Asset Allocation: Overview and Importance

Essentially, asset allocation is your risk pool's investment strategy; the types and quantity of investments your pool selected based on desired return, tolerable (potential) risk of loss and organization goals.

Determining your risk pool's strategic asset allocation structure is the most important decision that you will make throughout the investment process. Over 90% of your organization's investment performance and returns will be determined by the allocation decision.

Types of Asset Classes

Investment-Grade Fixed Income:
Fixed income is a type of investment debt security (aka bond) that pays investors fixed interest payments until its maturity date, when the principal investment amount is repaid.

Fixed Income bonds are evaluated by rating agencies on the probability that the issuer will repay its debt. Any issuer or bond with an investment-grade rating are considered highly likely to repay debt by the maturity date.

Due to policy holder obligations, necessary reserves and risk capital, most risk pooling portfolios are heavily allocated towards investment-grade fixed income.

Government and corporate bonds are the most common types of fixed-income allocations. Risk pools also commonly utilize fixed-income ETFs and/or mutual funds.

Investment-Grade Ratings:
S&P: "BBB" and Above
Moody's: "Baa" and Above
NAIC: Bonds Rated 1 to 2

Risk Assets:
Risk assets are any investment outside of investment-grade fixed income.
This includes, High-Yield Bonds, Common Stock (or Equities) and Preferred Stock, as well as certain Long-Term Schedule Ba Investments.

Risk assets provide greater potential returns, but with greater risk of loss and/or return volatility. Risk assets may also potentially help risk pools maximize portfolio diversification.

Risk Assets Primer:
Review how risk pools are utilizing risk assets.

View Risk Assets Primer >>

Alternatives:
Alternative assets are any investment outside of stocks and bonds, such as hedge funds or private equity.

Generally, risk pools do not invest in alternative assets due to the high level of fees, the potential lack of liquidity, agency problems, and the impact to capital ratios.

Continue to Key Considerations & Next Steps >>

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Key Considerations & Next Steps

Understanding Regulatory Constraints on Allowable Asset Classes:
Regulations can impose constraints on potential allocations to certain asset classes. For example, many government risk pools are limited to treasuries and agencies.

Thus, a review of the applicable regulatory framework is an integral part of any asset allocation modeling.

Determining Risk Appetite:
The risk tolerance of your risk pool's executive staff and Trustees/Investment Committee is important to the developing an optimal asset allocation.

Various scenarios based upon different investment structures can gauge the impact of these scenarios on key investment and company metrics. This can determine how much in terms of 'potential loss' your staff and Board/Committee are willing to take on the investment side.

Model Your Risk Appetite:
With SAA Solutions, your risk pool can review and test various risk allocations and potential downside impacts

Determine Risk Appetite >>

Review Current Asset Allocation and Potential Alternatives:
Government risk pools can compare their current asset allocation to other potential models in various ways. Potential asset allocation models can be focused on the asset side of the balance sheet or can also include the impact of insurance reserves.

Many risk pools also model asset allocations by considering reserves, surplus, and other financial considerations.

It may also be beneficial to utilize an 'asset only' approaching; Testing how your portfolio may perform by simply changing the allocated amount to certain asset classes.

Model Different Allocations:
Easily model various allocation scenarios to determine your company's expected portfolio return

Test Asset Allocation >>

Revising the Investment Policy Statement:
Once the strategic asset allocation has been completed, the investment policy should be revised to reflect changes made to the investment portfolio.

This includes target allocations to certain asset classes, procedures to rebalance the portfolio and assigned roles to staff or outsourced firms within the investment process.

View Investment Policy: What's Important and Why >>

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