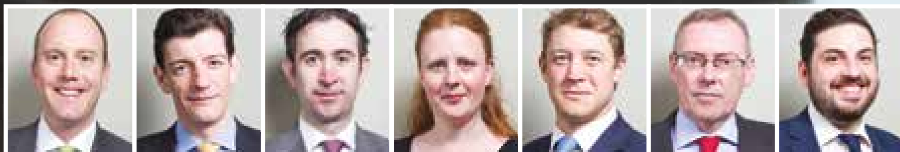
Multi-asset

Looking for a smoother investment ride



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A smoother investment ride

Exploding onto the institutional market amidst a flurry of product launches, multi-asset strategies have been one of the success stories of the past five years. These strategies, otherwise known as diversified growth funds (DGFs), offer a simple premise: access to a range of asset classes that will deliver equity-like returns with limited volatility.

Given the stormy weather experienced by most investors in recent years, the promise of a smooth ride has never been more appealing for institutional investors. Part of the multi-asset success story lies in its flexibility. While the appeal may be obvious to small and medium-sized schemes lacking the resource to create diversified and dynamically managed strategies in house, they have also gained traction among the multi-million pound behemoths. Meanwhile, since multi-asset strategies are all about offering diversification without the governance headache, they are also proving popular as a default option for defined contribution (DC) plans.

Investors still need to do their homework when opting for a multi-asset strategy, however. With limited time horizons over which to judge multi-asset strategies, it is tricky for investors to ascertain which managers have hit targets as a result of manager skill, and which simply got lucky. To complicate things further, DGFs were launched just before the markets enjoyed something of an improvement in 2009 and 2010, before falling back in 2011, they have benefitted from starting off in marginally easier economic times.

Separating the fortuitous managers from the skilful is not the only challenge for investors looking at this market. There are now so many wildly different strategies collected under the multi-asset banner, comparing the market is difficult.

There is also the potential threat that a sustained equity rally may challenge DGFs as the volatility protection they offer inevitably delivers muted returns. Persistent market volatility over the past four years has served DGF managers well but should there be a sustained bull run on the stock markets in which DGFs would not be able to wholly participate in nor profit from, the wheels could well come off the multi-asset wagon.

Over the following pages, investors, consultants and asset managers consider how the multi-asset market has grown, the areas potential and existing investors need to monitor and its potential within DC.

Chris Panteli
editor, *portfolio institutional*

Chris Panteli

Toby Hayes

"If you break down your average balanced portfolio, the factors of credit, equity and especially duration, are looking a little bit expensive. So diversifying away and gaining exposure to other factors makes sense." Toby Hayes

Multi-asset has grown considerably in recent years. Everyone has an offering, so instead of defining multi-asset, may I ask what it means to you?

Georgina Taylor: For me it's about getting the right exposure to the right asset classes, asset types, at the right time in the economic cycle. It's about having as much flexibility as you can to make sure that you can get that exposure. We don't think about the world from an asset-class perspective, but from an investment-opportunity perspective. It's about dampening the volatility, participating in returns and using all asset types and asset classes to achieve that.

Toby Hayes: The big issue in multi-asset is that a lot of traditional multi-assets funds are typically balanced products and if you break down your average balanced portfolio, there are three factors – duration, credit and equity. Those three factors – especially duration – are looking a little bit expensive, so to be able to diversify away from those and find other ways of getting exposure to other factors makes a lot of sense.

Bill McQuaker: I see it from a different perspective. More than most areas of asset management, multi-asset is about outcomes rather than what portfolio managers do. Clients are often not-overly concerned how their money is managed, but they are concerned about rates of return and levels of volatility and ultimately achieving the outcomes that allow them to get the lifestyle that they expect in return. The focus on volatility, which does lead to diversification, is particularly important. After the financial crisis, people are concerned about drawdown and about losses they see as unacceptable. There is a tendency for them to get scared and to run to cash in those circumstances. One of the great benefits of multi-asset propositions is they do tend to limit drawdowns and, as a result, people stay more exposed to risk assets

Bill McQuaker

"The focus on volatility, which does lead to diversification, is particularly important. After the financial crisis, people are concerned about drawdown and about losses they see as unacceptable." Bill McQuaker

for longer.

Tom Joy: People should have been worried about drawdowns in 2006 and 2007. Now everybody worries about drawdowns and multi-asset has become very popular. In many cases, investors would have been better off not doing it; not going down that road. We're beginning to see this constant cycle in the investment world where everyone is trying solve last cycle's problem. The worry about drawdown that you see post financial crisis, actually should have occurred when markets were really overvalued.

Pete Drewienkiewicz: But that's partly a differentiator between more of a total-return mindset and absolute-return mindset. In absolute return many funds are trying to avoid drawdown on a rolling 12-month period. That's very tough to do effectively while staying fully invested in risk assets. The outcome is really important because people are signing up for a smoother ride. Whether, looking back, they are happy with that smoother ride, that's a slightly different question.

Joy: That's a fair point. It might be right to differentiate between the retail world and institutional world. We keep it quite simple and just define multi-asset as all strategies that invest in a broad range of asset classes or strategies. We wouldn't differentiate between long-only and hedge. So multi-strategy hedge funds, global macro, traditional, balanced, DTR or whatever else. We'd bucket it all in together and then look at what we think is the most appropriate investment strategy for our fund.

Ciaran Mulligan: Let's be clear, a multi-asset is an advanced version of old balance funds. We research hundreds of these things and they are an extension of the old balanced approach, which we can all agree

were not a great idea. We had in 2008 an environment where following market turmoil a lot of the fund-management houses launched multi asset funds following significant drawdowns in equity markets, in an attempt to gain and gather assets, playing on that fear, to an extent. A lot of the investors, especially the early adopters of multi-asset funds, didn't appreciate what exactly they were getting into from a return perspective. As we've seen over the last year, a lot of the multi-asset funds have been trying to do exactly what they're meant to do; produce growth but with lower volatility than that of equity markets. Now, many investors are re-examining the need for multi-asset funds in their portfolios. There's a continual need for education both from the fund-management and the consultant community that needs to happen over the coming years to ensure investors are aware of what it is they are invested in and why.

McQuaker: That's interesting. My own perspective looking back over the last five years, is those invested in multi-asset strategies should be quite pleased with what's been delivered. The vast majority of strategies have done exactly what they set out to do. You suspect people are looking at outcomes in an environment where equities have done well and are beginning to wonder if multi-asset propositions are as appealing as they previously thought, because they haven't kept up with a strong equity market.

Hayes: The ones that have a track record over 2007 and 2008 by and large have done well. There were not many of them and there's some survivorship bias because some have fallen by the wayside. We all know the success of a few of those funds has spawned an entire industry. What happens in the next crisis will be the real test of their substance. If there is an issue with government debt, then there are very few places to hide in a conventional bond/equity mix.

Drewienkiewicz: It comes back to absolute return and trying to avoid drawdown. Institutional investors, generally speaking, if they have a good governance structure and a sensible asset-allocation process in place, can take a little bit more volatility and make better valuation-based calls on when to be in and out of things. When you have smaller clients, or DC clients who have effectively no governance, it's very difficult for them to make a market call. The point is well made, but the question is whether there is a better way to deliver what clients are looking for but get away from this obsession with avoiding drawdown.

Tom Joy

Taylor: It's quite interesting that everyone's talking about these equity-like returns. Surely we should be thinking a little bit longer term. We're all anchoring it around what equities did last year, but these funds are structured to give equity-like returns over the long term. 5% is the equity-risk premium and that's what a lot of these funds are targeting, versus cash or whatever it might be.

Joy: The other area we see a lot of opportunity that multi-asset funds can't really exploit is illiquidity, particularly in the fixed-income and credit worlds. Many of these funds are limited by the liquidity requirements of their underlying clients, so in terms of genuine multi-asset opportunities, that liquidity mismatch sometimes, between what the underlying clients are demanding and the market opportunity, is a limiting factor for these funds.

McQuaker: I'm surprised you see opportunity there. The last two or three years, areas that investors were nervous of have seen money return. A lot of the risk premium that existed has been harvested.

Joy: I would agree, but in Europe, in the smaller cap space in the US and in some other distressed credit areas, pricing has not really moved, so there's still quite a lot of opportunity there.

Hayes: You definitely get extra yield for the illiquidity premium, but I question the benefits and diversification of that type of asset class versus your standard credit fund. They sell off in the same fashion to credit as it is ultimately a spread product. There are other asset classes within derivatives space that you can access that are very un-correlated and very liquid at the same time. I'm not saying it's a panacea, but I

question the diversification benefit of illiquid spread products as a mechansism to limit drawdowns.

Mulligan: I agree with part of what you're both saying. There are some very sophisticated derivative-based strategies that offer a lowly correlated supplement to an existing portfolio. But I also agree that illiquid assets can benefit from the diversification of an overall portfolio. If you look at the correlation of some of these illiquid strategies, they do actually offer quite a substantial diversifier from credits that pension funds may already have exposure to.

Joy: Usually a multi-asset fund would have some exposure to credit. I would much prefer some illiquid strategies today than investment-grade corporate bonds or high-yield bonds.

Hayes: The benefit of having those types of products would be the equivalent of having an investment-grade corporate bond fund rather than emerging-market debt. There is definitely a correlation, there is definitely a spread pick-up, but there is also quite a lot of correlation between those two asset classes. There are other ways of getting access to alternative asset classes that have definitely very high-risk premia, but also are less correlated and have more diversification benefits but require a lot more sophistication in terms of access.

Drewienkiewicz: The way these products are set up ultimately mean they're not the home for that sort of thing. Now, especially given changes in the Budget, there are evolutions to drawdown products and to DC and perhaps we will find a sensible argument about whether DC investors really deal in liquidity. No one ever needs to move out at a day's notice. The problem is funds in DC need to take money in every day. The problem is if you're in something illiquid, like direct lending or infrastructure debt, and you are taking in an allocation of cash every single day, or even if it was every single month, it would be challenging.

Joy: So you're saying the problem is more on the asset-management side rather than the client side?

Drewienkiewicz: It's a more challenging problem. DC money is coming in all the time and if someone is getting allocated at a completely different spread, or not getting allocated for a little while because you're unable to allocate to that market, it becomes much more complicated.

Pete Drewienkiewicz

That's an interesting point. How do we match costs for the DC side and multi-asset classes?

Joy: Client fees, by definition, are always going to be there and they are going to be a headwind against return on a net-fee basis. But sometimes paying high fees, if someone's really skilful, it's worth it.

Hayes: There are some products that have a static asset allocation, so you can't really charge a large fee. Then you've got the individual allocations to the asset classes. You can use derivatives or maybe enhanced funds. You can design a product that's pretty much totally passive and is very hard to charge anything for it. But then you could design a very sophisticated derivative fund that has a lot of alternative strategies and weirdly, if you can get the scale, you can get the fees down on that.

Mulligan: The key thing is transparency of fees, because clients want to know what they're paying for. In a lot of cases, the underlying fees can be hidden in the pricing of the fund. Once there is complete transparency of the fees, investors and consultants are probably more willing to engage

Joy: Cheaper is not necessarily better. It's about value. We recently found we've ended up with more multi-strand hedge strategies in this space, compared to the traditional multi-asset manager and the fees there are much higher. But when analysed on a net-fee basis, we think they're going to provide better genuine diversification for our other assets and also deliver better returns.

Taylor: The grey area is performance-related fees. If you are targeting a Libor that's five or whatever it

Georgina Taylor

"We think about the world from an investment-opportunity rather than asset-class perspective. It's about dampening volatility, participating in returns and using all asset types and asset classes to achieve that." *Georgina Taylor*

might be, how does the incentive structure work for the managers in terms of performance fees? I'm anti performance fees but it's something we need to look at and maybe it's the Sharpe ratio you target to make sure you are keeping the volatility low.

Hayes: In my space, performance fees are dead in the water. They're very hard to justify in any style. DC platforms as well, seem to be very focused on fees. It seems to me the fee that DC platforms are trying to arrive at, in my mind, makes it really hard to get any sort of sophistication into the portfolio.

Drewienkiewicz: I can buy a bond fund yielding close to 5% for 20 basis points (bps). In a low-return environment, something's got to give if you ask me. Charging 90bps for Libor plus three to four when Libor looks like it's going to be under two for an awfully long time looks toppy compared to the fee load on a bog-standard corporate bond.

Joy: People didn't expect Libor would be zero and stay there for multiple years. Maybe that benchmark needs to be looked at and it needs to be more focused on an absolute return.

McQuaker: If you look at the structure of the vast majority of funds and apply some reasonable expected returns to each of the different components, not many of them are built to do Libor plus two. They're typically taking more risks than that. They may have a stated benchmark of Libor plus three. To my eye, they're built to deliver that level of return and no more.

So why not have a different benchmark?

Drewienkiewicz: Again, if you're trying to avoid drawdown, that limits the amount of vol you can run and

Tom Joy

"It's important to look across both traditional and alternative multi-asset strategies to broaden out the opportunity set that, as an investor, you get to choose between." Tom Joy

the amount of performance you can target. That limits the amount of equities you can put in the portfolio unless you're going to take exposure via derivatives, by buying calls for example. If you look at the track record of most of these funds, there are very few that are delivering substantially more than that.

McQuaker: If a fund is being managed on the basis that a drawdown over a 12-month period is unacceptable and it has be run in such a way that the aim is to avoid that, then it's going to be tough to deliver.

Drewienkiewicz: That's the definition of the sector. We can challenge that, but the targeted absolute-returns sector, that's the product definition.

Mulligan: That's the issue when you're trying to run funds with different objectives and different approaches. We would break it down into ascertaining the funds objective, be it a focus towards capital preservation, funds that are looking to mimic equity returns etc, but even that is subjective. It's hard to know what they are trying to achieve because they do not necessarily all stick to a stated philosophy.

Joy: Multi-asset has also become popular after an era of almost 20 years of silo mentality. There is a dearth of people with what I would argue is genuine multi-asset experience who have worked in both bonds, currency and equity.

Taylor: I'm quite worried about that. It's the biggest growing sector and the assets are coming in. It's a real concern because people are being squeezed into multi-asset who have never done it before and it's such a different mindset.

Hayes: It's getting a portfolio that can deliver performance from a long-term perspective but actually has

real diversification in the crash environment, which invariably, it might well mean, you have no gilt exposure or bond exposure in any sense. The SAA benchmark is effectively a comfort blanket and is anchoring what you put into a portfolio. Getting away from that traditional asset allocation mindset is the next challenge for the industry, because it is still in strategic asset allocation mode. Given low and potentially rising yields, a bond/equity mix is not going to wash for the next 30 years.

Joy: Sometimes funds are not set up to exploit the best ideas. If you're allocating to funds, so you're going to be creating a fund-of-funds, most of them will end up being over diversified. If they could just find some way of extracting the top ideas or the best ideas from the individual fund managers, rather than buying the whole of the underlying funds, they would do much, much better.

Hayes: It comes back to the targeting of risk and the top-down allocation. If you have an investment idea, finding a fund that represents that idea in its entirety is pretty unlikely.

McQuaker: I'm not sure that I agree with that point that it's difficult to find a fund that represents the top-down view. If you've got all of market access, you can usually find an actively managed fund that does the job that you want it to do. Even if it's a top-down driven view that you're trying to represent. The mutual-fund world is extremely diverse.

Are we seeing extreme focus on diversification give way to liquidity concentration?

Drewienkiewicz: It's easy to become over diversified, as you can't always be sure you are diversifying away risk. So you might actually be getting the worst of both worlds. If you can find a sensible asymmetric way that's going to be attractive to exploit, it's definitely attractive to see a bit more concentration and, yes, we are starting to see more products that are focused in that way.

Toby Hayes

Joy: Fund managers in general over-diversify, so the initial fund is over-diversified. If fund managers backed their best ideas more, they would do better, but for career risk and other reasons, that doesn't tend to happen. When that is then packaged up into multiple funds or multiple positions into a multi-asset, it's even more over-diversified.

Taylor: The problem is people are very much focused on a single asset class, they think about that single class and relative opportunities within it. This idea of gathering the best ideas is quite tough if you want to truly be multi-asset and think about the world from a multi-asset perspective.

Drewienkiewicz: You need to have the overall fund managers having accountability for those ideas, because we find it very difficult to get comfortable with an asset allocator passing money to someone else to run and then not really knowing what's going on.

Mulligan: I think that's a little harsh. There are some who do adopt that sort of approach who have done well. It's difficult, but not impossible.

McQuaker: Going back to liquidity risk, you can see it as certainly relatively attractive, maybe absolutely attractive. In a world where real yields have been crushed, some spread products have been significantly repriced, you end up wondering if to get more return you should consider some illiquidity risk. The opportunity set is diminishing, as we're back in a world where nothing is that appealing. Investors feel they have to reach for either more risk in a limited number of remaining opportunities or illiquidity risk or maybe one or two other sources of more esoteric risk. That tells us the world is getting a little bit more dangerous.

Joy: Look at liquid markets – high-yield bonds, the re-emergence of covenant-like deals, etc. As a buyer of that product, you're much less protected in many cases today than you were a year or 18 months ago. The investing world definitely is more risky and downside risks greater today than they were a year ago.

McQuaker: Some of the more excessive forms of behaviour are arguably beginning to re-emerge and multi-asset propositions haven't been truly tested.

Mulligan: You can't expect consistent double digit equity growth for the medium term, so returns will probably be sub-6%. If you look at where corporate bond spreads are, again you'll probably struggle to see strong growth from fixed income assets so trying to get consistently 6% or more from a multi-asset fund is just not going to happen. However, the multi-asset opportunity set does offer skilled investment managers license to hunt in more areas of the market. Those who can pinpoint where the opportunities and value lies will separate themselves from the market.

Taylor: But that is still looking at the world from an asset-class perspective. As you said, that's the thing that needs to kind of move on. For us, looking across the world, there are huge opportunities and anomalies. It's not switching from one asset class to another, it's within the asset class. The majority of our ideas at the minute are relative-value opportunities. That will change over time as you need the flexibility.

Hayes: There is also what I call, for want of a better word, systematic beta or risk premium strategies, which are effectively trading strategies that extract a risk premium from derivative markets. Volatility, as an example, has been around for a long time, but there are others, such as momentum-based strategies, or liquidity-driven strategies using commodities. You need a good skill set to assess whether there's value there. A lot of these strategies do have very nice correlation benefits versus more traditional asset-class factors. But it is hard; it's not like buying equity beta and just sitting on it asking how clever you are. You've actually really got to do your homework and not every house is set up to do it.

Taylor: How do you assess how you are going to achieve diversification going forward? That's one of the biggest challenges for these funds. There are quantitative techniques that we all have to use, but what period determines that? The correlation would be all over the place.

Hayes: When you get rid of this strategic asset allocation and tactical asset allocation model, designing and constructing portfolios gets quite convoluted and very hard. I don't think there's any defined set way of doing it, but in the current environment, an SAA approach, where you're effectively producing balanced portfolios concerns me deeply.

Pete Drewienkiewicz

Ciaran Mulligan

We've seen one or two consultants launch their own multi-asset funds. What kind of impact is that likely to have on the market?

McQuaker: Consultants are getting into that line of business. By definition, they have good relationships with clients and I imagine some of them will become serious competitors. From a cultural perspective, one of the challenges they've got is becoming more asset-management, more market-orientated, and less advisory. There is a significant shift that's required between those two mindsets.

Mulligan: Some consultants have embraced the asset management model for obvious reasons – it's an attractive business model. But I think Bill's right. They may not have the background, the expertise, or the personnel to compete successfully with fund management institutions who have been doing this for much longer.

However, consultancies will be close to some clients' liability-driven investment needs but that does not necessarily mean that they are best placed to implement investment solutions directly.

McQuaker: It's one thing to go out and hire people who have got the right experience and the right background. It's another to create an environment that really is consistent with the job in hand. The easy bit is making the hire. The harder bit is creating the corporate culture.

Georgina Taylor, Tom Joy and Bill McQuaker

"The key thing is transparency of fees, because clients want to know what they're paying for. Once there is complete transparency of the fees, investors and consultants are probably more willing to engage." Ciaran Mulligan

So, in summary, where is multi-asset investment heading?

Joy: I would like to see more concentration. More extraction of the best ideas into a portfolio from different fund managers would be a good evolution. It's important to look across both traditional and alternative multi-asset strategies to broaden out the opportunity set that, as an investor, you get to choose between.

Taylor: For me, it's all about education. I'd like to see education in this whole space. Making sure that the whole sector gets filtered is also important. I'm worried about inexperienced people coming into the space taking advantage of a market opportunity.

McQuaker: I'd like to see a continued focus on simplicity of language, as people need to understand what they're investing in. I have a lot of faith in the multi-asset concept and I'd like to see multi-asset propositions being mandatory for DC funds. I'm saying that slightly tongue in cheek, but multi-asset propositions are a lot better than the random process most of the public use to manage their wealth.

Mulligan: A development of multi-asset strategies to focus on drawdown requirements would be quite welcome. Education is also needed to ensure investors know what they're getting/giving up by investing in multi-assets relative to individual asset classes, so they're not disappointed.

Hayes: The future is moving towards more factor diversification, away from asset allocation which by necessity brings in a lot of complexity. There is this very real risk that the language associated with these products just gets very convoluted and confusing. This idea of clear communication at the same time as increased complexity is a massive problem.

Drewienkiewicz: It's more important people understand what how these things should perform rather than how they do it. I expect the market to evolve and look at long-only and hedge products together and you will see greater convergence with more meeting in the middle of these ideas. There will be further product development in drawdown or income-focused products and ideas that have more appetite for illiquidity risk for institutional investors where you don't have the same liquidity requirements. It is still in its infancy and hasn't quite been proven, but the outcomes focus or smoother ride has been delivered.

Providing true meaning to the word 'diversified'

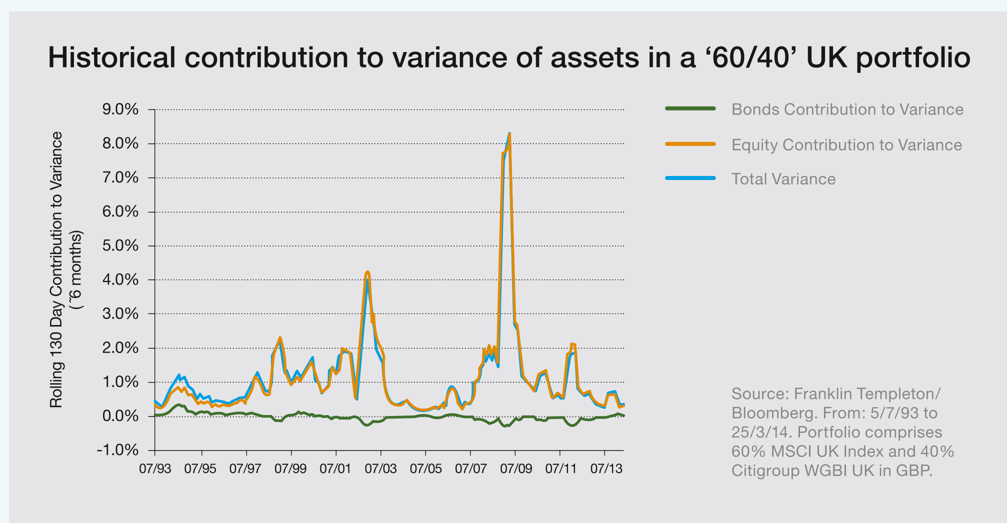
By Toby Hayes, portfolio manager, Franklin Templeton

With ever-evolving financial markets we have seen increased liquidity, leverage and sophistication but also higher asset volatility and correlations. Cross-asset investors are questioning the efficacy of traditional approaches having witnessed the failure of risk models over the 2008 crisis.

Asset class diversification, the basic tenet of cross-asset investing, didn't work because the risks factors embedded in traditional asset classes turned out to be highly correlated, and provided no shelter in turbulent markets. Investors are now realising that in order to deliver a truly diversified, risk-controlled portfolio, it is necessary to diversify the risk factors themselves and this means looking outside the traditional asset class toolkit.

Diversification is an often-used, but much-misunderstood term. Examining the risk of a typical balanced portfolio, one can see that contribution to total portfolio risk from bonds is minimal and that it is equity variance that dominates portfolio risk.

Historical contribution to variance of assets in a '60/40' UK portfolio

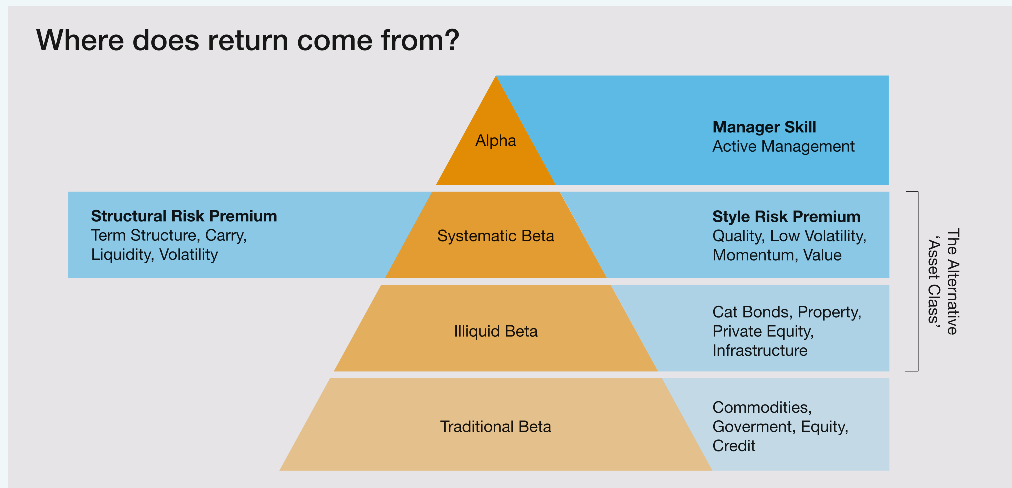


Source: Franklin Templeton/ Bloomberg. From: 5/7/93 to 25/3/14. Portfolio comprises 60% MSCI UK Index and 40% Citigroup WGBI UK in GBP.

For the average balanced portfolio, overall returns will still depend on the vagaries of the equity market. More sophisticated investors have intuitively countered this problem by 'diversifying' the typical multi-asset portfolio into corporate and emerging market bonds as well as further-flung equity markets. Yet still, at its core, the portfolio has exposure to only three broad risk factors, namely equity, interest rates and credit quality. With negative and rising real yields on government bonds currently pushing investors to further overweight equity and credit (two highly-correlated risk factors), the risk-mitigating qualities of such a portfolio is in question as the bull market matures.

Some investors have taken a different approach, moving away from traditional assets into 'alternatives'. However, the term is nondescript with the alternatives spectrum encompassing everything from property and infrastructure funds at one extreme to opaque hedge funds at the other. This amalgamation of alternative assets into one 'asset class' is unhelpful in the quest for risk factor diversification, especially considering the terrible (and correlated) returns from property and some hedge funds over the crisis.

However, a closer look at alternatives space shows that the 'asset class' can be decomposed into two broad camps – those asset classes that are 'illiquid', with investments that are typically associated directly with the physical world (property, infrastructure etc) versus those alternative asset classes that are 'systematic', with investments linked to liquid trading strategies in financial instruments.



Access to alternatives of both types has been a problem in the past with liquidity, fund structure and cost of the available vehicles all proving prohibitive. Yet it need not be: risk factor-based investing has shone a light on structures such as hedge funds, to expose not only how returns are generated, but also that elements of these returns are systematic, and therefore replicable in low-cost, liquid format.

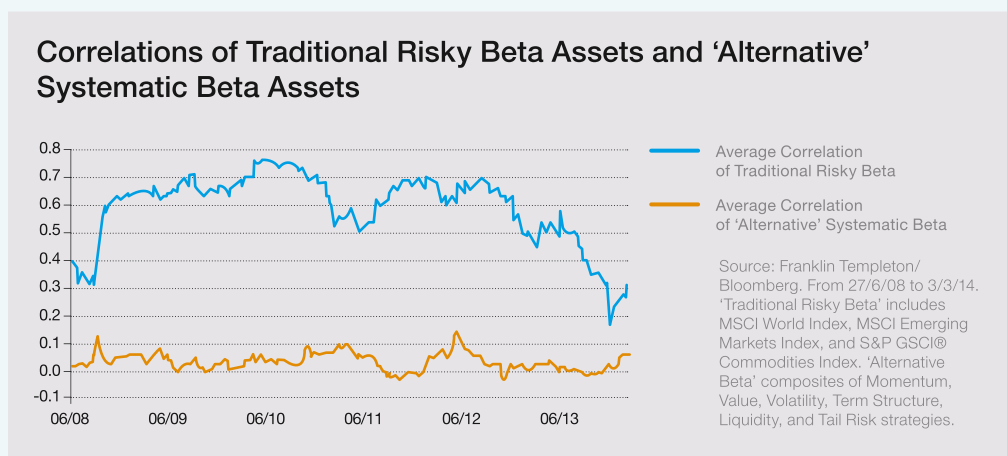
Just as long-only equity fund returns are decomposed into style risk exposures as well as broad market (beta) and stock selection skill (alpha), so too have hedge fund returns been dissected. While many hedge funds give access to the returns of truly skilful managers, much of the industry's returns can be explained in 'systematic' terminology.

These systematic risk factors (collectively named 'risk premia') represent an alternative source of return, distinct, liquid and most importantly uncorrelated with traditional risk factors. The 'Style' risk premia, for instance, while traditionally associated with the equity asset class, are also found across others. They represent returns that accrue to investors that systematically exploit market behavioural effects such as valuation biases (value and low volatility), herding tendencies (momentum), or survivorship bias (quality). Long-only equity funds have long since tilted portfolios towards these factors, but many hedge funds (such as 'equity quant', global tactical asset allocation (GTAA) and commodities trading (CTA) funds) also isolate and exploit the same factors but in market neutral format.

Likewise, with the advent of liquid derivative markets came 'structural' risk premia. Where a liquid options market exists, the volatility risk factor has been observed, with investors effectively being paid an excessive premium for insurance against sudden market moves. Likewise, asset classes that exhibit term structures have seen strategies develop that systematically exploit the shape of their curves and similarly, where there is a yield differential, there is a carry trade to be made.

All of these risk factors represent a widely expanded toolkit for the cross-asset investor. While exposure to risk factors individually may deliver good Sharpe ratios as stand-alone investments, the true power of risk factor investing comes at the portfolio level, where low correlation between

alternative risk factors can significantly reduce portfolio volatility and catastrophic downside risk from rare events (tail risk). When compared to traditional risky assets, correlations between alternative risk factors have remained low and stable, especially over the 2008 crisis.



In a world where volatility targeting is now ‘de rigueur,’ the addition of alternative risk factors to a traditional portfolio brings more stability to covariance estimates and therefore represents the simplest and most reliable methodology to forecast and control volatility.

Yet risk factor investing is not without its pitfalls. The model of strategic asset allocation with tactical overlays is settled as the standard framework for traditional multi-asset portfolios. Yet this approach struggles to cope with the vastly expanded opportunity set of alternative risk factors. Also, risk factors are expected to generate a positive premium and therefore must have a sound economic rationale for their existence. As exposure to many risk factors is gained by ‘design’ of systematic trading rules, the very existence of the risk factor can be questioned when back testing and data-mining are the only proffered evidence. Similarly, model risk aside, risk factors can also be cyclical and dependent on market regimes of volatility growth and inflation as well as also being capacity-constrained. All of these issues make design, selection and forecasting a non-trivial issue when including systematic factors in the portfolio, so significant research and resources is still required when allocating to these factors. In this brave new world, this at least, is one constant and similarity with more traditional asset allocation that has not been washed away.

Risk factor investing is no panacea for cross asset investors, but it does represent a seismic shift in portfolio design and philosophy. The decomposition of portfolio risks on a factor basis rather than on an asset class basis will often require a volte face of the mind-set of the cross asset investor, but when achieved, will allow for more targeted portfolio objectives, realigning expected risks and rewards across the portfolio, and finally giving true meaning to the word ‘diversified’.

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Structuring a diversified growth portfolio

By Bill McQuaker, Co-head of multi-asset, Henderson Global Investors

The growth in the popularity of diversified growth strategies in recent years has resulted in a proliferation of the number of products available, giving clients a wide and sometimes bewildering variety of choice. The products all claim to do a similar thing: deliver equity-like returns with lower than equity market volatility. However, the approach taken to achieve this outcome varies widely and there is no right or wrong methodology. Ultimately though, the chosen process must be able to achieve the desired objective.

In a world of uncertainty, patience can be a virtue, so we believe that the core structure of a diversified growth proposition should be aligned with the strategy's long-term objectives. Indeed, the predictability of asset class returns increases the longer the time horizon under consideration, rewarding the patient investor. Reflecting this, the Henderson Diversified Growth strategy employs a strategic asset allocation approach, based on long-term expectations, to determine a strategic portfolio that forms the core structure of the fund. 'In the shorter term, uncertainty can create risks for the strategic portfolio but can also provide opportunities. Consequently, the strategic core is complemented with shorter-term dynamic asset allocation decisions to capture upside and manage risks.

So if strategic asset allocation is to lie at the heart of the process, what are some of the key considerations?

Diversification

One of the major benefits of multi-asset investing is diversification: the desire to construct a portfolio of uncorrelated assets that maintains returns yet lowers risk.

However, it is not as simple as just adding extra assets; managers have to understand how an asset contributes to the overall portfolio in terms of return/risk and its interaction with other assets. An analogy can be drawn from a recent white paper by Lyxor[1] which considered the use of hedge funds in a multi-asset framework. Amongst their conclusions was the need to distinguish between hedge funds according to common characteristics: significant equity beta; significant bond beta; and significant alpha generation. We believe this idea can be applied more broadly to identify categories of assets that each add something distinctive to the strategic portfolio:

1. Equity-like assets: assets with high returns but generally higher volatility and high correlation with broad equity markets.
2. Diversifying assets: mid risk assets which have lower returns than equity assets but also have lower (but still positive) correlation with the equity market.
3. Hedging assets: tend to exhibit low returns with low volatility but also tend to typically have negative correlations to equities.

Given the objective of generating equity-like returns with less than equity market volatility, a robust portfolio will have exposure to assets that produce equity levels of return while offsetting some of the higher volatility associated with these types of assets by including allocations to diversifying or hedging categories.

Return Expectations

What returns should we expect in the future? There are a number of approaches that can be taken by investors when forecasting asset class returns. One option is to extrapolate forward historical

performance trends. However the adage “past performance is not a guide to future performance” highlights the dangers related to applying historical market returns as a proxy for future results. That said, in the long-term (5-10 years) there appears to be patterns that suggest at least some partial predictability: it seems that periods of low return actually appear to follow periods of high return, and high valuation multiples generally precede periods of low return and vice versa.

Academic studies suggest that simple valuation measures can explain much of the variation in stock market returns over time and that this predictability rises with an increasing time horizon. In addition, low dividend yields forecast low future returns. There appears to be no correlation between valuation multiples and future earnings/dividend growth. Consequently, it seems prudent to incorporate current valuation levels in any assessment of an asset class’s future return i.e. equity expectations to include the current dividend yield plus a forecast for the potential growth of those dividends.

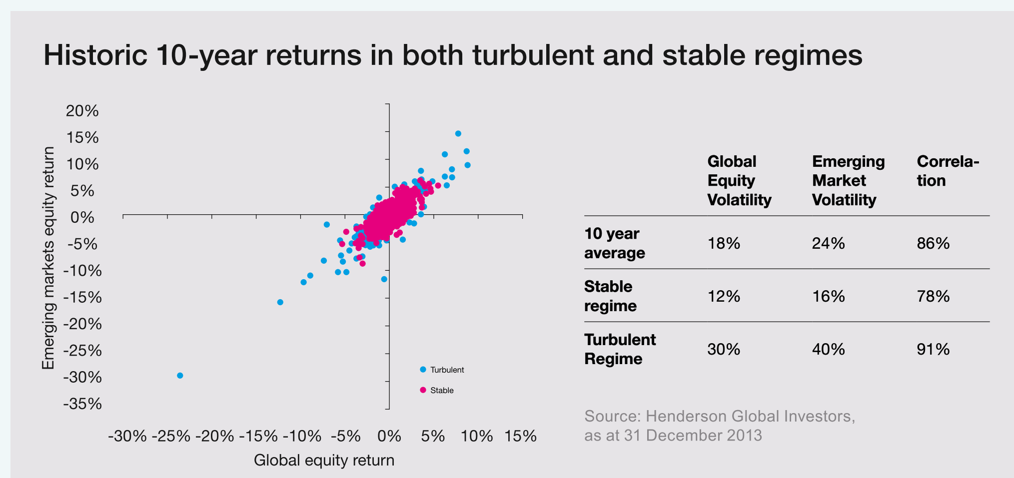
The notion of current yield shedding light on future returns can be extended to other yielding assets (bonds and property for example) with some adjustments made for any potential growth in income. For non-yielding assets, future returns can be based on the relationship of previous returns with prior equity and/or bond returns.

Of course these simplistic measures could be enhanced to produce slightly better estimates but expected returns are never entirely predictable, otherwise we could invest with complete certainty. In order to construct a strategic portfolio that is easily understood, we value simplicity over complexity and objectivity over subjectivity when quantifying expected returns.

Volatility Regimes

The global financial crisis was a timely reminder that the relationships between asset returns are not always stable. This period saw a number of “diversifying” assets become more correlated with equities at a time when stock markets were in freefall. The impact on multi-asset portfolios was a reduction in diversification benefits and thus an increase in portfolio risk at a time when overall risk was rising: just when investors needed them most, some assets were not offering the protection required.

How to deal with these phenomena is tricky because basic financial theory is mostly based on an assumption of stable volatility and correlations, with the methodology for calculating future volatility/correlation based on looking at history. One way of dealing with this issue was proposed by Kritzman *et al*[2] who suggested grouping historical data into different volatility regimes: “turbulent” and “stable”.



	Global Equity Volatility	Emerging Market Volatility	Correlation
10 year average	18%	24%	86%
Stable regime	12%	16%	78%
Turbulent Regime	30%	40%	91%

Source: Henderson Global Investors, as at 31 December 2013

It can be seen from the diagram that each regime exhibits quite different characteristics. In the example above the volatility of emerging market and global equities was 24% and 18%, respectively, over a 10-year period, while the correlation was 86%. Dividing returns into "stable" and "turbulent" regimes results in lower volatilities in quieter periods and higher volatilities/correlations in periods of market stress. Therefore in a turbulent regime, traditional methods of calculating volatility may under-estimate risk.

How can this information be incorporated into a strategic framework? Choosing to just use the results from one or other of the regimes would not give the best reflection of future risks unless regimes could be predicted with some degree of confidence. To reflect the uncertainty of not knowing what kind of regime we may face, the regimes are blended together depending on our views of how likely either stability or turbulence is in the future, producing a more effective volatility framework.

Bringing it all together

We now have a framework for understanding how different assets can contribute to a strategic portfolio, a relatively simple way of forming expectations of future asset returns and a method for incorporating the potential for unstable volatilities and correlations.

The next stage is to produce the strategic portfolio; the optimal mix of assets that are expected to generate a return at least equal to that for equities but with the lowest possible risk. A spread of allocations across the three categories and at an individual asset class level further ensures that the portfolio exhibits a good level of diversification.

In summary, a strategic asset allocation approach provides a good starting point for building a robust long-term portfolio. However, it must be recognised that this approach can be vulnerable to short term gyrations in markets and market "shocks". Dynamic asset allocation therefore plays an important role, within a clearly defined risk budget, of managing these shorter-term risks and capturing any opportunities that may arise from shorter-term market inefficiencies.

[1] Hedge Funds in strategic asset allocation. Zelia Cazalet and Ban Zheng, Lyxor Research White Paper, March 2014.

[2] Risk, Regimes, and Overconfidence. Mark Kritzman, Kenneth Lowry and Anne-Sophie Van Royen. The Journal of Derivatives, Spring 2001.

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We believe that bringing together the asset allocation talent of the fund managers and the experience of the broader multi-asset team, with an overarching focus on risk management and liquidity, leads to better investment outcomes for our clients.

For more information on the Henderson Diversified Growth Fund, visit HGi.co/DiversifiedGrowth

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Dynamic markets require a flexible investment approach

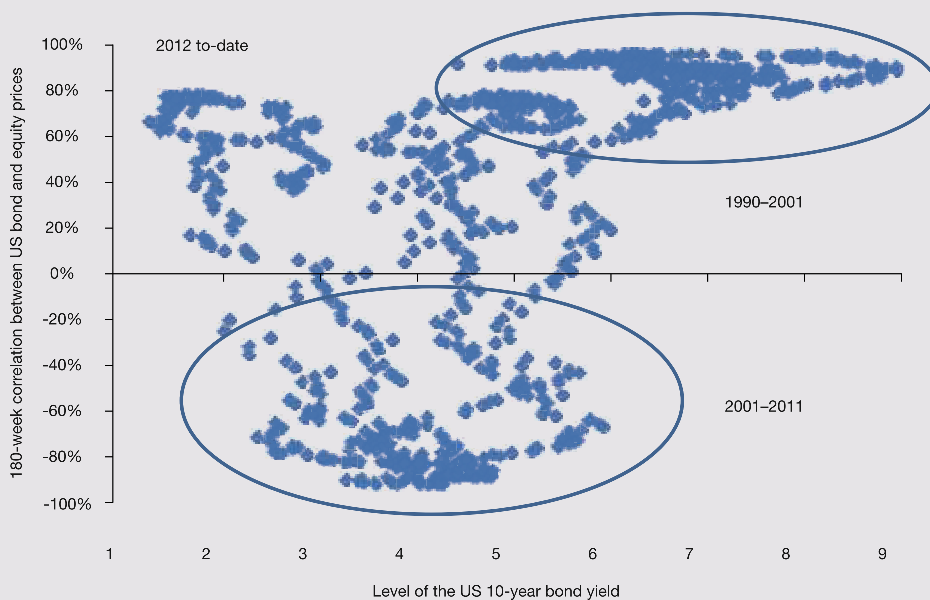
By Georgina Taylor, product director – multi asset, Invesco Perpetual

Traditionally, many investors have relied on the diversification benefits of holding both equities and bonds in a portfolio. However, over the years, the correlation between the two asset classes has constantly been changing.

Pre-2001, bond yields were on average a lot higher than they are now. When bond yields rose during the 1990s, equity markets responded negatively because the higher level of bond yields was not being fully offset by higher growth. However, in 2001, after bond yields followed base rates to historically low levels, the relationship between equities and bonds changed significantly. When bond yields rose equities also headed higher because the higher bond yields generally reflected stronger economic growth, which more than offset the increase in the cost of equity.

We have now been in a multi-year period of low bond yields and once again the relationship between equities and bonds seems to be changing. Since the start of 2012, a positive correlation between bond and equity prices has been seen once more. For much of the period that was because falling bond yields, partly as a result of central bank bond purchases, also acted to push up equity prices. In the second quarter of 2013, however, bond prices fell and yields rose at the same time as equity markets weakened.

The correlation between US equities and US bonds has moved in three broad phases since the 1990s



Source: Datastream, as of 7th April 2014.

These changing correlations underline the importance of a diversified portfolio that is able to pinpoint exposure within markets to isolate key macro themes without being restricted by asset class labels, which is what drives our approach.

Investing in ideas

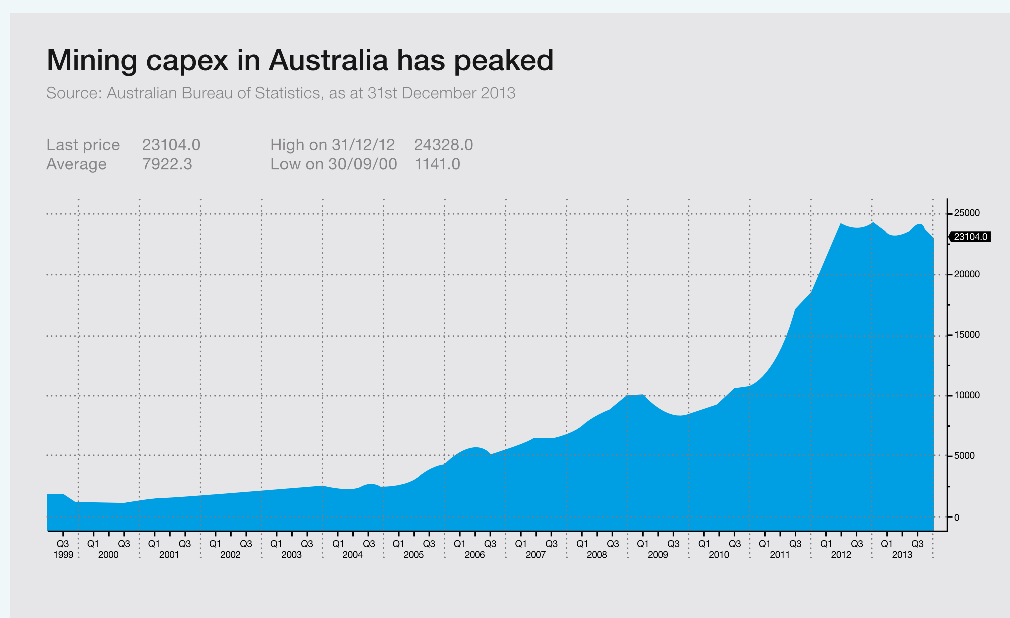
Our investment approach is to find good investment ideas without being constrained by asset labels. We believe that an unconstrained research agenda gives us the freedom to achieve true diversification, which, in our view, is necessary to negotiate the changing dynamics of global markets and to generate positive total returns long term.

Once we have looked across asset classes and geographies for good long term investment ideas, the next step is to apply robust risk management tools in order to bring the ideas together into a single, risk-managed portfolio. The key is how all the ideas work together and importantly how they interact with each other to reduce the overall risk of the fund.

Short Australian rates

For example, across the developed world, we expect monetary policy to remain accommodative and one idea the team has focused on is the Australian interest rate market and how it currently is pricing in interest rate rises.

The Reserve Bank of Australia (RBA) has its work cut out as it resides over a transition in the economy from one that has been highly dependent on commodities for growth to one that is more services led. After lowering its policy interest rate to 2.5% in August of last year, the RBA suggested it did not expect to cut rates again imminently, which led to a broad expectation that it had reached the end of its rate cutting cycle. However, there are now some dissenters who believe growing unemployment could provoke a further rate cut as mining capex drops off later this year. The two-year interest rate swap yield is 2.9% and the expectation of the two-year swap rate yield in two years' time is 4.2%. However, we believe growth pressure is unlikely to alter in the near future and have bought a two-year forward, two-year swap, which even if rates remain on hold, will fall towards current two-year swap levels and contribute a positive return.



Opportunities in European Financials

Another opportunity we see is in the European Financials sector where we believe corporate bonds offer some value. The current regulatory environment suggests banks, which dominate the financials index, will continue to need capital to further bullet-proof their balance sheets while defaults seem highly unlikely. Especially as central banks, including the ECB, seem committed to 'saving' the banking system from past excesses.

At the same time, we believe the current spread of senior financial credit already reflects the regulatory environment and the sector's low earnings visibility and, therefore, spreads could narrow. This makes us comfortable taking a long position on European senior financial credit.

We combine this trade with a long volatility position on the Euro Stoxx Banks Index. The slow pace of both economic growth and change in the European banking sector has led to low earnings visibility, which means bank equity may come under pressure in the years to come. This coupled with the currently low implied volatility of European banking stocks represents in our view an attractive entry point and adds some defensive qualities to the trade. Whereby, if things do go wrong in the sector and credit spreads rise to reflect increased risks, equity volatility levels will most probably increase.

Diversified exposure

Both of the examples here show how we isolate a specific theme and act on it, rather than needing to be exposed to particular markets or asset classes through traditional asset allocation. In addition, the use of volatility as a source of potential returns acts as another great example of how to diversify exposure by going beyond traditional asset types and labels.

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