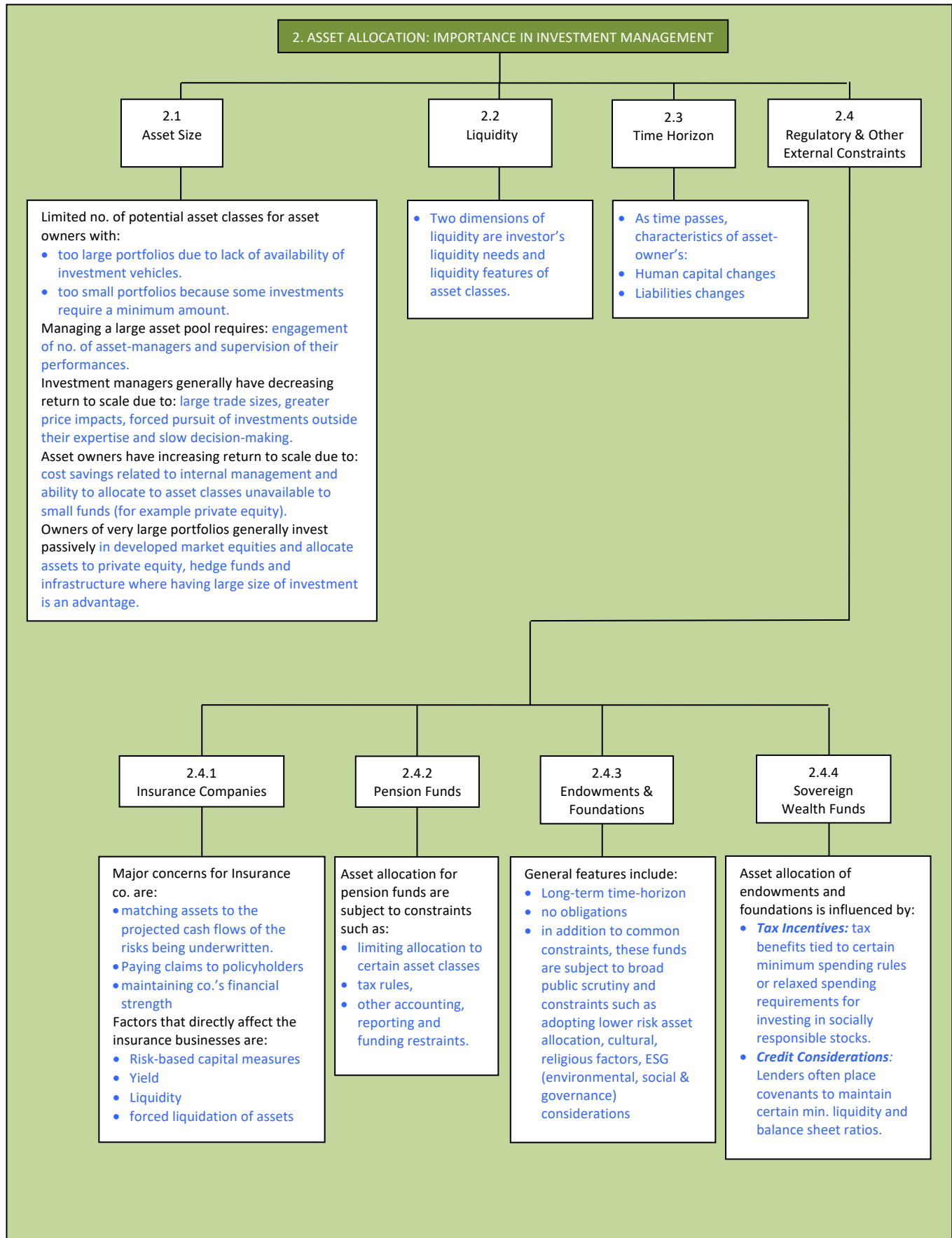
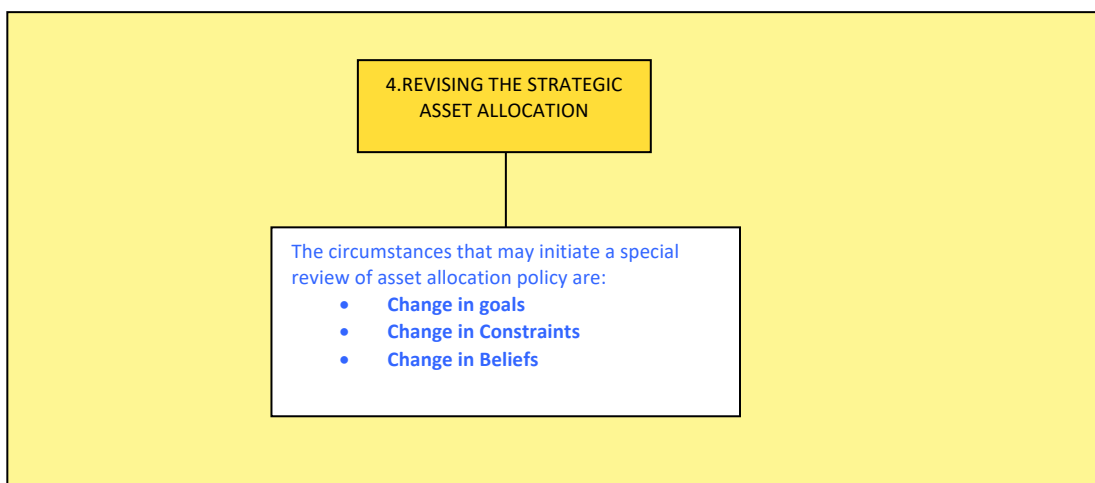
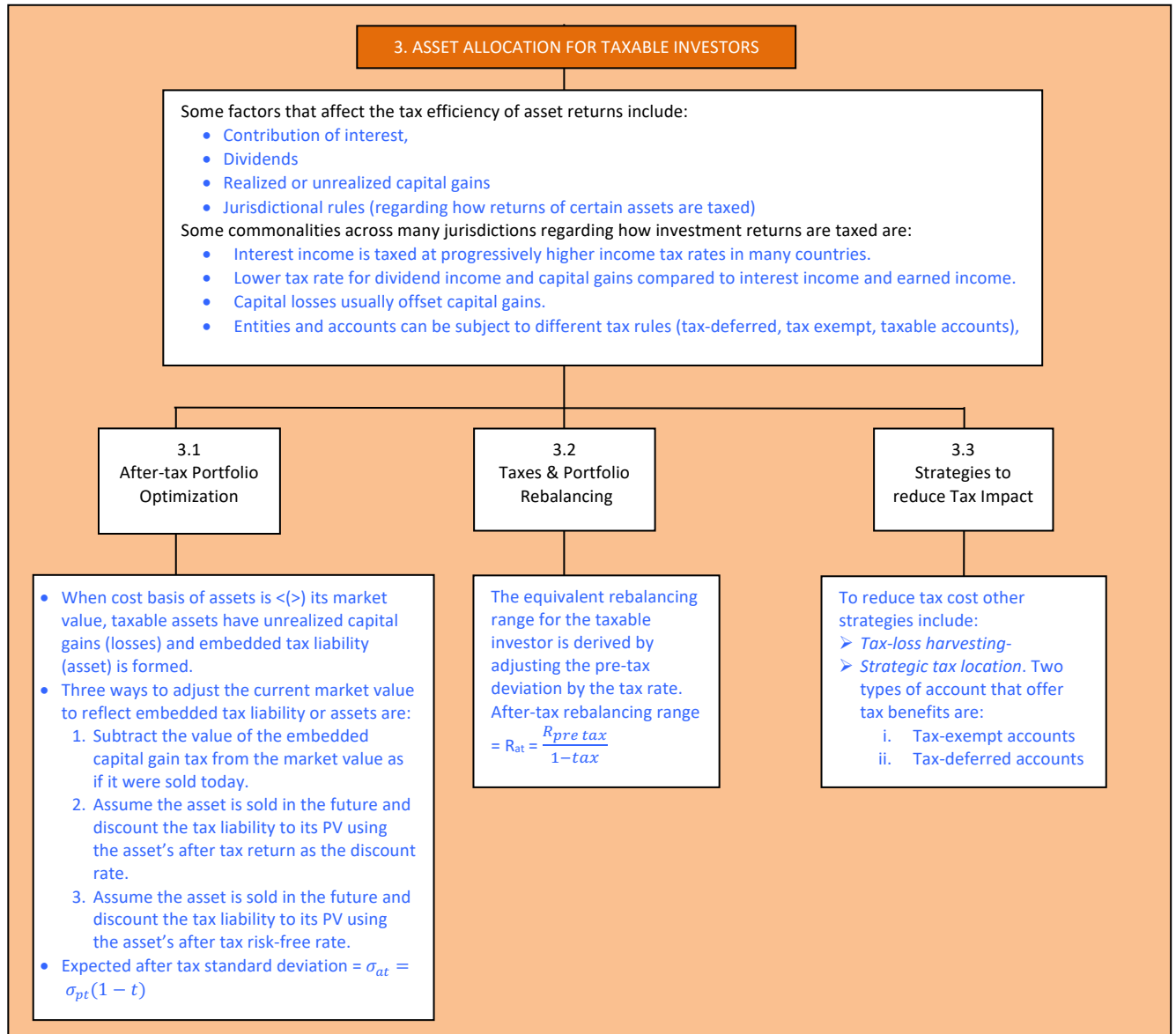


Asset Allocation with Real World Constraints





5. SHORT-TERM SHIFTS IN ASSET ALLOCATION

Characteristics of TAA are as follows:

- capturing temporary return opportunities regarding financial or economic market conditions.
- Assumes that investment returns are predictable in the short-run.
- Finding cyclical variations within a secular trend or short-term price changes in capital markets.
- Short-term adjustments to broad asset-classes, sectors or risk factor premiums

Common risk constraints:

- acceptable range around each asset class policy weights
- predicted tracking error budget versus range of targeted risk

TAA Evaluation: comparison of TAA and SAA with respect to

- Sharpe ratios
- information ratio or t-statistic of excess return
- realized risk and return of TAA portfolio and the realized risk and return of portfolios along the SAA's efficient frontier.
- performance difference using the attribution analysis

TAA Drawbacks:

- Higher trading costs and higher taxes (for taxable investors).
- Higher concentrated asset class risk

5.1 Discretionary TAA

Discretionary TAA typically focuses on:

- asymmetric return distribution
- skilled managers
- temporary market movements

Short-term forecasts require number of inputs that provide relevant information about:

1. Current and expected political, economic and financial market conditions: Valuation measures (such as P/E, P/BV, Div. yield), term & credit spreads, central bank policy, GDP growth, earnings expectations, inflation expectations, leading economic indicators.
2. Economic sentiment indicators: Consumer spending, level of optimism regarding economy and personal finances.
3. Market sentiment: Sentiments of financial market participants. Three key indicators are:
 - **Margin Borrowing:** Higher prices boost confidence and trigger more buying on margin that in turn spur higher prices.
 - **Short interest-** indicates current & future bearish sentiment
 - **Volatility Index:** (fear index), indicates market expectations of near-term volatility.

5.2 Systematic TAA

Systematic TAA captures asset class anomalies that have shown predictability and persistence historically.

1. Valuation signals: Different asset classes have their own value signals.

Equity Classes: Valuation ratios for equities include: dividend yield, cash flow yield and Shiller's earning yield

Fixed Income: yield-to-maturity and term premiums (yield in excess of the risk-free rate).

Commodities: comparing roll yields (+ve is backwardation, -ve is contango)

Currencies: comparing short-term interest rate gaps to determine which currency to overweight or underweight.

2. Trend Signals:

Most recent 12-month trend-Moving average cross-over

