Hi and welcome,

This is a brief sample to provide you with an idea of what my CFA study notes look like.

The style is to provide key content coverage followed by working examples.

Mixed in you will see my ***"Professor's Comments"*** and ***"Exam Tips"***, I've included these to give you my thoughts on how I believe something will show up on the exam or how best to approach learning a concept….or even if I believe you should just skip something altogether.

If you have written the exam before, you can use my materials to get back up to speed very quickly.

If you are a first time writer, you can use my materials to help focus your study efforts and build your knowledge base.

If you have any questions, please do not hesitate to reach out to me by email.

All the best,

Prof Brian Gordon, CFA, CFP, CIM, MBA, FCSI
Director of Learning
Exam Success

Level 3

Asset Allocation

READING 12:
Overview of Asset Allocation

READING 13:
Principles of Asset Allocation

READING 14:
Asset Allocation with Real World Constraints

Overview of Asset Allocation

Professor's Comments:
Many of the concepts covered in this reading are similar to concepts that have been covered in other areas of the curriculum. I think CFA Institute is trying to integrate the readings to flow better….so if you cover a concept in one section, save time and just skim it in the other sections.

I think you will see this material show up in IPS type questions, so you need to know how the concepts are applied to client situations.

Economic Balance Sheet
This is a balance sheet that includes *"financial assets and liabilities"* as well as *"extended portfolio assets and liabilities"*.

Extended portfolio assets are items such as human capital, the present value of pensions and inheritances and the present value of resources or royalties.

Extended portfolio liabilities refers to the present value of future consumption and future payouts.

Bottom Line:
Your asset allocation should consider financial and extended assets and liabilities.

On the exam look for "bond like" or "equity like" income or "life-cycle" balanced funds as a way to coordinate asset allocation with human capital.

Quick Learning Example:
During a client meeting you gather the following personal and financial information.

Age: 35	Occupation: Government Office Manager
Marital Status: Single	Income: $40,000
Annual Living Expenses: $28,000	Home: $750,000
U.S. Government Bond Portfolio: $100,000	Personal Line of Credit: $25,000
Mortgage: $275,000	Balance Mutual Fund: $500,000

Using your firm's financial planning software you estimate the following:

Present value of the client's expected future income: $400,000
Present value of the client's expected future consumption: $600,000

1. **Create** an economic balance sheet for the client:

2. Based on a holistic approach, **recommend** *one* change to the client's current asset allocation, **justify** your recommendation with *one* reason.

Solution:

1. **Economic Balance Sheet as of December 31**

Financial Assets		**Financial Liabilities**	
U.S. Government Bonds	$100,000	Personal Line of Credit	$25,000
Balanced Fund	$500,000	Mortgage	$275,000
Home	$750,000		
Extended Assets		**Extended Liabilities**	
PV(Income)	$400,000	PV(Consumption)	$600,000
		Economic Net Worth	$850,000
Total	$1,750,000	**Total**	$1,750,000

2. The concept to take away here is any type of secure, stable income such as that from a Government job or employment at a University or College, can be considered "bond like" and any income that is volatile, not stable or related to the performance of the markets in any way, can be considered to be "equity like".

   When this perspective is taken into account for a client's overall asset allocation, adjustments may be required.

   In this case, you should recommend decreasing the allocation to bonds (or selling the U.S. Government Bond Portfolio) because the client's income can be assumed to be "bond like" (because he is a government employee), and thus the client has an allocation to bonds that is too large (and not appropriate).

On the exam you most likely will see overlap of assets/liabilities and thus will suggest to change the asset allocation.

As human capital declines => increase your allocation to bonds.

LINK: Very similar material shows up in Private Wealth Management!

Asset Allocation Approaches:
The curriculum discusses three approaches to creating a client's asset allocation, *asset-only, liability-relative* and *goals-based.*

1) Asset-only approach - this is your traditional *mean-variance optimization (MVO)*, where you look at expected return, standard deviation and correlation to set the allocation. You are trying to maximize risk adjusted return (highest Sharpe ratio)

Under this approach risk includes items such as tracking error and benchmark relative performance. It is often measured by standard deviation and reduced by diversification.

2) Liability-relative approach - in this approach you match assets to insure funding of specific liabilities. Be aware that the text says *"surplus optimization"*, *"duration matching"* and *"liability hedging portfolios"* are all examples of this approach.

Under this approach risk focuses on shortfall caused by differences between assets and liability characteristics.

3) Goals-based approach - focuses on individuals dividing up their assets into sub-portfolios each with its own return objective, risk tolerance and time horizon (to overcome behavioral flaws) to achieve goals given certain probabilities.

Under this approach risk focuses on failing to achieve your goal and is related to the probabilities of achieving the outcome.

Exam Tip:
The "Blue box" examples are a MUST read…they will provide you with an idea of what to expect on the exam.

Learning Example:

Janice Pomerance, 67, is meeting with her Advisor to develop an asset allocation that will provide for her retirement spending needs. Her needs are significant and it would be very difficult to reduce her spending. Pomerance tells the Advisor that "her biggest fear is outliving her assets because she has no other sources of income".

Pomerance believes that a conservative allocation will provide the safety she needs. However, she wonders whether a more aggressive allocation to increase the value of the portfolio would be better over the long term.

During the meeting, the Advisor makes the following comment, "given your circumstances, an asset-liability management approach to strategic asset allocation is more appropriate than an asset-only approach."

Determine of the Advisor's comment is accurate or inaccurate. **Justify** your answer with *two* reasons based on Pomerance's situation.

Comment	**Justification**
Accurate Inaccurate	

(4 minutes)

Solution:

The Advisor's comment is accurate.

Justification can be based on any two of the following:

- Asset-liability approach provides an asset allocation that lowers the risk of shortfall.
- Asset-liability approach provides an asset allocation that better insures funding of her spending requirements.
- Asset-liability approach provides an asset allocation that would be considered lower overall risk than an asset only approach.
- Asset-liability approach provides an asset allocation that better insures that an investor will not outlive their capital.