

Case Study #1: Dynamic Asset Allocation

IFSWF Subcommittee II: Investment & Risk Management

Objectives

- Describe the key characteristics that comprise a successful active risk allocation (or dynamic asset allocation) framework, including supportive investments beliefs, strong governance, and a formal, disciplined approach to risk allocation.
- Identify the risks and challenges associated with active risk allocation and how these three key characteristics can help mitigate these risks.
- Introduce a disciplined approach to risk capital allocation that implements strategic tilts based on perceived misvaluations. Provide an overview of New Zealand's active risk tool (ART) and the role it plays in strategic tilting. Describe the ART's theoretical underpinnings and how it relates to New Zealand's time horizon and investment beliefs.
- Share insights from the New Zealand's implementation of the strategic tilt program and how it has aided the Fund in keeping its mandate of "maximizing returns without undue risk to the Fund" through value-adding activities.
- Draw conclusions that apply to the broadest possible set of SWFs, while recognizing that all SWFs have unique objectives, circumstances, and constraints, and that no single solution will apply for all SWFs.

Questions to be addressed

- What is risk capital allocation and how is it different (or similar) to dynamic asset allocation?
- What are the prospective risks and rewards that an SWF can expect when it engages in dynamic asset allocation?
- What is the role of qualitative judgment – as opposed to quantitative methods – in a dynamic asset allocation program? How can an SWF strike the optimal balance?

Overview

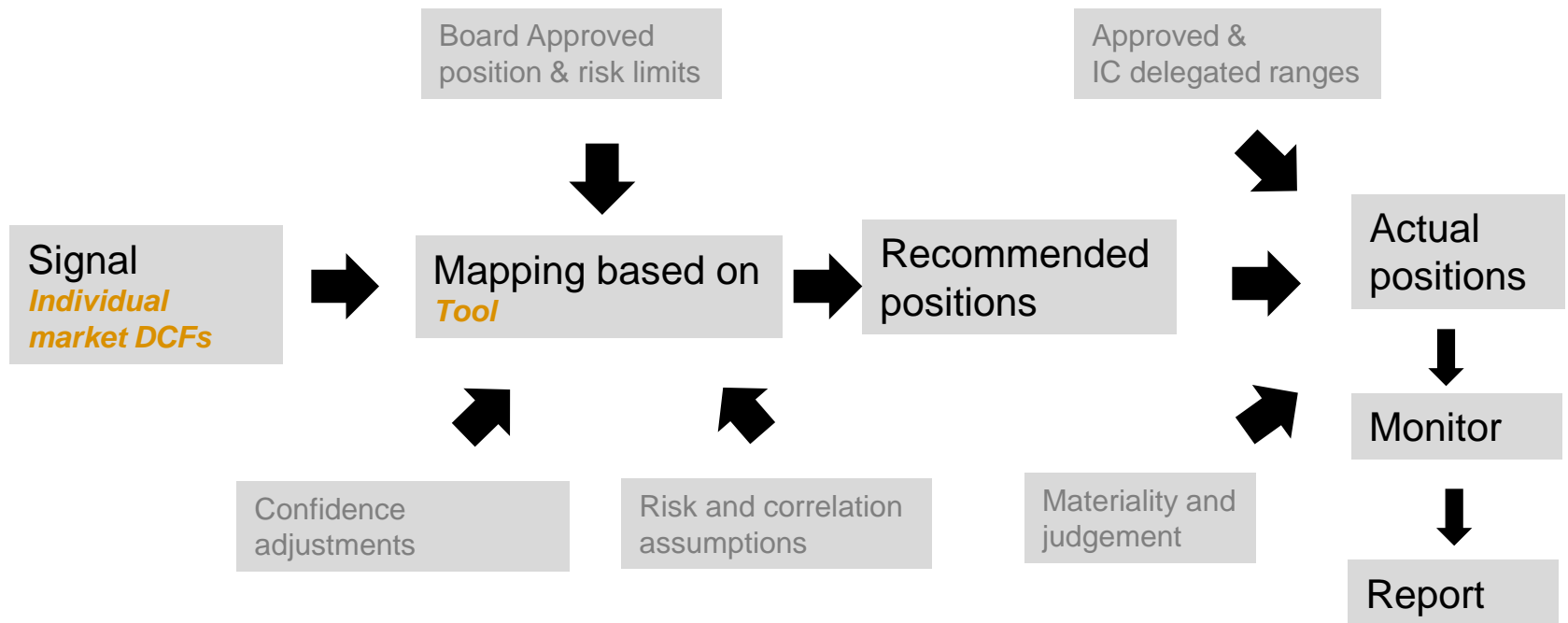
- Key elements for success
- The Fund's strategic tilting approach
- Benefits and advantages of approach

Elements for success

Three key elements to a successful strategic tilting programme are:

1. Supportive investment beliefs.
 - Asset prices are subject to mean reversion. Prices tend toward fair value.
 - NZSF's long time horizon allows it to bear this uncertainty and withstand the inevitable mark-to-market risk of a "contrarian" strategy.
 - Investors with a long-term horizon can outperform more short-term focused investors.
2. Strong governance.
 - Board commitment - avoid "stopping out" during inevitable periods of losses.
 - Alignment of interest - managed internally; "systematised" allocations
3. Disciplined allocation of risk.
 - Formalised, disciplined "tool"

Strategic tilting approach



Benefits and advantages of approach

- **Transparency and discipline.** Transparent application of risk budgets in setting position sizes for the tilting programme. Not a black box.
- **Clear decision-making framework.** Decision framework to size tilt positions based on key inputs:
 - an estimate of the relative size of each opportunity
 - our confidence in the estimate
 - an active risk budget
- **Explicit risk and return expectations.** Internal tools allows us measure anticipated active risk and return from each part of the strategic tilting programme.