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What really drives returns?

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Over the past few years headlines have been dominated by news of heightened market volatility. Many investors may be wondering what this means for their investments in diversified portfolios. In this environment, what type of portfolio should they be investing in, and where are returns likely to come from?

As part of our Building Better Portfolios series, we look at the factors that have the greatest influence over portfolio returns, and what investors should really be focusing on when evaluating the performance of diversified portfolios.

Asset allocation determines returns

Successful portfolio management always starts with the investor. This means developing a deep understanding of their investment objective, as well as their risk tolerance, cost preference and investment time horizon. This is an important first step in designing portfolios as clients have a diverse range of needs. Just consider how different the investment needs are between a person retiring in two years compared to a 25 year-old who is just launching their career.

Identifying the most appropriate long-term mix of assets is the foundation of portfolio construction, as it's this decision that drives the bulk of returns for diversified portfolios. Asset allocation is all about carefully balancing the expected returns and potential risks of each asset class to build a portfolio that has a strong probability of meeting the investor's long-term objectives with the lowest risk profile.

Once the correct mix of assets has been established, other opportunities to add value (such as stock selection and manager selection) can be explored. While these are important enhancements to a portfolio, their overall effect on performance is marginal compared to the impact of the asset allocation decision.

The following diagram is indicative of the contributors to return of a typical balanced portfolio over a three year period. Long-term asset allocation clearly makes up the vast bulk of the portfolio's overall performance, while stock/manager selection and active asset allocation combined accounts for around 5% of the total return.

Source: AMP Capital. For illustrative purposes only – based on three year performance of AMP Balanced Growth Option net of fees and taxes. Past performance is not a reliable indicator of future performance.

Why asset allocation is so important now

In the years prior to the Global Financial Crisis (GFC), there was less variation in the performance of markets than we see today, particularly in equity markets. In this environment, investors could simply sit back and rely on rising markets to deliver the returns they needed. As a result, conversations focussed on the marginal differences in fund performance. These differences generally arose from active stock or manager selection.

Since the GFC, however, markets have experienced heightened volatility which has led to large and frequent swings in the performance of different markets. In this environment, getting the right asset allocation mix has been more important than ever. By owning a portfolio with at least some exposure to a variety of key asset classes, this ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas of the market. This is the fundamental principle of diversification and a critical risk management step. When it comes to picking the right mix of assets, managers now have more choices available to them.

Alternative asset classes such as infrastructure, absolute return strategies and private equity offer important diversification benefits given their low correlation to mainstream asset classes such as equities and bonds. This means their inclusion in a portfolio can help to lower overall risk and improve consistency in returns over time. This, consequently, provides a smoother journey for the investor. In the table below, we show that by progressively allocating to more asset classes the risk/return trade-off can be improved for the investor.

Source: AMP Capital. Based on medium-/long-term assumptions. Denominated in AUD. Equities and bonds are 50/50 Australian and global. Alternatives include direct infrastructure and absolute return strategies. *Portfolio volatility is a measure of risk. The higher the volatility, the riskier the portfolio.

A flexible approach to portfolio management

Looking forward, the strong likelihood is that markets will remain volatile, and returns will be more constrained than in the pre-GFC years. This means the asset allocation decision will be more important than ever, as will the flexibility to move asset allocations as market conditions change.

As volatility continues in markets, this can cause assets to experience periods where their prices diverge from fair value. Over shorter timeframes this creates opportunities for fund managers to add value or reduce risk by varying the asset class mix from its long-term strategic asset allocation settings. This process is known as active asset allocation. Even quite small changes to the asset mix can contribute to a better return outcome or lower overall risk. This is why active management of asset allocation plays such an important role in portfolio management, particularly in terms of seeking to preserve capital when markets are falling.

Remember to focus on what really matters

It's easy to see how investors can be sidelined by the performance of an individual stock, or into analysing the performance of a manager, when confronted with daily headlines. As we have seen though, in a diversified portfolio, these factors are of little consequence for return or risk relative to the impact of the long-term asset allocation decision. The strategic asset allocation directly reflects what the portfolio is ultimately designed to achieve, and therefore accounts for the majority of the return it generates and risk it takes. The ability of managers to pick stocks that outperform the rest of the market or adjust the asset mix to reflect current conditions is important as an additional source of return for the portfolio. However, the resulting contribution to overall portfolio returns is generally small. This is an important point, and one worth keeping in mind.

In the next article in our Building Better Portfolios series we explore the second phase of portfolio construction. Once the asset mix has been determined, what are the various ways one can gain exposure to the underlying asset classes?

About the Author

Debbie Allison is the Head of Portfolio Management within the Multi-Asset Group. Debbie is responsible for overseeing the Group's multi-asset investment capability which specialises in the management of diversified portfolios. This includes portfolio construction and asset allocation, monitoring and risk management.

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