Strategic Asset Allocation for institutional investors and real estate

Ugo Pomante

Professor at "Tor Vergata" University

Rome, ***Hotel Ambasciatori Palace***

First *commandment* of the investor

The portfolio construction is a three-step process:

1. Strategic Asset Allocation

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2. Tactical Asset Allocation

+

3. Product Selection

It is a team-game, but there's a leader. And the leader is …

The Strategic Asset Allocation

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The Royal Swedish Academy of Sciences has decided to award The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel for 2013 to

Eugene F. Fama
University of Chicago, IL, USA

Lars Peter Hansen
University of Chicago, IL, USA

and

Robert J. Shiller
Yale University, New Haven, CT, USA

"for their empirical analysis of asset prices".

There is no way to predict the price of stocks and bonds over the next few days or weeks. But it is quite possible to foresee the broad course of these prices over longer periods, such as the next three to five years. These findings, which might seem both surprising and contradictory, were made and analyzed by this year's Laureates, Eugene Fama, Lars Peter Hansen and Robert Shiller.

The features of a good strategic asset allocation and the real estate contribution

A) Reasonable allocation

«*When investors have tried to use quantitative model to help optimize the critical allocation decisions, the unreasonable nature of the results has often thwarted their efforts*», Black e Litterman (1992).

In Italy, the reasonableness-factor facilitates the real estate sector, as "the brick" assumes a dominant position in the investment choices.
We can safely say that an asset allocation with zero real estate is assumed to be unreasonable.

The features of a good strategic asset allocation and the real estate contribution

B) Consistency with the objectives

«*The most interesting and relevant argument against the expected utility maxim involves specific cases in which human subject, after careful deliberation, choose alternatives inconsistent with the maxim […] we must conclude that human being has a natural propensity toward irrationality, even in his most reflective moments*», *Markowitz (1959).*

When building a strategic portfolio, we need to understand to what extent this solution is consistent with the objectives pursued (targeted funding ratio, targeted return given a level of risk)…

…or it is influenced by irrational behaviors ("*home bias*", for example).

The features of a good strategic asset allocation and the real estate contribution

C) Consistency between liquidity and holding period

Real estate gives a negative contribution to the liquidity of the portfolio.
Investors with a high propensity to real estate should therefore improve their model of liquidity risk management.

The features of a good strategic asset allocation and the real estate contribution

D) Diversification


(DAL NOSTRO INVIATO)

CERNOBBIO ■ Tre sono le regole d'oro per il risparmiatore: diversificare, diversificare, diversificare. Direte che non ci vuole un premio Nobel per sostenere questa tesi. Eppure William

All the most notorious cases of financial losses (LTCM, Barings, etc.) are the result of two factors: bad luck and error related to ***huge concentration***.

But diversification does not mean buying many products. Diversifying means taking positions in many *risk factors*.

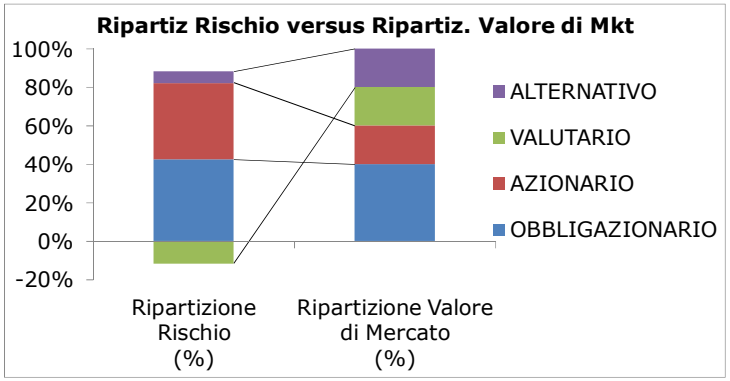
Real estate as Risk Factor

Given an equally weighted portfolio of four asset classes, each one corresponding to a specific risk factor:
- Bond area euro + Foreign Bond (hedged in euro);
- Equity World (hedged in euro);
- Foreign Currencies (both developed and emerging);
- Real Estate Italy (House price index by *Oxford Economics*).

Given a 2-years time series, the following slide shows the Risk Contribution (in terms of Marginal-VaR) of every asset class.

Real estate as Risk Factor

RISK DECOMPOSITION	Ripartizione Rischio (%)	Ripartizione Valore di Mercato (%)
OBBLIGAZIONARIO	55,3%	40,0%
AZIONARIO	52,1%	20,0%
VALUTARIO	-15,2%	20,0%
ALTERNATIVO	7,8%	20,0%
TOTALE	**100,0%**	**100,0%**



But the leader is often disputed

Unfortunately, Strategic Asset Allocation is often overlooked in favor of *market timing* and *product selection*.
And as a consequence, Strategic Asset Allocation ends to be the *center of gravity* around which move the tactics and the product picking.

Why Strategy is frequently mistreated?
Because dynamism is beautiful, static is bad. The driver is the hope of not losing money in bear-market years.
Because product selection and market timing are more funny, more subjective, never based on the precision of mathematics.
Paraphrasing the Chef Gusteau's famous motto: *"Anyone can pick a fund!"*.

But without the leader there is only anarchy

Unfortunately, if *market timing* and *product selection* are unruly, in other words if these choices are not consistent with the strategic allocation (that is a disciplined deviation from the strategy), the long term perspective loses all meaning and the investor becomes a short-term trader who lives *day after day*.

Grazie

ugo.pomante@uniroma2.it