STUDY SESSION

8

Asset Allocation and Related Decisions in Portfolio Management (1)

The strategic asset allocation follows the development of capital market expectations. The investment manager combines the investment policy statement with capital market expectations to determine target asset class weights for the portfolio. Maximum and minimum permissible asset class weights are often specified as a risk-control mechanism. The manager may consider both single-period and multi-period perspectives when evaluating the return and risk characteristics of various asset allocation alternatives. A single-period perspective has the advantage of simplicity. A multi-period perspective can address liquidity and tax considerations that arise from rebalancing portfolios and can also address serial correlation (long- and short-term dependencies) in returns. However, a multi-period perspective is more costly to implement than a single-period one.

READING ASSIGNMENTS

Reading 17 Asset Allocation
by William F. Sharpe, Peng Chen, PhD, CFA, Jerald E. Pinto, PhD, CFA, and Dennis W. McLeavey, CFA

LEARNING OUTCOMES

READING 17. ASSET ALLOCATION

The candidate should be able to:

a explain the function of strategic asset allocation in portfolio management and discuss its role in relation to specifying and controlling the investor's exposures to systematic risk;

b compare strategic and tactical asset allocation;

- **c** discuss the importance of asset allocation for portfolio performance;
- **d** contrast the asset-only and asset/liability management (ALM) approaches to asset allocation and discuss the investor circumstances in which they are commonly used;
- **e** explain the advantage of dynamic over static asset allocation and discuss the trade-offs of complexity and cost;
- **f** explain how loss aversion, mental accounting, and fear of regret may influence asset allocation policy;
- **g** evaluate return and risk objectives in relation to strategic asset allocation;
- **h** evaluate whether an asset class or set of asset classes has been appropriately specified;
- **i** select and justify an appropriate set of asset classes for an investor;
- **j** evaluate the theoretical and practical effects of including additional asset classes in an asset allocation;
- **k** demonstrate the application of mean–variance analysis to decide whether to include an additional asset class in an existing portfolio;
- **l** describe risk, cost, and opportunities associated with nondomestic equities and bonds;
- **m** explain the importance of conditional return correlations in evaluating the diversification benefits of nondomestic investments;
- **n** explain expected effects on share prices, expected returns, and return volatility as a segmented market becomes integrated with global markets;
- **o** explain the major steps involved in establishing an appropriate asset allocation;
- **p** discuss the strengths and limitations of the following approaches to asset allocation: mean–variance, resampled efficient frontier, Black–Litterman, Monte Carlo simulation, ALM, and experience based;
- **q** discuss the structure of the minimum-variance frontier with a constraint against short sales;
- **r** formulate and justify a strategic asset allocation, given an investment policy statement and capital market expectations;
- **s** compare the considerations that affect asset allocation for individual investors versus institutional investors and critique a proposed asset allocation in light of those considerations;
- **t** formulate and justify tactical asset allocation (TAA) adjustments to strategic asset class weights, given a TAA strategy and expectational data.