A Risk Management Approach to Optimal Asset Allocation

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Abstract

This paper extends the tactical asset allocation strategy of Flavin and Wickens(1998) to incorporate the effects of macroeconomic variables in the analysis. Using a VAR in mean with a M-GARCH error structure, we can jointly model financial asset returns and macroeconomic variables, thereby exploiting any predictability in either the first- or second-order moments. Taking a set of UK\ financial assets and the change in domestic inflation as an illustration, we find a much stronger impact on the conditional second order moments of the process than on the level of the excess return on financial assets. Taking the inflation effect into account generates portfolio frontiers that in general lie closer to the origin and therefore offer superior risk-return combinations to the investor.

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