists between different assets. Further, it assumes that asset prices fluctuate around their fundamental value with a tendency for mean-reversion to some equilibrium level. This form of TAA seeks to exploit mispricing relative to this fundamental value. The virtue of this approach is that it helps to overcome the momentum bias of most active managers; that is, their tendency to have maximum exposure at market peaks and minimum exposure at market troughs.

However, there are two main weaknesses with this approach. First, markets can be mispriced (relative to fundamental value) by large amounts for significant periods. A resulting underperformance can be protracted and requires the understanding and patience of the trustees. Second, structural changes – usually caused by government policy and regulation – can alter the fundamental relationships. Such changes can be factored into models only after a time lag.

These weaknesses can be overcome only by adopting an active approach, the success of which clearly depends on the skill of the manager. The choice for trustees therefore comes down to their confidence in the model versus their confidence in the manager.

**The question is which professional group can best meet their needs: the consultant or the fund manager.**

- Typically presented in the form of a league table, have led to the establishment of benchmark portfolios for many funds. The consulting community and fund managers have played constructive roles in this process. Often they have worked in partnership to design the most suitable benchmark from the fund’s viewpoint. While the trustees ultimately approve and adopt the benchmarks, it has not always been evident that they fully understand the implications of accepting benchmark management. Further, ranking the returns of funds which have different objectives or benchmarks does not generate reliable data about the relative performance of those funds.

A recent trend, in part stimulated by perceptions of the ramifications of SIS, has seen consultants encouraging funds to adopt a strategic asset allocation, often implemented through specialist funds. In this process, fund managers have seen their influence diminish and that of consultants increase.

These developments reflect two underlying assumptions. First, that asset allocation is important and should be determined at the superannuation plan level. Second, some consultants assert that fund managers are not the appropriate professional group to be involved, giving as evidence the apparent inability of balanced managers to add value through asset allocation. It is worth noting, however, that over the three years to December 1993 domestic shares and bonds produced similar returns of 24.0 per cent p.a. and 23.1 per cent p.a. respectively; this indicates the limited opportunity to add value through altering the debt-equity mix, which is usually the main source of asset allocation gains.

Trustees must be involved in establishing the investment objectives of the fund but few will have the necessary expertise to undertake strategic asset allocation. The question is which professional group can best meet their needs: the consultant or the fund manager.

The appropriate approach for each fund depends on:
- the nature of the fund’s liabilities, and hence its risk profile; and
- the historical behaviour of different assets and the relationship between them.

There is no doubt that the trustees, with the aid of a consultant, should determine the first of these and see that the decision is effectively communicated to the investment manager. Increasingly, consultants have made the decisions about the second issue. Is this appropriate?

Determining strategic asset allocations requires assumptions about the likely returns, volatilities of returns and covariances between asset classes. These assumptions are usually based on long-term observations.

Over 10, 20, 30 or 50 years, and even longer periods, the relationships vary considerably. Table 1 illustrates the excess return of Australian equities over Australian bonds, Australian equities over SA cash and Australian bonds over cash, covering a number of “long-term” periods to December 1993.
Table 1: Returns on asset classes (%p.a.)

<table>
<thead>
<tr>
<th>Number Of Years To December 1993</th>
<th>10</th>
<th>20</th>
<th>30</th>
<th>50</th>
<th>93</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total return equities minus total return bonds</td>
<td>-2.2</td>
<td>3.8</td>
<td>3.7</td>
<td>5.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Total return equities minus total return cash</td>
<td>3.9</td>
<td>5.0</td>
<td>3.3</td>
<td>5.9</td>
<td>na</td>
</tr>
<tr>
<td>Total return bonds minus total return cash</td>
<td>6.1</td>
<td>1.2</td>
<td>-0.5</td>
<td>0.0</td>
<td>na</td>
</tr>
<tr>
<td>Volatility of returns equities</td>
<td>23.7</td>
<td>27.3</td>
<td>26.5</td>
<td>22.9</td>
<td>18.6</td>
</tr>
<tr>
<td>Volatility of returns bonds</td>
<td>6.8</td>
<td>10.7</td>
<td>11.3</td>
<td>9.5</td>
<td>8.1</td>
</tr>
</tbody>
</table>

Source: Frank Russell Company — Capital Market History and Asset Allocation.

The longer the time period, the more stable these relationships are likely to be. However, because of the variable nature of risk/return relationships in financial markets, a benchmark devised using 50 years or more of data should be used only as a guide, since the time horizon of trustees and investment managers is likely to be much shorter. Thus tactical ranges around benchmark weights are an important component of the investment process.

Similarly, constant mix strategies may be inappropriate for extended periods if the assumptions underlying their construction are different from actual experience for such a period.

This analysis suggests that asset consultants are well qualified to establish the long-term strategic benchmark. However, this benchmark cannot be static and will need to be periodically reviewed (perhaps on a three-year to five-year cycle). Whoever undertakes that review should then be held accountable to the trustees. This will require measurement and monitoring of the effects of the changes.

If consultants are to perform this role they should be subject to the same regulatory and perhaps performance measurement regime applying to fund managers.

However, the fund manager is better qualified to undertake the review, as it is more likely to perceive and understand the structural changes in economies and markets that may justify a change to the benchmark. This view is reinforced if the justification for the change is more cyclical (tactical) in its nature.

Setting the strategic allocation of the fund without the involvement of the fund manager is akin to driving a motor vehicle using the rear view mirror and not the windscreen.

Whose responsibility?

One answer to the question of who bears responsibility for asset allocation lies in the general responsibility of trustees. Further, it is the trustees' trade-off between risk and return which will determine the fund's investment objectives.

However, common sense, not to mention prudence, suggests that trustees should seek professional guidance in exercising their responsibility. Where the assistance required is conceptual and strategic, asset consultants are probably best suited for the role. The more tactical and practical the trustees' need, the more likely it is that fund managers are the appropriate professionals.

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