



When it comes to setting investment strategy, most investors accept that the largest impact on the risk/return profile will come from the asset allocation. While variance within asset sectors (i.e. active management) will play a part, this is usually overwhelmed by the differences in returns between, say, equities and bonds.

Thus a key consideration is the policy in place to manage asset allocation. Traditionally, a strategic asset allocation (“SAA”) is set to guide the long-term profile of the investment portfolio. However, at this point there is a divergence in philosophies. Some will take a “set and forget” approach, rebalancing back to the SAA when required, while others will engage in tactical asset allocation (“TAA”).

TAA involves making active decisions to reweight the portfolio away from its SAA to generate better returns (or sometimes to reduce risk/volatility). It is important to note that TAA may in fact involve inaction (consciously allowing the portfolio to drift away from its SAA) and that adherence to the SAA will involve regular trading (bringing the portfolio back into line with the SAA).

The argument for TAA is compelling; surely if one believes in active management within asset sectors, it makes sense to apply active management to the asset allocation?

However, as our analysis in this paper shows, experience in the KiwiSaver market has been mixed at best.¹

Analysis of the KiwiSaver market

We see a range of approaches in New Zealand. Some managers have a well-developed TAA approach and are very active in adjusting their portfolios. Others take a more neutral view of the world, sticking relatively close to their SAA.

However, due to differences in relative returns, all funds will deviate from their SAA to some degree from time to time. The question is how much tolerance the managers have for this. Rebalancing back to the SAA too frequently is inefficient due to trading costs.

We have sought to quantify the effects of asset allocation deviations for the KiwiSaver balanced funds in our investment survey. We have compared the difference in returns from

- a static benchmark portfolio of the managers’ SAAs, to
- a portfolio using the managers’ actual asset allocations.

We use market index returns in both portfolios to remove the effect of active management within asset sectors. Thus, the difference between the two captures just the asset allocation effect.

We first look at how active the managers have been. For this we present the average absolute deviation from SAA over the three years to June 2018. That is, we take all the overweights and underweights and sum them to see how far away from SAA the managers are in aggregate.

For instance, an overweight of 5% to shares, balanced by an underweight of 5% to cash, would give an aggregate 10% position.

	Active measure %	Rank
AMP	22.6	(7)
ANZ	14.7	(8)
ASB	23.6	(6)
Booster	23.8	(5)
Fisher Two	28.1	(3)
Kiwi Wealth	61.0	(1)
Mercer	29.0	(2)
Milford	25.9	(4)
Nikko	7.4	(9)
Westpac	6.1	(10)
Average	24.2	

Most managers tend to have around 20-30% difference from SAA. Or, 10-15% of overweights balanced by 10-15% of underweights.

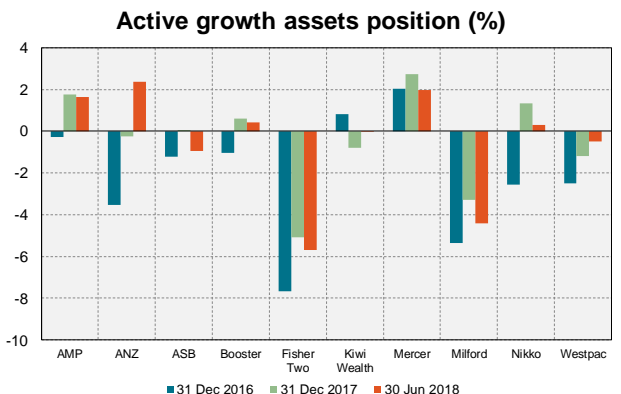
However, Nikko and Westpac clearly take a more controlled approach. A difference to SAA of 6-7% is probably indicative of a rigorous rebalancing policy.

Kiwi Wealth is a clear outlier, with over 60% difference to SAA. This mostly comes about from a holding in global bonds, whereas its target investment mix has a zero allocation to this sector.

Defensive/aggressive positioning

Even without large positions, the managers can express a bias towards or away from growth assets, illustrating a bullish or bearish view of the world.

The following chart shows the active position in growth assets versus SAA. A positive figure means that the manager was overweight growth assets compared to its neutral position.



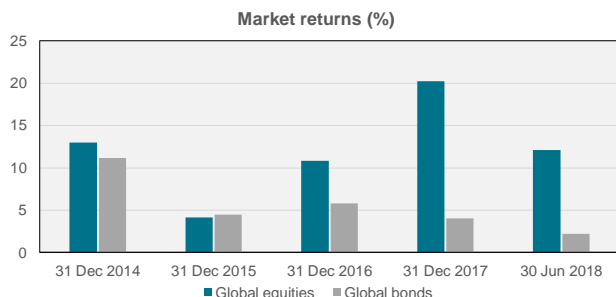
This shows that despite having significant variance amongst the sectors, Kiwi Wealth has tended to keep its overall growth/income mix very close to SAA. Fisher Two and Milford, on the other hand, have relatively defensive positions.

Overall, there is a defensive bias. The average tilt to income assets is 0.5% as at June 2018 and was as high as 2.1% in December 2016.

Mercer is a notable exception and AMP and ANZ have also moved to more bullish positioning.

The last two and half years have seen a very strong market for equities and so a pessimistic view would have proved incorrect.

In the following chart we show the performance of global equities and bonds (both fully hedged) for the last four and a half calendar years. With perfect foresight one would have tilted towards equities recently.



Results

In this section we show the returns from the static benchmark and the actual asset allocations.

3 years to 30 June 2018	AMP % pa	ANZ % pa	ASB % pa	Booster % pa	Fisher Two % pa	Kiwi Wealth % pa
Actual	8.2	8.0	8.6	7.6	7.6	6.3
Benchmark	8.1	8.5	8.5	7.6	8.0	6.2
Difference	0.2	-0.5	0.1	-0.0	-0.4	0.1

3 years to 30 June 2018	Mercer % pa	Milford % pa	Nikko % pa	Westpac % pa	Average % pa
Actual	7.3	7.6	8.8	8.3	7.8
Benchmark	7.6	7.9	8.4	8.6	7.9
Difference	-0.2	-0.3	0.4	-0.3	-0.1

There is an almost even split of those that have added value and those that have detracted value. Four of the ten managers added value over the period and the average result is close to zero (-0.1% pa).

Despite being one of the closest to its SAA, Nikko has added the most value. This mostly came from a period in 2015 where Nikko was tilted towards NZ shares over global shares. It has since been much closer to SAA.

Mercer has lost value despite being (correctly) overweight growth assets. This mostly came from positions such as being underweight global bonds in favour of cash in 2015/2016 and being underweight property in favour of alternative assets.

Concluding remarks

The results are underwhelming on two fronts. Firstly, they show that most managers have been inconsistent at best at adding value through their asset allocation tilts (whether conscious or tactical). The defensive bias to the group appears to have been enacted too early, missing out on some of the strong returns in 2017.

Secondly, the size of the effect is minor. Even for those managers with large deviations from SAA, the effect is relatively small compared to total returns. A larger effect clearly comes from the SAA. For instance, the difference in benchmark returns between Nikko (62% growth) and Fisher Two (57%) is 0.4% pa, as much as any fund produced from TAA. This implies there is better mileage to be had from getting the SAA position correct, rather than engaging in TAA.

Appendix: Methodology

We have used the actual and benchmark asset allocations for ten large KiwiSaver providers' balanced funds in the MJW June 2018 Investment Survey. We have interpolated quarterly data where monthly asset allocation data is unavailable.

We have used monthly index data to calculate the returns of the benchmark portfolio and the active portfolio. We ignore trading costs.

We have grouped assets into eight asset classes, using standard indices for each asset sector based off the funds' current product disclosure statements. These will not always match the actual indices in use, however they act as a guide for the asset sector performance profile.

- **Domestic shares:** A split of the S&P/NZX 50 Gross (including imputation credits) index and the S&P/ASX200 index (in AUD) depending on the strategic allocation to New Zealand and Australian respectively.
- **Global Shares:** MSCI World, MSCI Emerging Markets and/or MSCI ACWI indices (net). We use the long-term hedging strategy and do not allow for active currency positioning.
- **NZ Property:** A split of the S&P/NZX All Real Estate index and S&P/ASX200 AREIT index (in AUD).
- **Global Property:** FTSE EPRA/NAREIT developed rental index (100% hedged).
- **NZ Bonds:** A split of the S&P/NZX Government Bond index and the S&P/NZX Corporate A Grade index.
- **Global Bonds:** A split of the Bloomberg Barclays Global Aggregate index (100% hedged) and the FTSE WGBI (100% hedged).
- **Cash:** S&P/NZX 90 Day Bank Bill index.
- **Alternative assets:** S&P/NZX 90 Day Bank Bill index (plus appropriate hurdle if applicable)

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries providing advice on investment consulting, superannuation, and insurance. The firm, established in 1992, has offices in Auckland and Wellington and is an alliance partner of Willis Towers Watson, a leading global services company that is located on the web at willistowerswatson.com.

For further information please contact:
Ben Trollip 09 300 7315
ben.trollip@mjlw.co.nz

¹ There are two further issues to be aware of with TAA. The first is that by adjusting the asset allocation, the risk/return profile of the portfolio changes. One may argue that this is entirely the point of TAA. However, if there is a persistent bias to the TAA positioning, this affects the long-term risk/return profile of the portfolio – it may be being “mis-sold”.

The second is that TAA is a lower breadth decision. The amount of asset sectors that can be used to adjust the portfolio is an order of magnitude smaller than the number of securities that can be bought and sold within each asset class. This means that TAA positions need to be larger and/or need to be correct more often in order to be as successful as stock selection decisions which are a more diversified collection of bets.