Dynamic Asset Allocation
Strategy Overview

The Dynamic Asset Allocation (DAA) concept has been specially devised to meet the needs of institutional investors who want to apply a dynamic risk-management approach to managing risk at the overall investment brief level and are also interested in the option of using tactical allocation decisions tailored to their own asset structure to generate attractive returns.

**Investment Overview**

**Uses stringent, dynamic risk management methods to create security**

A number of approaches exist that can be used for the strategic risk management of funds as a whole. Firstly managers can choose between static and dynamic approaches.

Using the static approach, the risk is adjusted periodically (annually, monthly etc.) in line with a predetermined level, expressed by investment limits, target volatility or a VaR risk budget.

While static approaches require changes at longer intervals, dynamic approaches such as the dynamic asset allocation strategy generally require periodic intervention or situation-driven intervention. Although absolute targets for the degree of risk can be defined (e.g. “unit price may not fall below set minimum”) in the same way as for static strategies, the clear advantage of dynamic over static methods is that they address prevailing market conditions. While a static strategy generally maintains a constant investment ratio, a dynamic method constantly adjusts the structure of the portfolio against the prevailing risk budget and level of risk.

In the dynamic asset allocation concept, market movements and the success of the segment specialist also determine the risk budget at any one time, based on an initial budget. Falling markets or excessively negative returns reduce the risk budget available, whereas rising markets or excessively positive returns increase the risk budget. In practice, calculating the risk budget as promptly as possible to track the market as closely possible is fraught with difficulties, but it is essential to the success of a dynamic strategy.

**Risk management using Value at Risk**

Value at Risk (VaR) combined with a minimum value (floor) is the optimum performance measure for dynamic risk management as part of DAA. Derivatives are used to adjust the portfolio structure so that the VaR of the whole portfolio does not exceed the defined risk budget (= the difference between the prevailing fund value and the floor). The time horizon for calculating the VaR should be selected to take account of periods when markets are closed. In its dynamic risk management strategy, Deutsche Asset Management uses a VaR calculation with a confidence level of 99.9% and a time horizon of five days. The performance of the fund as a whole and its volatility in particular are integral elements in the VaR concept based on this method. Both elements use prevailing market data, i.e. real-time index prices are used to determine individual fund segments or index values are estimated if real-time prices are not available. Portfolio volatility, the central risk measure and key element in the VaR calculation, is also calculated constantly in real time and based on implied volatility. The dynamic asset allocation concept therefore ensures that the portfolio risk and the available risk budget are continuously measured by tracking the market. Changes in the market environment are therefore not only recognized promptly, but action can be taken immediately.

**Attractive returns through tactical asset allocation**

At times when returns are historically low, generating attractive returns is a high priority for many investors with relatively rigid target returns. For this reason, sources of consistent attractive returns (or alpha) are in great demand. Making tactical allocations as part of dynamic asset allocation is a source of alpha. In today’s global economy and environment of great information efficiency, successful tactical allocation depends on many interlinked global factors. It is equally important to generate, or anticipate, additional price-sensitive information. Staff with outstanding expertise in data interpretation is also essential for
identifying relative pricing anomalies between individual markets and asset classes. Deutsche Asset Management uses a purely discretionary concept for the tactical components of dynamic asset allocation, based on a stringent, disciplined investment process for analyzing both technical and fundamental investment signals. Potential investment opportunities are reviewed in detail to ascertain the additional risk they contribute to the overall portfolio of each individual customer. The tactical position taken is therefore dependent on investment signals and the specific risk budget of each client. This method of risk management often sets a maximum tracking error, i.e., an implicit market or situation driven deviation from a benchmark underlying the fund which may be either a specific combination of indices (e.g., 30% Euro Stoxx 50 + 70% iBoxx Government) or an absolute return (e.g., Libor + 150 basis points).

Traditional tactical allocation is restricted to markets defined as cash instruments in the investment universe. In a Deutsche Asset Management Dynamic Asset Allocation segment, it is also possible to trade in other markets, provided the customer opts to do so, e.g., using derivatives to take a position in Asian equities. Consequently, this additional latitude enables other sources of alpha to be tapped, i.e., strategic exposure to be built up, although the general starting point of the investment strategy remains the customer-specific distribution of different asset classes within cash instruments.

Furthermore, investments in different markets increase the diversification of the overall portfolio resulting in a potentially higher excess return per unit of risk.

### Implementation in the form of an overlay

Implementing different investment decisions as part of Dynamic Asset Allocation using derivatives has three significant advantages over cash transactions. Firstly, transactions in standard liquid derivatives are generally much more cost-effective, i.e., direct transaction costs such as brokerage and bid/offer spreads are lower in liquid derivative markets, as is the pressure on prices triggered by the transaction. Secondly, portfolios can be restructured quickly using derivatives. Thirdly, the use of derivatives in a separate subfund (in the Dynamic Asset Allocation segment) minimizes impediments for asset-class specialists in the various separate segments, which is essential for clearly identifying and allocating results. In addition, just a small supply of cash is needed for the segment.

### Dynamic Asset Allocation in Brief

- Dynamic risk management is undertaken as an overlay — the strategic asset allocation and management of individual client portfolios remain unchanged
- Dynamic risk management significantly reduces the overall risk of a portfolio while participating to a great extent in positive market phases
- Possible for a broad investment universe: e.g., equity, fixed income, emerging markets, corporate bonds, commodities, etc.
- Its objective is to secure individual, customer-specific minimum values (e.g., book value or 95% of the portfolio amount)
- Flexible mechanisms for raising minimum values according to individual customer requests
- Prompt, market-focused measurement of risk and the risk budget on an ongoing basis
- A rule-based, prediction-free process creates security at the overall portfolio level
- Attractive returns through a tactical asset allocation overlay based on a customized, overall investment-brief structure
- Tactical allocation decisions are based on a qualitative investment process and are made by an inhouse team of investment specialists
- Cost effective practical implementation through derivatives

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### Dynamic Asset Allocation Overview

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