OVERVIEW

Fall 2002

Asset Allocation
(an overview)

Who and why:

(1) Individuals
1. Retirement
2. Major purchases (Home, Education)
3. Bequest
4. Smooth consumption

(2) Corporations
1. Active employee pension fund
2. Retired employee pension fund

(3) Financial Intermediaries
1. Banks
2. Insurance Companies
3. Savings and Loan

(4) Endowments
1. Charities
2. Trusts
3. Universities

Key Characteristics of Financial Intermediaries:

(1) **Leverage**

(2) **Assets & liabilities are both financial instruments**

Leverage example - typical insurance company balance sheet:

Assets:	**41B**	**Liability:**	**40B**
		Net Worth:	**1B**

Types of Objectives

1. Maximize utility of multi-period consumption and final bequest.

2. Maximize utility in period 1 (maybe derived utility).

3. Maximize utility of terminal wealth.

4. Maximize utility of wealth at horizon subject to planned withdrawals.

5. Maximize probability of wealth greater than X at horizon.

6. Meet liabilities at minimum cost.

7. Maximize net worth.

Major Asset Classes:

(1) Common Equity

(2) Bonds

(3) Real Estate

(4) Commodity and Financial Futures

(5) Domestic and International

(6) Privately and publicly traded