STUDY SESSION

5

Asset Allocation and Related Decisions in Portfolio Management

Often considered the most important activity in the investment process, the strategic asset allocation decision takes place after the formation of capital market expectations. The portfolio's long-term asset class, or factor, exposures and the best means to achieve these exposures are determined only after considering the investor's unique financial situation and objectives, risk–return tradeoffs, and other key inputs.

This study session provides a conceptual framework for understanding asset allocation considerations and key implementation approaches. Consideration of an investor's overall financial context using an economic balance sheet to incorporate all relevant investor assets and liabilities is presented. Three major approaches to asset allocation are described: asset only, liability relative, and goals based. Concepts underlying active and passive implementation and strategic rebalancing are also introduced.

In practice, the asset allocation decision is affected by numerous constraints that present practical challenges to asset allocation. Significant investor-based constraints include investable assets, liquidity needs, time horizon, and regulatory and tax environments. The final reading examines the effects of these constraints and presents adaptations to address them by institutional investor type. Also discussed are behavioral biases that influence the asset allocation process and ways to overcome these biases.

READING ASSIGNMENTS

Reading 12	Overview of Asset Allocation by William W. Jennings, PhD, CFA, and Eugene L. Podkaminer, CFA
Reading 13	Principles of Asset Allocation by Jean L.P. Brunel, CFA, Thomas M. Idzorek, CFA, and John M. Mulvey, PhD

(continued)

Reading 14	Asset Allocation with Real-World Constraints by Peter Mladina, Brian J. Murphy, CFA, Mark Ruloff, FSA, EA, CERA

LEARNING OUTCOMES

READING 12. OVERVIEW OF ASSET ALLOCATION

The candidate should be able to:

a describe elements of effective investment governance and investment governance considerations in asset allocation;

b prepare an economic balance sheet for a client and interpret its implications for asset allocation;

c compare the investment objectives of asset-only, liability-relative, and goals-based asset allocation approaches;

d contrast concepts of risk relevant to asset-only, liability-relative, and goals-based asset allocation approaches;

e explain how asset classes are used to represent exposures to systematic risk and discuss criteria for asset class specification;

f explain the use of risk factors in asset allocation and their relation to traditional asset class–based approaches;

g select and justify an asset allocation based on an investor's objectives and constraints;

h describe the use of the global market portfolio as a baseline portfolio in asset allocation;

i discuss strategic implementation choices in asset allocation, including passive/active choices and vehicles for implementing passive and active mandates;

j discuss strategic considerations in rebalancing asset allocations.

READING 13. PRINCIPLES OF ASSET ALLOCATION

The candidate should be able to:

a describe and critique the use of mean–variance optimization in asset allocation;

b recommend and justify an asset allocation using mean–variance optimization;

c interpret and critique an asset allocation in relation to an investor's economic balance sheet;

d discuss asset class liquidity considerations in asset allocation;

e explain absolute and relative risk budgets and their use in determining and implementing an asset allocation;

f describe how client needs and preferences regarding investment risks can be incorporated into asset allocation;

g discuss the use of Monte Carlo simulation and scenario analysis to evaluate the robustness of an asset allocation;

h describe the use of investment factors in constructing and analyzing an asset allocation;

i recommend and justify an asset allocation based on the global market portfolio;

- **j** describe and evaluate characteristics of liabilities that are relevant to asset allocation;
- **k** discuss approaches to liability-relative asset allocation;
- **l** recommend and justify a liability-relative asset allocation;
- **m** recommend and justify an asset allocation using a goals-based approach;
- **n** describe and critique heuristic and other approaches to asset allocation;
- **o** discuss factors affecting rebalancing policy.

READING 14. ASSET ALLOCATION WITH REAL-WORLD CONSTRAINTS

The candidate should be able to:

- **a** discuss asset size, liquidity needs, time horizon, and regulatory or other considerations as constraints on asset allocation;
- **b** discuss tax considerations in asset allocation and rebalancing;
- **c** recommend and justify revisions to an asset allocation given change(s) in investment objectives and/or constraints;
- **d** discuss the use of short-term shifts in asset allocation;
- **e** identify behavioral biases that arise in asset allocation and recommend methods to overcome them.