

Asset Allocation in Financial Planning

Global capital markets over the last 5 years have been extraordinarily volatile. During this period we have seen the importance of asset allocation and the diversification that comes along with it. Investors would have done well diversifying away from Asia in 1998, technology in 2000 and equities in general in 2001.

Financial planning in a wider sense is asset allocation and risk management at the individual level. It is about allocating finite resources between consumption and savings; about identifying risks and managing them.

Within this framework, financial planners would need to advise clients on their allocation strategy for their savings. As financial planners we need to examine the client's asset allocation somewhat wider than his or her immediate investment portfolio. We have identified 5 aspects to the asset allocation question:

- Asset class
- Geography
- Sectors
- By Accounts
- Career or Business Exposure

Asset Class:

Listed equities, fixed income, direct investments, properties, commodities (includes precious metals), currencies and cash are key asset classes. These are often seen as distinct asset classes because of their low correlation with one another. In simple English, they are typically out of tune with each other. For example, a deflationary economic environment would be detrimental for commodities but fixed income would be attractive. The reverse would be the case if inflation soared.

Large institutional investors have always been able to invest in all key asset classes as the minimum amount to invest in each asset class has not been a barrier. For the individual investor, this has always been a problem. With unit trusts, some of these barriers have been reduced. For example, one could get proxy exposure into commodities by investing in a fund that specializes in basic materials and/or energy. Alternatively, there are, so-called, hedge funds which allow the individual investor to benefit from the differing swings of each asset class by going both long and short at different or at the same time.

Notwithstanding the limitations of fund size, individual investors should diversify where they can as some diversification is always better than no diversification. A good example is the poor performance of equities in 2000 and 2001 relative to fixed income.

Geography:

Many long-term studies have shown that diversifying widely over different geographical capital markets have allowed investors to reduce their risk without sacrificing returns. In the last few years, however, the performance of the US markets have skewed data such that it would appear that investors would be better off just investing in the US market rather than diversifying. Although the jury is out, it is worthwhile to examine the arguments behind this contention.

Based on the aggregate market value of listed companies of world markets, the US makes up about 50%, Europe circa 30%, Japan about 10% and the rest of the world making up the rest. This distribution is very often used as the global benchmark for performance measurement. However, this is inconsistent with the relative size of GDP of the 3 blocs. European GDP is currently larger than the US and Japan is about 40% of that of the US.

However, as investors our claim is not on GDP but on that one slice of GDP which accrues to investors – profits. Notwithstanding privatization, European quasi-government bodies are still large participants in the private sector e.g. German retail banking.

Another argument is the global nature of the S&P 500 companies. Companies such as IBM, Microsoft and MobilExxon are listed in the US but have a global impact on the world economy because they not only earn a significant amount of their profits outside the US but create jobs and profits outside the US by their investment or sub-contracting activities. Indeed, some US investors argue that they do not need to invest outside their home exchanges as they can access leading foreign companies such as BP, Nokia and Toyota through ADRs or GDRs listed on their exchanges.

This particular view might hold for the US investor but could we apply this “investment xenophobia” to ourselves? We believe this is not wise for the Asian investor. Currently, most economies outside the 3 major blocs i.e. the US, Europe and Japan are price takers and will surely be affected by any significant events in any of the 3. Hence, even if investors and financial advisers would like to concentrate their investments in the local market or Asia, they would need to understand the upside and downside risks from the US, Europe and Japan.

Sectors:

The great boom in technology stocks world-wide in the late 90s spawned the launch of a great number of sector unit trusts. Unfortunately, most of them were concentrated in the Information Technology sector. This notwithstanding, the arguments behind investing and diversifying along global sectors are fundamental.

The erosion of global trade and investment barriers has changed the nature of business. Indeed this erosion has made the major economies more linked to one another and have made certain industries such as IT, pharmaceuticals, energy and financials global in nature – with a major shock transmitting rapidly around the globe. Recent research has shown that major stock markets world-wide are now more correlated than before – thus reducing the benefits of geographical diversification.

On the other hand, research has shown that global business sectors are distinctly of low correlation. Indeed, we have seen how healthcare and energy in the past 2 years have marched very differently relative to technology. We are believers that one should have part of one’s investment portfolio managed and diversified from a global sector perspective. Local investors now have a wide choice of both managed and indexed sector funds to implement this strategy.

By Accounts:

There are 3 main retirement vehicles in Singapore viz. CPF, Supplementary Retirement Scheme (SRS) and Cash. The following table briefly compares the virtues of the 3 schemes:

	SRS	CPF	Cash
<i>Is contribution taxable?</i>	No.	No, unless one contributes beyond the statutory limits.	Yes.
<i>Is capital-gain taxable?</i>	Yes. When SRS proceeds are withdrawn eventually, tax is payable.	No.	No.
<i>Flexibility of investment and usage choices</i>	Limited.	Generally wider than SRS.	Unlimited as Singapore does not practice capital controls.
<i>Can lever investment?</i>	No.	Yes. Can use to purchase residential and commercial properties which can be financed with borrowings.	Yes.

Whilst SRS is favourable for tax avoidance and deferment, it is inferior to CPF and cash as an investment vehicle. CPF and cash are more flexible with regard to investment and usage choices and the access to investment leverage.

From an asset allocation perspective, the taxability of capital gains means that one should consider SRS as a vehicle for the low return/risk segment of one's investment portfolio. Indeed, we feel that the SRS should first be used as part of one's emergency cash fund before allocating the low return/risk assets in one's portfolio.

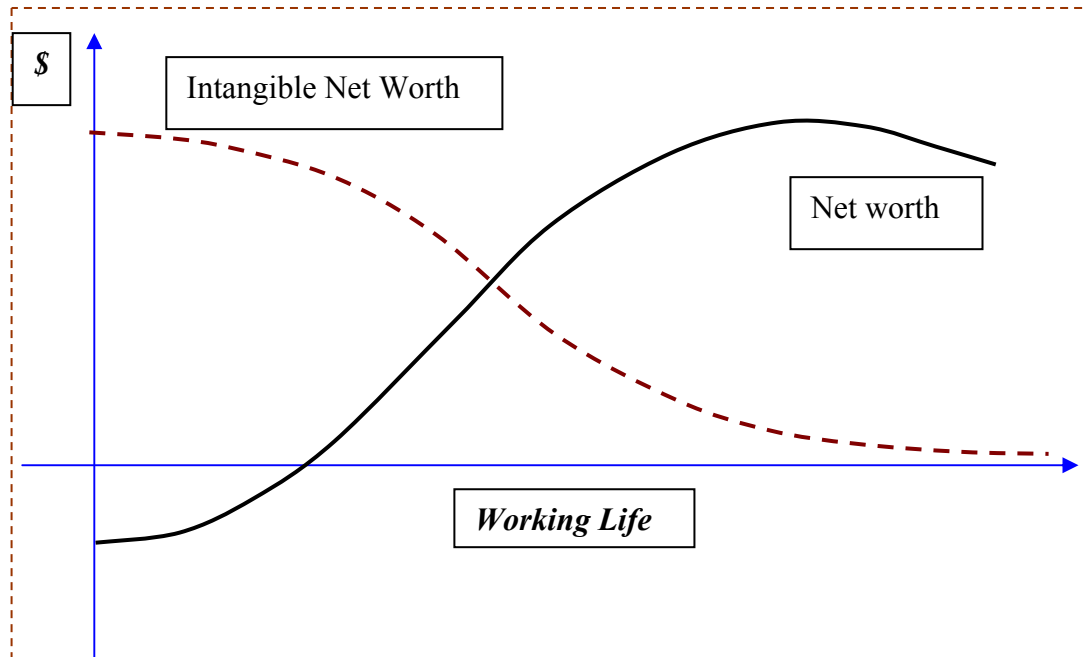
Career or Business Exposure

Finally, the investment portfolio is only one part of an individual's "intrinsic" or, what we call, "embedded" value, which is the sum of an individual's tangible and intangible net worth. An individual who has little net worth can have a high embedded value if he or she is able to earn and save considerably over a lifetime. The present value of this savings stream can be considered to be his or her "intangible net worth". This is typical of younger people who are talented and/or enterprising.

For most of us who endeavour to convert our intangible net worth into the tangible sort as we progress through our working life, our intangible net worth will be more than our tangible net worth for at least half our working life. The implication of this is that the industry we work in or in which our business is exposed to, has thus a significant impact. Hence, it is wise to diversify one's investment portfolio away from the industry or region that our career or business is exposed to. For example, if one is making a lot of money from Asian construction activities, it would be wise

not to be overweight in Asian developers or construction companies in one's portfolio.

An example of someone who does this is Bill Gates, Chairman of Microsoft. Bill's considerable personal portfolio has been reported to have little or no IT exposure, let alone Microsoft shares. A recent example of the dangers of not doing this is the Enron debacle where some employees had a high concentration of their retirement fund in Enron shares.



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Published in the Business Times 26 Feb 2002