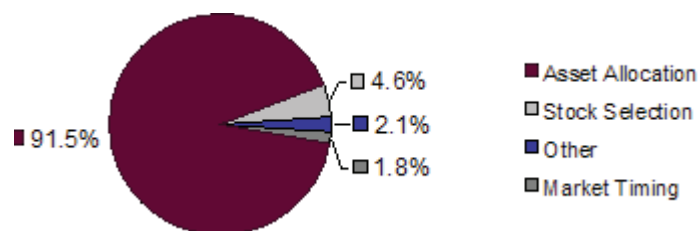




THE IMPORTANCE OF ASSET ALLOCATION

Traditional money management with its emphasis on fund or share selection to try and 'beat the market', has been eclipsed by the 'Modern Portfolio Theory' with its emphasis on diversification and asset allocation. The goal is no longer to beat the market, but rather to devise appropriate long term strategies that will allow you to move your financial goals with the least amount of risk. These strategies do not fight the capital markets so much as intelligently work alongside them and in our opinion are likely to produce more superior returns whilst offering significantly less volatility along the way.

Research has shown that asset allocation is the most important determinant of variation in investment return, far outweighing other factors like market timing and security selection. This means that the mix of asset classes (equities, bonds, cash and alternatives) in a portfolio is likely to drive long-term results much more than the decisions made within those asset classes – for example about which equity fund to hold. According to the Brinson study published in the Financial Analysts Journal in the early 1990's, as much as 91% of the variability of a portfolio's return may be attributed to its asset allocation policy. This led on from Harry Markowitz's 'Modern Portfolio Theory', published in the 1952 Journal of Finance. Markowitz went on to receive the Nobel Economic Prize in 1990, along with Merton Miller and William Forsyth Sharpe for their work in this arena.



Source: Brinson, Singer, Beebower, 1991

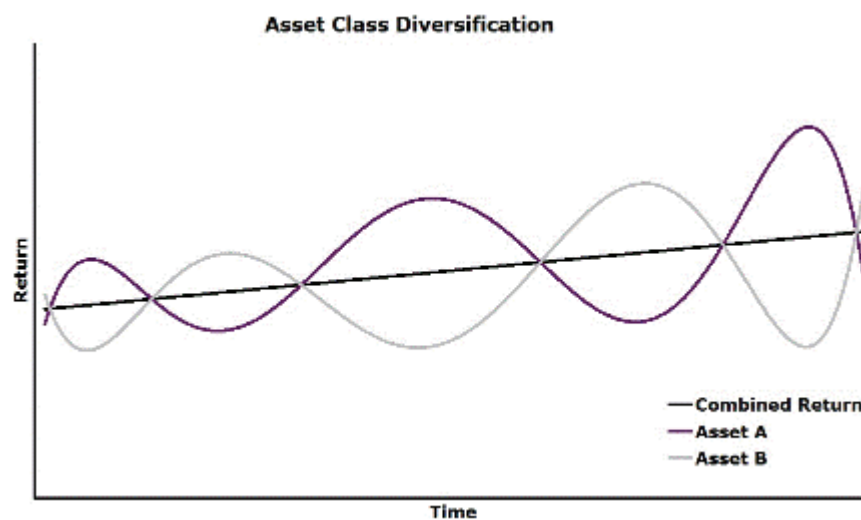
Further studies by Ibbotson Associates et al 2000 also showed that 91% of investment returns were derived from asset allocation, where stock selection only delivered 5% of returns, market timing 2% and other factors 2%.

The importance of asset allocation is reinforced by the Myners Report of March 2001 into institutional investment in the UK, commissioned by the Chancellor of the Exchequer. Part of the review defined best practice codes for pension fund decision-making, one of which stated: "The attention devoted to asset allocation decisions should fully reflect the contribution they can make to achieving the fund's investment objective".



It is now generally accepted that strategic asset allocation is by far the most important determinant of portfolio performance. This is the process of allocating your capital across a range of different asset classes, such as cash, fixed interest, property and equities. This is not simply a question of diversification, although

spreading risk amongst different asset classes is clearly important. The optimum split between these asset classes depends on your personal objectives for the portfolio and on the risk of failure that you are prepared to take over your chosen timescale.



The graph shows that holding two assets which are not positively correlated smoothes the overall return of the investor.

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Correlation and Diversification

You may be familiar with the broad concept of sensible diversification in investments, either within an asset class or across asset classes, to reduce specific risk to any one company or market experiencing problems: “Don’t put all your eggs in one basket”. Understanding the correlation between returns from different assets helps to diversify risk in a portfolio in an efficient and effective way. Simply put, there is very little real diversification achieved if we combine two asset classes whose expected returns show high correlation to each other.



Far better to combine asset classes which have appealing long-term risk and return characteristics in their own rights, as well as a relatively low correlation with each other: assets that behave differently at any point in the economic cycle, or are to some degree independent of the cycle. That way, if one asset falls at any point, there is a reasonable chance that the other may not, thus providing some protection and reducing volatility of returns for the portfolio.

Therefore, combining asset classes which show less than perfect correlation results in a diversification benefit.

The positive result of combining assets with relatively low correlations into an efficient portfolio should be that, for any level of risk, a well-diversified portfolio could have potential for a higher level of return. Equally, for any desired level of return, a well-diversified portfolio should be able to achieve it with lower risk – with less volatility. This should be attractive as price volatility can be unsettling and reducing that volatility gives a greater likelihood that investors can stick to their long-term strategy and realise their goals.

Correlation and Diversification can be implemented in three distinct ways:

Diversification across asset classes

The major asset classes – shares, bonds and cash – perform differently under different market conditions. Historically, no single asset class has consistently outperformed all others every year. So by investing across a variety of asset classes you may be able to reduce the volatility of your portfolio return.

Diversification across markets and regions

It is also valuable to spread your exposure within each asset class across a wide range of countries, currencies, industries and stocks. This global approach ensures that your investment is not narrowly concentrated in a particular region or industry, and helps to reduce the impact of a regional or industry downturn.

Diversification across investment management styles

Different investment management styles also tend to excel at different times under different economic and market conditions. By combining a range of investment managers with complementary investment styles you may be able to neutralise the bias to any one style in each asset class.

