Santander Asset Management

About Investing

A brief history of asset allocation

When US economist Harry Markowitz set out his Modern Portfolio Theory[1] in 1952 he probably didn't imagine that nearly 70 years later it would still be guiding the way we invest our money.

If you invest with the help of a professional, whether that's through a fund, model portfolio service or any other type of service, there's a very good chance that the Model Portfolio Theory has a big part to play in how your money is invested and the kind of outcomes you will get. That's mainly because of one of the key principles of Markowitz's work – asset allocation.[1]

The idea behind asset allocation is that the performance of each individual investment you hold matters less than the way that investment behaves as part of the broader portfolio it is held in.

What is Modern Portfolio Theory?

Markowitz's theory[1], for which he was awarded a Nobel Prize, was concerned with two broad ideas:

1. Investors generally want to maximise the return they get for a given level of risk.
2. That this can be achieved by putting together a portfolio of different, unrelated assets.

He showed that holding a mix of unrelated assets that don't move in the same way at the same time will significantly reduce the risk of the overall portfolio. This means that the risk you take isn't so much about the individual investments in your portfolio, but your portfolio as a whole. It's about correlation - how different investments move in relation to each other, and diversification – spreading your money across investments which move in different ways from one another.

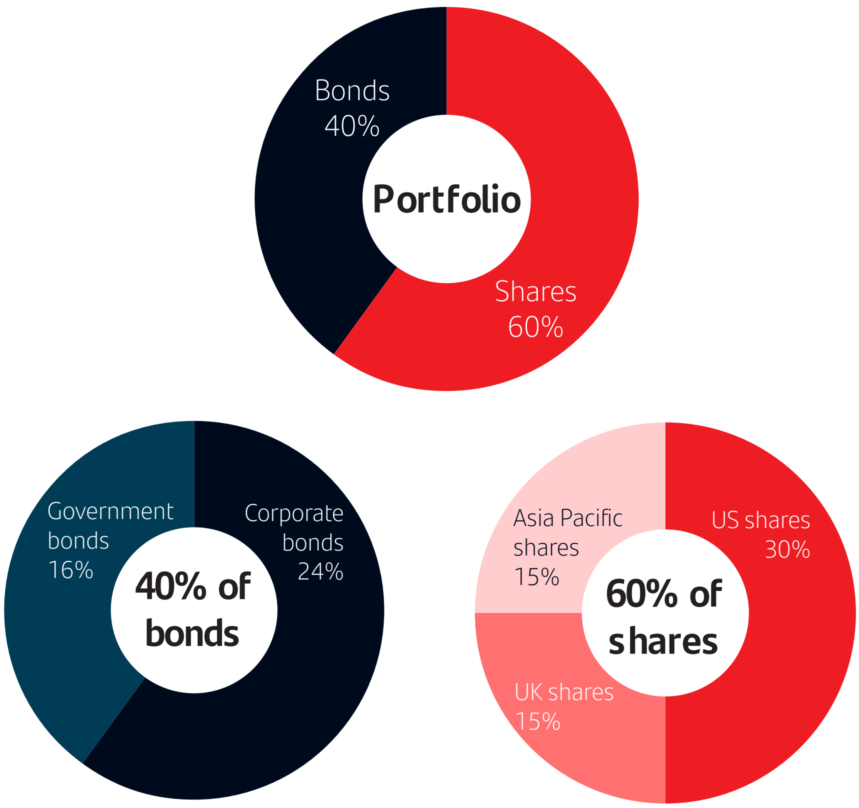
Let's be clear: a quick reminder

Asset classes are groups of investments with similar traits. Shares, bonds, property, cash and alternatives are all examples of asset classes. For more about the risks involved in each of the main asset classes read our **Risk matters: an introductory guide**.

Speaking the language

So the Modern Portfolio Theory is where the concept of asset allocation comes from, and why diversification is universally accepted as one of the golden rules of investing.

Today, the term asset allocation usually refers to the mix of asset classes and the broad categories within those that make up an investment portfolio. For example, you might have a portfolio made up of the following:



The term diversification tends to be used more generally to describe spreading your money across different investments that can be expected to behave in different ways at different times. So, for instance the US shares in our example would also be diversified across different individual companies in different industry sectors (say pharmaceuticals, food and drink, technology and renewable energy).

Asset Management

Risk targeted funds and portfolios

The reason multi asset investment funds are so popular is because typically they are designed to meet a forecasted level of risk versus return using a mix of different assets over the longer-term. Normally, the fund will have specific parameters within which the investment managers work within to deliver investment returns but ensuring that regardless of how they tilt the asset mix when market conditions change, they remain within this agreed risk appetite.

Putting it into practice

When you invest there is always a trade-off between risk and reward: the more risk you take, the higher your potential returns and losses; the less risk you take, the lower the investment returns or losses you're likely to experience.

How you diversify plays a key role in getting the best out of that trade-off. It typically involves investing in a mix of different asset classes, with the overall mix dictated by your personal circumstances, objectives, needs and attitude to risk.

For instance, if you don't want to take much risk the asset allocation in your portfolio will likely be skewed towards assets such as cash and bonds in usual market conditions. If you're happy taking more risk, you may have more invested in shares, possibly including exposure to higher risk areas such as emerging markets and smaller companies.

Asset allocation is about much more than just about managing risk. Academic research since Markovitz developed his theory has also found it to be the single most important driver of a portfolio's returns over time.

It's about getting two key things right. Firstly, investing in an appropriate solution to match your long-term objectives and risk appetite. Then secondly the responsibility rests with the investment manager to make day-to-day decisions about how to tilt the investments to benefit from changing market conditions whilst maintaining the approapriate level of risk throughout the investment journey. In addition, it's crucial that an investor takes time out to review their objectives and circumstances.

By underpinning these principles, the theory set out by Markowitz all those years ago still guides the way we invest and represents one of the keys to doing it so successfully.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

[1] Investopedia, 10 September 2021

Asset Management

Let's be clear!

Investment terms explained

Alternatives: Any investment other than equities and fixed income, such as property and absolute return funds.

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

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.

Commodities: 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.

Index: A way of tracking the overall performance of a basket of individual investments of a similar type. For example, the FTSE 100 index tracks the performance of shares in the 100 largest companies by market value on the London Stock Exchange.

Investment risk: The uncertainty that goes with investing and that means investments can go down in value as well as up.

Property: Property may be difficult to sell and can demonstrate significant declines in value due to changes in economic conditions and interest rates.

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.

Important Information

For retail distribution.

This document has been approved and issued by Santander Asset Management UK Limited (SAM UK). This document is for information purposes only and does not constitute an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. Opinions expressed within this document, if any, are current opinions as at 31 October 2022 and do not constitute investment or any other advice; the views are subject to change and do not necessarily reflect the views of Santander Asset Management as a whole or any part thereof. While we try and take every care over the information in this document, we cannot accept any responsibility for mistakes and missing information that may be presented.

The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. Past performance is not a guide to future performance.

All information is sourced, issued, and approved by Santander Asset Management UK Limited (Company Registration No. SC106669). Registered in Scotland at 287 St Vincent Street, Glasgow G2 5NB, United Kingdom. Authorised and regulated by the FCA. FCA registered number 122491. You can check this on the Financial Services Register by visiting the FCA's website www.fca.org.uk/register.