

The new landscape of Asset Allocation

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Institutional investors have been increasingly exposed to the topics of Liability Driven Investment, Alpha Transportation, and the role of alternative investments in asset allocation. Are these simply the topics 'du jour,' or do they correspond to the changing institutional landscape and justify debate?

Two important changes occurred over the past few years

First, the juxtaposition of low interest rates and poor equity performance at the beginning of this century unveiled a significant number of bona fide funding issues for pension funds, primarily due to the mismatch between the risk exposure of their liabilities and assets. Consequently, a number of countries issued – or are in the process of issuing – regulations leading to increased constraints on the valuation of liabilities and, therefore, on the investment of the asset portfolio relative to those liabilities.

Separation of assets

Integrating this new regulatory framework has led pension assets to deconstruct into a hedging portfolio and a performance enhancement portfolio. This separation of assets is the heart of the Liability Driven Investment concept, with the performance enhancement component encouraging alpha transportation techniques.

The second main change revolves around the tremendous development of alternative investments. The strong growth of the private equity sector and hedge fund industry has dramatically increased the number of performance sources available to investors. The strong development of these offerings also corresponded to the demand created from the low level of interest rates and the uncertainty surrounding equity markets.

The asset allocation framework must adapt to this new context. The traditional way – separating the strategic asset allocation to handle beta from the tactical asset allocation that intends to generate alpha within an asset class – cannot properly handle

the new investments that are not confined to a single asset class.

In addition, it cannot address the strategic role of alternative investments within an institutional portfolio. By construction, most alternative investments do not offer exposure to traditional betas and, therefore, should only be used as opportunistic positions.

The asset allocation process must begin to integrate alpha risks and expected returns at the strategic level, which is not an easy task. The risks associated with alpha originate not only from its exposure to risk factors similar to traditional asset classes, but also from actively adjusting the exposure. This second source of uncertainty does not necessarily escalate the total risk, but increases the difficulty of accurately assessing the level of risk at a certain point in time. In particular, volatility may not be adapted to measure the risk of non-linear strategies.

Attractive quality

An attractive quality of these alternative performance sources is the potentially low correlation and diversification they can bring to a portfolio. However, once again, an analysis more accurate than historical correlation is often necessary. Among alpha sources, the recent poor performance of all hedge fund indices reveals the existence of common factors, similar to 'alternative betas,' which must be accounted for in order to properly evaluate the potential diversification brought by these alternative alpha sources.

Last but not least, certain alternative funds present a level of correlation to traditional asset classes that is higher than expected as some 'absolute return' strategies have a structural directional bias that will impact the overall asset allocation process.

So, are Liability Driven, Alpha Transportation and alternative investments in asset allocation much ado about nothing? Of course not, but these issues are all part of a new environment that requires the asset allocation framework to adapt in such a way that investors are actually able to take advantage of these new opportunities.

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