Questioning long held beliefs in the superannuation industry

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Everyone knows that decisions about asset allocation are significantly important in portfolio management. Indeed, getting the asset allocation decision right is fundamental for any fund to meet their risk/return objectives. But little research has been undertaken to understand the importance of the asset allocation decision over periods of bull and bear markets (or when markets are particularly volatile – pertinent to the situation in recent years).

In his recent study ("Cross-Region, Cross Sector Allocation with Regimes") researcher Paul Dou asks the question how market conditions impact on performance, risk and diversification in an international asset allocation setting. The implications of the research offer three main highlights. First, economic conditions in asset allocation are really important. Second, setting asset allocation weights that ignore time variation in market cycles is problematic and can impact on performance outcomes. And third, following from these issues, the risk/return tradeoffs between market regimes (bull versus bear) are very different, and investors should be aware of this and not just what the long run means and volatilities are. This implies that while diversification matters, understanding the correlation structures between markets and within industries is really important.

The research suggests that correlations between international equity returns are usually higher during bear markets than bull markets. During tough economic conditions fund managers may fail to adequately achieve the diversification benefits that their portfolios are designed to capture. The study finds that returns have a different but predictable structure in both bear and bull regimes. Bull regimes have higher mean returns and low volatilities while bear regimes have a wider dispersion of returns and a much lower mean.

Conventional wisdom dictates that different regions and sectors perform differently in various stages of the business cycle. The study suggests that if fund managers use a regime switching model, using statistical techniques to predict when shifts in asset allocation need to be made, rather than a traditional model, their returns will be improved. The research questions certain long held beliefs in global portfolio management, which has implications for the superannuation industry due to a significant portion of assets being allocated to international stock markets.

Paul Dou is a doctoral student supervised by Professor David Gallagher. Their research aims to provide Australian fund managers and other Super Industry participants with value-added research outcomes.

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