

DYNAMIC ASSET ALLOCATION

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Dynamic asset allocation is a new name for market timing.

Reasons for changing proportions:

1. Changing risk tolerance:

- a. age**
- b. wealth**
- c. liabilities**

2. Changing estimates:

- a. mean return**
- b. variance**
- c. hedges**

Dynamic asset allocation is the modern name for market timing.

The current dollar amount of assets invested in market timing products is \$100 billion.

The main argument for it is:

- (1). alpha is small**
- (2). the choice of beta has a much greater effect on return.**

The main argument against is:

- (1). no evidence of successful timing**
- (2). not a diversifiable activity.**

Normally, asset allocation is set on long-term considerations. This asset allocation is called the target allocation. Then, period by period, there can be variations from the target. Variations come about due to:

- (1). change in wealth level**
- (2). change in risk tolerance**
- (3). change in beliefs about security characteristics, mean return and variance and covariance**
- (4). different hedging preferences.**

What theory and empirical evidence do we have that supports this behavior?

(1). The theory that has been developed in finance is that all results in decisions that are independent of wealth levels. This is because of the types of assumptions built into the analysis. Thus, there is not theoretical support for portions changing as wealth changes. However, most academics believe it's our analysis that is at fault, not practice.

(2). There is a weak evidence of predictability of returns within a market and cross-markets. The variables that are shown to be important are:

- a. dividend/price**
- b. past returns**