FINS2643 Final Exam Notes

Asset Allocation and Portfolio Construction

What is asset allocation and why is it important?

- Manner in which you spread your investments across different asset classes.
- Each asset class differs in E(r) at a moment in time, and average realised returns over time. Thus, asset allocation difference across investors is the most important factor for investors' portfolio returns.

The key asset classes and their investment characteristics

- **Cash** (e.g. ST treasury, bank deposits, commercial papers) – most liquid form of investment, with low nominal return risk and inflationary exposure. *Short horizon* and *extremely conservative* investors, not appropriate to have heavy weighting in cash LT.
- **Listed shares** – returns in the form of capital gains, dividends and franking credits. Tax efficient for individuals. Offers growth and liquidity. Increase the weighting as horizon and risk tolerance increases.
- **Fixed Income Securities** (e.g. bonds, preference shares, convertible securities) – receive coupon rate plus face value upon maturity. Long term debt instrument that is subjected to large losses if defaulted. Preference shares have ownership interest but receive a stated dividend rate, plus aims for capital gains. Lower E(r) and risk, conservative, medium investment horizons, looking to generate a secure income that matches maturity.
- **Property** (e.g. residential, land, warehouse, office, apartment building) – investment properties provide income and growth, whereas home ownership also provides tax and social security benefits.
- **Alternatives** (e.g. hedge funds, private equity, infrastructure funds, commodities and collectables, derivatives) – no more than 10% of a well-diversified portfolio.

Role of managed funds for asset allocation

- Cost-effective access to a pre-diversified and automatic periodically rebalanced fund that matches investment preferences.

The concept and purpose of investment policy statement (IPS)

- Plan that guides the investor and planner in long-term investment decisions. It identifies the goals of the portfolio (current income, capital growth, total return, preservation of capital), and the asset allocation and performance benchmark. Over your investment horizon, you may have to rebalance, reassess, and reforecast investment decisions.

Efficient frontier for portfolio choice decisions

- No matter what type of investor you are, you will hold some 50/50 stocks/bonds. Cash is the risk free rate at which (we assume) you can borrow and lend at.
- Due to bank interest rate margins (issue loans at margin for what they pay = gap between borrowing rate and investing rate. You have two tangency portfolios (low and high risk), where you are more weighted to stocks (on the upper tangent) and more weighted to bonds (on the lower tangent).