THE IMPORTANCE OF ESTABLISHING A STRATEGIC ASSET ALLOCATION FRAMEWORK

What is the first step to establishing a strategic asset allocation framework?

Andrew Vogelstein: Given the specific needs and financial circumstances of any institution, it is essential to establish a strategic asset allocation framework to effectively manage their investment portfolios over the long-term. The first step is to identify the types and degrees of risk that the institution is able and willing to incur and the return goals consistent with those risks. The tolerance for negative outcomes or, drawdown risk, and the possibility of a permanent loss of capital, should be the ultimate drivers of a client's risk appetite. Standard deviation is a useful indicator of the market's sense for the level of uncertainty associated with an investment but using it as the only risk metric is not recommended. Peer or benchmark risk (e.g., tracking error), are also important considerations; although too close adherence to benchmarks or peer behavior can impede wealth creation and make it more difficult to protect against more relevant absolute measures of risk.

What are some of the other important factors that should be considered when constructing a strategic framework?

AV: An institution's annual draw requirement, its absolute return and relative return objectives, and investment preferences and restrictions. When examined in combination with an institution's risk tolerance, these factors both inform and guide decision-makers in establishing a clear and concise long-term strategic framework consistent with the institution's mission and long-term financial goals.

How detailed should a strategic asset allocation framework be?

AV: A degree of specificity is important when establishing an asset allocation framework; however, too much detail can be detrimental to the effective long-term management of the portfolio. For example, establishing a strategic asset allocation framework that requires specific exposures to sub-asset classes such as equity market capitalizations or particular geographies can limit a portfolio's flexibility to take advantage of opportunities or avoid risky situations. Instead, identifying strategic allocations for broad asset class categories such as U.S. long-only equity, international long-only equity, private equity, alternatives, fixed income, and cash, can provide an institution sufficient flexibility to manage the portfolio prudently over time.

Within an asset allocation framework, there are strategic asset allocation targets and tactical asset allocation parameters, what are the differences?

AV: Long-term strategic asset allocation targets represent the percentage of an investment portfolio that should be allocated to a particular asset class when the risk and return dynamic is balanced. Tactical asset allocation parameters are typically ranges within which investment decision-makers, based upon their investment outlook, can opportunistically increase or decrease a portfolio's allocation relative to a specific strategic target. The magnitude of these tactical ranges can vary and are usually determined by an institution's degree of comfort with short-term volatility - or tracking error - of returns relative to a benchmark. With a high(er) degree of comfort with portfolio returns that do not look like a benchmark's, tactical ranges around strategic targets can be relati vely wide; or, if there is a need to track a benchmark more closely, then ranges should be tighter around the strategic targets and rebalancing more frequent. Again, this is unique to every institution.

Once a strategic and tactical asset allocation framework is established, what's next?

AV: The implementation process and the ongoing management of the portfolio involves determining exposures to asset classes and investment managers based upon the various quantitative and qualitative factors discussed earlier. Going forward, tactically adjusting them to reflect evolving opportunities and risks while simultaneously satisfying the external demands or constraints set forth by the institution will be necessary, albeit infrequent. Remember, risk and return opportunities are dynamic over time; therefore, avoiding static portfolio structures is important. Said differently, if risk and return change with the environment, then maintaining consistent allocations across asset classes translates into accepting a dramatically different risk and return dynamic over time.

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As an investment professional, Andrew serves as President of Colony's Institutional Advisory Practice. Andrew and his team provide a full spectrum of OCIO solutions on a discretionary and non-discretionary basis to institutional for-profit and nonprofit clients and large family offices. In addition to working with clients to create, amend, and improve their governance structure, investment policies and strategic asset allocation, Andrew's team takes responsibility for manager selection and research across all asset classes. Andrew is also a member of Colony's Executive Committee and Investment Committee.

Andrew's career in the financial services industry spans more than 30 years. His knowledge and experience across various asset classes and securities, are instrumental in advising clients, and constructing and managing their portfolios. Andrew served as the CEO and a partner at New Providence Asset Management prior to merging with The Colony Group in 2021.

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