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Asset Allocation of Portfolio Management

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Abstract

This review article mentioned about introduction of asset allocation, assets allocation models, determination of asset allocation, portfolio management process, policy statement of asset allocation, return objectives and investment constraints, need for a policy statement, constructing a policy statement, preliminaries of financial plan, individual investor life cycle, life cycle investment goals and, conclusion of asset allocation.

Keywords: Asset Allocation; Portfolio Management; Methods of Asset Allocation; Life Cycle Investment and Risk and Return.

Introduction

Asset allocation is an investment portfolio technique which goals to balance different types of risks and create diversification by dividing tangible assets, current assets, movable assets, immovable assets among major categories such as cash, bonds, stocks, real estate; option, futures and contracts of derivatives. Each types of asset has different ratios of return and risks, hence, each shall behave differently in over the different periods of time.

The amount in assets of an investors might have in stocks and bonds which is based on two different factors. First, the allocation is based on the expected return that an investor need to meet their financial aims, and second, it is based on the amount of investment, risk that a person can accept by knowing beta value. A fruitful and successful allocation is one that achieves an investor's financial achievement (profit) without so much volatility that it causes the investors to make different behavioral mistakes.

Modes of Different Allocation

The general asset allocation models which are designed to aid investors and advisors in categorizing their preferences. They are,

i. **Capital Preservation**

ii. **Income**

iii. **Balanced / Income – Growth**

iv. **Growth**

i. Capital Preservation

This is for different types of investors who aim to use the funds somewhere in the near future like 12 to 24 months. This may be for housing down payment, vehicles payment, quality education, a potential and useful trip or anything else that would require the hard money to be there in its whole. Usually this not indeed invested money it is normally in a savings form like savings account, recurring deposit account or some short term guaranteed investment such as government bonds, treasury bills, commercial papers, repo, saving certificates, savings schemes programme. The aim of this kind of savings is to protect the investor capital and earn a interest rate at reasonable.

ii. Income Diversification

This income is planned for those who need the income from their different types of investment. Usually it retires but could be anyone who needs the income from their investment for any purposes. The majority of the investments are in income generating such as government and corporate sector bonds. This portfolio suggests 25% in stocks or equity funds, 50% in bonds or fixed income funds, and 25% in money market which is short term fund. The 25% to 30% equity components is intended to help investors stay ahead of inflation.

iii. Balanced/ Income-Growth

This kind of portfolio seeks to balance growth and stability. It recommends 50% in different stock, 30% in bonds or fixed-income funds and 20% in short-term money market funds or cash equivalents. This portfolio would seek to provide regular income with moderate protection against inflation. The equity components provides the potential growth but in the component in bonds and short term instruments helps balance out fluctuations in the stock market.

iv. Growth

This is a more difficult model which aims to provide capital appreciation with no or low income. A peculiar investor is a young employed individual who is searching to increase their net worth and do not care much about income or capital preservation.

Types of investments help over here are mostly growth stocks may be some small portion of dividend stocks and bonds. Here mostly 25% on bonds, 65% on stocks and 10% on short term funds.

Determination of Asset Allocation

The asset allocation is based on different factors, so we can not calculate accurately. Nevertheless some important factors which affect the asset allocation. They are as follows,

i. **Risk Tolerance :** Without risk there is no return. It is all depends upon the investor that amount of volatility handling. Low risk low return and vice versa.

ii. **Time Horizon :** It is based on the time. Till how many periods you need a money.

iii. **Situations of Finance :** It is a matter of standard of living after you lost your money in portfolio. This could be an example.

Phases of Portfolio Management

i. Identification of objectives

ii. Selection of the Asset Mix

iii. Formulation of Portfolio Strategy

iv. Security Analysis

v. Portfolio Selection

vi. Portfolio Evaluation

vii. Portfolio Revision

Let us explain in brief of the above points

i. Identification of objectives : Identifying the objectives must be the first process. The investors' objectives. The investors objectives may be income generation, capital asset appreciation or future security.

ii. Selection of the asset mix : An appropriate of different mix between stock and bonds depends on the different types of risk tolerance and investment limit of the investors. Asset mix means diversifying the assets in to different parameters of different ratios.

iii. Formulation of portfolio strategies : There are two strategies involved in formulation of portfolio strategies. They are,

a. An active portfolio strategy

b. A passive portfolio strategy

a. An active portfolio strategies always try to involve in a superior risk possibility by different market timings, security combination and selection.

b. A passive portfolio strategies always predetermine the risk level and go for diversification.

iv. **Security Analysis :** In security analysis , risk-return parameters would be critically examined. The sources of the information of the economic policy also important so that it can be analysed the prices, return and beta value. We need to know the fundamental and technical analysis.

v. **Portfolio Selection:** Efficient portfolio of the investment would be the input of portfolio selection. Investor look at optimum portfolio for selection.

vi. **Portfolio Evaluation:** It is a process which is concerned with assessing the performance of the portfolio over a selected period of time which involves risk and return. Portfolio evaluation is useful to identifying the weakness in the investment process and for improving the deficiency areas. Evaluations always provide a feed back to improve the portfolio management process.

vii. **Portfolio Revision:** Revision and monitoring is very essential when a portfolio was constructed. Changes in investors' financial status, preferences and market conditions also necessary for portfolio composition changes. It usually changes of one stock to another stock.

Policy Statement

A policy statement is a road map which guides the investment process. Constructing a policy statement is invaluable pre-determined course of action tools which can help the investor to understand the needs as well as assist an advisor or portfolio manager in managing a client's funds. While it does not guarantee investment success, a policy statement provides discipline for the investment process and reduce the possibility of making hasty and inappropriate decisions.

There are two important valid reasons for constructing a policy statement.

First, it helps the investor decide on realistic investment aims after learning about the financial markets and services and the risk of investing.

Second, it creates a appropriate standard by which to judge the performance of the portfolio manager.

Return Objectives and Investment Constraints

Before constructing a policy statement by an investor and advisor, it is need to have open and transparent exchange of information, ideas, fears and goals. To build a framework for this information gathering process, the client and advisor need to discuss the clients' investments objectives and different constraints.

The main return objectives are, capital preservation, capital appreciation, current income and total return. Let can be explained one by one of them.

Capital Preservation: Capital preservation is essential to maintain capital. To accomplish this objective, the return objective should at a minimum, be equal t to inflation rate. In other words, nominal rate of return would equal the inflation rate. Here, an investor simply wants to preserve his/her existing capital.

Capital Appreciation: Capital appreciation is the need to grow, rather than simply preserve, capital. To accomplish this objective, the return objective should be equal to a return that exceeds the expected inflation. Here, the investors' intention is to grow his existing capital base.

Current Income: Current income is the need to create income from the investor's capital base. With this objective, an investor needs to generate income from his/her investments. Usually, this could find it from retired employees who has no longer have income and need to generate income off of their investments to meet living expenses and other spending needs.

Total Return: It is the need to grow the capital base through both capital appreciation and reinvestment of that appreciation.

Investment Constraints

When creating a policy statement, it is important to consider an investor's constraints. These are five types of constraints that need to be considered when creating a policy statement. They are as follows,

i. **Liquidity Constraints :** It identify an investors need for liquidity, i.e easily convertible to cash for example, within the next year, an investor needs Birr 100000 for the purchase of a new home. The 100000 would be considered a liquidity constraints because it liquid needs to be set aside (be liquid) for the investors.

ii. **Time Horizon:** A time horizon constraint develops a timeline of an investors various financial needs. The time horizon also affects an investor's ability to accept different risks because he/she would have a longer time period to recoup any losses. This is unlike an investor with a shorter time horizon whose skills to accept risk may be lower because he would not have the ability to recoup any losses.

iii. **Tax Concern:** After tax returns are the returns investors are focused on when creating an investment portfolio. If an investor is currently in a high tax bracket as a result of his/her home, it may be important to focus on investments that would not make the investors' situation worse, like investing more heavily in tax-deferred investments.

iv. **Legal and Regulatory:** Legal and regulatory factors can act as an investment constraint and must be considered. Example, trust.

v. **Unique Circumstances:** Any special needs or constraints not recognized in any of the constraints listed above would fall in this category. Example, Cigarette Company.

The Need for a Policy Statement

- It helps investors to understand their own needs, objectives, and investment constraints.
- It sets standards for evaluating portfolio performance.
- It reduces the possibility of inappropriate behavior on the part of the portfolio manager.

Policy Statement Construction

An appropriate policy statement should satisfactorily answer to the following questions.

- What are the real risk of an adverse financial outcome, especially in the short duration of periods?
- What probable emotional reactions will I have to an adverse financial outcome?
- How much knowledge kept about investments and financial markets?
- What other capital or other income sources? Which I have? How important is this particular portfolio to my overall financial position?
- What, if any, legal restrictions may affect my investment needs?
- What, if any, unanticipated consequences of interim fluctuations in portfolio value must affect my investment policy?

Financial Plan Preliminaries

Financial plans and investment needs are as different as each individual. Investment needs change over a person's life cycle. The individual's structure their financial plan should be related to their age, financial status, future plans, risk diversion elements and needs.

Before embarking on an investment program, we need to make sure other needs are satisfied. No serious investment plan should be started until a potential investor has adequate investor has adequate income to cover up living expenses and has a safety net should the unexpected occur.

Insurance

Life insurance should be a component of any financial plan. Life insurance protects loved ones against financial hardship should death occur before our financial goals are met.

The death benefit paid by the insurance company can help pay medical bills and funeral expenses and provide cash that family members can use to maintain their lifestyle, retire debt, or invest for future needs. Example, suppose retirement. Hence, one of the first steps in developing a financial plan is to purchase adequate life insurance coverage.

Life Insurance

It provides death benefit only. Premium could change every renewal period. It is least expensive like insurance to purchase.

Universal and Variable like Insurance – It provides cash value plus health benefits. Insurance coverage also provides protection against other uncertainties.

Health Insurance – It helps to pay medical bills.

Disability Insurance – It provides continuing income if a person become unable to work.

Automobile and Home/Rental Insurance – It provides protection against accidents and damage to cars or residences.

Cash Reserve

Cash reserve always meets emergency needs. It includes cash equivalents (liquid investments). If it is equal to six months living expenses which would be recommended by experts. A cash reserve reduces the likelihood of being forced to sell investments at an opportune times to cover unexpected expenses.

Individual Investor Life Cycle

i. **Accumulation Phase:** In this phase, individual in the early-to-middle years of their working careers are involved. Usually, these investor attempt to accumulate assets during this period.

   As a result of their typical long term investment horizon and their future earnings ability with knowledge, character, communication, health, etc. individuals in this phase are willing to make relatively make high-risk investments.

ii. **Consolidation Phase:** Individuals are in this phase are typically past the midpoint of their careers. Their earnings are greater that expenses. So the expenses can be invested to provide for future retirement or estate planning needs.The typical investment horizon for this phase usually from 20-30 years, so moderately high risk investments are attractive. At the same time, because individuals in this phase are concerned about capital preservation and they may not take high risks.

iii. **Spending Phase:** The spending phase typically begins when individuals retire. Living expenses covered by social security funds and income from prior investments because their earnings years have concluded and they seek greater protection of their capital.At the same time, they must balance their desire to preserve the nominal value of their savings with the need to protect themselves against a decline in the real value of their savings due to inflation rate.

iv. **Gifting Phase:** The gifting phase is similar to the spending phase. In this stage, individuals, believe they have sufficient income and assets to cover their expenses while maintaining a reserve for uncertainties. Excess assets can be helped whom they like. Some even help to get rebate.

Life Cycle Investment Goals

During the investment life cycle, individuals have a variety of financial goals like profit and wealth maximization.

Short/Near –term, high –priority goals :

These are short term financial objectives that individuals set to fund purchases that are personally important to them, such as accumulating funds to make a down or initial payment to avail the property.

Long term, high-priority goals

Typically it includes some form of financial independence such as the ability to retire at a certain age. Because of their long-term nature, higher-risk investments can be used to help meet their objectives.

Lower-priority goals

Lower-priority goals are just that might be nice to meet those objectives, but it is not critical.

Conclusion

Asset allocation, most of the investors do it in the same manner but different proportions which can comfortable to them to make profit maximization and wealth maximization ethically. As we know that, political, technical, cultural, traditional, emotional, spiritual, economical and feasible environmental are different from country to country, investor has to go for permutation and combination to find an appropriate investments in their portfolio to gain what they want.

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