ASSET ALLOCATION

Using Investment Consumption Value to Select Asset Classes

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For investors, selecting the appropriate asset classes to be included in a portfolio is arguably the most important task, but the traditional analytical frameworks use only historical mean- variance analysis to identify asset classes and fail to look into the future. As a result, portfolios built using the traditional approach might not maximize value for investors.

This article introduces a new process, called investment consumption value (ICV), to determine the appropriate asset classes for investment based on the fundamentals of economics and finance. In a nutshell, because all investing is done to fulfill consumption need, this new concept looks into how consumers may benefit from investment transactions.

In essence, the efficient portfolio is one that offers the best expected return and risk profile to meet the consumption desires associated with different investments or economic states.

Passive assets, such as commodities and alternative assets, should be considered suitable asset classes according to the concept of ICV. Passive assets are used as inputs in production and converted into other assets, and their intrinsic values are often difficult to measure.

We contend that commodities serve as insurance to protect against unexpected inflation, and including them in a portfolio will reduce overall volatility. Certain hedge fund strategies also add ICV as part of a portfolio.

Other nonfinancial sector investments, such as education and insurance policies, help reduce the need for precautionary savings, increase spending levels during a person's lifetime, and contribute positive ICV. From an ICV perspective, risk should be thought of as the likelihood that portfolio goals will not be met.