Dynamic Allocation or Diversification: A Regime-Based Approach to Multiple Assets

This article investigates whether regime-based asset allocation can effectively respond to changes in financial regimes at the portfolio level in an effort to provide better long-term results when compared to a static 60/40 benchmark. The potential benefit from taking large positions in a few assets at a time comes at the cost of reduced diversification. The authors analyze this trade-off in a multi-asset universe with great potential for static diversification. The regime-based approach is centered around a regime-switching model with time-varying parameters that can match financial markets’ behavior and a new, more intuitive way of inferring the hidden market regimes. The empirical results show that regime-based asset allocation is profitable, even when compared to a diversified benchmark portfolio. The results are robust because they are based on available market data with no assumptions about forecasting skills.

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