Asset Allocation in UOBAM

In this and forthcoming issues of Fund Focus, we introduce investors to the various investment units in UOB Asset Management Ltd (UOBAM). We hope to help investors understand how we think about the financial markets. Most of our investors are probably familiar with our investment philosophy but may not know what it means in practical terms. What is it we look for when we make our investment decisions? What are the factors which drive our investment calls? What are we focusing on in the current environment?

We kick-off with UOBAM's Asset Allocation unit. The Asset Allocation team looks at the global economy and financial markets from a top down perspective. Its role is to provide a macro anchor for the other UOBAM teams in the positioning of their portfolios.

Why Asset Allocation matters?

Asset Allocation is a fundamental investment decision. Deciding how much a portfolio to invest in the different asset classes – equities, fixed income, commodities – can significantly affect the return of a portfolio, in fact more so than the selection of individual securities.

Before we move further, let us sort out a potential confusion. Every investor has his own personal asset allocation, based on his individual risk profile. A person who has just entered the workforce typically holds more equities and lesser bonds than someone who is retired. This type of asset allocation is a "mean-variance optimisation" decision, which is the basis of modern portfolio theory. For any given level of expected risk, there is an optimal mix of equities, bond and commodities that an investor could hold. As risk profiles usually only change gradually, mostly with the passage of time, asset allocation revisions are therefore usually small. Investors who are familiar with our Growthpath portfolios will recognise these asset allocation features.

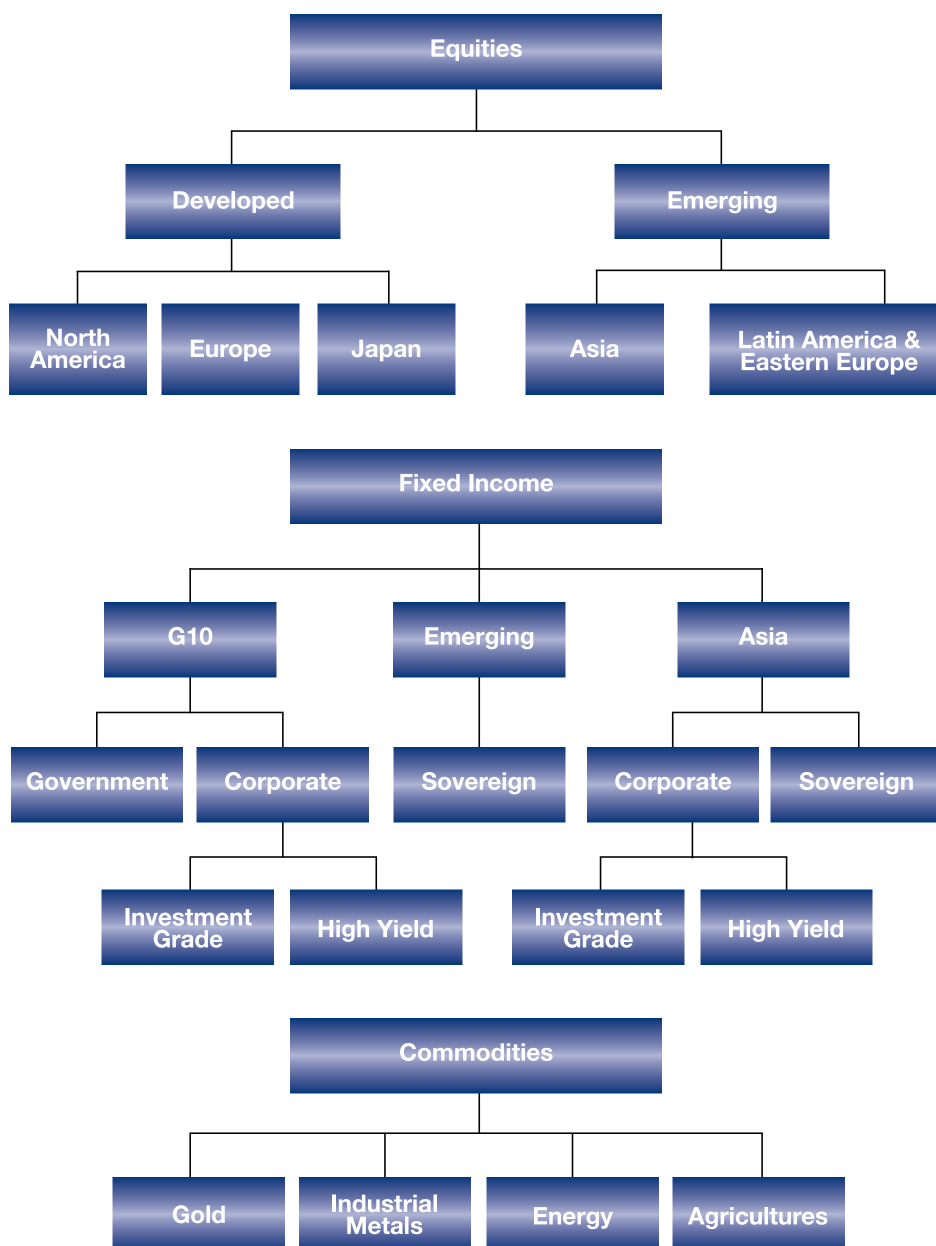
The type of asset allocation we describe here is different. It is commonly known as *Dynamic* or *Strategic Asset Allocation*. It refers to strategies that adjust the allocations in portfolios in response to changing market conditions.

Going back to the question of why Asset Allocation matters, empirical studies have shown that the Asset Allocation decision accounts for about 90%[1] of the variation in returns between different portfolios. A simple way to understand this is to consider an equity bear market. The definition of a bear market is a sustained broad decline across the market. In other words, it is very difficult to find a meaningful number of stocks whose prices can rise during a bear market. Similarly, in a bull market, it is common to find the prices of the majority of stocks rising.

From an asset allocation point of view, you could say that, within each asset class, the similarities are greater than the differences. It is because of this inherent feature of asset classes that the first decision we make in the management of portfolio is the asset allocation one. How much equities? How much bonds? How much commodities? How much cash?

What asset classes do we look at?

The UOBAM Asset Allocation team focuses on three main asset classes - equities, fixed income and commodities. We break down these broad classes into more specific markets.



[1] *Source: Ibbotson Associates, The Role of Asset Allocation in Portfolio Management, 1 June 1994*

What drives our Asset Allocation decisions?

We believe that the different asset classes have a high likelihood of outperforming at different stages of an economic cycle. As the global economy moves through its phases of expansion and contraction, we expect different asset classes to respond in characteristic ways to the shifts in outlook for economic growth, earnings, inflation and interest rates. 2008 was a classic example where we saw the growing risk of a deep global recession leading to a massive underperformance for equities and the strong outperformance of government bonds. So far in 2009, equities have outperformed government bonds in line with indications that the worst could be over for the global economy.

Financial markets are forward looking and move in anticipation of what lies ahead. Of course markets can frequently get things wrong and as a result there is often volatility in markets, especially so in the current environment. Investors who aim for quick short-term profits also add to day-to-day swings in markets. The Asset Allocation team does not attempt to trade these bounces and dips but concentrates on identifying the critical turning points in markets. Given that the global economy is our starting point, the Asset Allocation team monitors a wide range of economic and financial indicators. The main ones are described as follows:

i. Real Economy

In the developed economies, a comprehensive range of economic indicators is available for investors to monitor. They includes property prices, unemployment claims, retail sales, lending standards, copper prices, durable goods orders, industrial production, capacity utilisation, producer prices, and so on. The economic data is reliable and it can often trigger large moves in markets. In the emerging economies, the data that is available is not as comprehensive and perhaps also not nearly as reliable.

We monitor a large number of economic indicators every day. They form the basis of our assessments of the global economic outlook. No two economic cycles are alike and depending on the circumstances, we pay more attention to some indicators than others.

We are currently monitoring US retail sales to provide confirmation that the US economy is likely to return to positive growth in the third quarter of 2009. The recent pick up in production appears largely to be driven by a rebuilding of inventories. For the recovery of the economy to be sustained, final demand must also improve.

We are also tracking demand in the Emerging Markets. When thinking about any economic recovery, two useful milestones are the return of an economy to its trend growth level and the closure of its output gap (the amount of slack in the system). We believe that China could be the first major economy to return to its trend growth levels given the strong increase in credit growth and fixed investment. China retail sales also appear to have good momentum behind them.

ii. Inflation

Inflation is a key concern of central banks and therefore of financial markets. Too much of inflation is a bad thing while having none of it, which is deflation, is also a bad thing. When prices are rising rapidly, inflation expectations tend to be stoked and this can lead to a wage-price spiral. When prices are falling, households and corporates tend to delay their purchases as they expect prices to fall further.

Inflation spiked sharply in the first half of 2008, as food and energy prices reached record levels. The plunge in commodity prices in the second half of 2008 reversed the picture and a number of countries had close to zero or even negative inflation. However, inflationary fear has returned as commodity prices have picked up again. There is also a degree of unease in the market about the aggressive manner in which central banks have flooded the system with liquidity since the start of the credit crisis and the potential longer term consequences of this for inflation.

For now, we do not expect inflation to pick up to any worrying extent in the developed economies because there is a lot of spare capacity. Wage pressures tend to be subdued when unemployment is rising. We are more concerned about the potential for inflation to pick up again in Asia. Energy prices form a large part of the consumer price index in Asia and in our view inflation would be a problem once more if oil prices head towards US$100/barrel.

iii. Policy Response

The market pays intense attention to what policy makers say and do. During the most turbulent months of the credit crisis, policy response was the major driver of financial markets. The response of policymakers to the crisis has been to employ a mixture of conventional and unconventional policies. By and large, it would appear that central banks and governments have succeeded in stabilising the financial system and also in preventing the global economy from sliding into a prolonged slump.

However, in their efforts to stabilise the system, a number of central banks embarked on various programmes to purchase financial assets, such as government debt and mortgage securities. This huge expansion of the central banks' balance sheets, in particular, that of the US Federal Reserve, is of concern. The asset purchases are not yet completed but the way in which the central banks will execute their "exit strategy" will affect financial markets.

For the near term, the market is focussed on how quickly policymakers will 'normalise' policy interest rates, that is, raise them from the current very low levels. The interest rate futures market has moved to price the first raising of interest rate by the US Federal Reserve within 12 months[2] but we do not believe this is likely. We see a greater likelihood of interest rates being raised only when jobs are actually being created in the US labour market.

iv. Currencies

Many factors affect the currency markets. Interest rates usually play a large role in influencing currency moves. In the present environment where key policy interest rates around the world are all approaching zero, other factors have become more important.

One concern of the market is the US dollar. During the crisis months, the US dollar was supported because investors sought liquidity and safety. With the return of a more stable environment, investors are now focused on deteriorating US fundamentals, in particular the expanding US fiscal deficit.

Most G10 governments have announced large fiscal spending programmes to support their economies and in the coming few years, most of their fiscal positions will deteriorate as a result. The reason why the US dollar is more vulnerable is because of the greater dependence[3] of the US on foreign investors to finance the government debt.

We believe that the reserve status of the US dollar will protect it from collapse but the possibility of high volatility in currency markets cannot be ruled out. Confidence in a currency can be undermined if policymakers, intentionally or unintentionally, display neglect for the value of their currency. We believe that one way to hedge against currency uncertainty is to have some exposure to gold and gold equities.

v. Valuation of Markets

Financial markets move extremely rapidly and as a result, what investors expect in the future quickly become reflected in prices. Markets however also have a tendency to 'overshoot' and because of this, we often see markets either pricing too optimistic or too bleak a scenario. This is how we get both bubbles and distressed markets.

Equity valuations at the beginning of March were at extremely depressed levels and reflected expectations of a deep, prolonged economic slump. After the rebound of equity markets in the second quarter, valuations have become consistent with a more 'normal' recession. Equity markets however do not go up in a straight line and markets paused as we entered the third quarter. Equities are now not that 'cheap' but valuations are reasonable on a historical price-to-book measure and also on mid-cycle price-to-earnings considerations and in our view, equity markets are likely to resume their advance.

vi. Financial Market Indicators

We also look within the financial markets themselves when forming our asset allocation decisions. Matters such as the shape of the yield curve, credit spreads, volatility indices are all indicative of underlying investor risk appetite and expectations. The VIX[4] volatility index for example surged above 30[5] after the Lehman episode and remained elevated all through the crisis months. The VIX finally fell below 305 in the middle of May and this for us was a positive signal. The sharp improvement in corporate bond markets in recent months was another signal to us to increase our exposure to the riskier asset classes.

Quantitative Model

Asset allocation decisions are primarily driven by qualitative evaluations. In addition, we employ a quantitative model which provides an independent set of asset allocation signals. Quantitative techniques use mathematical models to determine relationships between key indicators and the movement in financial markets. Quantitative models can have powerful predictive abilities although historical relationships break down from time to time because the underlying structure of the global economy and financial markets is evolving continuously. As we entered the third quarter, our quantitative model was recommending a neutral allocation between equities and fixed income.

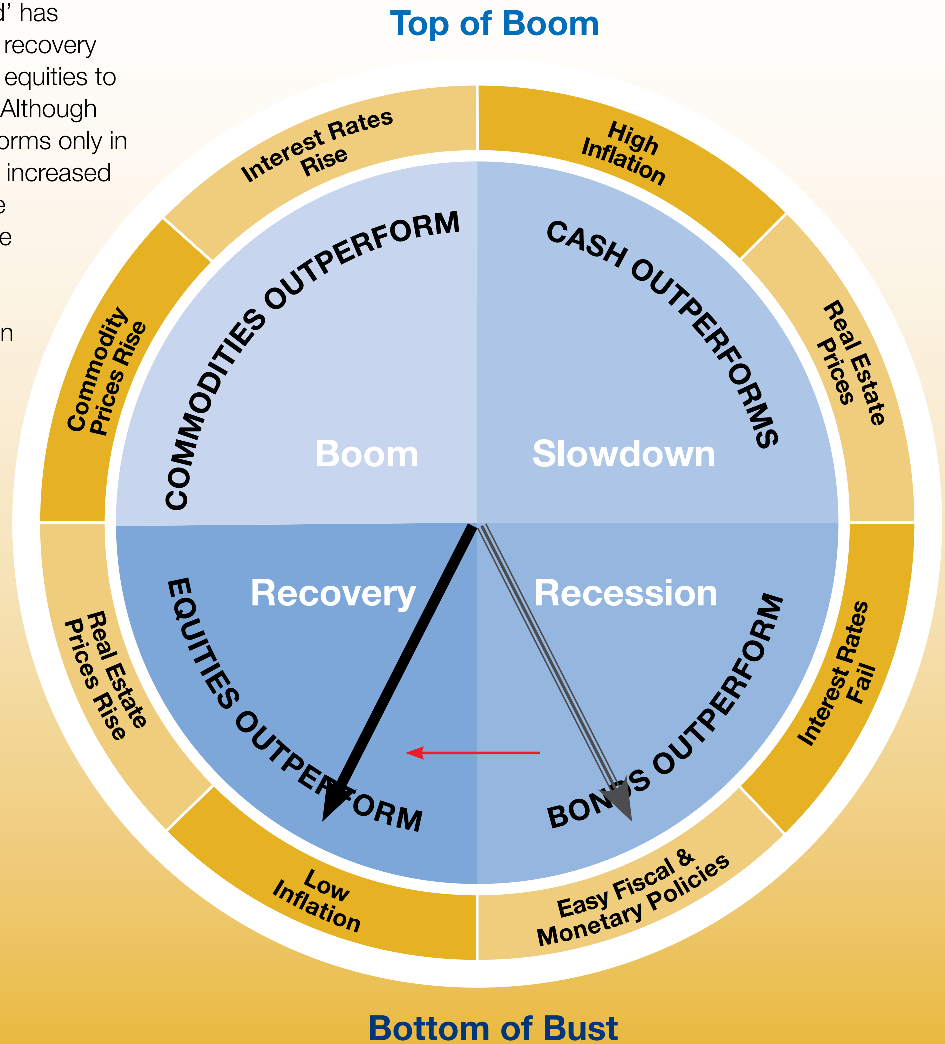
[2] *Source: Bloomberg, 23 June 2009*
[3] *Source: Morgan Stanley FX Pulse, 7 May 2009*
[4] *Note: VIX refers to the Chicago Board of Exchange Volatility index, and measures the implied volatility of equity markets*
[5] *Source: Bloomberg 23, June 2009*

UOBAM INVESTMENT CLOCK

What time is it?

The UOBAM Investment Clock encapsulates the way we view the asset allocation cycle. We believe the 'investment hand' has moved past 6 and we are in the recovery phase. In this phase, we expect equities to outperform government bonds. Although commodities historically outperforms only in the later stages of the cycle, the increased importance of China in this cycle appears to be pulling forward the timeline of commodities.

We have an **overweight** position in **equities** and **commodities**, and an **underweight** position in **bonds**.



The Asset Allocation Unit is headed by **Mr. Tony Raza, Director**.

Tony started out as a Financial Analyst in Chase Manhattan Bank (New York) and came to Singapore in 1996 as Regional Bank Analyst at Daiwa Securities. In 2001, he moved to DBS Bank as Vice President (Corporate Planning) and was involved in capital management, financial projects and investor relations. In 2004, he joined Merrill Lynch Singapore as Head of Research, covering the Singapore market. Tony joined UOBAM in 2008. Apart from formulating macro strategies for UOBAM, Tony also manages equity and fixed income portfolios.