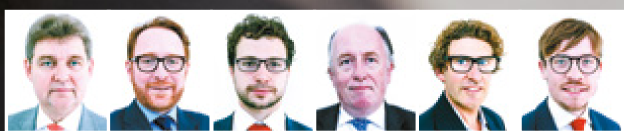
Multi asset

Navigating the proliferation of approaches



In conversation:

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Navigating the proliferation of approaches

No one can doubt the popularity of multi-asset products in the institutional space as investors are increasingly seeking diversification from traditional asset classes and additional sources of return.

However, making sense of the sector is difficult as strategies grouped under the multi-asset banner come from far and wide. Everything from diversified growth funds (DGFs) through to hedge fund-type strategies and more traditional balanced mandates can fall into this category.

And getting the balance of these strategies is equally as difficult. To borrow an analogy from a comment piece recently written for *portfolio institutional* on the subject: "Multi-asset portfolio management is like cooking: you need good ingredients, but it is the delicate combination of them that makes a good dish great. Dishes need flavour - risk – but in the right and complementary quantity."

But getting the right balance of assets has not been easy of late. In recent times bonds have offered investors next to nothing and for some funds this has meant their long-term track record is meaningfully lower than originally targeted. Elsewhere, commentators have warned correlations between asset classes have begun to converge and investors must take care to protect against a potential market shock.

With so many strategies on offer, investors need to be sure exactly what they want the strategy to do for the portfolio and this involves looking at the bigger picture of how it fits with the rest of the assets.

In some cases people have argued these strategies have failed to do what they say on the tin. A fund may, for example, be branded as a mixture of equity, debt and property, but on closer inspection the property is in fact property equities, which are likely to be highly-correlated with traditional equities and have a knock-on effect on performance. Indeed, many also believe some multi-asset funds rely too much on equity risk and are therefore not diversified enough in terms of risk and return sources. To this end, managers and providers have been working hard to produce more unconstrained strategies that allocate to risk rather than by asset class.

Elsewhere, from a governance perspective investors need to decide whether to conduct their own multi-asset allocation or delegate by buying into a fund or outsourcing the decision-making process to a third party.

This roundtable sees an expert panel of asset owners, consultants and managers discuss multi-asset investing, from how the different types of strategy fit into a portfolio through to how they have fared in recent macro-economic conditions and how performance should be judged.

Sebastian Cheek
deputy editor, *portfolio institutional*

David Smart

"Wearing my trustee hat, there are some multi-asset funds, which I don't think have really done as much as they could have done in terms of acting as that active asset allocation component." David Smart

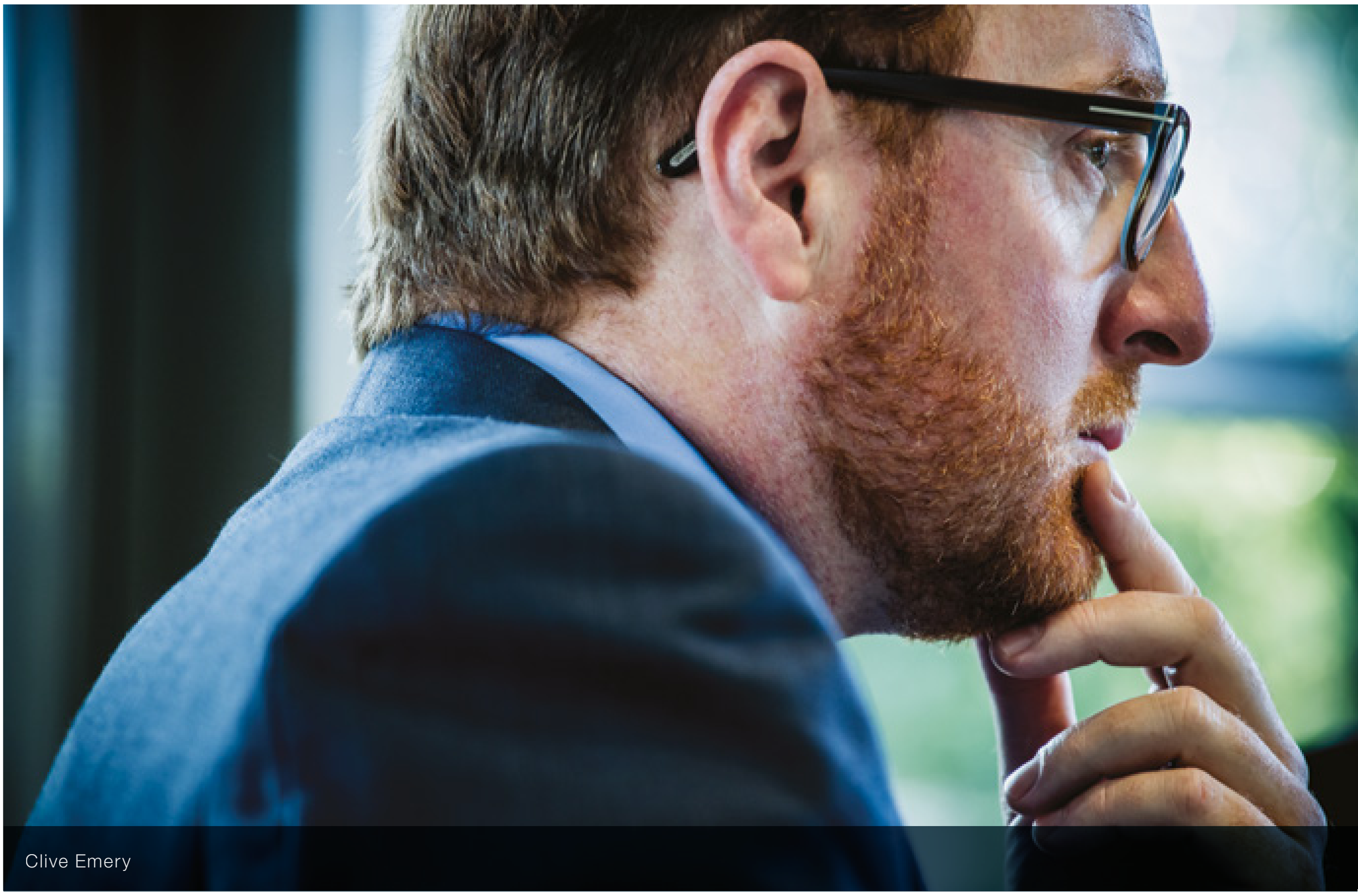
People often say multi-asset lacks a track record and that many solutions haven't been through difficult times to be properly tested. So, have they lived up to expectations?

Ben Shaw: I have noticed there are a number of multi-asset strategies out there that don't quite do what they say on the tin. They'll be branded as a mixture of equity, debt and property, and maybe other assets, but when you delve down, you find their property is in fact property equities. So, when equities go down, you don't get the multi-asset effect that you ought to.

David Smart: I'm also a trustee and chair of the National Trust internal investment committee, so sit on both sides. I would say there are those new balanced-type portfolios, where equity risk is still by far the dominant risk factor and a new, more idiosyncratic breed where equity risk is not the dominant risk factor. There are a number of skill-based strategies involved that arguably achieve greater diversification.

Clive Emery: The multi-asset class is still young. It is also very diverse. There are a significant number of different strategies, philosophies and approaches. Some are restricted to two asset classes and some funds are unconstrained and can utilise multiple assets such as volatility, inflation and currencies. Diversified growth funds (DGFs), hedge funds and balanced funds can all fit into this investment class, as well as very sophisticated multi-asset funds which have a much less constrained and far more diversified approach to both risk and return. Though, while the asset class is young, there are some funds which have demonstrated a good track record.

Alex White: From our perspective, there is a spectrum from completely passive, where you've got things like risk parity managers, working up through more traditional DGFs with a benchmark, to sort-of DGFs


Clive Emery

"There are a number of funds out there that don't look at an asset allocation approach. They look at ideas in a very unconstrained nature, which is different to 60/40 or balanced funds that are constrained by their asset classes." Clive Emery

that don't have a benchmark and swing around their allocations massively. There are a few which were normally quite equity-biased, but pulled out in 2008 and 2011. Then, at the extreme other end, you've got Invesco and Standard Life. Track record is quite a bad way to judge alpha strategies, but there's a smattering of funds across the spectrum with 15-year track records, certainly at the more passive end.

Andrew Cole: The universe has diverged in terms of style through the years, and in 2008, 2011 and possibly 2015, there's an interesting dynamic in terms of whether you're driven – or controlled – by your risk or the desire for return. How you control and target that will become increasingly apparent so historic track record, in terms of risk characteristics, is necessarily a good steer. As somebody who runs a more unconstrained but beta-type management, I know that long-term track record, in terms of its risk characteristics, is meaningfully lower than we targeted, largely as a result of the performance of bonds.

Originally it was born out of DB schemes wanting to de-risk, but the long track record with some appealing risk/return characteristics means insurance companies think that suits their objective. Whether in the long run their objectives are aligned with pension funds, will be an interesting development.

How do institutional investors make the choice as to the type of fund they go for?

Shaw: It always comes back to the bigger context of what they're doing with the rest of their assets and how well they understand their strategy and how reliable it is. People will generally tolerate a period of poor returns if it fits with what the strategy was designed to do.

Smart: The first thing a pension scheme needs to decide is whether it's going to be its own multi-asset allocation, delegate that to a fund that it buys into, or take a combination approach. Most schemes take a combination approach. One way of doing that is investing in a DGF fund, rather than equities and bonds oneself, where you see more of the fluctuation.

Cole: Our smaller, mid-sized pension scheme clients have seen us as a governance solution.The trustees think about the issues facing them, rather than what invariably becomes something of a part-time job thinking about investment. So, they're delegating that.

Shaw: Do they place 100% of their funds with you?

Cole: It depends on the size of the scheme. For small schemes, yes, it's cost effective. Bigger schemes will have passive bonds, passive equities, and have somebody like us in the middle that they hope makes a big enough difference. It comes down to ratios and their risk profile.

Shaw: It makes a lot of sense for smaller schemes that meet infrequently, can't get good returns with relatively small amounts with lots of different managers, and can't easily get the diversification.

Emery: There are a number of funds out there that don't look at an asset allocation approach. They look at ideas in a very unconstrained nature, which is different to 60/40 or balanced funds that are constrained by their asset classes. These funds are an asset allocation tool, but other funds are trying to move past that into more sophisticated solutions that do provide this dual return and volatility target.

Smart: Wearing my trustee hat, there are some multi-asset funds, which I don't think have really done as much as they could have done in terms of acting as that active asset allocation component. In the future, a number of people will still do things on an asset allocation basis, but we've seen some of the Nordic pension funds moving into a risk factor-based approach. That does lead to a much more effective diversification and likelihood of achieving demanding targets. One could argue the whole industry has got slightly overstated returns and understated risk, because of the exceptional bond returns we've seen.


Ben Shaw

Cole: While we're all bucketed in one DGF or multi-asset fund, I'm encouraged that so many managers go about achieving the objective in so many different ways. That keeps the universe clean and healthy because if we all decided to do it one way, we'd all be watching each other and that wouldn't serve anybody particularly well. Some clients will be more attracted to one way than another and I think that keeps us honest.

How should investors assess these strategies if benchmarks are not being used?

Cole: There was a huge desire to make our fund less vulnerable to equities, but with a deficit needing to generate returns. But some, are increasing risk by looking at multi-asset, as for them, it's a bond alternative. Certainly, multi-asset in Europe is seen much more as a bond replacement, whereas its birth here in the UK it was very much an equity replacement, though I'm not sure that is still the case.

Smart: One of the main funds within the sector grew out of the life insurance business with a liability management focus. That then grew into an institutional and retail product. On the continent, quantitative easing by the ECB has definitely been a powerful driving force behind looking at these types of fund as a bond replacement strategy. If you're sitting in five-year bonds, and paying Mrs Merkel a fair amount for the privilege, it does concentrate your mind. There needs to be some distinction on the equity products between risk levels, because the risk levels associated with cash or RPI plus five are probably too high for the bond substitute-type strategies that continental Europe is more looking for.

Emery: Your question as to how to judge the sector is part of the issue. The divergence of underlying funds with a variety of targets and objectives means it isn't easy to monitor the sector relative to an underlying benchmark. It isn't appropriate, as the different funds have different objectives. In my view, you have to measure them on a case-by-case basis, rather than necessarily in their entirety as a sector or as an investment space.

Smart: Depending on whether you have a Libor-plus target, or an RPI-plus target, in the last few years there's been quite a divergence between what normally – historically – would have been a very similar target. If we get back to a situation where short-term interest rates are reasonably positive in real terms then that difference will be eradicated.

White: It's very easy to get bogged down with benchmarks and they can do a lot of harm because you end up constraining your investment universe to fit your reporting universe. Monitoring is about whether they are doing what you bought them to do. Are they giving you the diversification you expected?

Smart: A number of funds have a longer-term horizon, and suggest a rolling rather than annualised return on a two to three-year basis. That suggests that, given many of the funds are offering this cash plus 5%, which is like an equity risk, there will be periods where the returns aren't constant.

How resilient are current multi-asset strategies to market shocks?

Cole: We've been reasonably focused in terms of where we've had equity exposure and that has served us well. We have been bearish about the prospects for emerging markets for the last three years, and I suppose one of our differentials against your standard balanced-type mandate is that we haven't had exposure to emerging, whether it be debt or equity.

We have been conscious about the prospects for emerging and not being exposed there. When you start to see global trade slowing rapidly, you start to consider the point earnings are at risk. The prospective equity risk premium starts to get small, you've got to make some more heroic assumptions about earnings growth than you might want to do, given what's going on in the world and you decide to start de-risking out of equities. We've done enough of that without selling everything and I'm happy with what we've got now. Hopefully, we satisfied our clients, but I'm not looking over my shoulder to see what other people have done.


Alex White

Emery: We look at the best way to implement an idea by analysing all the various asset classes at our disposal. It is important to appreciate that while we have ideas implemented in an asset class, that doesn't mean the idea is correlated to the underlying asset. In January, we lowered the duration of the overall fund from about two and a half years to roughly zero, given our long held view that rates would fall for longer had played out. Today we have ideas implemented within the fund using interest rates, but they tend to be relative value and therefore do not have duration. Also being unconstrained allows us to utilise sophisticated solutions that enable us to lower the equity beta of a position or hedge the downside risk by adding crash protection. On that latter point we do a lot of analysis to find crash protection that doesn't cost a lot because otherwise you just start paying away your returns – which is important in the current market conditions. Our target is to deliver returns with less volatility and hopefully we can continue to provide investors with a smoother path of return as we have done since the inception of the fund.

Smart: Given that you've both weathered the volatility quite well, are you now going back in seeing this is a buying opportunity?

Andrew Cole

"Analysts tend to be optimistic about countries they follow and are probably still too optimistic for earnings in 2016. We might get some help from lower bond yields, but it's volatile and will remain so." Andrew Cole

Emery: Our portfolio turnover is still at two and a half, to three years, which is in keeping with our investment horizon. We do have the ability to increase or decrease the fund's total independent risk between 4/3rds and 2/3rds of global equity risk. So we can shift the funds exposure to market risk but it's a slow process. We are not trying to tactically trade the daily or monthly gyrations of the market. Though in these market conditions we have to do quite a lot of delta hedging.

Smart: Even though we're quite well-known for our emerging market exposure within the multi-asset group, we have had differentiation within emerging markets, rather than just not liking them en masse, because for a long time, they could be treated as a relatively homogeneous whole.

We've had a very strong, positive theme on India in a variety of ways over, I guess, a couple of years now.

So, there are still opportunities?

Smart: Yes. The commodity theme and what's going on in China has been enormously influential in understanding the dynamics of emerging markets. There are some that actually can benefit quite a lot from what's going on, just in the same way that the western consumer can benefit from it.

Cole: We tend to work with a 12 to 18 month time horizon, and we still have concerns about the prospects for earnings. Analysts tend to be optimistic about countries they follow and are probably still too optimistic for earnings in 2016. We might get some help from lower bond yields, as people start to worry about deflationary impacts from devaluing emerging markets and China. It's volatile and will remain so.

Are multi-asset strategies perhaps too equity-biased?

Smart: I guess wearing my trustee hat, I would say that the answer to that question is yes.

Shaw: It comes back to some strategies disguising themselves as multi-asset strategies, but are actually just reallocating equities from one pot to another. There are some people genuinely doing multi-asset strategies, and as a pension scheme trustee, if that is what you're trying to achieve, you need to look at the underlying fund and its strategy and make sure it does what it's meant to be doing.

White: You want a certain amount of equity bias, because equities are cheap, they're liquid, and of all the various any sources of returns, equities are the best-evidenced. It's the one return premium that everyone agrees on over any long-term horizon. If you're a bigger fund looking for something with diversification, then it's the last thing you want. There's not one answer for multi-asset.

Shaw: You need to get a consultant to go in and determine whether these asset classes are correlated.

Emery: I think we're all familiar with the classic phrase: past returns are not a guide to future returns. However, it is important both for the industry and for our clients to appreciate that past risks and past diversification is not a guide to future risk and future diversification. Risk is dynamic. To look at the correlations of asset classes and presume them moving forward in time at a constant level is a fallacy. Equities and bonds over time have been correlated both negatively and positively, and have fluctuated massively over time and between countries. A number of funds have a risk function that sits on a different floor, in a different building or in a different team, rather than being embedded in the actual fund management process. Risk is a key focus and you need to be analysing risk as much as you need to be analysing returns.

Cole: Also, the biggest risk is having a fixed-weighted benchmark. If you've got bonds and equities, the fact is that the correlations change, invariably just when you don't want them to. In fact, the riskiness of equities changes relative to its history, or the relative riskiness of bonds. So it is a moving dynamic that, as portfolio constructors, we need to be aware of and we need to manage.

Emery: If you look at backward data, you must constantly look at different periods of time because the

correlation matrix changes. You have to put your fund through the sausage grinder of different periods where different correlations have existed and try to analyse future potential events because the past is not necessarily a guide to the future. Then make a qualitative judgement on top of the quantitative analysis.

Cole: Most people rationally believe in the equity risk premium. The risk is part of the capital structure. If you pay the right price for it, you should expect the highest rate of return. Therefore, it's understandable that our clients say they need all the return associated with that. The other proven long-run risk premium is, of course, the illiquidity. That has become more troublesome, not just for us as managers, but for trustees and everyone because in the aftermath of not just 2000, but 2008, and 2009, everybody wanted liquidity. Trying to grab the illiquidity risk premia that exists in things like direct private equity or property is problematic. If you're going to buy an illiquid debt strategy wrapped up as an investment trust, we call it equity, not debt, because you know that it can invariably suffer big discounts to NAV at times of stress. Property in itself is actually reasonably liquid. If you own a building and you want to sell it, you can sell it reasonably quickly if you can tolerate the price. What you don't want is other unit holders not wanting to sell. We had our managed property portfolio wrapped up in a unit trust with us as the only unit holder.

Shaw: We do that, as with lending we provide what you might call illiquid debt product for a couple of pension schemes, who say they have a 20-year time horizon and are happy to tie up money for individual loans for three, six, nine, 12 or 18 months or sometimes seven or eight years. You don't get the volatility, and we're giving double-digit returns.

"You want a certain amount of equity bias, because equities are cheap, they're liquid, and the best-evidenced. If you're a bigger fund looking for something with diversification, then it's the last thing you want." Alex White

Clive Emery, Ben Shaw and Andrew Cole

"Larger funds should be looking at doing some of their multi-asset themselves. It gives you the flexibility that you need. You don't have to be subject to other people not wanting to sell when you want to sell." Ben Shaw

Cole: There's a wonderful way of reducing your volatility: you have something that you value once a year. That's really helpful. Unfortunately, those of us who have got daily-priced funds, or even weekly-priced funds, are not in a position to do that. You're always looking for compromises.

Shaw: But larger funds should be looking at doing some of their multi-asset themselves, just like you've done with your property and we do with private debt for a couple of funds. It gives you the flexibility that you need. You don't have to be subject to other people not wanting to sell when you want to sell.

What the best way is to allocate to multi-asset – by asset class or risk?

Smart: It is relatively rare to find institutional pension or endowment funds that are genuinely allocating by risk. The ones that we run, that we would definitely categorise as being run on a risk factor basis. But there are relatively few schemes that actually allocate their overall assets on a risk factor basis.

The leader in the field is ATP in Denmark, who have been doing it for quite some time, but even some of the very big Dutch pension funds who are looking at this on a risk factor basis are still doing it very much in an asset allocation framework.

Cole: The regulator has a part to play. If solvency is your issue, then you're at the risk end of the spectrum. Otherwise, most people seem to sit at the return end. The regulatory environment is very different here in the UK from Europe, so it will be horses for courses, and different clients will have different approaches.

Shaw: It's not helped by the PPF. Their levy is based on asset allocation, so if you've got equities, they charge you more. For the portion you have as equities, they charge you more than the portion you have as debt, for example.

White: The PPF levy has to be designed to be as simple and as objective as possible, and the most important thing is that you rely on it as little as possible. If you do it on a risk basis, there will be a lot of people who take advantage of that and arbitrage the risk. For an enormous number of pension schemes, the PPF levy is quite appropriate. A lot of funds are run on a very simple basis and having something that's easy and objective – even if it captures 70% or 80% and is wrong 20% or 30% of the time – is still useful information at the big picture level they're trying to operate at.

After freedom and choice and the charge cap, how does multi-asset feature in DC?

Shaw: Unfortunately, if I look at the funds I'm involved with, 85% and more are in the default strategy. The real issue here is communication, because I think it's a much better strategy for people to be in than just an equity/bond strategy. But how you communicate that to people is a challenge.

Smart: Some of the evidence from the glide paths of some of the target date funds in the US has not been terribly good. What is missing in those sort of predetermined age-based glide paths, is that it doesn't take any account of relative valuation of assets and that has been very unfortunate. What the end-user wants is some kind of predictability, and a multi-asset solution does dampen that volatility and still achieves a return. It's an incredibly good strategy for a lot of people.

Cole: What you really need to do is hedge against the annuity purchase, but that no longer exists, so do you really need to de-risk against that at the tail? Relative valuation between assets is perhaps less important. Well, the valuation relative to annuity pricing is perhaps less important than it once was.

David Smart

White: You certainly have more scope to work around it. If you're holding a DC pot, ultimately what you want to get out of it is income. You don't need to be as precisely tied to annuity prices, but you do still want some of that interest rate element. For a lot of people, you are going to want – or at least it would be advisable – to take a certain amount in annuities just for the longevity protection that you can't really get elsewhere.

Cole: It comes down to cost and governance and all of the issues that apply to DB schemes apply – only more so – to DC. The biggest impact to the construction of the default is going to come from the charge cap.

So, we're talking about illiquidity premium and alternative assets.

Cole: If you genuinely want exposure to commercial property, given the costs associated with that investment process, it might become prohibitive under the cap.

Smart: There are so many of these observable risk premia that have multiplied a great deal from the work that Fama and French originally did in '92. They have become much more accessible and cheaper than they were that I suspect you couldn't get very significant diversification from those things without going into the illiquidity premium. Actually, Andrew, I slightly disagree with you on this illiquidity premium, because I think a lot of it is tied up with leverage, anyway, and it's a leverage premium.

Cole: Yes, so there's a lot of muddy water to crawl through before we get clear on it. I think it is going to have big ramifications and I think we'll be led by the consultants and the people who put the packages and the DC proposals in front of clients.

We'll be looking for guidance from them. How do they go about it, and what do they want from us, and what are they prepared to pay for it?

Providing true meaning to the word ‘diversified’

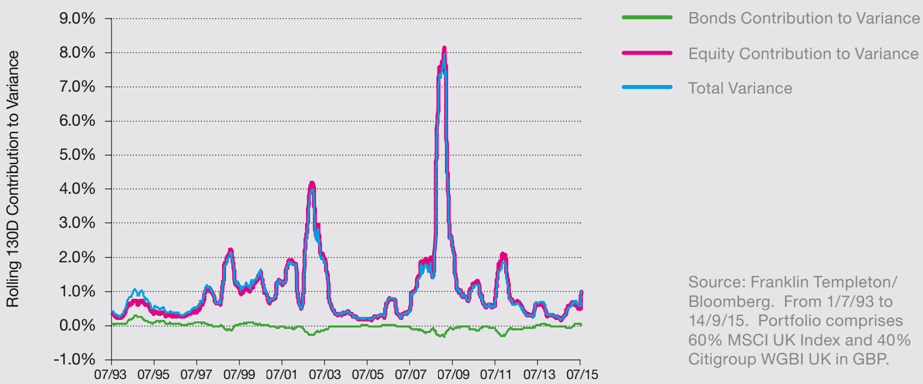
By David Smart, Head of Investment Solutions –EMEA, Franklin Templeton Investments

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.

Contribution to Variance of Assets in a ‘60/40’ UK Portfolio



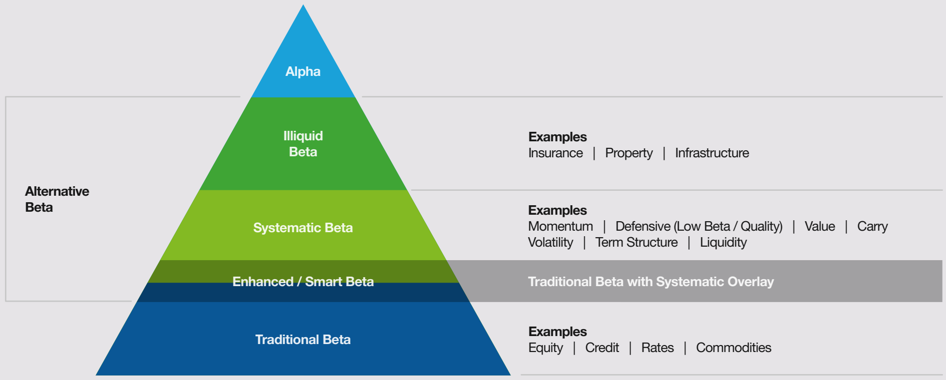
Source: Franklin Templeton/ Bloomberg. From 1/7/93 to 14/9/15. Portfolio comprises 60% MSCI UK Index and 40% Citigroup WGBI UK in GBP.

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.

Where does return come from?



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.

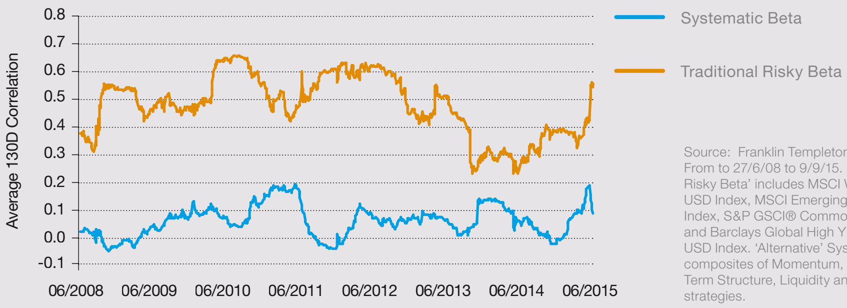
Just as long-only equity fund returns are decomposed into style risk exposures as well as broad market (beta) and stock selection skill (alpha), so too have hedge fund returns been dissected. While many hedge funds give access to the returns of truly skillful managers, much of the industry's returns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

Correlations of Traditional Risky Beta Assets and 'Alternative' Systematic Beta Assets



Source: Franklin Templeton/Bloomberg. From to 27/6/08 to 9/9/15. 'Traditional Risky Beta' includes MSCI World Hedged USD Index, MSCI Emerging Markets Index, S&P GSCI® Commodities Index and Barclays Global High Yield Hedged USD Index. 'Alternative' Systematic Beta composites of Momentum, Value, Volatility, Term Structure, Liquidity and Tail Risk strategies.

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.

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'.

Risk management in multi asset investing

By Gerogina Taylor, Product Director – Multi Asset, Invesco Perpetual

History can provide countless examples of those who hoped to capture returns in a rising market, only to suffer losses when the boom turned into a bust. Even Isaac Newton could not claim immunity – after having lost a fortune in the South Sea Bubble, he reportedly said: 'I can calculate the movement of the stars but not the madness of men.'

What is often missing is a diligent investment process – one in which the evaluation of risk is more than a mere after thought. For our own Multi Asset team, risk management forms an integral part of the investment process. This is evident in our team structure. While our fund managers take ultimate responsibility for all investment ideas, our team also includes a risk manager and a risk analyst, who are tasked with reviewing and providing advice on the risk attached to each investment idea prior to any final decisions being made. This aims to ensure that the risk is not underestimated, even though an investment idea may offer potentially enticing returns.

There are two primary activities our risk management process can be divided into. An examination of investment ideas for their diversification benefits and risk dynamics, the results of which could lead to the rejection of an otherwise compelling investment idea. Secondly, we perform hypothetical scenario testing to check how 'possible but not probable' economic scenarios may impact the performance of the strategy.

Diversification benefit and risk dynamics analysis

To illustrate how the first pillar of our risk management process works in practice, we will provide you with two examples. In March 2014, we considered several new and, what we believed to be, attractive investment ideas as well as changes of trading implementations of existing ideas. One of the new ideas was currency-based, setting the Polish zloty against the Czech koruna, and was intended to be implemented through long and short forward contracts. In our view, the Polish zloty seemed more attractive due to Poland's stronger economic outlook. It boasted more robust GDP figures and retail sales that surpassed that of its regional rival. Return expectations were in line with the two to three year return expectations we target across the portfolio per investment idea, so we began to look at what impact it would have on our portfolio.

Other portfolio changes were being considered at the same time, and we noted that adding the Polish zloty versus Czech koruna idea increased the volatility of the overall portfolio most. The idea was therefore rejected in favour of other changes, which produced a lower volatility and which also met return expectations.

Another currency-based investment idea was reviewed in mid-2014, which involved setting the Indian rupee against the Chinese renminbi. India has been slowly reforming its economy and its currency looked cheap relative to the Chinese renminbi. We also felt that it was in China's interest to weaken its currency to ensure its competitiveness. An improving budget and GDP in India relative to China also supported our view. Of all the investment ideas being reviewed at the time, adding the Indian rupee vs Chinese renminbi trade into our simulated portfolio produced the least volatile result.

Hypothetical scenario analysis

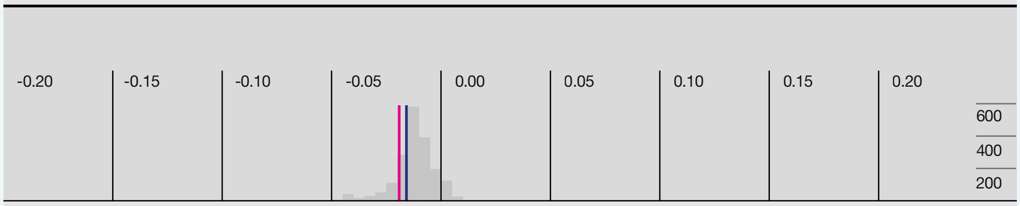
The second pillar of the risk management process looks at how our portfolios would perform in extreme market environments. To do so, we gather the views and opinions of a wide variety of individuals (these can be team members, other investment colleagues or external researchers) who can suggest relevant economic scenarios that can be defined in terms of potential market movements. The key is to collect a diverse set of opinions and avoid 'groupthink'. The scenarios are then clustered into themes to produce a manageable number of scenarios.

Next, we use quantitative analysis. We start by amassing as much historical data as possible in order to capture as much variety in historical relationships as we can. A risk model is then constructed for each rolling window (typically one year) in the data, which is used to imply the returns for the underlying markets we are invested in, based on the definitions of a given scenario.

This is done in such a way that we are able to stress-test both correlations and volatilities of assets in a coherent manner. From the projected moves in the underlying markets we are able to revalue all the positions in the strategy, and look at the change in value of the portfolio. This exercise is repeated for every window from the available historical dataset in order to gather as much information as possible about the potential impact on the strategy.

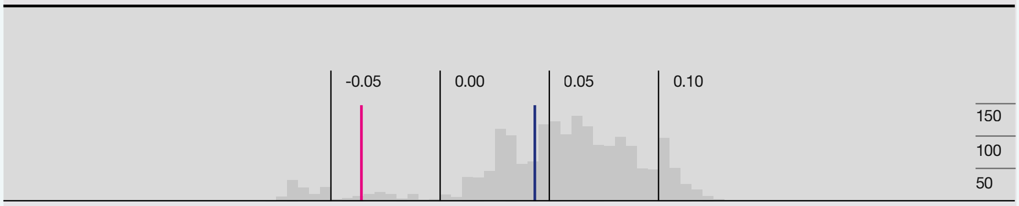
The results are best represented in a histogram. This can be either a reasonably tight distribution (figure 1), which indicates that the result is not that sensitive to the varying correlations between markets, or a wide distribution (figure 2), which can indicate either sensitivity to a particular regime or uncertainty in the possible outcome.

Figure 1: Tight distribution of potential returns



Source: Invesco Perpetual. For illustrative purposes only.

Figure 2: A wide distribution of potential returns



Source: Invesco Perpetual. For illustrative purposes only.

This distribution is in itself very useful, but should there be a wide range of possible outcomes we would need to establish the most probable of them. We do this by weighting each historical period by the probability that a certain scenario had in the risk model defined for that period. To think about this more intuitively, if we have a scenario where bonds and equities are positively correlated we will weigh more heavily on estimates established from periods where the correlation was positive – these probably provide a better estimate of how other assets are likely to behave. The weighted average of all the possible portfolio returns in a particular scenario is then used to get a best estimate. This is represented by the blue vertical line. The pink line represents the most recent data window.

The interpretation of the results relies on judgement. For example, the scenario shown in figure 2 is defined by a fall in Chinese equity markets. We have protective trades in Chinese equity volatility, and we would expect these to 'kick in' and cushion losses from equity holdings. This is indeed what we see from the blue 'best estimate' line. However, when we look at the pink lines, this does not happen. Here, we need to use our understanding of specific markets to judge whether this is a risk we should be concerned about.

In this case, the impact of structured product hedging on the Chinese equity markets has meant that implied volatility had generally fallen during equity market falls in recent years – a reversal of the normal relationship. Nevertheless, the dynamics of this hedging process means this would reverse during any large fall, and we would expect the protective volatility trades to indeed be effective. This illustrates both the limits of a quantitative system that relies purely on realised relationships and the importance of expert judgement in interpreting the results.

It is important to note our Multi Asset team's risk management does not stop with our team. Other functions across the firm, such as our Independent Risk Function (IRF), the Investment Oversight Function and Compliance, provide additional risk oversight and governance. The IRF, for example carries out historical stress testing for our strategy. So, while our team aims to provide a strong risk management process for our strategy, we receive full support from other functions within the firm whose main priorities lie in risk oversight and governance. We believe that our in-team efforts, combined with the support of these firm-wide functions provide a robust method of managing risk.

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The evolution of diversified growth – a manager's perspective

By Percival Stanion, Andrew Cole and Shaniel Ramjee, multi asset team, Pictet Asset Management

Multi asset funds have enjoyed a surge in popularity in recent years from an increasing diverse range of investors. Investment management companies have not been slow to add resources and have built teams to cater for this increase in demand. The financial crisis of 2008, when people who had endured sickening drops in the value of their investments during the market falls following the demise of Lehman Brothers, certainly precipitated a significant increase in demand. However for us the genesis was in the aftermath of the Dot.com bust of the early 2000's. That's when many investors recognised the extent to which a fixed weighted asset allocation benchmark had through time become less representative of their actual liabilities or return objectives and became increasingly attracted to investment strategies that did a better job of aligning their risk/return objectives with the potential rewards on offer from markets.

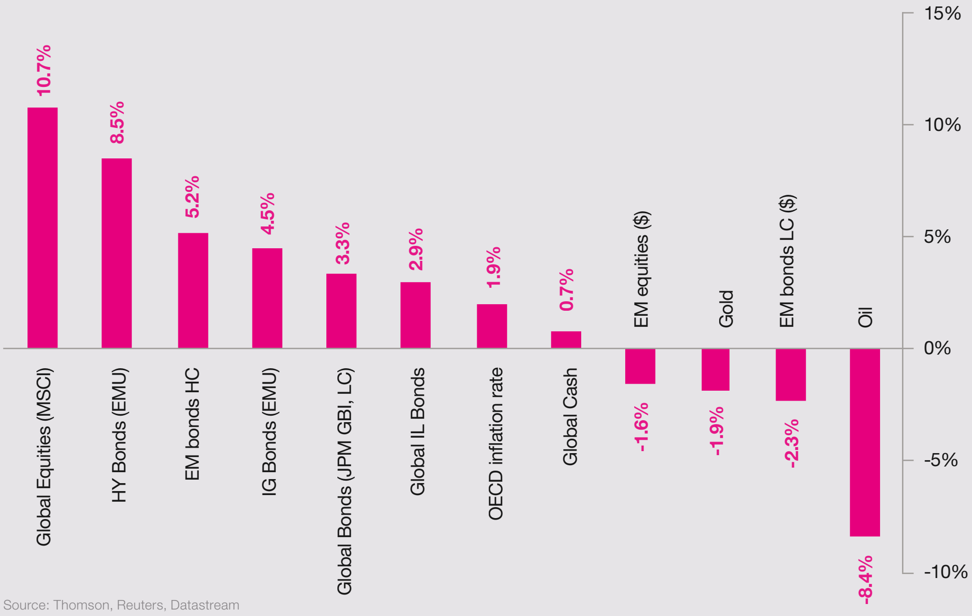
Since then the types of clients that invest in multi asset funds has broadened considerably. The introduction of regulation has always steered investors into certain strategies and the diversified growth sector is no different. Rules governing how pension fund deficits were treated by the sponsor in the aftermath of the 2001-02 stock market decline, FRS 17, led to a preference for more stable asset levels as sponsors were less keen to infuse capital to shore up the pension deficit in the wake of a poor period for equities, especially as this was most likely to occur when the economic environment was itself presenting challenges to the sponsors' cash flow. However, with many plans experiencing significant deficits in their funding levels, they could not give up the prospect of growth in their assets, typically 6–8% per year to meet liabilities. Hence the needs for equity or equity like returns, but without as much volatility.

Similarly, the Retail Distribution Review (RDR) legislation has seen many independent financial advisors seek to outsource all or part of the investment management of their client funds. Here diversified growth funds have offered a cost effective governance solution to this client base as they have done for both defined benefit and defined contribution pension schemes.

As competition from an increasing number of fund groups grows, the client base has extended beyond traditional pension funds, notably by the insurance industry, who are increasingly attracted by the low volatility of the return stream that these funds have historically generated. This reflects a regulatory push since the financial crisis to make insurers hold bigger capital cushions so they are more resilient to financial market shocks. The lower the volatility of the assets they own, the lower the capital ratio required.

The universe of diversified growth managers has for the most part delivered reasonable risk adjusted returns in recent years though many have fallen short on matching equity like returns. Of course this has come against a backdrop of strong returns from lower volatility assets, namely bonds (see chart). Going forward bonds are due a shift in direction, providing lower returns given the low yields on offer, whilst becoming more volatile as they lack the cushion from meaningful coupon income to offset the changes in capital values. Therefore strategies will find it harder to rely on the fixed income trend that has flattered the risk return profile of many diversified growth funds, including our own, over the recent past. In short, better utilisation of other asset classes and or a wider risk budget will be required if return targets are to be met for those clients seeking the higher levels of return associated with equities.

Performance % per annum, over 5 years to 2nd of September 2015 (in local currency)



Source: Thomson, Reuters, Datastream

As a result we think there will be a wider dispersion of returns across the multi-asset industry. This will be the likely outcome of both the investment managers differing strategies and philosophies adopted but also the dispersion of the different risk/return preferences of their clients. Those funds having both pension funds and insurers invested in the same strategy will likely have blurred objectives. If growth seeking clients such as pension funds are going to require higher risk levels given the argument about bonds, how does that sit with the insurers who still require much lower volatility to satisfy regulatory requirements? By trying to satisfy both pension funds and insurance companies, diversified growth funds will likely disappoint one cohort if not both.

We know where we stand. Whilst our long-run track record shows that we have achieved our return objective with less than half the risk of equities we don't believe that to be a likely outcome going forward. So constrain the risk budget to what the ex-post outcomes has been or, utilise all of the risk budget that our clients have mandated us to use in the quest for the higher returns? For us it has to be the latter.

Our beliefs remain unchanged. To get an equity-like return you have to capture the equity risk premium – or the extra return you can expect, if all goes well, for having braved a higher level of risk. This premium exists for a reason and you cannot really achieve it without taking some equity risk. A key benefit of our strategy is its flexibility, particularly around the risk level taken within the portfolio. We do not target a predetermined level of risk. The risk of assets change, the relationships between assets change and therefore the riskiness of your portfolio should be adjusted over time, within our permitted limit. We want the portfolio to participate in growth assets when conditions are benign, but importantly we want to hunker down and defend capital when markets are turbulent. We are always mindful that one disastrous year, destroys several years of growth.

Our strategy therefore is to build a portfolio which encompasses, by our analysis, the most attractive equity returns over the medium term, across geographies and sectors. However, if one is not being appropriately compensated for taking equity risk, one should not participate at all. We take this view on all assets classes as we look across the capital structure of various economies, investing in attractive credit, real yield, property or alternative assets where we see opportunities, but not being beholden to any benchmark or minimum weighting. The characteristics of different parts of the capital structure fall in and out of favour during different parts of the cycle, and adjusting the portfolio to diversify excessive risks must evolve as we move through that cycle. In our case, while returns have been achieved over the medium term with less than 50% of equity risk on average it is important to recognises that on occasion, risk levels have been higher and we allow a maximum of 75% of equity risk in our portfolio to take into account the needs of different cyclical periods.

In terms of how this approach has shaped our asset allocation, we've seen relatively attractive equity risk premia available particularly in Europe and Japan and as a consequence are meaningfully exposed to those areas. We do not find the equity risk premium to be attractive in Asia and emerging markets. Despite our long term view for those markets being positive, we currently have no investment in this sector. China in particular remains an area of serious concern as we have yet to see an economic landing se we hold no equities in China or other emerging markets as for the time being we believe investors are unlikely to be rewarded adequately for the risk they are taking.

Every asset that is in our portfolio is there for a purpose. We keep the portfolio simple, long only and built of clear, transparent building blocks where every exposure has risk-return characteristics that are easily understood by us and our clients.

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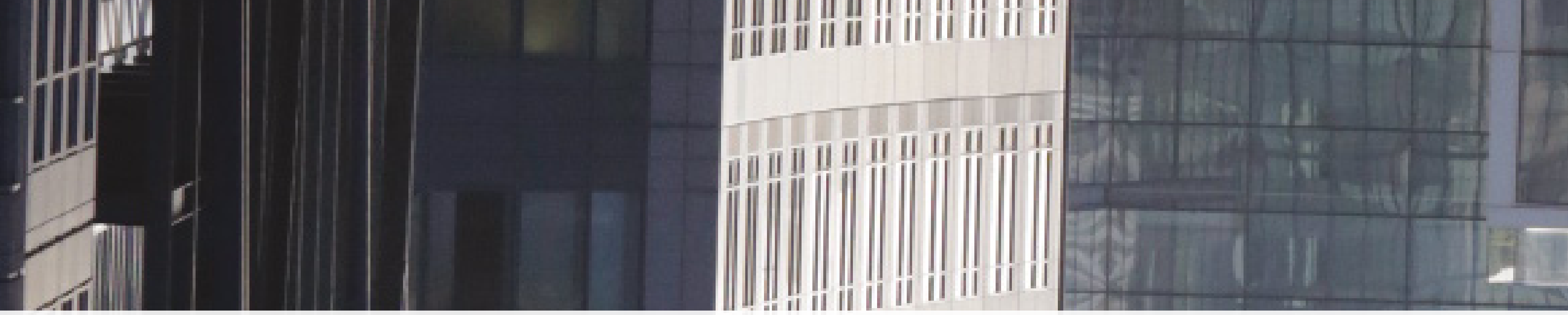

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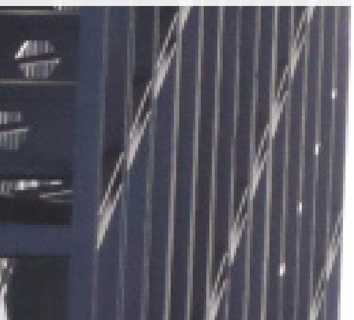

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Investors and investment consultants are invited to share their opinion and can be offered a complimentary place in future roundtable events. Asset managers interested in joining the panel can secure one of the limited sponsorship packages.

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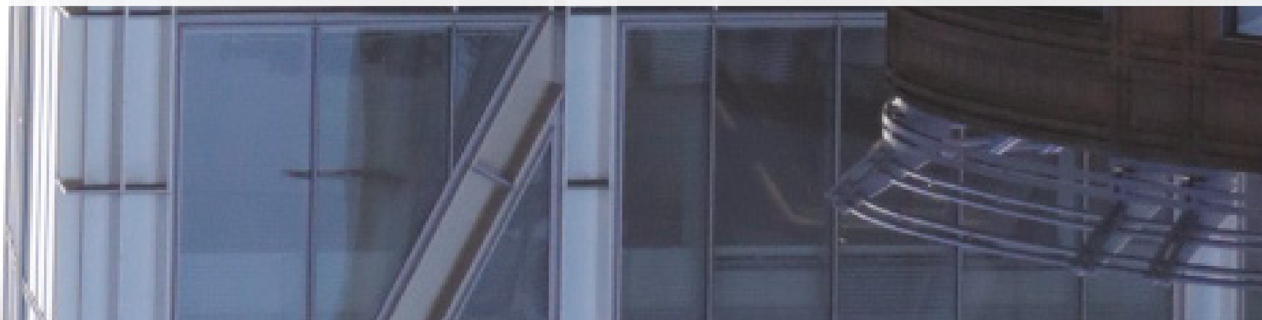

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