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HOW DOES ILP REBALANCING HELP IN BOOSTING ILP FUND PERFORMANCE. (PART 1)

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After a portfolio manager has worked closely with a client to document investment objectives and constraints in an investment policy statement (IPS), agreed on the strategic asset allocation that best positions the client to achieve stated objectives, and executed the strategic asset allocation through appropriate investment strategies in an ILP for each asset class segment, the manager must constantly monitor and rebalance the portfolio. The need arises for several reasons.

First, clients' needs and circumstances change, and portfolio managers must respond to these changes to ensure that the portfolio reflects those changes. Life-cycle changes are expected for individual investors, so the portfolio manager must plan for these changes and respond to them when they occur. Institutional investors face changing circumstances just as commonly. A pension fund may receive a mandate from its trustees to assume less volatility. A university endowment may need to react to higher-than-anticipated inflation in faculty salaries.

Second, capital market conditions change. Portfolio managers must monitor such changes, adjust their capital market expectations appropriately, and reflect changed expectations in how the portfolio is invested. For example, if a client's return requirement is 8 percent but the strategic asset allocation promises to return on average 6.5 percent in the current climate, what changes should a portfolio manager recommend in light of the anticipated 150 bps shortfall?

Third, fluctuations in the market values of assets create differences between a portfolio's current asset allocation and its strategic asset allocation. These differences may be trivial on a daily basis; over longer periods of time, however, they can result in a significant divergence between the intended and actual allocations. When and how a portfolio manager rebalances the portfolio to the strategic asset allocation is one of the primary focuses of this reading.
This process involve both monitoring and rebalancing. I will more on rebalancing but will briefly touch on monitoring as it is the basis on which rebalancing is carried out.

For a portfolio manager, designing and building a portfolio is only the beginning of the dynamic and interactive process that lasts for as long as she is the client's trusted advisor. As markets evolve, maintaining the alignment between a client's portfolio and his investment objectives requires constant vigilance. Therefore, monitoring and rebalancing the portfolio is one of the most important elements of the dynamic process of portfolio management.

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MONITORING

To monitor something means to systematically keep watch over it to collect information that is relevant to one's purpose. In investments, the purpose is to achieve investment goals. And a reality of investing is that what you don't know can hurt you. An overlooked fact may mean not reaching a goal. A portfolio manager should track everything affecting the client's portfolio. We can categorize most items that need to be monitored in one of three ways:

- investor circumstances, including wealth and constraints;
- market and economic changes; and
- the portfolio itself.

Monitoring investor-related factors sometimes results in changes to a client's investment policy statement, strategic asset allocation, or individual portfolio holdings. Monitoring market and economic changes sometimes results in changes to the strategic asset allocation (when they relate to long-term capital market expectations), tactical asset allocation adjustments (when they relate to shorter-term capital market expectations), changes in style and sector exposures, or adjustments in individual holdings. Monitoring the portfolio can lead to additions or deletions to holdings or to rebalancing the strategic asset allocation.

MONITORING CHANGES IN INVESTOR CIRCUMSTANCES AND CONSTRAINTS

Changes in circumstances and wealth often affect a client's investment plans. For private wealth clients, events such as changes in employment, marital status, and the birth of children may affect income, expenditures, risk exposures, and risk preferences. Each such change may affect the client's income, expected retirement income, and perhaps risk preferences. The responsibilities of marriage or children have repercussions for nearly all aspects of a client's financial situation. Such events often mark occasions to review the client's investment policy statement and overall financial plan. For institutional clients, operating performance, constituent pressures (such as demands for increased support from the beneficiaries of endowments), and changes in governance practices are among the factors that may affect income, expenditures, risk exposures, and risk preferences. A portfolio manager should communicate regularly with the client to become aware of such changes.

THE KEY FACTORS FOR MONITORING :

Return Requirement:
What is the required return that was required during financial planning and is this still viable with the current portfolio?

Risk Profile:
Have the risk profile changed due to lifestyle and income changes?

Time Horizon:
Individuals age and pension funds mature. Reducing investment risk is generally advisable as an individual moves through the life cycle and his time horizon shortens; bonds become increasingly suitable investments as this process occurs. Today's life-cycle mutual funds reflect that principle in their asset allocations. In contrast to individuals, some entities such as endowment funds have the hope of perpetual life; the passage of time in and of itself does not change their time horizon, risk budgets, or appropriate asset allocation.

Tax Circumstances:
Taxes are certain; the form they will take and their amount in the future are uncertain. Taxable investors should make all decisions on an after-tax basis. Managers for taxable investors must construct portfolios that deal with each client's current tax situation and take future possible tax circumstances into account. For taxable investors, holding period length and portfolio turnover rates are important because of their effect on after-tax returns.
In evaluating investment strategies to meet a taxable investor's changed objective, a portfolio manager will take into account each strategy's tax efficiency (the proportion of the expected pre-tax total return that will be retained after taxes).

THE KEY FACTORS FOR MONITORING :

Changing Liquidity Requirements:
When a client needs money to spend, the portfolio manager should strive to provide it. A liquidity requirement is a need for cash in excess of new contributions or savings as a consequence of some event, either anticipated or unanticipated. Individual clients experience changes in liquidity requirements as a result of a variety of events, including unemployment, illness, court judgments, retirement, divorce, the death of a spouse, or the building or purchase of a home. Changes in liquidity requirements occur for a variety of reasons for institutional clients, such as the payment of claims by insurers or of retirement benefits by defined-benefit pension plans, or the funding of a capital project by a foundation or endowment.

Changes in Laws and Regulations:
Laws and regulations create the environment in which the investor can lawfully operate, and the portfolio manager must monitor them to ensure compliance and understand how they affect the scope of the advisor's responsibility and discretion in managing client portfolios.

Unique Circumstances:
A unique circumstance is an internal factor (other than a liquidity requirement, time horizon, or tax concern) that may constrain portfolio choice. The client may present the portfolio manager with a variety of challenges in this respect. For example, some clients direct portfolio managers to retain concentrated stock positions because of an emotional attachment to the particular holding, because the client must maintain the stock position to demonstrate his or her commitment as an officer of the company, or because the concentrated position effectively has an extremely large unrealized capital gain. Is it feasible and appropriate to hedge or monetize the position through one of several special strategies? If not, given the volatility and concentrated risk of this single holding, how should the portfolio manager allocate the balance of the client's portfolio? As a portfolio manager, what investment actions will you recommend or implement when the emotional attachment is gone, when the client is no longer an officer of the company, or when the client's heirs receive the position?

MONITORING MARKET AND ECONOMIC CHANGES

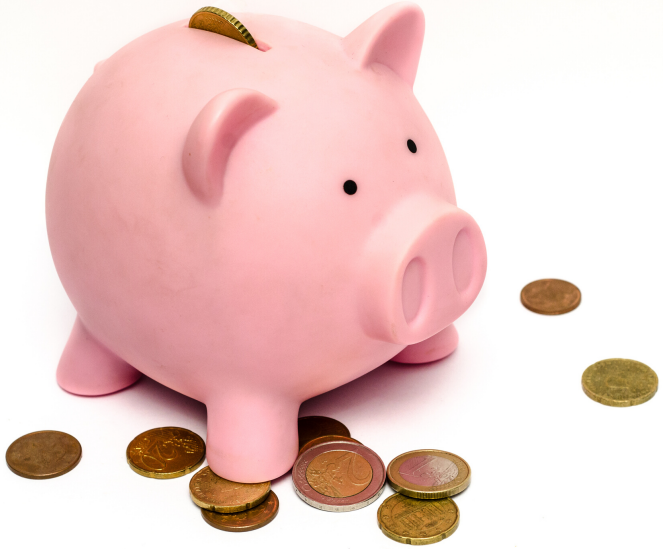
In addition to changes in individual client circumstances, the economic and financial markets contexts of investments also require monitoring. Those contexts are not static. The economy moves through phases of expansion and contraction, each with some unique characteristics. Financial markets, which are linked to the economy and expectations of its future course, reflect the resulting changing relationships among asset classes and individual securities. A portfolio manager's monitoring of market and economic conditions should be broad and inclusive. Changes in asset risk attributes, market cycles, central bank policy, and the yield curve and inflation are among the factors that need to be monitored.

Changes in Asset Risk Attributes: The historical record reflects that underlying mean return, volatility, and correlations of asset classes sometimes meaningfully change. An asset allocation that once promised to satisfy an investor's investment objectives may no longer do so after such a shift. If that is the case, investors will need either to adjust their asset allocations or to reconsider their investment objectives. Monitoring changes in asset risk attributes is thus essential.

Market Cycles: Investors monitor market cycles and valuation levels to form a view on the short-term risks and rewards that financial markets offer. Based on these opinions, investors may make tactical adjustments to asset allocations or adjust individual securities holdings.

Tactically, the markets' major swings present unusual opportunities to be either very right or very wrong. When things are going well, securities eventually perform too well; during economic weakness, stock prices often decline excessively. Weakness engenders an environment that may foreshadow extraordinary profits, while ebullient markets provide unusual opportunities to sell, reinvesting elsewhere. Reducing exposure to outperforming asset classes and increasing exposure to underperforming asset classes at the asset-class level—selling the stocks that had proven so comfortable and buying the bonds that the investment world seemed then to abhor—would have had a profound positive influence on total portfolio risk and return during those times.

Central Bank Policy: Central banks wield power in the capital markets through the influence of their monetary and interest rate decisions on liquidity and interest rates. Their influence is felt in both bond and stock markets. In bond markets, the most immediate impact of monetary policy is on money market yields rather than long-term bond yields. A central bank's influence on bond market volatility, however, is profound. Turning to the stock market, "Do not fight the Fed" has been a longstanding warning from Martin Zweig—a warning that it can be problematic to invest in the market when the Fed is tightening the money supply. Jensen, Johnson, and Mercer (2000) and Conover, Jensen, Johnson, and Mercer (2005) have documented that in the United States, stock returns are on average higher during periods of expansionary monetary policy than in periods of restrictive monetary policy, as indicated by decreases and increases in the discount rate, respectively. These lessons bear repetition. Fed policy does matter and should not be ignored: Restricted credit and higher interest rates usually hurt stock returns; eased credit and lower interest rates usually enhance stock returns.



MONITORING MARKET AND ECONOMIC CHANGES

The Yield Curve and Inflation:
The default-risk-free yield curve reflects investors' required return at various maturities. It incorporates not only individuals' time preferences for current versus future real consumption but also expected inflation and the maturity premium demanded. Yield curve changes reflect changes in bond values, and bond value changes affect equity values through the competition that bonds supply to equities. Thus investors closely monitor the yield curve. The premium on long-term bonds over short-term bonds tends to be countercyclical (i.e., high during recessions and low at the top of expansions) because investors demand greater rewards for bearing risk during bad times. By contrast, short-term yields tend to be pro-cyclical because central banks tend to lower short rates in an attempt to stimulate economic activity during recessions. Yield curves thus tend to become steeply upward-sloping during recessions, to flatten in the course of expansions, and to be downward sloping (inverted) before an impending recession. In the United States, for example, nearly every recession after the mid-1960s was predicted by an inverted yield curve within six quarters of the recession; only one inverted yield curve was not followed by a recession during this period. Thus the evidence suggests that the yield curve contains information about future GDP growth. Theory also suggests that the yield curve reflects expectations about future inflation. Inflation has a pervasive influence on investors' ability to achieve their financial and investment objectives. On the one hand, it affects the nominal amount of money required to purchase a given basket of goods and services. On the other hand, inflation influences returns and risk in capital markets. When inflation rises beyond expectations, bond investors face a cut in real yield. As nominal yields rise in turn to counteract this loss, bond prices fall. Unexpected changes in the inflation rate are highly significant to stock market returns as well.

MONITORING THE PORTFOLIO

Monitoring a portfolio is a continuous process that requires the manager to evaluate 1) events and trends affecting the prospects of individual holdings and asset classes and their suitability

for attaining client objectives and 2) changes in asset values that create unintended divergences from the client's strategic asset allocation. The former tend to lead to changes in investment policy or to substitutions of individual holdings; the latter lead directly to rebalancing to the existing strategic asset allocation. New information on economic and market conditions or on individual companies may lead a portfolio manager to take a variety of investment actions in an effort to add value for the client. The following examples offer some perspectives for the practitioner to consider as he or she translates monitoring into investment action.

HOW ACTIVE MANAGERS MAY USE NEW ANALYSIS AND INFORMATION

As portfolio managers gather and analyze information that leads to capital market expectation revisions, they may attempt to add value through at least three types of portfolio actions:

- Tactical asset allocation. The portfolio manager may, in the short term, adjust the target asset mix within the parameters of the investment policy statement by selling perceived overpriced asset classes and reinvesting the proceeds in perceived underpriced asset classes in an attempt to profit from perceived disequilibria. When an investor's long-term capital market expectations change, however, the manager must revisit the strategic asset allocation.

- Style and sector exposures. Portfolio managers may alter investment emphasis within asset classes because of changes in capital market expectations. For example, a portfolio manager may lengthen the duration in the fixed-income allocation based on expectations of a sustained period of declining interest rates or adjust the style of the equity portfolio based on expectations that an economy is entering a period of sustained economic growth. Portfolio managers also may adjust the exposure to certain sectors back to or closer to historical weightings to reduce sector exposure relative to the index. For example, consider the impact on portfolio risk and return of reducing the exposure to the technology sector (within the large-cap US equity allocation) in January 2000, when technology represented more than 31 percent of the S&P 500 Index relative to the historical average of about 17 percent.

- Individual security exposures. A portfolio manager may trade an individual issue for one that seems to offer better value or reduce the exposure of a specific security as the returns of a single security begin to contribute a greater proportion of the total return than the manager believes to be appropriate.

About the Author:
Wong Kwek Yong is a licensed financial practitioner. He holds the CHFC and CLU Designations.