ASSET ALLOCATION

Liquidity-Driven Dynamic Asset Allocation

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Portfolio management is moving toward a more flexible approach capable of capturing dynamics in risk and return expectations across an array of global asset classes.

As the decision to invest — whether to take risk and how much — is the most important investment decision, managers are seeking to take risks only if the returns appear to represent fair compensation. That is, at any given time, some asset classes may offer an acceptable, or even generous, compensation while others may offer an unacceptable trade-off.

Therefore, managers can improve performance by taking full advantage of time-varying risk premiums — such as the liquidity premium — that are driven, in large part, by investors' cycling between risk aversion and risk adoration. For instance, during market turmoil, liquidity providers demand higher expected return from liquidity provision.

To address this challenge, we consider how market liquidity characteristics vary across time and states of the economy and affect a diversified portfolio of asset classes. Using dynamic liquidity information, we consider asset allocation implications in a practical setting.

Our model provides a portfolio framework that illuminates the changing nature of market liquidity risk and directs accordingly asset allocation decisions. The intuition behind our approach is that proper portfolio construction is an ongoing, dynamic process, one of calibrating portfolio asset allocation against current and expected macroeconomic and investment conditions.

We offer a framework that integrates the time-varying macro-picture with microspecific firm analysis for a powerful opportunity to improve portfolio construction and investment outcomes.