

Dynamic Strategic Asset Allocation

Recent events have provided a timely reminder that investment markets can often behave in an erratic, unpredictable fashion. Institutional investors have been hit hard, and many are asking whether there was any way that the turmoil could have been predicted, and preventative action taken. Not surprisingly therefore, in recent times we have seen a surge of interest in Dynamic Strategic Asset Allocation.

Introduction to Dynamic Strategic Asset Allocation

- Almost all super funds and other institutional investors have a long term Strategic Asset Allocation (SAA). The SAA describes the asset exposures that the fund aims for, to achieve its risk and return objectives. There is nothing controversial about this—after all, everyone needs a map if they want to arrive at their destination.
- Almost always, the SAA is set with a *long term* timeframe in mind. “Long term” means different things to different people, but when Watson Wyatt uses this term, we are typically referring to periods of at least ten years.
- Of course, funds do not set their SAAs and leave them unchanged for ten years. As the investment environment changes, as new opportunities emerge, and as fund objectives evolve, it is common-practice to review the SAA and to make adjustments to reflect these changes. Traditionally these adjustments would be made using the same long term timeframe that was originally used to develop the SAA. But increasingly, funds are now also changing their asset allocations with shorter term time horizons in mind. Watson Wyatt uses the term *Dynamic Strategic Asset Allocation (DSAA)* to describe this.
- More specifically, DSAA (the way we define it) aims to capitalise upon medium term opportunities in investment markets. History shows us that markets do not always get things right. Factors such as emotion, politics, misaligned incentives, and knowledge gaps conspire to make markets susceptible to booms and busts. DSAA seeks to exploit, or protect against, these market extremes.



How does DSAA differ from Tactical Asset Allocation?

It is important to differentiate DSAA from Tactical Asset Allocation (TAA):

- TAA aims to make profits by predicting the movements of investment markets over *short term* periods—often measured in weeks or months. TAA is typically implemented by investment managers (often hedge funds), and TAA positions are implemented only in liquid asset classes—by taking either long or short positions.
- By contrast, DSAA decisions are made with a longer time horizon in mind. Decisions are typically made and implemented by the fund fiduciaries rather than investment managers, and DSAA positions tend to be long only exposures in both liquid and illiquid asset classes, although the time horizon and level of conviction required is likely to be longer for illiquid asset classes.

Long term SAA, DSAA, and TAA are compared in Table 1 below.

Watson Wyatt's DSAA framework

Watson Wyatt has invested substantial resources in building a robust, globally integrated DSAA framework. Its key features include:

- **A medium-term (3 year +) time horizon.**

It is important to note that this does not mean that funds will always have to wait three or more years before their DSAA decisions will bear fruit. Far from it. Some DSAA decisions will have pay-offs over considerably shorter periods. However, the timeframe recognises that mispricings in investment markets (in either direction) can persist for lengthy periods and so investors need to have patience to reap DSAA rewards. They also need to accept that extreme mispricings can become even more extreme before they correct. In fact, this is one of the reasons why we believe that such medium-term opportunities do exist—very few organisations have the ability to tolerate underperformance for several years, and so the absence of market participants willing to 'stay the course' over such a time horizon means that occasional, but significant, anomalies will occur.

- **A focus on unsustainable pricing anomalies and new opportunities.**

We are seeking to identify two main types of DSAA opportunities:

1. unsustainable pricing anomalies based on our assessment of valuation and the fundamental return drivers for each asset class and the associated risks; and
2. new opportunities expected to perform well in current/emerging conditions, and that offer significant diversity.

We expect compelling opportunities to occur with a relatively low frequency. Therefore, in order to have confidence in the overall outcome from taking on a DSAA position, we need to have a high degree of confidence in the 'signal', so that we can be more confident that the actual outcome will be consistent with our prediction. As a result, we look for a strong signal, e.g. a mispricing of 'two standard deviations' from true value.

Table 1 | Long term SAA, DSAA and TAA comparison

	Long Term Strategic Asset Allocation (SAA)	Dynamic Strategic Asset Allocation (DSAA)	Tactical Asset Allocation (TAA)
Timeframe	10 + years	3+ years	Months
Breadth	Generally extends to all asset classes	All asset classes. Generally long only	Liquid assets only. Long and short
Implementation	Funds implement directly	Funds implement directly	Funds implement via institutional managers and hedge funds
Focus	Risk, return, liability profile, cashflow and funding requirements	Risk and return	Return

■ **DSAA decisions can take several different forms.**

The traditional method of implementing DSAA-type decisions has been by ‘tilting’ the fund’s asset allocation towards or away from certain asset classes. Watson Wyatt believes that this traditional approach can be expanded to include a number of additional forms of implementation, including investing in specialist or niche products designed to:

- Provide exposure to a specific sector of an existing asset class (e.g. investment grade credit)
- Provide access to a new or niche risk premium (e.g. catastrophe insurance)

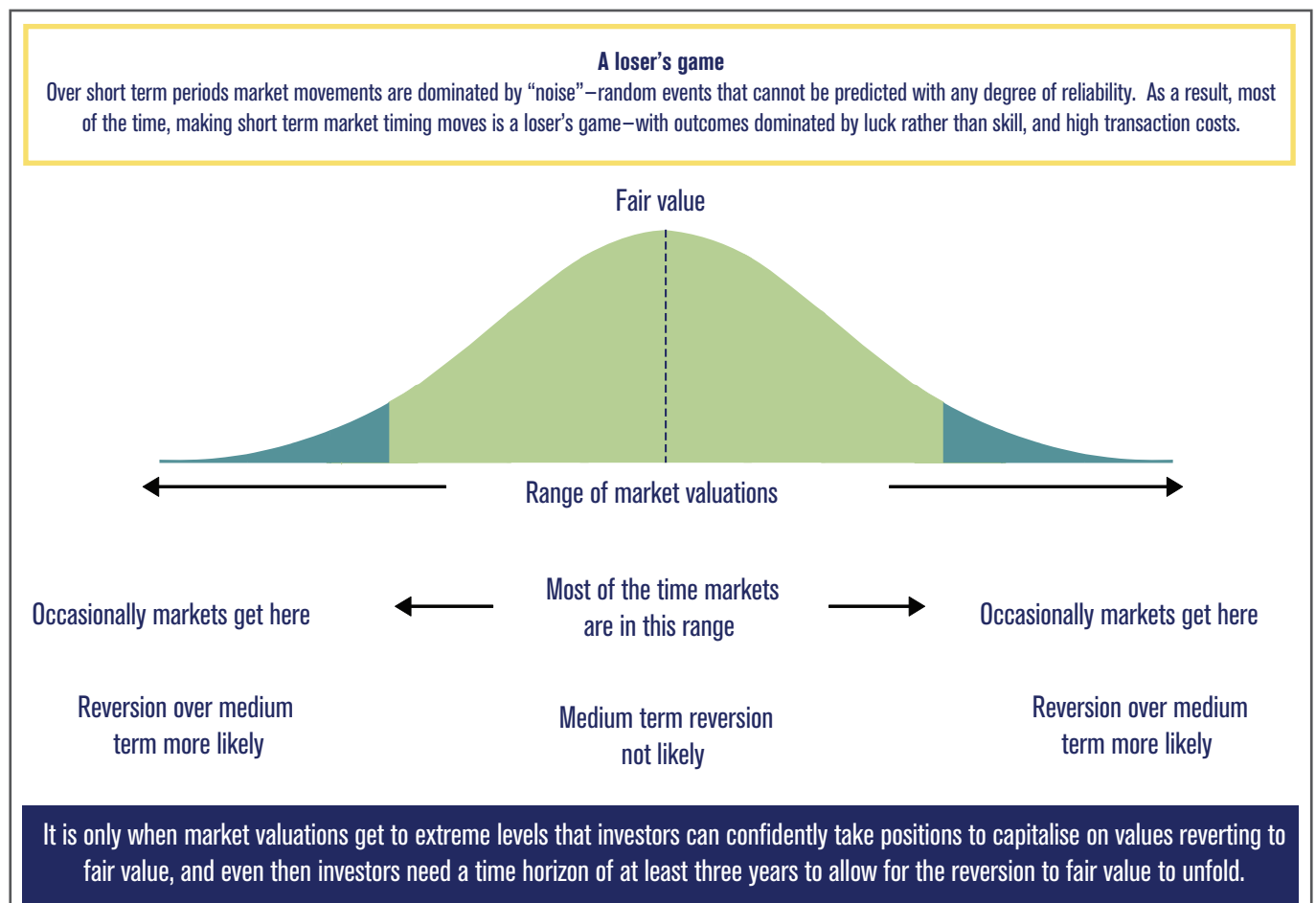
- Benefit from a macro trend or theme (e.g. the greater rates of productivity and economic growth in emerging economies)
- Provide downside protection (or indeed upside payoff) in the event of a sharp fall in a particular market (e.g. at the height of the tech boom)
- Exploit pricing anomalies between listed and unlisted markets (e.g. physical securities and synthetic exposures); or
- Invest in an emerging asset class (e.g. carbon credits).

We believe the probability of success can be increased by focussing on opportunities, that cannot easily be exploited by other market participants, or where an investor may be able to have greater insight, as well as seeking to exploit first mover advantage when opportunities arise.

■ **An equal focus on implementing DSAA positions and subsequently removing these positions.**

It is important to note that each DSAA position requires two decisions—when to establish the position and when to take it off. In our experience, it is tempting to pay more attention to the former decision than the latter. A well-developed, consistent decision framework is required for both of these decisions.

Chart 1 | DSAA opportunities will present themselves relatively infrequently



Making effective DSAA decisions

Effective DSAA decisions require a blend of macroeconomics and asset class valuation analysis.

On the macroeconomic front, a fund needs to form a view about the long term secular economic picture, as well as more medium term economic and market cycle dynamics. But more than this, the fund also needs to form a view on the extent to which current pricing across a range of investment markets reflects this economic outlook and the underlying value of assets given this outlook.

This process is, of course, not straightforward—and requires the rigorous application of a consistent framework over time, covering a broad range of economic and valuation measures. In addition, the relative importance of the various economic and valuation measures will vary over time as conditions change. Examples of such measures are shown in Chart 2 and 3.

Chart 2 | Macroeconomic indicators (selected for current economic/financial environment)

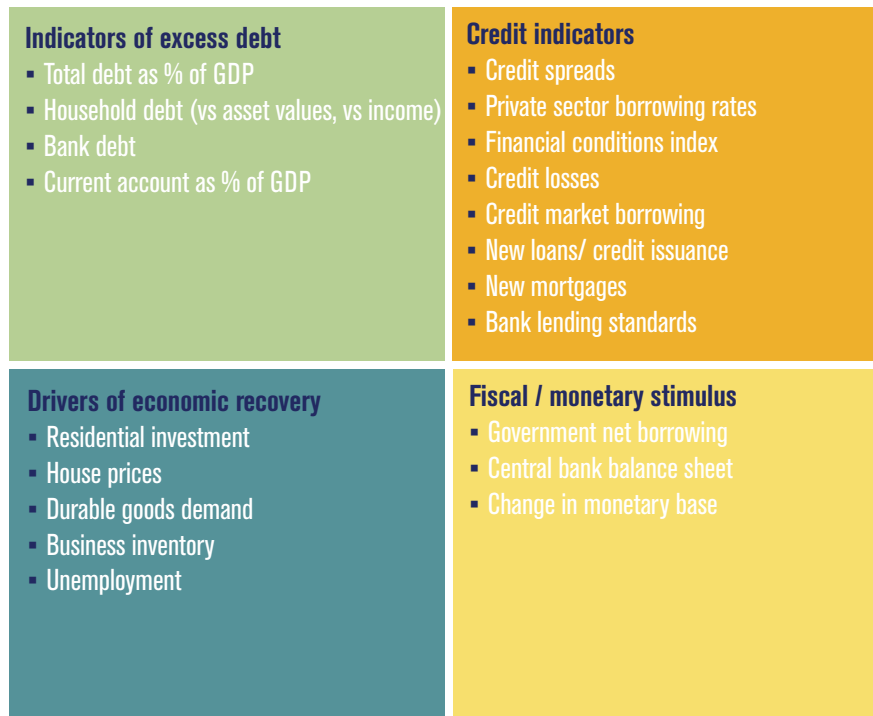


Chart 3 | Asset class valuation indicators

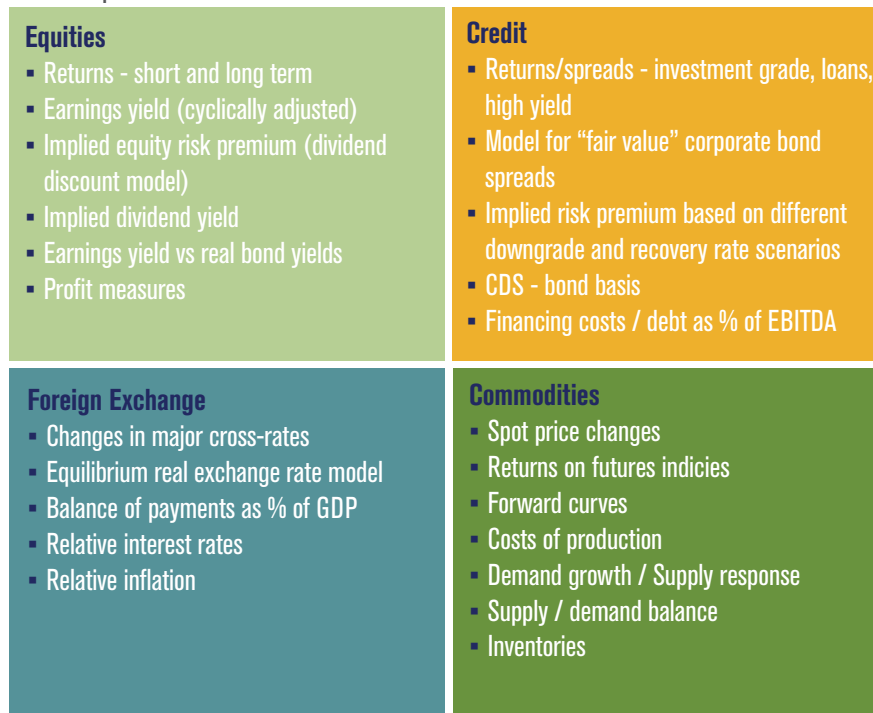


Table 2 | Long term SAA, DSAA and TAA comparison

Source of risk	% of risk budget
Long term SAA (“beta”)	65%-85%
Active management (“alpha”)	5%-15%
DSAA	10%-20%

How much of the risk budget should be allocated to DSAA decisions?

Clearly, the objective of DSAA is to have a meaningful impact on the risk and return outcomes of a fund's investment process. Careful consideration is therefore required in setting the size of DSAA allocations. On the one hand, funds might argue for a relatively large allocation, so as to ensure a meaningful impact on portfolio outcomes. On the other hand, if DSAA allocations are too large, they can begin to dominate the active risk within the portfolio. This is especially the case in respect of DSAA positions that are based on a single hypothesis about the future pricing of an asset class.

Watson Wyatt's view is that for most institutional investors, the 'sweet spot' total allocation to DSAA-type positions is likely to be in the range 5%-15% of the portfolio. Ideally, there would be several different DSAA positions within a portfolio at any point in time, with no more than around 5% of the aggregate fund capital allocated to any single position. On this basis, in a growth-oriented investment portfolio that also included a diversified active management program, the composition of the risk budget might be as shown in [Table 2](#).

We would suggest that the expected net reward for a *well implemented* DSAA allocation of this size could be expected to be long term outperformance of the SAA of 1%-1.5% pa, with a standard deviation of around 2%-4%pa.

Governance

As noted above, the objectives of DSAA are to identify asset class mispricings that are likely to correct (i.e. revert to fair value) over a timeframe of around three years or more, or investment opportunities that are likely to profit over a similar timeframe.

However DSAA is not easy—to implement it well requires:

- Sufficient opportunities (and/or recognising the impact of a narrow scope of opportunities).
- A very broad range of inputs and analysis.
- A sound, consistent, basis for making decisions.
- A tolerance for short term (and indeed medium term) underperformance.

In short, an effective DSAA program requires *strong governance*. There are a number of such governance models ranging from internally resourced teams and decision making structures, to largely outsourced models. The most appropriate model for a fund depends on the skills, resources, and beliefs of the fund, as well as the degree to which the fund's governing body is willing to delegate the decision.

Conclusion

DSAA is simply another source of risk and return that can be used in the investment process. We believe that a well structured DSAA program can deliver rewards in the form of risk reduction and/or return enhancement, but it is by no means guaranteed to do so.

Like every other aspect of the investment process, a successful DSAA program requires decisions to be made on the basis of a well defined, rigorously researched, and sustainable framework.

Further information

If you would like to discuss any of the areas covered in more detail, please contact your usual Watson Wyatt consultant or:

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June 2009

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