ABOUT INVESTING

An insider's guide to portfolio construction

Effective asset allocation is the cornerstone of investing. Investment professionals use a range of tried and tested processes to construct and manage the portfolios you may invest in. Here we look behind the scenes at some of what's involved and the language that's used to describe it.

Learn more

You can find out more about Modern Portfolio Theory in our **Brief history of asset allocation**.

Academic studies have found that asset allocation – picking the right balance of bonds, shares and other investments – is the main driver of long-term performance, accounting for around 90% of returns.[1]

Asset allocation works on the basis that the performance of each individual investment matters less than how they perform as a whole, as a portfolio. This is the foundation of the Modern Portfolio Theory which informs much of how we invest today.

The need for balance in portfolios

When investment professionals create a portfolio to help meet a set of investor needs, it is often formed of different asset classes, each with their own qualities when it comes to risk and potential returns. The skill is in achieving the right balance – the right asset allocation - between, say, bonds, shares, property and alternative assets like infrastructure and commodities, to meet that portfolio's agreed objective.

Asset allocation can work at two levels, strategic and tactical, and both are important in building and managing a robust, long-term portfolio.

Strategic asset allocation

Strategic asset allocation is concerned with the big picture: what percentage of a portfolio should usually be allocated to each relevant asset class to support its objective? This decision is made and kept under review in light of global economic conditions, geopolitical events and also long-term investment trends like the ageing population and the move towards more sustainable investment.

You can think of strategic asset allocation as the foundation for a portfolio. From this foundation, the selection of investments held within it is built.

Tactical asset allocation

While the fundamental characteristics of individual assets may not vary all that much, the performance of different asset classes, and sub-categories within those asset classes (holding more US shares at certain times and reducing the holdings in another like - emerging market shares for example), will be affected in different ways by different economic conditions and events.

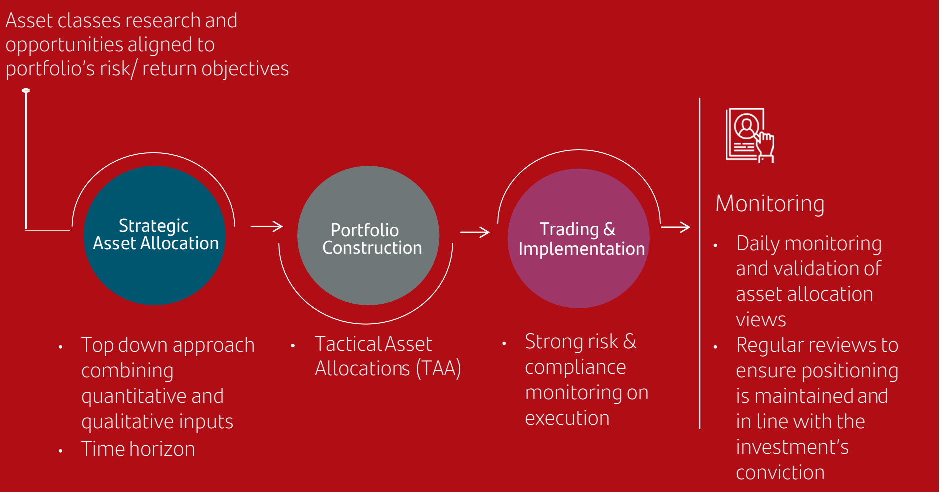
Tactical asset allocation aims to take advantage of shorter-term investment opportunities and manage shorter-term risks associated with these performance differentials. It involves 'tilting' the portfolio around the agreed strategic allocation; responding to current conditions in a way that doesn't materially alter its overall balance but, if successful, will potentially help improve returns. An example of a tilt might be towards (going 'overweight' in) US shares and away from (going 'underweight' in) emerging market shares.

A robust, repeatable process is key

A robust, repeatable investment process for reviewing and managing strategic and tactical asset allocations is an essential part of effective portfolio construction and management. Investment performance is never guaranteed but good discipline, structure and oversight can help portfolio managers to deliver consistent results and avoid any unpleasant surprises for you.

An example from Santander Asset Management

Here is a very high level summary of what's involved in managing our global multi-asset portfolios at Santander Asset Management.



Anyone you entrust with your money should be able to explain why they hold the investments they hold in your portfolio, and the process they follow to get there.

Quantitative or qualitative?

Throughout the portfolio construction and review process portfolio managers are constantly processing information to help inform their views on the various aspects of the market and their decisions at both the strategic and tactical level. While much of this will be quantitative, for example rich data on the performance of economies, sectors and individual assets, qualitative data, covering things like market themes and reputational issues are also valuable.

Top down or bottom up?

Quantitative and qualitative data may inform a 'top-down' approach to portfolio construction. This is where a portfolio manager starts at the general level by analysing influences like monetary policy, economic growth (gross domestic product, shortened to GDP) and inflation expectations, and narrows things down to specifics for various markets, sectors and companies from there.

Or it may form the basis for a 'bottom-up' approach which starts with specifics, building a deep understanding of the strengths and weaknesses of individual companies, sectors or markets and then considering how each may be impacted by bigger picture economic developments over time.

Accessing professional portfolio construction

There are several ways to benefit from an 'instant portfolio', constructed and managed by a team of investment professionals and designed to be resilient through different market conditions and economic environments.

Multi-asset funds invest in a broad range of assets, sectors, geographic areas and fund types for example. An alternative is a managed portfolio service (MPS), where a portfolio manager typically uses a selection of investment funds, potentially including multi-asset funds, to form portfolios that meet different investor needs.

There's a lot to navigate when it comes to portfolio construction. That's why it can be a good idea to seek help from a professional, either by investing through an 'instant portfolio' or by speaking to a financial adviser. They can help identify the most appropriate investment solution for your own situation, risk appetite, goals and requirements.

Learn more

Stay up-to-date with our latest **Markets and Insights** at santanderassetmanagement.co.uk.

[1] Determinants of Portfolio Performance by Brinson, Hood and Beebower, 1986. Abstract at JSTOR.

Let's be clear!

Investment terms explained

Asset class: A group of investments with similar traits. shares, bonds, property, cash and alternatives are all examples of asset classes.

Asset allocation: The proportion of a fund invested in different asset classes, i.e. equities, bonds, cash, property, geographic regions or industry sectors, in order to achieve the highest expected returns for the lowest possible risk.

Bonds: A bond is a loan issued by a government or a company. When you buy a bond, the issuer promises to pay a certain amount of income until the bond redeems and is repaid by the issuer. The strength of that promise varies by the issuer of the bond. This is known as creditworthiness.

Comodities: A raw material or product that has a market value and can be traded on an exchange. Examples include, precious metals such as gold, industrial metals such as aluminium or agricultural goods such as wheat.

Diversification: Spreading your money across different investments to help manage risk.

Gross Domestic Product (GDP): The value of goods produced and services provided in a country during a calendar year.

Inflation: Measures the increase in price of selected goods and services in an economy over a period of time.

Portfolio: a group of investments that are managed together to meet a particular objective.

Shares (often referred to as equities or stocks): In investing, this is a share of ownership in a company. Investing in a fund gives exposure to underlying share prices without investors actually owning the shares themselves.