The Final Frontier: Capital Asset Management

One of the hottest products on the street is called *Tactical Asset Allocation*, *Strategic Asset Management*, *Asset Allocation Tools* – or *Capital Asset Management* (the name I prefer). Instead of picking particular securities, the program chooses classes of assets – cash, stocks, bonds. Given an investor's preference for risk taking, a portfolio of these asset classes is calculated to maximize risk-adjusted returns. The software runs for about $10,000. Some houses will give clients the results of the asset allocation for free.

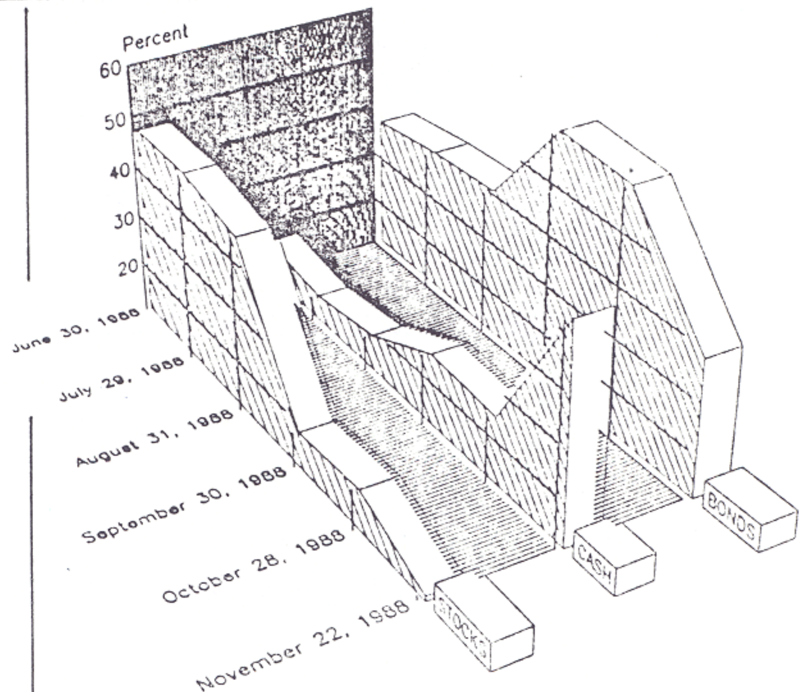
Picking individual stocks is extremely difficult. The *Wall Street Journal* and Burton Makiel of Princeton are engaged in an exercise to compare analysts' best picks against darts thrown at the *Journal*. So far there is no clear winner.

The advantage of asset classes is that you have a diversified portfolio in each class. As a result, if one of the securities in your portfolio has unexpectedly bad news there is probably another security that has good news. As a result, the portfolio returns are more stable.

Morgan Stanley runs a routine that considers countries as asset classes. They might recommend a positive weighting in Britain, United States and Germany and a short sale in France. Each country is characterized by a basket of 10-20 stocks that have maximum correlation with a large stock index in that country.

Salomon Bros. has an asset allocation model that determines the optimal weights in three U.S. asset classes: stocks (portfolio of NYSE stocks), cash (Treasury bills, Eurodollar deposits,...) and bonds (portfolio of U.S. Treasury bonds). Figure 1 shows the shifts in their asset allocation from June 1988 to the end of November.

Figure 1. Shifts in the Salomon Brothers Tactical Asset Allocation Model, 30 Jun 88-Present



The current Salomon allocation is 11% stocks, 37% bonds and 52% cash. From the figure, it is evident that there has been a switch from bonds to cash. This reflects the recent increases in short term interest rates and the flattening of the Treasury yield curve. Perhaps equities are given a small weight because of their vulnerability in the late stages of a business cycle expansion, the uncertainty about the budgetary policy of the new President and the recent increases in the interest rates.

The allocation routine delivers an "optimal" portfolio given the information the investor provides. The quality of this information is critical to the success of the program. The investor must provide estimates of expected returns of the asset classes, the volatility of the asset classes and the correlation between the returns of these groups along with her preference for risk taking. Typically, the historical correlations are used. The implied volatilities from options contracts on a stock index, the Treasury bond and the Eurodollar deposit are used to proxy for the variances. The expected returns on the portfolios are obtained by many methods. A method that is growing in popularity is regression based forecasting of stock returns that is studied in my BA453.

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