ASSET ALLOCATION IN UOBAM

Most of our investors are probably familiar with our investment philosophy but they 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 focused on in the current environment?

To help investors understand how we think about financial markets, we publish a short feature on 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 portfolios.

Why Asset Allocation matters

Asset Allocation is a fundamental investment decision. Deciding how much 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.

An important first point to make is the difference between an individual's risk allocation and strategic allocation. Every investor has a specific risk profile and an optimal asset allocation. An institution that has a short investment horizon will be more conservative compared to an institution with a longer investment horizon. An individual who has just entered the work force is likely to have a higher risk appetite than someone reaching retirement. Asset allocation decisions based on risk profiles are "mean-variance optimisation" decisions, 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, asset allocation revisions of individual portfolios are usually small.

The type of asset allocation we are describing 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%[8] 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. 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?

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

Please refer to the last page for important notice & disclaimer.

UOB Asset Management 大華資產管理

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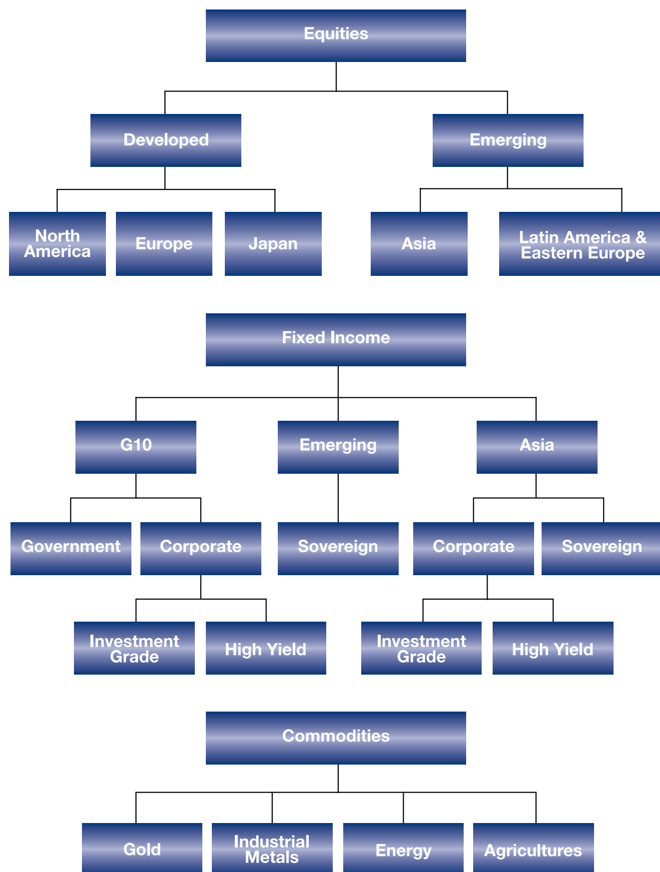
What Asset Classes do we look at

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.



What drives our Asset Allocation decisions

We believe that the different asset classes have a high likelihood of outperforming at the different stages of the economic cycle. As the global economy moves through its phases of expansion and contraction, we expect the 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 instance 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 strongly outperformed government bonds, in line with indications that the global economy is on the road to recovery.

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. 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 below:

Real Economy

In the developed economies, a comprehensive range of economic indicators is available for investors to monitor. They include house prices, unemployment claims, retail sales, lending standards, copper prices, durable goods orders, industrial production, capacity utilisation, producer prices, and so on. The accuracy of the data is reliable and the releases 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, the US personal savings rate and the US housing market to provide confirmation that we will be able to avoid a "double dip" recession. The recent pick-up in industrial production was largely driven by a rebuilding of inventories and car scrapping incentives. For

the recovery of the economy to be sustained, final demand must also improve. So far, the signs are that US consumer spending has stabilised although it is unlikely to return to vigorous growth in the next few years given the ongoing de-leveraging of the US and European banking system.

We are also tracking demand in the Emerging Markets, given their growing importance in the global economy. When thinking about any economic recovery, one useful milestone is the return of an economy to its trend growth level. We believe that China could be the first major economy to return to its trend growth level given the strong increase in credit growth and fixed investment. China retail sales also appear to have good momentum behind them.

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, inflationary 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 in the expectations that prices will fall further, and this leads to a weak economy.

With the plunge in commodity prices in the second half of 2008 and the global economic recession, a number of countries are currently experiencing close to zero or even negative inflation. However there is a degree of unease in the market about the aggressive manner in which central banks have flooded the system with liquidity in response to the credit crisis and the potential longer-term consequences 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 in Asia. Asia is closely tied to the US dollar and effectively “imports” US monetary policy, where official interest rates are likely to remain close to zero for some time. Asia’s banking system is not broken and the increase in liquidity has fed though the system more swiftly than in the developed economies. Also, commodity prices increases, in particular food and energy, have a greater impact on Asian inflation trends.

Policy Response

The market pays intense attention to what policymakers say and do. During the most turbulent months of the credit crisis, policy response was the major driver of financial markets. By and large, it appears that central banks and governments have succeeded in preventing the global economy from sliding into a depression.

However, in their efforts to stabilise the system, policymakers undertook a host of unconventional measures including the purchase of financial assets, such as government debt and mortgage securities. This huge expansion of central banks’ balance sheets, in particular, that of the US Federal Reserve, is of concern to the market and the way in which the central banks execute their “exit strategy” will affect financial markets.

The market is also focussed on how quickly policymakers will ‘normalise’ policy interest rates, that is, raise them from the current very low levels. We expect the US Federal Reserve to start raising interest rates when the US economy is on a surer footing and risks of inflation returns. Among the indicators we are watching to monitor growth and inflation risks are the US labour market, the US housing market, capacity utilisation and the ease of obtaining credit.

But it is in China where the first major tightening of policy is, in our view, likely to come. China’s economic growth has recovered sharply and inflation risk is rising, and the first steps of tightening could be as early as the first half of 2010.

Currencies

Many factors affect the currency markets. Interest rates usually play a large role in influencing currency moves. As the global economy recovers, the currencies whose central banks are likely to raise interest rates first, in particular the Australian dollar and the Norwegian Krone, have been steadily appreciating. Currency moves like these are driven by cyclical factors.

Currencies are also driven by structural considerations. The global financial crisis and the aggressive response of the US policymakers have created a medium-term problem for 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 will be more focused on the deteriorating US fundamentals, in particular the expanding US fiscal deficit.

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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[9] 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.

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 2009 were at extremely depressed levels and reflected expectations of a deep, prolonged economic slump similar to the 1930s Great Depression. After the rebound of equity markets in the second and third quarters, valuations have become consistent with a more 'normal' recession. Equities are now no longer '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, valuations as we enter the final quarter of 2009 are not a constraint to equity markets continuing their advance.

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[10] volatility index for example, reached as high as 80[11] after the Lehman episode and remained elevated all through the crisis months. The VIX finally fell below 30 in the middle of May and this, for us, was a positive signal. The sharp improvement in corporate bond markets in recent months has been another signal to us to continue to maintain our higher exposure to the riskier asset classes.

Quantitative Model

Our 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.

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

Tony started out as a Financial Analyst in Chase Manhatten Bank (New York) and came to Singapore in 1996 as Regional Bank Analyst at Daiwa Securities. In 2001, he moved to DBS 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.

[9] Source: Morgan Stanley FX Pulse, 7 May 2009
[10] Note: VIX refers to the Chicago Board of Exchange Volatility index, and measures the implied volatility of equity markets
[11] Source: Bloomberg 16 September, June 2009

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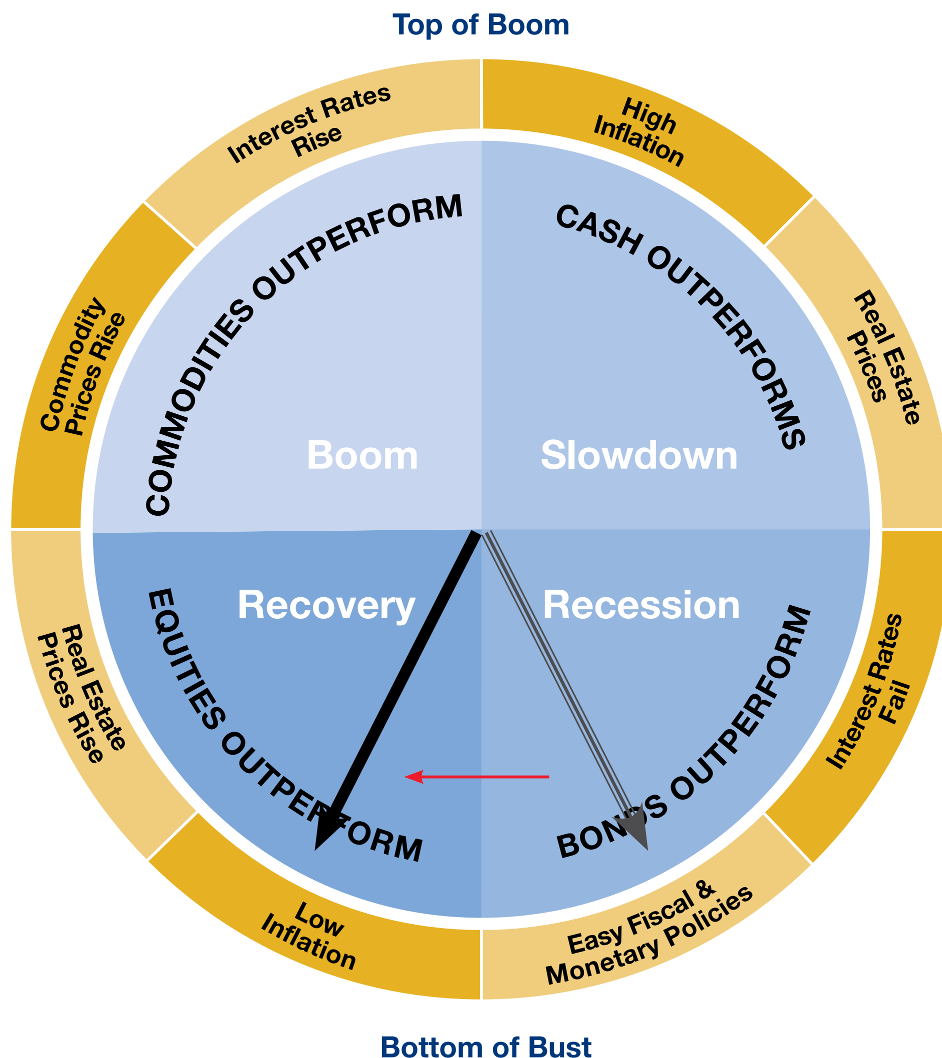
What Time Is It?

The UOBAM Investment Clock encapsulates the way we view the asset allocation cycle. We believe the investment hand has moved past six and we are in the recovery phase. In this phase, we expect equities to outperform government bonds. Although commodities historically outperform only in the latter 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.

UOBAM Investment Clock



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