9

Asset Allocation and Related Decisions in Portfolio Management (2)

In practice, the asset allocation decision is affected by numerous constraints that present practical challenges to asset allocation. Significant investor-based constraints include investable assets, liquidity needs, time horizon, and regulatory and tax environments.

This study session examines the effects of these constraints and presents adaptations to address them by institutional investor type. Also discussed are behavioral biases that influence the asset allocation process and ways to overcome these biases.

When the strategic asset allocation includes exposure to global markets, non-domestic currencies create additional sources of portfolio volatility and potential returns. How currency exposures can be managed to reflect a client's investment objectives and constraints is explored. To evaluate performance, the asset allocation strategy and its underlying exposures are often measured against specified benchmarks. The session concludes with coverage of market indexes, including their use as performance benchmarks.

READING ASSIGNMENTS

Reading 18	Asset Allocation with Real-World Constranits by Peter Mladina, Brian J. Murphy, CFA, and Mark Ruloff, FSA, EA, CERA
Reading 19	Currency Management: An Introduction by William A. Barker, PhD, CFA
Reading 20	Market Indexes and Benchmarks by C. Mitchell Conover, PhD, CFA, CIPM

LEARNING OUTCOMES

READING 18. ASSET ALLOCATION WITH REAL-WORLD CONSTRAINTS

The candidate should be able to:

a   discuss asset size, liquidity needs, time horizon, and regulatory or other considerations as constraints on asset allocation;

b   discuss tax considerations in asset allocation and rebalancing;

c   recommend and justify revisions to an asset allocation given change(s) in investment objectives and/or constraints;

d   discuss the use of short-term shifts in asset allocation;

e   identify behavioral biases that arise in asset allocation and recommend methods to overcome them.

READING 19. CURRENCY MANAGEMENT: AN INTRODUCTION

The candidate should be able to:

a   analyze the effects of currency movements on portfolio risk and return;

b   discuss strategic choices in currency management;

c   formulate an appropriate currency management program given financial market conditions and portfolio objectives and constraints;

d   compare active currency trading strategies based on economic fundamentals, technical analysis, carry-trade, and volatility trading;

e   describe how changes in factors underlying active trading strategies affect tactical trading decisions;

f   describe how forward contracts and FX (foreign exchange) swaps are used to adjust hedge ratios;

g   describe trading strategies used to reduce hedging costs and modify the risk–return characteristics of a foreign-currency portfolio;

h   describe the use of cross-hedges, macro-hedges, and minimum-variance-hedge ratios in portfolios exposed to multiple foreign currencies;

i   discuss challenges for managing emerging market currency exposures.

READING 20. MARKET INDEXES AND BENCHMARKS

The candidate should be able to:

a   distinguish between benchmarks and market indexes;

b   describe investment uses of benchmarks;

c   compare types of benchmarks;

d   contrast liability-based benchmarks with asset-based benchmarks;

e   describe investment uses of market indexes;

f   discuss tradeoffs in constructing market indexes;

g   discuss advantages and disadvantages of index weighting schemes;

h   evaluate the selection of a benchmark for a particular investment strategy.