Dynamic asset allocation

What is it and why is it important for portfolio construction?

Damien Hennessy

Multi-sector portfolio managers use a range of approaches and investment styles when managing and investing money and a portfolio's strategic asset allocation (SAA) is always a major focus.

A portfolio's SAA is constructed in a way that maximises the probability of achieving a return objective over a given longer-term horizon. For example, an SAA for a typical balanced portfolio may include a 20-40% allocation to Australian equities, a 20-40% allocation to international equities, a 20-30% allocation to cash and bonds and a 10-20% allocation to other assets, including alternatives and other unlisted assets. Each investment manager manages their portfolio with the intent of keeping their allocation to those asset classes within those bands.

However, investment markets are not static. With recent events particularly front of mind, we know that markets can be extremely volatile, with assets performing differently to the longer-term assumptions used in the SAA.

This is where dynamic asset allocation comes in.

What is dynamic asset allocation (DAA)?

Increasingly recognised as a valuable portfolio construction option, dynamic asset allocation (DAA) seeks to enhance returns and smooth risk by altering the short-to-medium-term weightings to assets based on factors such as valuations, the business cycle, policy developments and other major events. It is about tilting a portfolio away from the underlying SAA—typically something fixed for a long period of time—in order to take into account major macroeconomic changes, policy developments and changes to asset valuations.

A dynamic asset allocator considers the potential risk to portfolio positions and how markets might move over a three-month to two-year horizon. Remember, the SAA for a portfolio reflects return and volatility assumptions over a 5–10-year period typically.

> **Tactical Asset Allocation**
> Tactical asset allocation (TAA) is sometimes used interchangeably with dynamic asset allocation (DAA). However, TAA generally involves decisions made considering a much shorter time horizon than DAA.

The other important thing to note with DAA is that investors should not be moving their actual portfolio positions outside of the range they would have expected from their SAA. If an investor is in a conservative portfolio, DAA does not involve taking positions that push them up into a balanced or a growth-type portfolio setting.

DAA in action

Over the past few years through the COVID pandemic, Zenith have been quite active in terms of DAA recommendations. As COVID struck early in 2020, the goal was reducing portfolio risk where possi-

ble. But as the economy and markets adapted to the risk, with central bank and government policy support, the DAA process made it possible to take advantage of these changes. The best DAA strategy at that point involved an overweight position in equities, mainly at the expense of bonds and cash.

From mid-2021, the DAA strategy has been more about trying to cut back on risk in portfolios, initially because the indicators of growth momentum had peaked but more recently because high inflation has raised the risk of central banks tightening policy to an extent that undermined the growth outlook.

The prospect of higher bond yields and extreme valuations meant reducing exposure to assets like US equities and more recently, real estate investment trusts (REITs). From a DAA point of view, it is important to identify where the risks and opportunities might be. Since the highly stimulatory policy response to COVID in 2020, the view is that inflation risks were rising, and the response was to be underweight bonds. There has also been a move to be underweight corporate credit in the belief that credit was priced for perfection and vulnerable to rising rates.

From late 2021, one of the positions Zenith adopted was a preference for Australian equities over global equities, based on relative valuations but also Australia's greater exposure to commodities. Although both markets are down, the relative outperformance of Australian equities has worked reasonably well for our clients.

Unfortunately, not everything has gone to plan. Based on our commodities view we were predicting the Australian currency would strengthen, but that has not eventuated yet. In hindsight, a more significant underweight position to equities would have benefited portfolios.

Three key things to remember about DAA

Understand the objective of the DAA program

DAA is not so much about adopting massive deviations from longer-term SAA and trying to achieve huge outperformance; rather it is about trying to enhance returns and minimise risk. For instance, a goal may be to generate a return of 50bps p.a. over an SAA benchmark over a full cycle.

A consistent process is important

It is important to not be thrown by the narratives of the day. A data driven approach and a set of rigorously formulated signals which are modelled and tested helps ensure this. Developing a range of indicators and signals over a long period of time and across different market conditions assists in the decision-making process. These are updated and reviewed day to day, week to week, culminating in a monthly DAA report. This combined with a monthly meeting with a senior investment team, where the process is reviewed and decisions and recommendations are voted on, ensures this data driven approach.

Different factors work at different stages

A combination of valuations, policy and liquidity conditions, the business cycle position and shorter-term momentum help determine DAA tilts. The factors tend to operate over different time periods; for example, markets may appear expensive on the valuation signals but may remain well supported due to policy settings and the macro backdrop. The challenge is to try to understand when or the likelihood that the policy and/or macro environment will have changed sufficiently to expose already expensive valuations. Also, to create a consistent framework within which to look at DAA.

Uncertain times

This current period is perhaps one of the most interesting periods in years for asset allocation. The longer-term drivers of the disinflation and of low and declining interest rates that have been experienced over recent decades may be in the process of changing. Demographic changes, productivity trends, de-globalisation and geopolitics tend to shape the broad growth and inflation outlook over the long term.

There are also cyclical challenges that are occurring now. Central banks are trying to deal with rising inflation through higher interest rates, However, if they push too far too soon, there is the possibility of recession risk. A DAA approach needs to be hyper-aware of these risks when it comes to portfolio positioning. That is the key challenge for asset allocation in the current environment.

What does a DAA process look like?

Understanding what DAA looks like in the real world and how it benefits investment portfolios is the first step. However, it is also important to understand what goes into DAA investment decision making with a deeper dive into the process.

Many DAA processes involve a combination of quantitative tools and a qualitative overlay. One of the key parts of a quantitative DAA strategy is formulating, developing and testing signals.

At Zenith these signals are grouped together under the following categories:

- **Valuations.** Valuation measures such as cyclically-adjusted price-to-earnings (CAPE), forward price-to-earnings (PE), equity risk premium and price/book are used for equities. For bonds, real yield levels, carry, and yields relative to GDP are used. While valuation signals are more closely associated with returns over the long term—two to 10 years—they are still important drivers of DAA decisions.
- **Policy and liquidity.** These signals tend to work best over the short to medium term—six to 18 months. Policy signals that are looked at include the level of cash rates in absolute terms, cash rates relative to recent history, and cash rates both current and prospective, relative to neutral. Also considered is central bank net tightening/lending, excess liquidity, and credit growth.

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Damien is head of asset allocation and strategy for Zenith Investment Partners. He is responsible for providing investment strategy and dynamic asset allocation services to Zenith's clients. In 2003, Damien co-founded Heuristic Investment Systems that provided investment strategy, economic analysis and asset allocation research and advice to fund managers, industry funds, wealth managers, asset consultants and financial planning groups.

The quote

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- **Macro and earnings per share cycle.** This is another short-to-medium-term signal including global and domestic growth momentum, earnings per share (EPS) revisions and momentum, and the phase of the business cycle. For example, the early recovery phase of a business cycle when there is plenty of excess capacity but growth is lifting, is favourable to risk assets. Declining growth momentum—the derivative of annual growth rates—tends to be a negative signal.
- **Price momentum.** This is a short-term signal, impacting returns over the subsequent one to 12 months. It includes one, three and six-month performance and deviation from 100- and 200-day moving averages.

The development and testing process

Zenith is continually developing and testing the different signals to use in the DAA process. Our proprietary StrategyEngine assists us in this process. It houses all the economic, market and fundamental data, as well as a range of tools that can analyse the relationship between different series. Correlation analysis, models, event and regime analysis, back testers, filters and screening and ranking tools are all used to support development of signals.

These tools help provide some indication of what might happen to the performance of a particular asset class based on particular readings for the signal. It is best to use as many indicators as possible to capture a range of factors in support of a particular decision, rather than relying on one or two key indicators. The signals used must be timely, intuitive, have some statistical basis and not be subject to significant revision.

Qualitative overlay

A qualitative input overlay helps to take into account probabilities of switching to alternate investment regimes, for instance, inflation/growth, as well as non-numeric events such as pandemics, trade wars and geopolitical risk.

The qualitative overlay includes the identification of plausible alternate investment scenarios for the next 12 months for which Zenith estimate return expectations and attach probabilities to.

For example, a qualitative overlay in the current environment would consider the likelihood that higher than expected inflation and rising interest rates leads to recession.

Importantly, while a qualitative input might alter the quantitative signals' suggested position, it rarely contradicts it.

Conclusion

DAA is an important tool that can add value to multi-manager portfolios. Rigorous quantitative modelling ensures that there is a consistent framework for decision making.

Combined with a qualitative overlay, Zenith believes that it has developed a process that gives investors a sound and robust framework for enhancing returns while seeking to minimise risk. **FS**