Spotlight

The importance of Strategic Asset Allocation in times of declining financial markets

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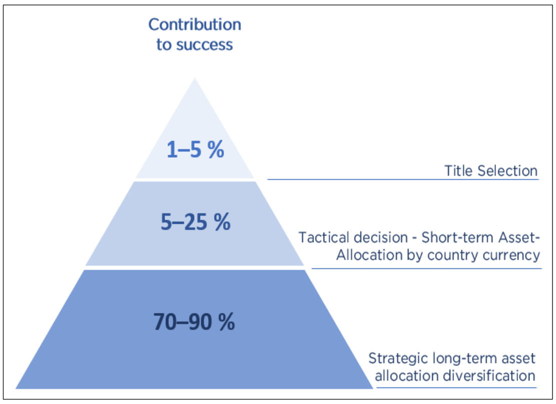
The definition of a coordinated Strategic Asset Allocation ensures that investments develop in line with expectations and protects against unpleasant surprises

Asset allocation refers to the allocation of the overall portfolio to various asset classes such as equities, bonds, currencies, or alternative investments. Individual risk tolerance and -ability, investment horizon and liquidity requirements are taken into account. The Strategic Asset Allocation (SAA) is derived from this, which defines the 'normal positions' for the various asset classes and markets over a longer period of time. A distinction is made between this and the Tactical Asset Allocation (TAA), which aims to benefit from current trends and movements in the markets by changing the percentage weighting of individual asset classes.

SAA is of the utmost importance for long-term investment success. Various studies show[1)] that strategic asset allocation has by far the greatest influence on the long-term success of the investment approach.



Equity selection, i.e. the selection of individual equities or bonds that perform better than the market as a whole, as well as tactical allocation in response to short-term market movements, also contribute to investment success, but with a lower significance. Nevertheless, many investors pay comparatively little attention to the strategic orientation of their portfolios. If a serious approach is taken when defining the strategic asset allocation - i.e. with consistent consideration of the input factors (risk, investment horizon, liquidity requirements) - it is possible to navigate successfully despite unavoidable price declines, even in times of major distortions in the financial markets such as those we are experiencing these weeks. In recent weeks, investors have had to bear the unpleasant 'consequences' of insufficiently well coordinated asset allocation. Some of these problem areas will be briefly discussed below:

Insufficient consideration of liquidity needs

The liquidity requirements exist independently of the developments on the financial markets. In defining the SAA, it is therefore important to ensure that liquidity needs are covered by regular payments of dividends, interest, etc., as independently of market developments as possible. An excessively high proportion of illiquid investments (e.g. real estate, private equity, private debt, hedge funds) and a lack of consideration of, for example, the level of dividend payments will sooner or later lead to liquidity bottlenecks and thus to the need to sell securities - in crises, at the 'worst' moment.

Excessive leverage of investments (leverage)

Quite a few investors have been confronted with capital calls from their banks in recent weeks. Partly due to the continuing bull market, existing portfolios were borrowed against in order to make additional investments in anticipation of further price increases. The sharp price corrections in recent weeks have led to significantly lower lending values, prompting lenders to call for additional funds to cover their loans (margin calls). If these funds cannot be made available at very short notice, the Bank liquidates corresponding positions in the portfolio to cover them - naturally against the background of market weaknesses at very low prices and corresponding losses. The issue is further accentuated by the behaviour of banks, which 'unexpectedly' adjust their loan-to-value ratios downwards during the market weakness. These problems can largely be avoided by taking appropriate account of the so-called risk capacity in the SAA.

Missing re-balancing

Once defined, a strategic asset allocation provides bandwidths for the various asset classes. Over time, fluctuations in the value of the individual positions lead to changes in the investment structure. For example, the sharp rise in share prices in many portfolios in the months prior to the crisis led to a significant increase in the proportion of equities - and thus in risk. In a disciplined investment process, appropriate reviews are carried out regularly and then, if defined deviations (e.g. 3%, 5%, 10% - to be determined individually, also taking into account the transaction costs incurred) from the originally defined SAA are exceeded, the originally targeted weightings - and thus the desired risk/return profile - are restored by means of appropriate purchases and sales. In the current market development, shares would therefore have been sold at a high price level thanks to the rebalancing before the crisis.

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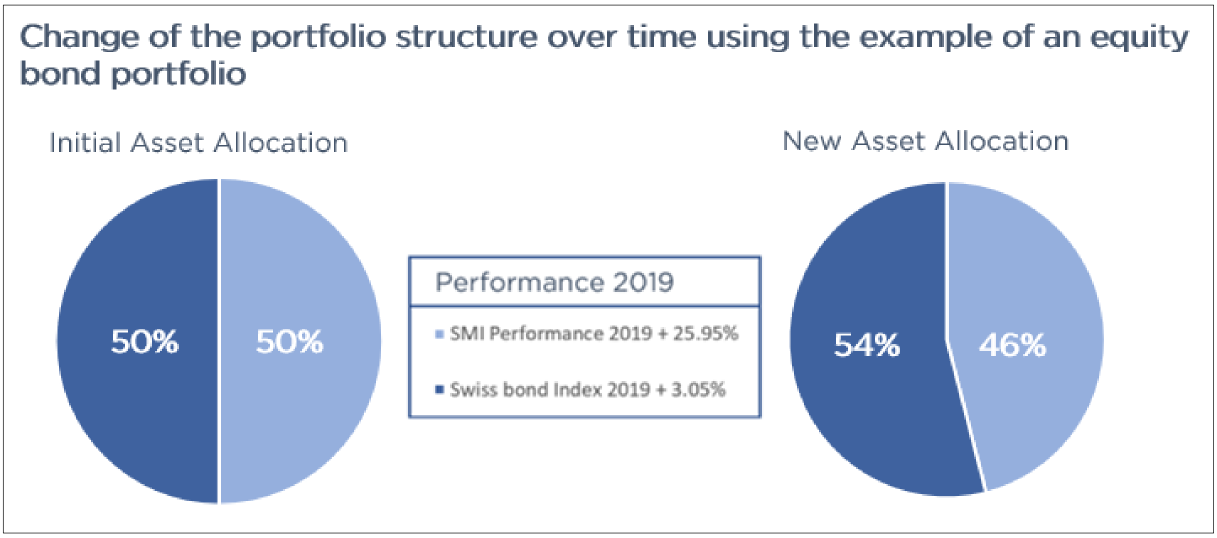
The chart below illustrates the 'market-related' change in the weighting of the asset classes for 2019 using the simplified example of a portfolio with originally 50% SMI equities and 50% Swiss bonds.
Where a rebalancing process with a relatively narrow deviation tolerance existed, the equity component was reduced even before the 'corona crisis'. Or, this process has been overridden (and has not been executed) by 'personal' or 'emotional' assessments - with corresponding negative consequences in recent weeks.



Conclusion

The importance of a well-coordinated Strategic Asset Allocation (SAA) - taking into account input factors such as individual risk appetite and ability, investment horizon and liquidity requirements - was confirmed once again in the 'corona crash' of recent weeks. Although the SAA does not offer protection against market-related performance losses either, it does protect against unpleasant surprises, especially in crisis situations. What is important is a disciplined process to ensure that the principles defined in the SAA are not overridden by 'emotional' decisions.

We would be happy to assist you in the implementation or review of your Strategic Asset Allocation.

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