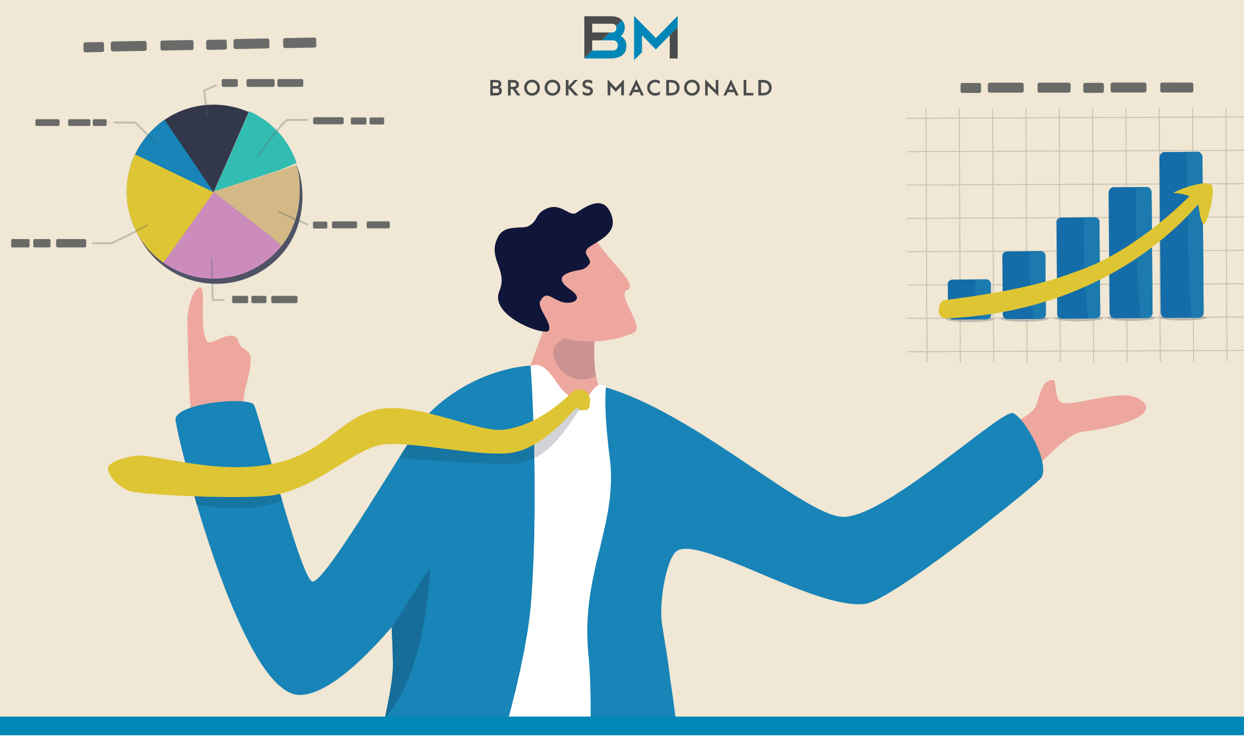
13 July 2023



The importance of asset allocation for investment returns

Asset allocation is at the heart of what we do. At Brooks Macdonald, we recognise that asset allocation is an important building-block in generating long-term investment returns. While asset allocation is important though, it works best in combination with active portfolio management, and it is this coordination and partnership which can help to target the investment outcomes that our clients are looking for.

At the core of our asset allocation approach is Brooks Macdonald's Centralised Investment Process. This allows us to create diversified investment portfolios with varying risk profiles. It is designed to ensure that each client's investment portfolio is able to leverage the broad and varied expertise of our asset allocation committee, investment committee and specialist sector research teams.

What is asset allocation?

Asset allocation involves the distribution of capital to various asset classes (such as stocks and bonds) and geographies. It is based on the principle that the values of different assets react in different ways to changes in economic and market conditions.

In setting our asset allocation strategy, our asset allocation committee evaluates investment research to make short-term (tactical) and longer-term (strategic) assessments of prevailing global economic and financial conditions. The committee quantifies its assessments and communicates its strategy through several 'guidance portfolios', each pertaining to a certain risk profile and consisting of recommended allocations to various asset classes. The committee meets at least monthly to adjust its strategy.

Asset allocation works best with active portfolio management.

Our investment managers are organised into sector research teams, each of which specialises in a particular area of the market. This structure allows them to pool their knowledge and experience, as well as ensuring that the managers of client portfolios are at the centre of our research process.

It is the responsibility of each sector research team to produce a buy list of recommended investments pertaining to their area of specialism. When combined, these lists form a central buy list consisting of a range of different types of investments. The investment cases of all buy list investments are reviewed regularly.

Empirical evidence recognises the value of asset allocation.

There has been a huge amount of academic and empirical research undertaken to try to determine the value of asset allocation in investment returns. From this, the key observation is that rather than acting in isolation, asset allocation works alongside active portfolio management.

Asset allocation is important, but it is not the only factor. From a paper called 'The Equal Importance of Asset Allocation and Active Management'[1] (Xiong, Ibbotson, Idzorek and Chen, 2010), the authors noted that investment returns can be divided into three parts: the return generated by the market, the extra return added from asset allocation, and the added return from active portfolio management. Their studies showed that after removing the dominant market return component, asset allocation and active portfolio management are equally important.

This supports the Brooks Macdonald approach of using an asset allocation framework alongside active portfolio management choices from a buy list of recommended investments.

> “Asset allocation is important, but it is not the only factor.”

Asset allocation encourages longer-term thinking.

Asset allocation can also encourage good investor behaviour and discipline. By providing investors with a clear asset allocation framework, this can promote a long-term investment outlook and thereby help to avoid the risk of emotional knee-jerk reactions during more volatile markets.

As is the subject of a Brooks Macdonald article, 'The importance of remaining invested'[2], we have shown that during the global financial crisis of 2008, and again with the coronavirus pandemic of 2020, the best and worst days of market performance are often clustered together. Rather than try to time the market, we recognise that it is time in the market, through a diversified asset allocation, which can help to target our clients' long-term investment performance goals.

Regulators also recognise the value in asset allocation.

The question of asset allocation is arguably even more important now, as we reflect on a period of unprecedented market volatility during the 2020 coronavirus pandemic. Similarly, in 2009 following the end of the global financial crisis, and no doubt looking back on an equally challenging investment environment, the US Securities and Exchange Commission (SEC) published a paper where they asked the question of 'Why Asset Allocation is so important'[3] (SEC, 2009).

As the SEC noted in their answer, 'asset allocation is important because it has a major impact on whether you will meet your financial goal'. A successful asset allocation strategy not only includes asset categories which could deliver a diversified set of investment returns under different market conditions, but also, importantly, by holding to a longer-term investment horizon, this supports the taking of additional expected risk for expected returns. As the SEC paper notes, 'when it comes to investing, risk and reward are inextricably entwined', but 'if you have a financial goal with a long time horizon, you are likely to make more money by carefully investing in asset categories with greater risk, like stocks or bonds, rather than restricting your investments to assets with less risk, like cash equivalents.'

Ultimately, different levels of risk will suit different investment goals and investment horizons, but by utilising asset allocation at the heart of our investment process, this helps to manage the appropriate levels of expected risk and return accordingly.

Asset allocation and the importance of rebalancing.

Rebalancing is the bringing of investment portfolios back to the target asset allocation mix. This is necessary because over time, some investments may grow faster than others. By rebalancing in line with our Centralised Investment Process, we ensure that investment exposures keep to both a targeted asset allocation mix, as well as reflecting the particular level of risk. In addition to helping to target long-term returns, an effective asset allocation strategy helps to keep in balance the level of risk that investment portfolios are taking.

“By rebalancing in line with our Centralised Investment Process, we ensure that investment exposures keep to both a targeted asset allocation mix, as well as reflecting the particular level of risk.”

[1] The Equal Importance of Asset Allocation and Active Management, James X. Xiong, Roger G. Ibbotson, Thomas M. Idzorek & Peng Chen, Financial Analysts Journal, 66:2, 22-30 (1 March 2010), https://doi.org/10.2469/faj.v66.n2.7

[2] The importance of remaining invested, Brooks Macdonald (4 August 2022), https://www.brooksmacdonald.com/insights/the-importance-of-remaining-invested

[3] Beginners' Guide to Asset Allocation, Diversification, and Rebalancing, US Securities and Exchange Commission (28 August 2009), https://www.sec.gov/reportspubs/investor-publications/investorpubsassetallocationhtm.html

BROOKS MACDONALD

Important information

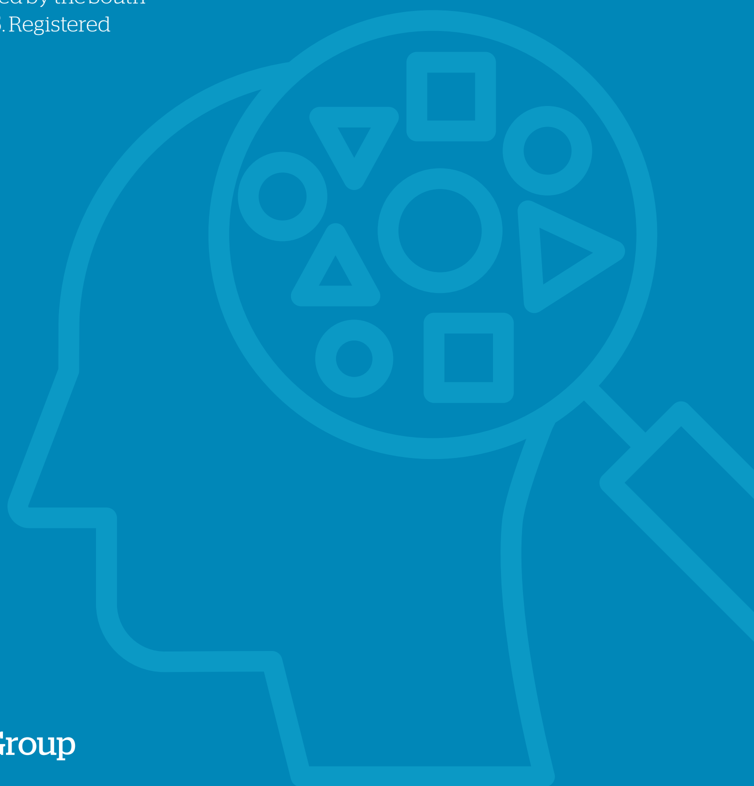
Investors should be aware that the price of investments and the income from them can go down as well as up and that neither is guaranteed. Past performance is not a reliable indicator of future results. Investors may not get back the amount invested. Changes in rates of exchange may have an adverse effect on the value, price or income of an investment. Investors should be aware of the additional risks associated with investing in smaller companies, emerging or developing markets. The value of your investment may be impacted if the issuers of underlying fixed income holdings default, or market perceptions of their credit risk change.

The information in this document does not constitute advice or a recommendation and you should not make any investment decisions on the basis of it. This document is for the information of the recipient only and should not be reproduced, copied or made available to others.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)

Brooks Macdonald is a trading name of Brooks Macdonald Group plc used by various companies in the Brooks Macdonald group of companies. Brooks Macdonald Group plc is registered in England No: 04402058. Registered office: 21 Lombard Street, London, EC3V 9AH.

Brooks Macdonald International is a trading name of Brooks Macdonald Asset Management (International) Limited. Brooks Macdonald Asset Management (International) Limited is licensed and regulated by the Jersey Financial Services Commission. Its Guernsey branch is licensed and regulated by the Guernsey Financial Services Commission and its Isle of Man branch is licensed and regulated by the Isle of Man Financial Services Authority. In respect of services provided in the Republic of South Africa, Brooks Macdonald Asset Management (International) Limited is an authorised Financial Services Provider regulated by the South African Financial Sector Conduct Authority. Registered in Jersey No: 143275. Registered office: 5 Anley Street, St Helier, Jersey, JE2 3QE.



More information about the Brooks Macdonald Group can be found at: **www.brooksmacdonald.com**.