

The practice of asset allocation refers to high level investment decisions. Rather than deciding between one equity and another, or between one bond and another, which is generally referred to as stock selection, asset allocators are tasked to choose between broad asset classes. Thus the process of asset allocation involves choosing between equities, bonds, property, cash and currencies. And within each of these asset classes, asset allocation decisions will need to be taken between for example, UK and US equities, or between government bonds and corporate bonds.

Asset allocation practitioners: Asset allocation is generally practiced by investment professionals who manage balanced portfolios, that is, portfolios that combine the broad asset classes. Life assurance companies employ asset allocation techniques to manage the multi-asset class portfolios which they use to back their life funds. Some investment management companies offer balanced funds to institutional and retail clients and therefore also need to make asset allocation decisions, while pension investment consultants typically advise pension fund trustees on the appropriate mix for their pension fund assets.

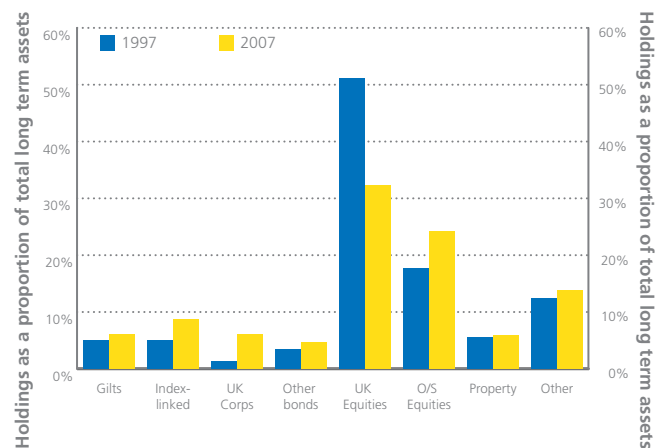
Strategic versus tactical asset allocation: We can draw a distinction between strategic asset allocation (SAA) and tactical asset allocation (TAA).

SAA: The purpose of SAA is to determine the basic investment benchmark. This will begin by identifying the return objectives of the fund and the risk tolerance of the fund's investors. Asset classes then have to be combined to produce the optimal mix of return and risk given these objectives. To do this, the asset allocator will often have to come to a view about the likely return prospects of each asset class over the very long term (see Long-term asset class returns), the likely risks associated with these asset classes and the return correlations between each asset class over the same period. Once these estimates have been made, asset allocators can construct an efficient frontier to determine the optimum mix of assets. This optimal mix will form the strategic benchmark asset proportions.

TAA: The strategic benchmark represents the strategic objectives of the fund. TAA is the asset allocation process that attempts to take advantage of short-term fluctuations in markets. For instance, the strategic benchmark proportions may be 50% in equities and 30% in bonds. However, if the asset allocator believes that bonds are overvalued with respect to equities, they may, for example, allocate an additional 2% of the fund to equities, by selling an appropriate amount of bonds. Thus the fund would be overweight equities by 2% and underweight bonds by 2%, relative to the strategic benchmark. Thus the purpose of TAA is to add value to the fund over and above the return expected from the strategic asset class positions that were determined by the SAA process.

Pension funds and asset allocation: The chart below shows how the holdings of the UK's Defined Benefit pension schemes have changed over a ten-year period from 1997 to 2007. Compared with 1997, UK pension funds now hold relatively less in UK equities, balancing this with higher holdings of overseas equities and bonds. (see Trends in Pension Fund Management).

UK DB pension fund holdings as a proportion of total long-term assets



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