PRESCIENT

# ASSET ALLOCATION IN CONSTANTLY EVOLVING MARKETS

With constantly changing markets and macroeconomic fundamentals, asset allocation has become a more engaging process where the employment of robust processes no longer serves as a way of staying ahead of the curve, but rather a prerequisite for survival. At Prescient Investment Management we are cognisant of continuously evolving markets and take on a quantitatively and macroeconomically inclined asset allocation methodology.

Our investable asset universe spans a wide range that includes local cash, equities, bonds, real assets (for example, listed property and inflation-linked bonds) and SA alternatives. Furthermore, there are off-shore variants including developed market cash, emerging market and developed market bonds and equities, amongst others.

The foundation of asset allocation lies in understanding the co-movements of these various asset classes with one another and the extent to which each class is affected by changes in macroeconomic fundamentals - keeping in mind various constraints like Regulation 28 and other fund-specific limitations. Ultimately, the core objective is to structure an optimal allocation that is well-diversified, offering attractive risk adjusted returns over the long-term.

Though we base optimal allocation on the standard deviation of the asset's historical returns (using an efficient frontier), we believe that past performance is in no way an accurate indicator of future performance, hence our calculation of expected long-term returns for each asset class does not rely on recent historic performance.

Rather, we employ a risk premia based approach in which we add a premium for each risk factor that is embedded in the asset class. For instance, within the main asset classes that we access across our balanced portfolios, cash would have the lowest expected return and emerging market small caps would have the highest expected returns as the latter are exposed to more risk factors compared to cash. This approach ensures that we price each risk factor within an asset class, ensuring that our long-term return expectations are properly informed.

Our asset allocation process starts with a strategic asset allocation (SAA), which is essentially a long-term view that focuses on tracking the benchmark. Generally, this would be the strategy employed for passive funds. However, none of our funds are of a passive nature. Rather, the funds rely on tactical asset allocation (TAA), which introduces tilts to the SAA to capitalise on prevalent short- to medium-term market mispricing. It is for this reason that valuations form part of our well-defined set of indicators - along with analysis of the prevailing economic environment, available liquidity and market sentiment - that govern our TAA process.

In addition, the TAA adjustments are grouped into three buckets: Alpha, Beta and Vega. Generally, an Alpha tilt would allow an investor to gain a market neutral exposure (for example, overweight resources vs financials within the SA equity allocation), whereas a Beta tilt is one that would enable the exploitation of weights among various asset classes (for example, overweight bonds and underweight equities), whilst a Vega tilt mainly speaks to volatility trades where one would either buy or sell options based on the level of volatility (for example, sell options when volatility is high and vice versa).

Once the tilt to be explored has been identified, the decision as to whether it materialises rests on the strength and the level of conviction. For more conservative funds, which have a relatively tight tracking error, the level of conviction has to be high for the tilt to be exercised.

From a real yield perspective, SA and global emerging market yields remain attractive relative to their more developed counterparts including the European Union and the US. As a result, we are overweight SA and global emerging market bonds, but underweight US and EU bonds. On the other hand, for real assets like SA listed property and inflation-linked bonds, we are moderately overweight as their respective yields remain in the top quartile relative to their historic yields, and the slope of the US yield curve is still in positive territory.

Overall, given the current macroeconomic fundamentals, we expect riskier asset allocations to outperform more conservative ones, hence at Prescient Investment Management we are also overweight equities.

The quest to remain relevant in constantly evolving markets can play on one's emotions – making taking bets that would otherwise be seen as unfeasible, an option. However, our robust TAA process ensures that we have strict guidelines to base our decisions on, rendering emotions an insignificant factor to our overall asset allocation process.

ends

## About Prescient

- Prescient Investment Management (Pty) Ltd (Prescient Investment Management), is an authorised financial services provider (FSP 612).
- For any additional information, including our services, fund prices, fees, brochures, minimum disclosure documents and application forms please go to www.prescient.co.za