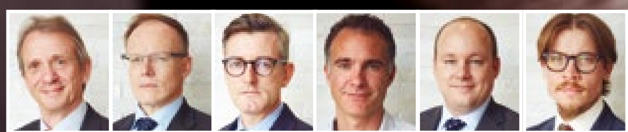
Multi-asset

Understanding all the options



In conversation:
Percival Stanion | Peter Hill-King | David Vickers | Tristan Hanson
Stephen Budge | Sebastian Cheek

SEPTEMBER 2016 | PORTFOLIO INSTITUTIONAL ROUNDTABLE

Multi-asset: understanding all the options

The UK's decision to leave the European Union on 23 June threw financial markets and domestic politics into turmoil.

On the day following the referendum, the FTSE 100 shed £120bn as investors panicked over the uncertainty of the UK's future. This was exacerbated by David Cameron's sudden resignation as Prime Minister having led an unsuccessful bid for the UK to remain in the EU.

On 6 July the pound sunk to its lowest level against the dollar in 31 years shortly after the yield on gilts dropped to below 1% (0.8%) on 27 June. Despite this, investors piled into gilts as a safe haven, a move which pushed UK scheme liabilities to record highs throughout June.

In central government resignations, cabinet reshuffles and chaos within the opposition party created further uncertainty around the direction of the country. A new Prime Minister in Theresa May helped calm markets somewhat, but opacity remains over the negotiations around, and triggering of, Article 50.

Across Europe big elections are expected next year in France, Germany and possibly Italy and The Netherlands. In global financial markets, Swiss government bond yields took a hit on the news of Brexit, as did US bonds.

This culmination of events and consequences has seriously skewed the market's perception of political risk in developed and emerging markets. Certain developed markets, usually seen as politically sound, have been aggressively dragged into a state of future uncertainty. Some believe Brexit could pave the way for further disruption across Europe, such as the rise of anti-establishment political parties and even the potential break-up of the eurozone.

Institutional investors have always had to deal with volatility in their portfolios and the 'low rate, low yield' saga has been playing out for some time. However, with the country's future hanging in the balance following Brexit, these two factors are now front and centre of portfolio management and now more than ever, investors need to safeguard against market shocks. Step forward multi-asset funds which purport to achieve equity-like returns, but with lower volatility and downside protection. However, despite these claims, events like Brexit don't come around all that often and even the steeliest of funds will have been stretched. Many believe this calls for dynamic portfolio management, but investors need to understand the what, how and why of these strategies before investing.

This roundtable discussion, featuring an expert panel of asset managers and consultants, considers the role of multi-asset funds by analysing the effect of Brexit, looking at the correlation between asset classes and how dynamic management is the best approach.

Sebastian Cheek

deputy editor, *portfolio institutional*

Come together

Some commentators believe traditionally low-correlated asset classes are starting to move in the same direction. *Pádraig Floyd* investigates what this means for multi-asset funds.

In recent years, investors have chosen multi-asset products as a means of protecting themselves from volatility and to guard against the downside.

But commentators have warned correlations between asset classes have begun to converge again and that investors must take care to protect against a market shock. So where does that leave multi-asset investing?

THE CHALLENGE

The big challenge of multi-asset investment is that equity markets are all well correlated, says Toby Nangle, head of multi-asset allocation, Columbia Threadneedle.

"If you believe in the risk/return notion of combining assets such as government bonds with equities, real estate and a spread of corporate bonds, then if they become correlated with the discount rates of other asset classes, this is a problem."

Correlation changes over time, but this problem is due to the historically low markets. Despite people being less concerned about correlation, earnings yields on equities compared to investment grade and high yield over the last few years has seen a tightening of the spread which means that all in yields have been falling on bonds and so equity yields have been falling.

Forward price-to-earnings ratios (P/Es) have risen by 40% over the last three years says Nangle, the same rise experienced in global equities prices. Earnings have fallen while forward P/Es have been rising – this is a valuation effect, a function of falling discount rates, not fundamental growth.

NOT GETTING ANY EASIER

Things have become more difficult and we were already at the end of a 30-year rally on fixed income yields, yields which have kept going lower.

While this is more apparent in some markets than others, the trend is the same across the developed world, says Marino Valensise, head of multi-asset, Barings Asset Management.

"The biggest problem is that fixed income is a diversifying product in portfolios, but to get the benefit of duration sensitivity in a slowdown scenario, it's not good enough to buy five or 10-year bonds as the yield is close to zero," says Valensise.

The rally in prices and falling yields makes G-7 fixed income unattractive and lower yields and interest rates have boosted equity markets, says Valensise.

As the discount rate is reduced, so the value of cashflow increases. If yields increase, then equity prices will go down.

Forecasts show a significant rise in bond yields would be matched by a fall in equity yields. With bonds, a significant amount is covered by small numbers, for instance two to three is a big movement compared to one that is 10 to 12.

"That's pushing managers to look at the correlation of equities and bonds as equalling one for that reason," adds Valensise, and as a result asset allocation

has "lost a building block" for constructing portfolios. Yoram Lustig, head of multi-asset investments UK, Axa Investment Managers, agrees with the long-term diagnosis of what influences correlations, but says there are other short-term factors to consider.

These include a reduced liquidity for corporate bonds – banks no longer hold them as they did – the change in the super cycle with China's slowdown, and also the impact on commodities from the depressed oil price.

"The dynamics have all changed with the US oil boom and war in the Middle East, meaning the effect of energy has not been the same as facts of history," says Lustig. "Changes to correlation happen, but they are currently all over the place and we lack any fundamental tool to measure it effectively."

THE X FACTOR

There are of course alternatives – corporate bonds, real estate, private equity, hedge funds and infrastructure. Each of the managers in this article has their own preferences for one or more of these, but apart from the issues of fees (hedge funds and private equity), liquidity (real estate and infrastructure), there is correlation to consider.

Hedge funds, private equity and real estate were all caught with their pants down in 2008 when the liquidity plug was pulled and they were highly leveraged. Which is why some managers have settled on using risk factors. You don't need to buy the actual security itself, but can buy just the factor says Toby Hayes, fund manager, Franklin Templeton. If you're of the belief the Fed will increase rates, while the interest rate element may not do as well, the credit components may perform better. This is usually achieved through derivatives, and is a kind of investment 'outsourcing'.

Of course, it's not foolproof: "You still have to have the correct view of the world, but it gives you a fighting chance your defensive assets will behave as you expect them to. So, for gilts, the risks in the portfolio should reflect the view, but you're not using a sledgehammer to crack a nut," says Hayes.

DO IT YOURSELF

But not everyone is happy with this concept of outsourcing the risk factors. Paul Flood, manager of the Newton Multi-Asset Diversified Return fund says farming the constituent parts to specialist managers means you lose the holistic understanding of what is happening in the portfolio.

"If you're not directly-invested, you can't understand the risks," he says. "Some of our competition will hold 3,000 stocks, but how can they possibly remain in control of all that?" Flood is clearly making a play for active management and emphasises that a bumpy ride can play into the hands of those who want to demonstrate they can generate alpha.

"Volatility can be your friend if

> **There is strong evidence some people are looking at investments simply for their potential return rather than in a manner that considers the balance between risk and return more closely.**

Giles Payne

you're comfortable with it," says Flood. "If not, you're selling off, but can't sell off the bad credits and therefore your tracking error goes through the roof."

Less constraint on the mandate is a strength of multi-asset managers, argues Flood, so they are better able to take advantage of opportunities. They can reach the parts of the financial structure – such as preferential shares or convertible bonds – that other managers cannot reach, or at least where both equity and bond managers cannot invest. These are also often under-researched and offer better asymmetrical return profiles.

He adds: "The benefit of a multi-asset portfolio is understanding the risks of different asset classes and regions. But if you don't have someone in control the end client doesn't benefit from the full array of what can derive from multi-asset investment."

AND WE LIKE SHEEP...

Whatever the managers do in their funds, some consultants remain concerned schemes are buying things they don't understand.

"There is strong evidence that some people are looking at investments simply for their potential return rather than in a more selective manner that considers the balance between risk and return more closely," says Giles Payne, a director at HR Trustees.

As the price of an asset increases and the potential return or yield reduces, investors are moving onto the next asset class which purports to offer a higher potential return. And with all the money chasing yield, this is bringing asset classes previously considered higher risk into the mainstream.

Phil Irvine, a director of PiRho Investment Consulting believes there is nothing wrong standing behind artificial definitions of assets and what is moving markets, provided you accept they can all become highly correlated as they have in the past.

"If yields have gone up in gilts," Irvine offers optimistically, "they will need to sell leverage products to buy gilts. But what do they sell if bonds fall?"

Columbia Threadneedle's Nangle says thinking about safe places which may shield you from correlation "is the wrong approach to take". He adds: "Better to digest the incoming information and prevent overtrading, as that is one way to add lots of cost to your fund."

BUY CHEAP, BUY TWICE

Axa IM's Lustig says investors need to be careful because only truly long-term investors don't care about volatility, which is fine as long as the manager underweights bonds as they are likely to be a bad investment over the next decade.

"Live with volatility and expect to lose a bit of money," says Lustig. "If you look at performance quarterly, you need to be more dynamic, which is why smart beta has been coming to the fore as a good way to reduce fees and deliver some alpha."

However, there is one large – and growing – area where

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Marino Valensise

investors have little ability to protect themselves from the increasingly heavy swell, and that’s the defined contribution (DC) market.

There is little money around to throw at the problem and this reduces choice, increasing the members’ exposure to volatility, says PiRho’s Irvine.

“A number of multi-asset funds are playing dynamic active allocation with underlying assets as they use active selection of securities,” he says.

The concern for Irvine is that the 0.75% charge cap leaves little room for diversification into alternatives or funds that can charge more for dynamic asset allocation – which may prove particularly useful in times of market dislocation.

Funds predominantly invested in passive underlying indices have the opportunity to weather storms by dynamic asset allocation, says Irvine, but he cautions some bond ETFs may suffer badly during any liquidity shock.

“Members are more likely to experience greater volatility due to there being insufficient exposure to risk-reducing techniques or strategies,” says Irvine, “though all multi-asset funds will go through periods of underperformance and should position themselves to ride through any storms.”

HR Trustees’ Payne is equally non-committal about the claims of multi-asset funds: “We might have to wait until after the event to find out whose models have most accurately predicated correlations in various scenarios.”

He believes some have ridden a “benign wave” and may be found out, while others who have been criticised for lower than average returns may prove to have been more cautious and put better downside protections in place.

Whichever is the case, he believes now more than ever DC schemes must resolve the communications gap between what they do and what their members understand.

“The objective of the fund is to reduce volatility, but not necessarily capital preservation, especially as everyone was looking at staying in growth assets for longer,” says Payne. “This needs more work to explain this to members.”

Stephen Budge
principal, DC investment consultant, Mercer

Peter Hill-King
director of manager research, Dean Wetton Advisory

Tristan Hanson
fund manager, multi-asset, M&G

David Vickers
multi-asset fund manager,
Russell Investments

Percival Stanion
head of multi-asset investing,
Pictet Asset Management

Sebastian Cheek
deputy editor,
portfolio institutional


Percival Stanion

"Most of the multi-asset funds will be used by investors with a reasonable investment horizon. Therefore, you cannot be a trader on the day of events like Brexit. So you should be prepared for events like this." Percival Stanion

How resilient are multi-asset strategies to potential market shocks and macro events like Brexit and how dynamic do they need to be to mitigate these risks?

David Vickers: It really depends on how you are positioned. I would imagine there will be a lot of different results coming out of the turbulence we've just had with Brexit. Correlations increase when you get a liquidity event or an event that leads to withdrawal of capital, so diversification doesn't do quite as much for you. It depends on what you did going into that, and how you thought about Brexit, or the broader risks that are generally present. To protect yourself being as dynamic as possible is a good starting place.

Peter Hill-King: What will people do next – whether they are acting in line with their investment philosophy – is an important consideration. They may have an urge to do something quite different, but if they stick to their process, the long-term outcome can be quite different from allowing themselves to be caught in the short-term volatility we're going to see.

Stephen Budge: There's a wide range of multi-asset strategies out there, but a key reason for using an active fund is that they can prepare for events in advance. They can make sure the portfolio is positioned to manage against those risks and adapt to the outcome.

Tristan Hanson: There are all sorts of different funds with different characteristics under the multi-asset umbrella so it is difficult to talk in general terms. These events also raise a different question, which is how important is short-term volatility? Should it be something you're willing to look through, and see as an opportunity, or is it something that you're saying to your investors that you will limit?

Percival Stanion: Most of the multi-asset funds will be used by investors with a reasonable investment horizon. Therefore, you cannot be a trader on the day of events like Brexit. So you should, at least to some extent, be prepared for events like this, which don't come out of the blue. Investors would be expecting managers in our UK multi-asset universe to some extent have insulated portfolios from this type of shock. And then expect managers to take advantage of opportunities as they arise.

Okay, so managers will have been prepared for this even if they didn't call the final result?

Vickers: It's not just that you knew the event was coming, but a market reaction to the event. A couple of weeks ago, your reaction function might have been very different. So, it isn't just the event, but the level of pricing around it, and the probability of it materialising and the potential upside relative to the downside. Typically, it's about trying to create asymmetry and mitigating that drawdown, then creating asymmetry on the way back out again – that is the route to success.

Hanson: I feel people's horizons have been massively compressed. It doesn't really matter what your portfolio has done on any given day – it's ludicrous to invest on that basis – it is the outcome over a sensible investment horizon that matters. Some people will embrace short-term volatility, while others will want to limit it.

Budge: Yes, you wouldn't expect portfolios to suddenly change on the back of events, but the outcome could change your view as a manager. It's this active governance around the fund, the preparation for events, and the ongoing revision of portfolio allocation which is the obvious value in a multi-asset approach.

Vickers: The multi-asset situation we're in now is vastly improved on the old balanced days. People are still trying to second guess where there is consensus but managers are having to think much more for themselves in terms of what they want to do with their clients, given the expectations of their own behaviour. Typically, you're not now constrained by a relative return benchmark, which means you consider 65 relative to 70 and consider it's been a successful day at the office, despite the negative return you may have generated.

Stephen Budge

Budge: It's an interesting point you make about the balanced consensus funds because they've done quite well being beta-heavy. However, we're probably going to see a divergence between the older, traditional multi-asset funds and the newer generation funds.

Hanson: If you're long both bonds and equities the last however many years, you've done fantastically well. Fixed income seems to be getting more negative in terms of yield, and so the relationship of funds versus the fixed income market, is going to be a big differentiator in a couple of years.

Are there any thoughts on how the Brexit vote might change your views?

Stanion: The outside risk of a euro break-up has materially increased. The wholesale rejection of the establishment position in the UK, despite the strongest exultations of Davos man and woman brought in to try to cow the population, is a wake-up call for the whole of the European establishment. The risk of a euro breakup has materially increased as a result of this, and I think we'll see that in European asset prices. We're seeing a bit of it already, and we'll probably see more of it over the next few weeks.

Vickers: The only thing I'm thinking about is to close down some of the US dollar position we put into the portfolio ahead of this event. I don't know where sterling is now, but when we were trading at 1.34, that was getting towards the lower balance of where we thought it should stop. So we will decrease some of our overseas currency position and close down that source of risk within our portfolio.

Hill-King: It will certainly feed into thinking about what the optimal asset mix is, or what the role of different asset classes within the multi-asset fund is. There seems to be a consensus that equities are there for growth, but what do you do with negative-yielding government securities? Where are you going to get that target return of Libor-plus? Should we think about other things, such as alternatives?

Is there too much of an equity bias to some of these multi-asset strategies?

Budge: It depends on the role of the fund. If you're looking for an equity replacement with some risk management, then it doesn't necessarily matter that a fund is quite equity-biased. But if you're using it as a diversification away from equities, then clearly you want to seek something which is not equity-biased.

I'd always favour something less equity-biased later on in the glide path for members to provide more drawdown protection. So, less focus around equity, but more just general, absolute-focused returns.

Stanion: The equity risk premium is one of the risk premia that multi-asset managers can access. The others are credit risk premia, government bond risk premia and inflation risk premia. We make no apology for the fact that we will access the equity risk premium and flex it over time.

The problem with the current environment is that, apart from some risk premia in credit, bond risk premia – whether inflation or otherwise – have all evaporated. So as a multi-asset manager, you have a very limited opportunity set.

For bonds to go on getting more and more negative yields, producing still positive returns, would probably be a world which would be hugely hostile, not just to equities, but corporate structures, governments, etc.

That bond bull market is very close to an end, and if that is the correct assumption, you're going to be subject to more volatility, either through running people to play in equities and credit, or because of the negative impact of bond yields, to some extent, normalising.

With limited choices, you're paying for the multi-asset manager being able, to some extent, navigate this much more problematic world.

Vickers: There's also a very simplistic point that correlation to equities isn't always a bad thing. It's deliberate, it's warranted, it's your desired effect. But dynamic management is the part that tries to reduce the correlation,

Peter Hill-King

David Vickers

"Correlation to equities isn't always a bad thing. It's deliberate, it's warranted, it's your desired effect. But dynamic management is the part that tries to reduce the correlation, perhaps when those returns aren't there." David Vickers

perhaps when those returns aren't there.

We've been in a correlated world for a very long while, with yield term premia, credit premia, equity risk premia. Commodities have really been the only one that hasn't and provided diversification, if slightly the wrong type of diversification.

How do you manage this correlation risk dynamically?

Hanson: There's no magic solution. Backward-looking strategies that are long bonds and equities have done well, but it's unlikely that same allocation is going to do particularly well in the future. Strategies which provide exposure to equities might be the way to go – the equity risk premium is one of the largest anomalies out there at the moment because there is massive aversion to short-term volatility. People are obsessed with monthly or weekly performance which if you've got a sensible time horizon, shouldn't matter to you much. In fact, short-term volatility is a source of opportunity.

Vickers: It's a question of what other sources of return are out there we can get access to. Whether you look to tactically allocate your assets or be dynamic in how you allocate your assets, that is a source of skill. So what are the sources of skill we can gain in addition to the asset class exposure – especially in the DC world – and how much are you having to pay for that? Cost is an increasingly important measure in multi-asset.

Otherwise, we're looking at illiquidity premia and insurance premia and whether there are other areas of return, especially uncorrelated to equity that we can efficiently bring to the savers' pot.

Vickers: There are strategies that have very short-term high correlations with equities, but if you move out more than a couple of months, that correlation breaks down. Mortgage pre-payment strategies would be an example of an asset class that has quite a good – as in negative or low – correlation to equities, but in the first instance, it's tied up with credit premia and housing premia, and it will suffer before the real fundamentals reassert themselves.

There are more of these strategies coming to light as banks have pulled away from some of their traditional areas as they can no longer warehouse these instruments and more comes to market.

We might get kind of a daily dealing loan market up and running in Europe – they've had one in the US for a very long time. It still has correlations in the equity market in the short term, but acts very differently over the long term.

Do you allocate from a risk perspective or by asset class?

Vickers: I would argue that you should start with the risk first and foremost. If return is asymmetric – even if you're right, and the upside is relatively negative when it's early in the cycle – you can look at return with

"There are times when you're not paid any risk premia at all for an asset, and even though it might be a normal part of a portfolio, it doesn't justify its presence." Percival Stanion

a bigger smile, because the growth in the supportive cycle is there. For me, that's the point of dynamic multi-asset portfolios – putting a risk framework around your asset allocation decisions.

Stanion: We always start by looking at risk premia, but we get paid for taking that risk. Even if we like an individual asset, how do we mix that with other assets to mitigate that risk? There are times when you're not paid any risk premia at all for an asset, and even though it might be a normal part of a portfolio, it doesn't justify its presence. You'll also look at what the market might have discounted and how the asset pricing might change. Sometimes that might be rewarded, but at other times might not be.

Hanson: The asset class distinctions only get you so far, so you need to look at the fundamental driver, or factor, you're getting exposure to. Owning Greek government bonds is very different from owning German government bonds. They're both government bonds, but you've got a very different bet on there.

Budge: Risk parity-type multi-asset will very much just focus around the risk of holdings in the fund, but typically invest in a broad range of asset classes implemented on a passive basis. These are more quant-driven solutions and their focus is on risk premia of assets, rather than the assets themselves. There are other types of approaches which use techniques such as relative trade that can bring a helpful dimension to a multi-asset portfolio, so there's a lot of choice out there with the broad asset class getting more and more attention. We continue to see a lot of value in them.

Tristan Hanson

"The asset class distinctions only get you so far, so you need to look at the fundamental driver or factor. Owning Greek government bonds is very different from owning German government bonds." Tristan Hanson

It's good that the choice is expanding and rather than everyone doing the same thing, we're seeing lots of different approaches, which is helpful as you have more opportunity to find the right solution for the client.

Is there not a danger of everyone doing the same thing?

Stanion: There's been huge pressure on fund houses to get into the multi-asset business, so there's a plethora of offerings, many of which don't really reach critical mass because the groups and resources assembled really aren't credible.

Budge: It allows fund managers to play to their strengths – you can't expect many managers to be able to do everything and I would be one of the first to say they shouldn't try.

But the value in having such a range of choices is that a manager can develop a solution that fits their best thinking and expertise.

Hanson: The role of consultants is to identify the differences between – and strengths of – the many varied multi-asset strategies out there, and then pick from those the ones that genuinely meet the investor's need.

Hill-King: We make some use of multi-asset, in terms of core and default allocation, though we're not blending many multi-asset funds with each other. Many of our clients are DC and while you're still in the accumulation stage, we don't want too much complexity in the portfolio, especially when portfolios are small. I can see a case for some of the fixed income multi-asset funds and maybe there's a case for blending there, but we don't want to go back to the days when clients had two or three balanced funds where clients effectively end up owning the consensus.

Budge: Once you get to about £100m-plus, then you may see a stronger argument for adding manager diversification within approaches. However, the nature of platforms makes implementation easier and allows you to blend two managers together.

Some of the biggest schemes have multiple diversified funds to dampen the manager risk and to allow for combinations of approaches – but primarily it's a useful hedge against having to make a change quickly.

Stanion: The challenge is to ask what they are populating their multi-asset product with. If they don't have enough resources in-house to manufacture internally, they're going to be at a cost disadvantage, buying in a lot of specialist components from third parties. That's going to skew their cost base. In a world where cost efficiency is of critical importance, the costs you build into your products becomes a key consideration. In that sense, boutiques in multi-asset probably have a struggle.

There will be some schemes that outsource large amounts and others that just have a part of their portfolio with a multi-asset manager. Are we seeing any trends there?

Vickers: Some of the smaller ones outsource completely. We create a bespoke DGF for some of our very large clients. Middle order schemes, even with the very big in-house teams, tend to sit alongside others and we see that increasingly being a trend.

Stanion: We see some local authorities using them as a type of low burn asset allocation type product which would be a small segment of their growth assets, side by side with big lumps of equity. Smaller schemes are using mixtures of multi-asset products to completely replace their growth assets, maybe

Stephen Budge and Percival Stanion

bolted together with an LDI or some other matching product.

Budge: Many schemes have strong in-house resources, so they're able to do a lot of due diligence around funds and make choices themselves. However, even if you want to construct your own bespoke solution, it's going to be quite difficult to structure it. There are things you're going to miss out on, in terms of tactical stuff and structuring using leverage which you just can't access, no matter what the size, in the DC world.

Hill-King: For some of our clients, it's about simplicity and using simplicity as a tool for member engagement. The more complicated it sounds, the less willing they may be to engage. For a master trust, if the investment looks less complicated, there can be an advantage in that type of engagement.

When using a multi-asset fund there is, in effect, a delegation of responsibility for the asset allocation, for the manager selection, governance and due diligence. If we've hired a multi-asset fund, they are the custodian and decision-maker for the portfolio. Our role is to govern that, and that makes for a straightforward and efficient structure.

Well, that moves us nicely on to talking about DC. How does multi-asset fit within the charge cap?

Budge: There are more lower cost options now available which are targeted at DC – although I'm not sure they are gathering much in the way of assets – however we continue to believe there is more value in higher cost solutions, although it will depend on the requirements of the scheme. Clearly schemes will be constrained by a charge cap so it's all about working out which one fits best for the solution.

Vickers: It's the net return that's important, because the value for money comes from the net return.

Budge: Yes, net return over the long term is exactly what we should be looking for. But the pressure is now focusing on 12-month returns, due to the requirements of annual, value for money reviews, and trustees are now having to evidence the fund's value over this shorter time horizon.

Vickers: As long as you can manufacture and make a profit, you can vary how much profit you make. There is a decision to be made here by the management. Do they want to grow volume, at a lower margin or stay in DB where it's a slightly higher margin, but there is no growth?

David Vickers

Stephen Budge

"It's good that the choice is expanding and rather than everyone doing the same thing, we're seeing lots of different approaches, which is helpful as you can try to find the right solution for the client." Stephen Budge

Big investment houses shouldn't struggle to get underneath the cap. It just means the margins have to come down to accommodate the regulations, if you want to grow in that space. And that's very much a business decision.

Budge: DC still has a long way to go, but the ability to construct next generation portfolios means we are in a much better position than we used to be.

Hill-King: We increasingly see a lot more commitment to product for DC; DC is no longer the incidental neighbour to DB, but a key growth strategy. Asset managers do have to consider how the fee works for each component.

Stanion: What people are struggling with at the moment is trying to find a structure that transitions through both pre-retirement and post-retirement stages. At this point, the platforms which are the ultimate structures through which pre-retirement is delivered don't have an incentive to favour a permanent solution, where you seamlessly pass from pre-retirement to post-retirement, potentially retaining the same fund.

Peter Hill-King

Budge: I see a lot of value in master trusts as a post-retirement solution. Rather than trying to provide flexible retirement choices in a company-sponsored scheme, the trustees can pass members over to a master trust. The route through to the post-retirement solution is probably multi-asset, rather than an annuity-focused fund, or cash, but you need to be clever how you move members across without impacting their savings.

Hill-King: With the post-retirement market, there's a whole new focus on post-retirement income funds. Asset managers are thinking constructively about how to take account of things like longevity, the risk of drawdown of income at adverse times, and such issues – how one can improve the retirement outcome.

Is there anything else about how trustees, or asset owners, should approach multi-asset?

Stanion: Trustees have to really probe what the manager is seeking to achieve, because subtly buried in the marketing material, I think you will find that there are actually significant philosophical differences between funds, and where the particular managers are seeking returns. What exactly are they trying to do, how does that fit with what they want and what is likely to be appropriate for my structure?

Hill-King: Cost is important. What exactly is the asset manager trying to do, how are they charging for it – for example, is a product in essence beta with some tactical asset allocation, so should the fee be comparable to something more passive?

Managers adapt and change. We have to be able to understand performance and the pattern of returns with attribution systems and so on, so we can analyse decisions and evaluate whether the fund management is in line with out initial expectations.

In terms of working out what you should pay, it's an understanding of what the manager is actually bringing to the table and whether that type of management is in line with our initial expectations.

Vickers: All of our communication, marketing and sales folk talk in the same language, so clients will understand what they should expect and that builds trust.

You might still get it wrong, but everyone's on that journey. The worst thing, whoever you are, is the unexpected. Even if it's a good one, because you may have made a bad decision, but the outcome was positive.

Hanson: I think it's crucially important that the buyer of the fund understands the process, the methodology and philosophy beyond the recent performance characteristics of the fund.

So investors need to familiarise themselves with the process.

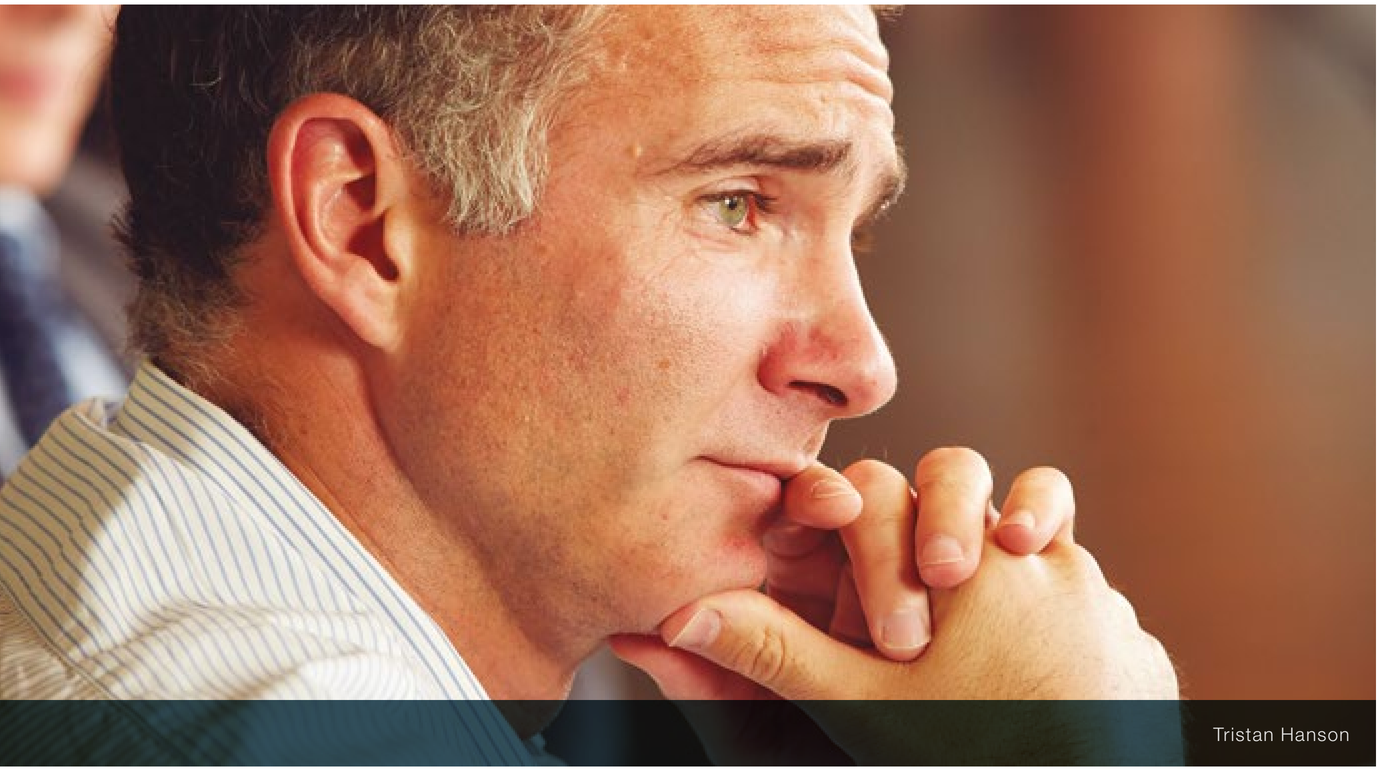
Vickers: It's a lot of discretion to hand over, but I would say it's the right thing to do, because if you're very static, you've taken the decision, even if you don't realise it. It's very important for clients to know not just the performance, clearly, but as much as they can about the big shifts you're making with clients.

Budge: Our global manager database that we use for our research had less than 100 funds back in 2011. I believe it is now up to nearly 500.

So that just shows the amount of choice that's out there. I'd absolutely agree that schemes need to understand what the manager does, how the returns have been generated by the portfolio, the shape of those returns, but most importantly, how they're likely to generate returns, given a different market perspective than that of the last five-plus years .

At the end of my presentations, I always try to give people a feel for what they might do, if one of the paths that we think is likely comes to fruition.

Also, what happens if one we're not hoping for comes to fruition, because you want to try to build your portfolio for a multitude of outcomes, even knowing that, clearly, only one is going to come to pass.



Tristan Hanson

Generating returns and managing volatility in a changing world

By Tony Finding, fund manager, M&G

Pension funds across Europe are facing challenges due to regulatory changes and two decades of market shocks. The result of this is an emphasis on de-risking at the same time as funding levels have deteriorated.

Multi-asset portfolios are being increasingly seen as a solution. Diversification across an expanded opportunity set may offer the best chance of both safeguarding capital while seeking to generate attractive returns.
Diversified growth funds ('DGFs') is one label for a new perspective on multi-asset portfolios, with greater flexibility to achieve growth-style returns with lower volatility.

To achieve effective diversification, these funds require an approach that goes beyond the 'set-it-and-forget-it' methods of traditional balanced funds. Just as the best assets to hold will vary over time, so will the best ways of managing volatility.

A dynamic approach to changing regimes

It is important to understand the changeable nature of correlation patterns and return opportunities in order to develop a good diversified growth strategy. This involves prepared willingness to be dynamic and active in asset allocation, rather than simply holding a wide range of assets and hoping that past correlation patterns will persist. For example, many investors are used to mainstream government bonds acting as an insurance policy for equities in recent years, but this hasn't always been the case.

The M&G Multi Asset team has been running multi-asset portfolios since the late 1990s and over that period has developed the belief that the prevailing economic regime – which is determined by such structural forces as inflation, interest rates and growth – as well as valuations are key determinants of both returns and drive the nature of volatility and correlations.

In the case of government bonds for example, the team believes that they are far more likely to offer portfolio protection in 'risk off' periods when yields are higher and inflation is contained, than when the starting level of yield is depressed. Alternatively, there can often be surprising diversification within so-called risky assets when one can identify sections of the market with a significant value buffer in place. However, keeping an eye on these ever evolving dynamics requires active management and experience across multiple investment environments.

Assessing opportunities and risk

The M&G Multi Asset team believes that the best chance to navigate uncertainty is to build, and actively manage, a well-diversified portfolio of global assets for which the current price over-compensates the holder for the level of fundamental risk. This forms the bedrock of the team's 'Episode' philosophy, which they have used to manage multi-asset portfolios for over 15 years.

The essence of the 'Episode' investment process is in-depth valuation analysis combined with elements of behavioural finance to exploit attractive investment opportunities anywhere around the world. It is centred on the observation that, while value is the key determinant of long-term returns, prices often move for non-fundamental reasons. Such phases or 'episodes' can create opportunities to generate returns over long or short term periods.

Any investment requires consideration of three key variables – the price at which you buy, the price at which you sell, and the nature of the journey in between – but it is only ever possible to be certain about the first. The team therefore focuses its resources on researching and analysing the 'fair value' of a wide range of global assets relative to their current prices.

To put this philosophy into practice the disciplined 'episode' investment process follows two key elements for idea generation:

1. **Valuation analysis** – Do any assets currently appear mispriced versus an assessment of long term 'fair value' or 'neutrality', in the context of the fundamental economic environment?
2. **Behavioural assessment** – Is there evidence that this mispricing is the result of investors making decisions based on emotion rather than facts? These considerations entail a greater supplementation of value observations with subjective considerations to identify genuine behavioural episodic opportunities. The team identifies several factors that can help to recognise a behavioural event, for example:
   - Focus on a single story: when market participants draw their attention to a specific event and disregard other information
   - Inconsistent responses to news flow: e.g. when markets decline in the face of positive economic developments
   - Rapid price movement: of any asset class either up or downwards, suggesting an ill-considered response

Such factors may be evident in market commentary, or in the nature of price action itself. The team believes that these emotional drivers of return are more likely to correct as fundamentals assert themselves over the longer term. This stage of the process also relies heavily on the long experience of the team and their relationship with the wider resources of M&G.

Managing volatility

The team also believes that the concept of 'episodes' can also tell you about the nature of the riskiness of individual assets. This rests upon a belief that, while true risk is more about the possibility of protracted or permanent loss of capital than volatility, understanding behavioural drivers of market moves can help understand likely future behaviour and aid the management of the investment journey.

Most of us are aware that those assets that have delivered strong returns in the past are not guaranteed to do so in the future. However, with prevailing valuation signals, and signs that we have arrived at a crossroads for economic regimes around the world, it may be more important than it has been for much of the last ten years to be active in negotiating a changing environment.

Our heritage in multi-asset investing

Dynamic asset allocation is at the core of what the M&G Multi Asset team does. The skills and experience of our dedicated multi-asset fund managers are applied across a range of multi-asset funds, tailored to suit a variety of risk and return appetites.

The core team members have been applying the 'Episode' investment philosophy and process for over 15 years. Today, the team comprises seven fund managers who sit together in M&G's London office. At M&G, we believe the stability and heritage of our Multi Asset team, combined with their robust, repeatable investment process, provides a powerful investment edge in the multi-asset space. To read market perspectives from the M&G Multi Asset team please visit our blog, www.episodeblog.com

Reassessing Brexit: silver linings to the Brexit clouds

By Percival Stanion, head of international multi asset, Pictet Asset Management

The UK's vote to leave the EU has sent shockwaves through financial markets. The political upheaval unleashed by the unexpected referendum result and the ensuing rise in market volatility will surely weigh on the global economy. But there are silver linings to the Brexit clouds – alert to the need to contain the fallout from UK's landmark decision, policymakers are sure to act, relaxing fiscal austerity and maintaining a loose monetary policy.

For instance, we now expect the Fed to leave interest rates on hold at least until next year, offering substantial support to riskier asset classes. Moreover, Brexit may encourage governments in both Europe and elsewhere to push through economic stimulus measures to insure against shocks.

According to our business cycle indicators, growth is slowing somewhat in the US because of weaker investment and manufacturing activity, and sluggish exports, which are suffering thanks to the strong US dollar. Labour market conditions are weakening too, with the economy adding only 38,000 jobs in May, the fewest since September 2010. However, the decline in non-farm payrolls growth does not point to a sharp slowdown, and recent consumption data shows more evidence of resilience. Following the Brexit vote, it now seems unlikely that the Fed will raise the cost of borrowing this year; the market is now implying that the next rate rise will not materialise until 2018. Easier-than-expected US monetary policy should help underpin growth, in our view.

The euro zone economy, meanwhile, has been growing moderately, supported by European Central Bank stimulus measures, low oil prices and better labour market conditions. Also, the euro zone manufacturing PMI has risen to its highest level in six months. Political developments will have the biggest influence on business sentiment in the near term. We are closely watching Italy's plans to recapitalise its banks, which are saddled with some EUR200 billion (gross) of bad loans – a third of the euro zone's total. If Italian Prime Minister Matteo Renzi manages to convince EU partners to be more flexible on state aid for banks, this could give a strong positive signal. A gradual relaxation of fiscal deficit target would also suggest that European governments are ready to do more to boost growth, building on the expansive monetary policies set in motion by the ECB.

Japan's growth momentum remains weak. A strong Japanese yen is weighing on exports and the manufacturing sector. While improving labour market conditions should support consumption, headline inflation is edging further into negative territory. But there are encouraging signs. Prime Minister Shinzo Abe postponed a proposed VAT hike until October 2019, while authorities are also likely to support the economy with fiscal and monetary easing. The government is expected to announce fiscal spending of up to JPY10 trillion and the Bank of Japan may purchase more exchange-traded funds to extend the scope of its quantitative easing.

In China, economic activity is stabilising, underpinned by Beijing's recent fiscal and monetary stimulus measures. The housing market is accelerating further, especially in Tier 1 cities. Although the renminbi has depreciated in recent weeks and is near a five-year low against the dollar, capital outflows from China have so far remained muted.

Elsewhere in emerging economies, China's renewed stability and expectations that the Fed will keep its monetary policy on hold should underpin growth in the near term. Some emerging economies are also increasing spending to support their economies, with South Korea planning a fiscal stimulus package of more than KRW20 trillion (USD17 billion). In another positive development, India is looking to pass a key tax reform bill sooner than expected.

Our valuation signals show equities continue to be attractive relative to bonds. Our model indicates that Japanese shares are now approaching their cheapest levels on record, both in absolute terms and relative to other asset classes. European shares have also become much better value.

Our technical readings suggest riskier asset classes are now in oversold territory, raising the prospect of a bounce. Our indicators are also favourable for government bonds and credit, asset classes that tend to do better than their riskier counterparts in the summer months. Seasonal factors also favour gold, even though the latest rally limits the scope for further gains in the precious metal. Following the outcome of the referendum, we have increased our allocation to continental European, UK and Japanese stocks.

In the euro zone, the ECB has said it stands ready to provide additional liquidity to mitigate the impact of the vote and shore up the currency bloc. This leaves European equities looking increasingly attractive, particularly as equity risk premia for European stocks are in line with their levels during the financial crisis of 2008.* What is more, analyst consensus corporate earnings forecasts for European firms have turned higher in recent weeks even though Brexit might eventually slow that advance. The technical picture is also positive.. European stocks have suffered heavy outflows over the past few weeks, suggesting investor positioning is now excessively bearish, increasing the scope for a rebound.

In the UK, fears over what Brexit might hold in store for the UK economy has seen a number of domestically-exposed companies such as banks, homebuilders and real estate punished by investors. On reflection, however, we believe the overall market is not as vulnerable to political turmoil as it would appear.

The UK equity market is very diverse, composed of a mix of companies active in cyclical sectors such as energy and materials – which benefit from the recent recovery in commodity prices – and more defensive, multi-nationals that should reap significant gains from the weakening of sterling. In addition, we believe the government may look to enact some business-friendly reforms to reassure investors post-Brexit, including a potential cut in the corporate tax rate that would be an additional support for UK companies.

In Japan, the recent correction has pushed the equity market to levels that make it one of the cheapest asset classes on our global scorecard. This in part reflects the fact that Japanese Prime Minister Shinzo Abe's economic revival programme is struggling to lift growth; declining valuations are also a response to a stronger yen, which could prove to be a drag on Japanese exporters' profits.

However, the strength of the currency may force a policy response, one that will probably take the form of monetary and fiscal stimulus. According to our models, which takes into account bond yields and the value of the yen, Japanese equities exhibit a 10 per cent upside.

The "Leave" vote has no doubt unleashed widespread chaos in Europe's political and economic landscape. However, under the smokescreen of Brexit, impediments to badly-needed change and reform in Europe and elsewhere may be removed. This, if it happens, will bring attractive opportunities for investors in the long term.

July 2016

* In our model, the equity risk premia is calculated using European stocks' 12-month forward P/E ratio, trend nominal GDP growth, the 10-year Bund yield and assumes a dividend payout ratio of 45 per cent.

Can multi-asset funds protect you from market shocks? A case study on risk management in the current volatile environment

By David Vickers, senior portfolio manager, multi-asset solutions, Russell Investments

Multi-asset funds have become increasingly popular among investors who want to focus on a specific objective rather than on beating a stock-market benchmark. Casey Quirk, a management consultant focused on asset management, recently forecast there will be more than $3 trillion of demand for multi-asset and benchmark-agnostic strategies worldwide between now and 2020. However, meeting objectives becomes harder when markets have low yields and high risks.

Multi-asset funds will not give you immunity from market shocks, but the better funds can help you mitigate them through skilful management. That requires a number of key competences:

1. A robust investment process that can help navigate changes in market values, business conditions and investor sentiment
2. Thorough preparation for risk events through effective portfolio diversification
3. Real-time monitoring of the portfolio and markets
4. Comprehensive risk analysis at the total portfolio level and constant re-evaluation of risk/reward pay-offs
5. Expert trading skills to implement new ideas quickly and cost-effectively.

During 2016, in our own multi-asset funds we have relied on all of those competences to navigate a challenging start to the year. I describe our experience, and our action around Brexit, in more detail below.

Risk mitigation strategies – the background

Global risks have been on the rise for some time. The first step in risk mitigation is to assess their probability and likely impact. At the turn of the year, our investment process delivered a sober evaluation, based on our three assessment factors – cycle, valutation, and sentiment (CVS):

- **Business cycle:** Our research showed that growth had slowed and world economies were struggling to regain momentum.
- **Market valuation:** We knew most developed markets were expensively valued. An expensive market is by definition a risky market and prone to shocks.
- **Investor sentiment:** Our technical indicators showed that the primary uptrend for equity markets had broken down when the US interest rate cycle started to turn in late 2015.

Against that background, we entered 2016 with our multi-asset portfolios in defensive mode, with relatively low equity exposure and relatively high cash and Treasury bond holdings. We had also diversified extensively across different asset classes and strategies that we believed would be more resilient in a risk-off environment. These investments included infrastructure, absolute return strategies, convertible bonds and volatility management strategies. Lastly, we had put in place derivative protection strategies that provided us with some protection against market falls from higher levels and would increase our equity exposure if markets were to become more attractively priced.

In the New Year, equity markets started their worst January sell-off on record. We continuously monitored developments as our CVS process guided us to add back some equity exposure; this led us to put in place a new call option strategy as markets bottomed around 11th February. This strategy replaced our previous US equity sales with new synthetic exposure. To finance the cost of the trade we sold part of the upside at the 1900 level on the S&P, and committed to buy additional exposure if the market fell to 1650 (which was our fair-value target level). The prevailing option pricing meant that our sale of put options at the 1650 level allowed us to buy roughly twice as many call options on the US market (7.8% versus 4%, or 1.8x).

That sequence of actions illustrated our focus on three key attributes of multi-asset investing: dynamic allocation, effective diversification and downside protection. Those attributes came back into play as we approached the June European referendum.

Risk mitigation strategies – A focus on Brexit

By June, markets had substantially recovered and we were back in more defensive mode. We had no specific insights into the referendum outcome, but our CVS process told us that markets were once more expensive. Also, our monitoring and risk analysis pointed to a risk/reward asymmetry as we approached polling day. Markets were progressively pricing in significantly lower risk on growing conviction in a 'Remain' victory; for instance, the sterling/dollar exchange rate had recovered almost to 2015 levels. So if the 'Remain' campaign proved successful, we perceived very limited further upside of perhaps 2%-3% for both sterling and the UK equity market. Conversely, if there was an upset and the Brexit vote succeeded, we expected very significant downside for both sterling and equity markets. Our risk/reward assessment therefore encouraged us to cut back risk quickly.
In our flagship Multi-asset Growth Strategies fund (MAGS):

- We increased our exposure to safe-haven US dollars to about 20%, moderating our default position of fully hedged overseas currency exposure into sterling.
- Very late on Thursday, hours before the voting was due to close, we bought additional equity-market protection on the S&P 500 Index, at the 2,100 level, at a time when the market was trading over 2,100 in anticipation of a 'Remain' win. The new strategy effectively took MAGS' equity exposure below 30% for the first time in the history of the Fund.
- Following the announcement of the Brexit vote, we saw a sharp (-12%) fall in the UK equity market, followed by a swift rebound to the -2% level. This very brief window of opportunity allowed us to trim our UK equity exposure by another 3% at a FTSE price level that was still up on the year.

These changes resulted from thorough preparation, careful risk analysis and, last but not least, the skills of our in-house trading team. As a result, MAGS' performance was positive over the two days following the vote when equity markets generally recorded falls in excess of 5%.

Risk mitigation – in future

We believe that uncertainty will continue to dog markets for the foreseeable future. An unsettling environment in Europe will be followed by the further uncertainties around the US election. It is likely to be a choppy environment and our default position is a risk-mitigating asset mix. In the rest of the year, we aim to rely on the same key competences, and to exploit the same three key attributes:

- Dynamic allocation, moving quickly to capture opportunities to add value as they arise.
- Effective diversification, combining asset classes in which we have conviction to diversify risk and generate consistent returns.
- Downside protection, using a variety of techniques and derivative strategies, both to protect against big falls and to increase our risk exposures at levels we believe are attractive.

Our multi-asset funds can never be entirely bullet-proof against market shocks, but by preparing carefully and managing in real time, I hope that I have shown you that we can mitigate their impact.

portfolio institutional

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Pictures: Richie Hopson
Layout: Wani Creative

Publisher:
portfolio Verlag
Office 5.05 - 5th floor
Fleet House
8-12 New Bridge Street
London EC4V 6AL

ISSN: 2052-0409

This publication is a supplement of *portfolio institutional* and sponsored by:

M&G INVESTMENTS

PICTET 1805 Asset Management

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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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The next roundtable is on income investing and will be held on Friday 9 September.

Topics for upcoming roundtable discussions include:

Infrastructure investment

Impact investing

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