MY ASSET ALLOCATION

WHY JUDGING WHAT IS CHEAP AND WHAT IS EXPENSIVE IS NO LONGER AN EASY TASK

The difficult asset allocation decision as we approach late 2011 centres around sovereign fixed income.

Asset allocators are often instinctive contrarians and – apart from some insolvent European sovereigns – the asset class appears fully priced and in the case of high grade sovereigns, at historic levels.

Surely at such a time, most asset allocators are moving portfolios away from these ‘expensive’ assets and towards those most think are ‘cheap’? Should active asset allocators be contemplating more than a mere sliver in fixed income when so many commentators are describing equities as cheap today?

This is where allocators must balance making strong commitments to asset classes that look promising with retaining diversified portfolios. However, the corollary to this is that a portfolio that diversifies away the opportunities in each asset class because dampening down volatility has been emphasised at the expense of return is an exercise in futility. How then to create meaningful allocations with diversification at a time when one central asset class looks undesirable?

The first step is to take a sceptical look at what commentators are describing as ‘cheap’ and as ‘expensive’. The problem with cheap asset classes, we find, is that their cheapness is only really visible in hindsight.

For the past few years, US Treasuries have looked expensive and yet, in retrospect, they were cheap. This encapsulates the conundrum with fixed income. One part of the investment universe thinks the world is coming to an end and that only the 30-year bond is worth having, every other asset being capable of being destroyed by a puff of wind. The other part thinks sovereigns are a bubble that is about to collapse, and that equities now are cheap.

Standing back from this dichotomy, we prefer to look for assets we think are fairly priced: equities, for instance. We are similarly circumspect about real assets. Although emerging market real estate looks fully priced in some areas, some OECD real estate looks fairly valued. Both, then, get a significant, but not a starring role, in our asset allocation. In cash-like assets, we continue to emphasise good macro traders, both systematic and discretionary. Our asset allocation gives sufficient room to these asset classes without betting the farm on them.

Meanwhile, we retain an interest in fixed income because although we cannot describe fixed income as cheap, it might well be viewed as fairly priced given the uncertainty we face. In that sense, it remains a useful element in a 2011 portfolio.

In summary, our asset allocation decision on fixed income is that you need to own some of this asset – but not a lot. Evidently, there are no guarantees that yields will fall further but if they don’t, it will be because other elements of the portfolio have performed well. If yields do fall further – and the history of the past few years suggests this is by no means impossible – any portfolio owner would be pleased to have had fixed income in their allocation.

Again, the key here is not overemphasising the cheap and ruthlessly excising the expensive. Rather it is seeking a balance of assets that appear to us to be fairly priced. This is not an asset allocation that will endure over the long term – dynamic rebalancing is required frequently, particularly at a time of economic flux. Once we have some clarity on how the indebtedness of nations will play out then we will re-evaluate the situation. But for now, fixed income remains a small but significant player.