The Six Step Guide to an Effective Asset Allocation

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Determining your asset allocation is probably the most important decision you can make as an investor when constructing a portfolio. It is the foundation of which a portfolio is modelled and depending on how assets are apportioned, your portfolio can either work towards helping you achieve your investment objectives or work against your expectation.

Contrary to what some might think, the asset allocation process is NOT about allocating your pool of resources to which asset-classes (% equities, % bonds) that has the highest returns. That would be an investment fallacy that would result in a risk-return mismatch, as well as a portfolio lacking in diversification or that deviates from your objectives.

Therefore, it is imperative than an investor gets this part right first before looking at other moving parts in their portfolio.

Here is a step-by-step guide on how investors can achieve an optimal asset allocation:-

Defining your Investment Objectives

It's the first step in the asset allocation process that often gets overlooked. But really, it is the most important part that you should invest the most time with before modelling a portfolio. Asking yourself basic questions such as who am I, what your aspirations are, as well as expectations can help define your objectives. Are you a millennial looking to build and accumulate wealth to eventually move out from your parent's home? Or are you someone in your mid-50s looking to prepare for retirement and have a steady income stream?

Once you've established these answers, it's crucial then to be as specific as possible and to be able to quantify your financial objectives. Saying that you are a millennial who wants to be rich so that you can move out from your parent's home is not clearly defined enough. How much wealth do you want to build exactly? Do you prefer to rent or buy your next home? Are you a city person or are you comfortable dwelling in the suburbs?

Likewise, someone in their mid-50s will need to determine how much wealth they would like to accumulate by the time they reach retirement, as well as the rate of return % they need to achieve as a hedge against inflation.

All these considerations are important because it lays down the parameter of your investment objectives, so that your portfolio is geared towards achieving its stated purpose.

Whilst, it is possible that one could go overboard in this step and start dreaming-up fantastical or outlandish goals, it is important that you remain grounded and be realistic of what you can actually achieve. Setting expectations are important, especially when money is involved so that you don't come off disappointed.

Gauging your Risk-Tolerance

Determining your risk-tolerance is the next step in the asset allocation process. Understanding what your risk-tolerance is can also be gauged by asking yourself basic questions such as your age, monthly income & expenditure and other types of commitment you have. Different psychological profiles and imprints often determine what type of person you are and if you are a risk-taker or risk-averse.

It's critical here to separate what your risk-tolerance and risk-acceptance are, as the two gauges measure different things. For example, an investor in their mid-20s may be more inclined to take on more risk because of his youthful exuberance and more daring nature. Therefore, he has a high risk-acceptance.

But if you consider the fact, that if he is already married with a child along the way, as well as parents and in-laws to take care off, his capacity to take on risk is actually limited. As such, the investor actually has a low risk-tolerance and would not be able to stomach an aggressive portfolio that is highly tilted towards riskier asset-classes.

Time Horizon and Liquidity Needs

Next, an investor would need to determine their investment time horizon and liquidity constraints. Think of these two factors as the levers shifting the gears of your portfolio that will ultimately determine your capacity to invest and by how much.

For instance, an investor in their mid-20s who does not need the principal sum and returns back from the investment for the next 8 – 10 years would have a long investment horizon and hence a higher capacity to invest. This would allow the investor to take on more risk and be more exposed towards longer-dated instruments or riskier asset-classes that only show returns at a later stage. Such asset-classes typically include small-caps or growth stocks that are high-risk and typically exhibit strong earnings and growth only at a later cycle. Thus, investors with a shorter investment horizon should avoid such asset-classes.

Similarly, as an investor you should also assess your liquidity needs and determine how much you are willing to set aside from your wealth as investments. It's crucial that you understand that this is a separate pool of wealth that is different from your own savings account that you use for your own daily sustenance and allowance. Thus, as much as possible, you should avoid dipping into either pools of wealth and using your savings for investments and vice-versa.

You need to give time for your portfolio to work and to compound returns. Opting to cash-out from your portfolio can be disruptive to your investments especially at a crucial stage of the market cycle when it is starting to rebound. Thus, investors should remain disciplined and focused.

Liquidity is often a critical factor for most of us when it comes to investing, especially with so many different types of commitment, obligation and ongoing expenditure to meet. But it does not always have to be an impediment to investing. You can also construct an income portfolio that provides regular pay out and income distribution that will fulfil your liquidity requirements and sustain your current lifestyle.

Understanding Different Asset-classes

These are the 'building blocks' of your portfolio. There are 3 broad asset-classes for an investor to work with, i.e. equities, fixed-income and cash.

Equities are the most risky asset-class but has the potential to provide the highest returns. Common instruments include ordinary shares or equity funds that an investor can easily transact through their broker or agent.

Fixed-income also known as debt is a less risky asset-class that provides more stable but often lower returns. Investors may not be able to gain exposure to this asset-class by investing in bonds directly yet, but they can do so via bond funds.

Cash or cash-equivalents are the most liquid asset-class and typically provide little to no returns especially in inflationary periods. But they serve its importance by being extremely liquid to quickly move in and out of a market correction as well as a buffer during an emergency.

There are also other types of asset-classes including REITs, commodities, precious metals, real estate or even alternative asset-classes such as private equity, derivative contracts and futures. But more importantly, you need to really understand what it is that you are investing and the underlying asset-class of the product before deciding to include it in your portfolio.

Certain investment products and vehicles can often include complicated structures and payout definitions, but it's crucial that you ask questions to get a good grasp of what it is that you are actually investing in.

Constructing your Portfolio

Finally, you are ready to construct your portfolio. There is no single method or approach in building the 'perfect' portfolio, as each portfolio would need to be customised according to the needs and risk-profile of the investor. But there are some model blueprints that an investor can follow as a start.

For more risk-inclined investors, they can invest in a more aggressive portfolio composed of 70% - 80% in equities and the rest in fixed-income. On the flip-side a more risk-averse investor should have a higher tilt towards fixed-income of between 70% - 80% in bonds, with minimal holdings in equity and some in cash. A risk-moderate investor could have equal exposure to both asset-classes.

Underpinning all these considerations in the asset allocation process is also the simple principle of diversification that states an investor should not place all their eggs in one basket. The principle of diversification strives to minimise risk in a portfolio by investing in a mix of different types of asset-class that are not or less correlated, so that gains from one asset-class can more than offset losses from another. It is a risk mitigation technique that has been proven to outperform over the long-run by protecting against losses, whilst maintaining sufficient exposure to capture market growth.

Core and Tactical Holdings

An investor can then take one step further in building their portfolio by maintaining core and tactical holdings. This is especially for investors keen to take a view on a particular asset-class and its performance.

An investor relies on their core holding as the bedrock of their portfolio for stability. It should make up the bulk of the entire portfolio and be sufficiently diversified. The remaining portion of the portfolio can then be apportioned to a tactical holding that allows you to scope out for opportunities in the market and possibly amplify gains (or losses) in your portfolio. Suffice to say, your tactical holding has to be managed on an active basis.

But by maintaining two different holdings, an investor is able to take a more hands-on approach with their investment without risking their entire portfolio.

To illustrate, say a risk-moderate investor opts for a balanced portfolio with equal allocation to equities and fixed-income. But, the investor would also like to be weighted towards small-cap and equities in China to leverage on opportunities in global growth and strong earnings momentum from small-caps, as well as supply-side and financial reforms in China.

The investor can then build a portfolio composed of a core holding made up of 45% equities and 45% fixed income. The remaining 10% can be tactically allocated to a small-cap fund and a China growth fund that will allow the investor to take positions in these markets.

Model Balanced Portfolio

Core holdings (90%)	Tactical holdings (10%)
Fixed Income (45%)	-
• Bond Fund A	
• Income Fund B	
Equity (45%)	**Equity (10%)**
• Equity Fund A	• Small-Cap Fund
• Growth Fund B	• China Equity Fund

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