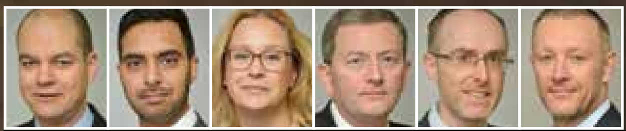
Multi-asset investing

Testing times



*Tony Finding | Kishen Ganatra | Katherine Lynas | Peter Martin
Daniel Peters | Adam Willis*


Helping you find
YOUR OWN PATH
through the complexities of pension investment
Trustees need a partner to provide bespoke investment solutions for today and tomorrow. And with us, it's always personal. As a market leader, we use our size to benefit clients by delivering advice with a personal touch – rooted by a thorough knowledge of our clients' individual needs and preferences, we help schemes to find their own path through the complexities of pension scheme investment.
So talk to us about your scheme's investment requirements.
For more information, visit aonhewitt.co.uk/investment, email talktous@aonhewitt.com, or call us on 0800 279 5588.
Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority. Aon Hewitt Limited Registered in England & Wales. Registered No: 4396810. Registered Office: The Aon Centre, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AN.
AON
Empower Results®

Multi-asset investing: Testing times

It's an interesting time to examine multi-asset investing. We last discussed the asset class at a roundtable in October, but much has changed since then leading us to revisit the subject.

The number of such funds available for those wishing to move away from a traditional equity/bond portfolio keeps growing and many of them are different when investors lift the bonnet to look at the moving parts.

The marketing says that these funds are designed to provide equity-like returns, while offering greater protection in times of volatility.

The wobble in global equities and the bond sell-off at the start of the year was the markets first real experience of volatility since the UK voted the leave the European Union (EU) in June 2016.

It appears that the various funds reacted differently, but the overall consensus appears to be that they performed worse than many had expected.

For some this is a time to look at what happened and work on how to strengthen their funds to repel any similar shocks that may lie ahead. Others, however, are embracing the volatility that they have waited so long for, believing it highlights the benefit of ditching a passive approach for an active management strategy.

Our autopsy of what happened earlier this year includes the views of a pension scheme investor, multi-asset managers and consultants. We assessed the lessons to be learned from the rough ride markets had experienced and looked at how multi-asset investing is evolving.

The debate starts on page 4.

Mark Dunne

Editor, *portfolio institutional*

Contents

Kishen Ganatra
Senior associate, hedge fund & multi-asset researcher
Mercer Investment Consulting

Chair:
Mark Dunne
portfolio institutional

Peter Martin
Investment officer
Medical Defence Union

Katherine Lynas
Head of manager research
Xafinity Punter Southall

Adam Willis
Head of index &
multi-asset distribution
Legal & General
Investment Management

Daniel Peters
Partner &
investment consultant
Aon

Tony Finding
Fund manager, macro
investment business
M&G Investments


Daniel Peters

"Running out of cash isn't a bad thing as long as you're running out of liabilities at the same pace."

Daniel Peters, Aon

How do you define multi-asset investing?

Tony Finding: It's having the flexibility to invest across a range of asset classes. As asset allocators and multi-asset investors, we can avoid an asset class if we think it's overpriced and set-up for the risk of permanent loss. You can use it to create a range of different outcomes because you are not constrained to one particular asset class.

Daniel Peters: It's a form of delegation. Ultimately, all trustees are looking after multi-asset portfolios and decide which asset classes they want to invest in. Looking at multi-asset funds is effectively saying that they are going to delegate some of those asset-class decisions to a fund manager.

Katherine Lynas: It also gives smaller investors access to investment opportunities that they couldn't access by themselves.

Peter Martin: It's a way of approaching an outcome, an investment return that you desire or meets your needs. It's making sure that you have a diverse source of return across different asset classes and move away from looking at two types of risk and two types of exposure. People are moving away from the equity/bond percentage split. As return expectations get lower and lower for mainstream asset classes a lot of pension trustees and other investors are being forced to look for other sources of return or in areas which are less familiar. You may do that yourself or you may do it through multi-asset funds, but it's not just investing through diversified growth funds (DGF). It's more a philosophy. It's how you get the return which is not as correlated to traditional markets.

Kishen Ganatra: We've got a feel for that. There is a significant breadth of styles and approaches within multi asset trying to tackle different objectives. The two core multi-asset strategies try to provide an almost all-in-one solution to traditional beta or an all-in-one growth portfolio. Then we have idiosyncratic multi asset which are much more about diversifying away from traditional beta and almost being a liquid alternative approaching what some would describe as more hedge fund like.

Adam Willis: That's a key question. We could probably all agree on a sensible definition for what a multi-asset fund is. It's a pretty uncontroversial topic. However, it's the categorisation of different DGFs that I see trustees struggling with. On the face of it they have similar objectives but they achieve them in different ways. On some occasions there may be a selection process where three DGFs turn up. One is, perhaps, a strategic or a low turnover DGF, and easy to understand. It could be up against a DGF that employs a lot of hedge fund-like tactics including leverage and complex use of derivatives. Having them in the same-use class is difficult, because if things go wrong it's hard from a governance point of view to understand why that's happened.

Ganatra: When we talk to clients about selections, we need to understand the exact objective of the multi-asset strategy in terms of where it fits into the portfolio. Is it a step between fixed income and equities or is it trying to provide an alternative return stream in terms of diversifying by using more alternatives or relative value-type trades? The objectives become important when trying to work out which strategies are the most appropriate to different clients.

Martin: It's not just DGFs. As pension funds mature it's about producing the income source to pay the pensioners. In my previous lives I referred to multi-asset diversified income funds or multi-asset liquid products or multi-asset credit. The idea was a diversified source of returns for different sources of outcome. One could be growth and you could have LIBOR plus 5%, you could have multi-asset credits or go for an income approach which involves equities. It's a broad church, which goes back to my point about philosophy. Look at what you're trying to achieve and work backwards.

Peters: I see two reasons why trustees typically look at multi-asset funds: governance, specifically to access asset classes that they wouldn't otherwise have access to, or to enable more tactical asset allocation between strategies. It's important to understand what the key driver is because some funds will be more active in their asset allocation than others, so knowing what the purpose of the fund is in the first place is critical.

What multi-asset strategies are popular at the moment?

Ganatra: Different types of investor have different preferences. In DC, a core multi-asset strategy is trying to provide a low governance all-in-one solution for a wide breadth of asset classes. In DB, the core multi-asset space where we see the most interest is where schemes are de-risking and capital preservation is the main focus. Idiosyncratic or other liquid alternatives outside of multi asset are probably the most interesting opportunities.

Lynas: We are starting to see interest move away from a full multi-asset fund like a DGF to a multi-asset credit fund. As the scheme de-risks they prefer to go down that route, something which has got an income distributing share class that they can switch in and out of as part of the de-risking journey that they're going on.

Martin: Going forward, I may want a multi-asset credit-type product that will still produce income. For DC there is an awful lot of work to do for those types of products to come through. Over the years, in terms of the DC trustees that we've been involved with, the emphasis is always on DGFs and growth assets. Not as much time is spent on the cash product or the bond product. There's an awful lot more work to do in the industry. Some DC investments have cash-return bond products in them as a multi-asset source, but a lot don't.

Ganatra: There's a lot of innovation in the DC space. You're right, DGFs have typically been seen as a one-stop-shop for DC investors, but things like risk premium investing and more unconstrained forms that previously were only available to DB clients are starting to be looked at by DC schemes. That's definitely something we encourage. Something like risk premium or alternative risk premium is something that while it doesn't necessarily sit in the DGF space is a popular topic even within DC investing to access different return providers that typically may not be available to DC schemes.

Willis: We're starting to see enormous demand in DC for strategic, low-cost and easy-to-understand diversified growth funds as the core growth engine. This is likely to continue. We are also seeing more and more DB investors coming to a diversified growth fund to deal with their cash-flow needs. We have plenty of investors coming to us asking if they can do this with their fixed income portfolio. Our experience suggests that doing it in multi asset allows you to increase the expected return of the portfolio, but meet your cash-flow needs by having a diverse range of assets generating natural cash-flows. We expect to see this trend growing.

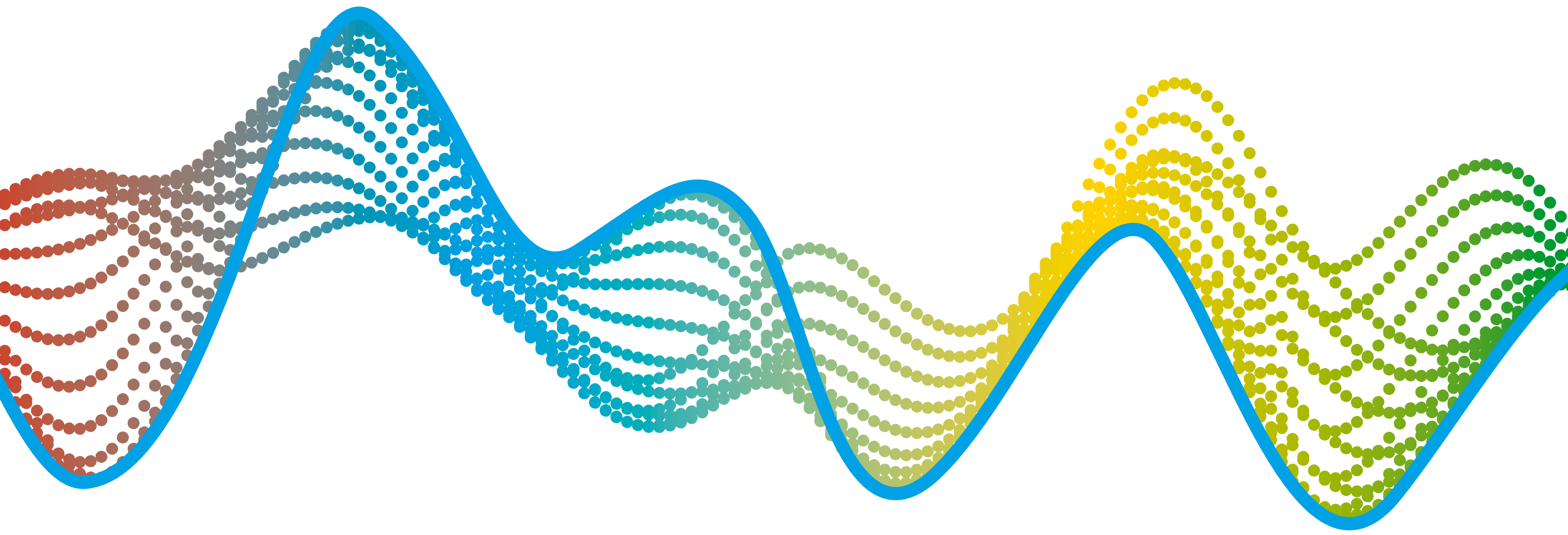
Cash-flow negativity is a big topic at the moment for DB schemes. Is multi-asset the answer?

Peters: You have to be careful, to be honest. Cash-flow needs are absolutely critical, but we have to remember that the assets of a pension scheme are there to pay the benefits. The idea is that over time you sell your assets and give the money to your members. That's the point. So running out of cash isn't a bad thing as long as you're running out of liabilities at the same pace. Cash-flow generative portfolios have a place, but they do place an additional constraint on the assets. The theme of the discussion is about removing constraints from managers and allowing them to access other asset classes. Then saying you have to generate x% of cash in the portfolio is putting a constraint back on. Before you put that constraint back on you have to be clear that it's a necessary one and you're not constraining the manager without due course.

Ganatra: If there is a need for income we generally prefer investors, where possible, to access this through more illiquid, secured finance-type structures rather than a daily dealing multi asset-type structure. It removes some of those constrains where income generation may be more conducive. Again, multi asset may not be the perfect solution if income generation is what you want and you are a more unconstrained investor.

Willis: It's probably more accurate to describe the multi-asset opportunity as cash-flow aware. You can match your cash-flows on the fixed income side and that's fine, but if you have unplanned cash-flows, for example transfer values, then you need to have some other source of generating income.

Finding: It's a challenge, isn't it? If you're constraining yourself to certain income assets that are priced at such a level that they're not capable of giving you the sort of income that they ought to be given their risk properties, it would make more sense to have a multi-asset income solution that could go anywhere globally to find those sources of income and put them together into a vehicle that was offering a reasonable cash-flow for the risk that it was investing in. If you just go



after alternative areas, almost regardless because they are giving you some cash-flow, potentially you're introducing other risks to do with more severe capital loss. If it's pure cash-flow matching that's fine, so long as you are matched. For me, a multi-asset income solution seems a natural place to be looking. We have income funds where some investors will take accumulation units and when they want to drawdown will switch to the income units. The asset shape of that fund will move over time depending on where the opportunities are, which is a more natural solution. It's not specifically cash-flow matching.

Peters: As we move into the drawdown phase in DC that will be increasingly important. Probably more so than in DB in terms of the range of assets that a scheme tends to have, there tends to be enough liquidity there for the vast majority. There are a few where it's a real constraint, but the vast majority will have plenty of liquidity. In DC, I can absolutely see that.

With so many of these funds available, how do you pick the right vehicle?

Ganatra: In the core space most strategies rely on traditional beta so the dispersion between them is probably lower because they're all in the market at slightly different weights. In the idiosyncratic space you're much more reliant on manager skill. That's where you naturally have much more dispersion between different providers because manager skill introduces a lot of risk around alpha generation.

I wouldn't say you'd want 15 managers, but maybe two or three makes sense rather than one. There is definitely a middle ground there.

Martin: Diversified growth funds are a broad church, but within that there are perhaps 100 shades of grey. You just have to understand what you are investing in.

Ganatra: This might be a bit pedantic, but we've always banned the term 'diversified growth fund' internally. It's almost misleading because some strategies are not diversifying growth funds; they are very much absolute return or macro hedge funds. Using the diversified growth fund term for some of those strategies may be misleading for some investors so we are trying to go away from it and just stick to multi asset and try out the different variations.

Willis: An important way to distinguish yourself is to tell investors who the fund is designed for. One of the things that our experience suggests investors like is when the manager says: "This was designed for DB pension schemes. We don't sell in retail. We don't sell in wealth. We've built this for you."

It's been a volatile start to the year. How have multi-asset funds performed? Have they done what the marketing says they would?

Lynas: That reverts back to the differences in the universe. Some have and some haven't. On the whole, all of the gains in January were destroyed in the first couple of weeks of February. Some were destroyed worse than others. It goes back to the risk budgeting and how the investment process works in market shocks.

Martin: Some of them fell further and faster than what we would have expected. The questions for the consultants and advisers when they look at these products in stressed environments is how did they react, what positioning caught them out and was that in-line with the risk controls.

Finding: From my point of view, the past couple of years have been interesting. When DGFs are delivering a similar return over 12 and 18 month phases, it probably is quite hard objectively to look at it from the outside and say how they are differing. If you look at these phases where you see a big differential return when you start changing correlations in markets or stressing markets then that, in my view, ought to make it somewhat easier when you look at those funds ex-post to try and unravel what it is they are actually doing.

Something we were saying in the summer of 2016 was that the economic environment was shifting and that's going to test some of these strategies. The recent volatility scare is a great example of this because historically strategies that were quite reliant on bonds and bond proxies to give them diversification could over time give equity-like returns, but with lower volatility because the bonds were providing diversification in these risk-off events. What we've seen in the volatility scare in early February is that those strategies that are quite reliant on fixed income exposures to give them diversification did no better than those funds that were more heavily invested in equity because fixed income has been

badly hit. One of the reasons why equity has been weak is it doesn't like fixed income yields rising too aggressively. If you've got a fund that's holding a lot of fixed income, over the last couple of years it's not really giving you returns to match the equity and actually during these phases it's becoming more and more challenging to get that diversification and protection against the downside. It is becoming much more important for active management and asset allocation to play a role here in this shifting environment. Arguably since the summer of 2016 the environment has been shifting which is why you've seen this dispersion in some of the DGFs and it's certainly getting much harder for some of the more static diversified beta-type DGFs to deliver the sorts of returns they've done historically with the delivered volatility being low. The volatility is going to have to go up to generate those returns or investors are going to have to pull their expected returns down.

Willis: We spend a lot of time focusing on the risk management properties of DGFs. We have to remember that the 'g' stands for growth. We spend a lot of time thinking about the drawdowns, but we should also spend a little bit of time focusing on the delivery of growth. One of the things we therefore think about is 'reckless prudence', where managers spend a lot of time thinking about risk management and, particularly over the last three years, forget to bank the good performance that's been available in higher beta asset classes. Therefore, when you get situations like February and experience a drawdown you start to be challenged from three and five-year perspectives because you haven't put the good returns in when they were available. You've focused on risk. You've experienced the drawdown just like everyone else and you're not going to meet your performance targets and that's as important as the risk component.

Peters: This nirvana of low volatility, but still getting plenty of growth, is much harder than we perhaps thought it was. In the DC space the idea of reckless prudence is important. The notion that an individual in a DC scheme has all their growth phase assets in a diversified growth fund is a challenging one for me because they shouldn't worry about volatility when they're 25-years-old. They should be embracing it.

Ganatra: It's all about time horizon. Where you have that length of time horizon something like volatility should be less of an issue. You should be able to ride the volatility in the drawdown because you have that time horizon. Your main focus should be on maximising the return in that period. Obviously, where

Tony Finding

"As an active manager, without any volatility I'm not sure what I'm going to do other than buy some illiquidity premia."

Tony Finding, M&G Investments

you have a shorter time horizon, you're much more aware of capital preservation and that's why you need to introduce more diversification. With the longer time horizon it's a bit of a misnomer, but fees really come into it. You want to take into account the fees because, in theory, fees are more important than volatility if you have that longer time horizon.

Martin: When people are young they need to be encouraged to save, but if they put a bit of money in and they see it halve in value then it's going to discourage them from saving longer term. You need to encourage saving. A diversified product doesn't put people off. There may be some small drawdowns, but don't expect equities to fall 20% or 30%. That's when people get scared and will be discouraged to invest, which is what they need to do. It's a compromise of growth and return, but to make sure people are saving.

Willis: The behavioural finance influence on the size of the pot is enormous. If you experience a big drawdown you are not going to continue to contribute above what's mandatory.

Finding: Not all volatility is equal. I certainly see a lot of volatility as an opportunity. As an active manager, without any volatility I'm not sure what I'm going to do other than buy some illiquidity premia. The skill is to understand when volatility is a real risk and assets are set-up for permanent loss. The volatility in 1999/2000 was something to be extremely concerned about if you were investing in stocks because it set them up for a decade with no return. That's permanent loss in my view, whereas the volatility in February, we don't know yet. The jury is still out, but it looks like it's associated with unwinding leverage and certain volatility strategies but economies are still doing well. This ought to be an opportunity for active managers to respond. The good ones will have responded before that event and de-risked. As an active manager we need some volatility to generate returns. We shouldn't be running for the hills because volatility picks up, but we shouldn't be jumping in either without thinking about the sources of that volatility. If it looks behavioural rather than fundamental, that's a good opportunity for longer-term investors.

Martin: When I hear some managers saying it's not volatile enough, that raises a red flag because it's never the right type of volatility.

Finding: You have to be careful what you wish for, that is for sure. We have pretty much record low levels of volatility, certainly measured volatility. It now feels like we've gone back to a more normal environment, it's just that we've forgotten how volatile markets can be periodically.

Martin: It's not often you see the VIX go from 10 to 35.

Finding: Indeed, it temporarily touched 50. It was fascinating. If you go back to the start of 2017 investors came out of 2016 thinking brexit happened, Trump is going to be in the White House, I'm expecting lots of shocks but the surprise of 2017 was you didn't really get them. You had some fantastic returns and everyone was waiting for a setback to buy. Then there is the first pick up in volatility and people are petrified again even though they've been saying for 18 months: "I want a setback in equities." As soon as you get that behaviourally people find it difficult to invest.

Martin: When we talk about other types of multi-asset products and multi-asset credit a lot of those are defensive. It will be interesting to see whether or not they've dispensed some of their dry powder as prices have increased. So it's a question of you have seen all of these products become more and more defensive over the last two to three years, at what point do they start buying back into spread widening or other volatility events.

Peters: That's an interesting one. In multi-asset credit we see quite a difference between where high yield is priced now versus, for example, emerging market debt and see some opportunity in the latter. Where we're advising clients on individual allocations we'll be proactive in that advice. Where that's delegated to a manager to make that decision is a critical point, the manager needs to make a call between asset classes at this time.

Ganatra: Some may argue that's a benefit for a multi-asset approach. If a client doesn't have the governance or the ability to switch their allocations tactically themselves they are delegating that asset allocation ability to a manager.

Peters: It highlights another challenge within multi-asset portfolios, which is that one manager cannot be an expert in all areas. We look at various multi-asset credit funds. Some have a range of expertise in different areas. Others may be strong in high yield and bank loans, but weak in emerging market debt. That's a challenge for investors. It links to another trend that we've seen in the broader multi-asset space towards the recognition that a fiduciary mandate with a consultant can potentially be considered in comparable light to a multi-asset portfolio with an individual fund manager. They are both given flexibility to


Adam Willis

"We spend a lot of time thinking about the drawdowns, but we should also spend a little bit of time focusing on the delivery of growth."
Adam Willis, Legal & General Investment Management

invest across different asset portfolios, but one will diversify between managers and the other will have one manager managing the whole piece. The recognition that the boundaries between multi-asset portfolios and fiduciary are becoming much closer is a trend that we've seen as well.

When building these strategies, is it better to go down a risk or an asset route?
Willis: Building diversification around risk models is something we have less comfort with. Risk parity is not a strategy we employ. You are reliant on risk models, which we think is questionable. It does, however, bring into focus if your diversification is based on risk and risk alone for estimates of volatility. How diversified is it? Is it really diversified on a capital basis? What about on a currency basis? Or on a regional basis?
Ganatra: We assess multi-asset strategies in terms of their risk attribution. It is the basic way of trying to breakdown how diversified you are. A basic 60/40 index isn't a diversified portfolio. The issue with risk is what is risk? How do you measure it? Some people think about volatility as the common definition of risk, but others think about expected drawdown or tail risk. The problem with the risk is that, unfortunately, there's not one way to measure it. In terms of volatility, do you look back over one month

or one year? Do you look back on a rolling basis? There are lots of different variations and that leads to different definitions.

Peters: The challenge is the cleverer we try to be about it the more we endanger ourselves that when things spike all the analysis goes out the window.

Martin: Analysis is fine and you need it, but don't rely on that. You have to have the drawdowns and stress test environments and look at how they've reacted in true market conditions. I always like looking at the various taper tantrums, 2008 scenarios, extreme events over one day, one month and one year. I also look at the average of bad outcomes. That's how you look at the overall portfolio for your pension fund because in the end you will have a number of different pools of money, whether it's segregated, private or open ended, you look across the portfolio holistically. We looked at individual products, but when we talked about provision of multi-asset investment I got back to that philosophy, you're constructing a fund for different outcomes and you need to understand how these things knit together holistically. It is a question of what analysis you do as the portfolio or the asset owner in order to understand the risk you are running. You may have individual pools of money, but how do they knit together. Generally, the industry needs to be a bit smarter about how you bring things together and

show an easy understanding of things to do with governance for trustees. How it fits together in the risk exposures.

Peters: It's an interesting question as to whether you construct a portfolio and understand the risk by looking through the risk factors, which I completely buy, or you use the risk factors to construct the portfolio. Those are different things. The latter is more challenging, but that's a nuance that we have seen between different funds.

Finding: A lot of risk management is pseudo-science. People draw comfort from numbers and volatility, because you can measure it. For me, risk and return are inseparable. They're two sides of the same coin in as much as the expected return from different asset classes varies over time depending on pricing and so do the risk properties. You can't get away from having to apply your brain and thinking about what are the true risks that you are taking, given how these assets are priced. I completely agree that if you do shock one of the key economic variables, take real interest rates or inflation for example, you'll probably find out you haven't got much diversification if that's a genuine shock to markets relative to a previous regime where those macro factors have been quite stable. For us, it's about watching closely how these assets are behaving, what is it that investors are really worried about? Are they worried about

Peter Martin

“Diversified growth funds are a broad church, but within that there are perhaps 100 shades of grey. You just have to understand what you are investing in.”

Peter Martin, Medical Defence Union

inflation? Are they worried about growth, because that can change the sign on a bond-equity trade. Ultimately, if a risk model is telling you that you’re taking a lot of risk you should be well aware of that. If the risk model is telling you you’re not taking much risk you want to be very cautious in reading too much into that.

Willis: Everyone has talked about having this broad lens of risk analytics available, different risk settings in your VAR estimation, and looking at using correlations from different stress environments to estimate your conditional measures. All of that needs to be done. You need to have a broad range of stress tests as well, but what happens once you get those risk analytics is the risk management component? What I described earlier about risk parity was using risk to construct products which can be a difficult ground to construct products. Having this broad lens in terms of risk management is an absolute ‘must have’ in our view.

We talked about diversification, but are you seeing many alternatives in some of these funds?

Finding: I would caution against over-reliance on diversification from what many investors term alternatives. In my view, a lot of these alternatives have not been truly tested in a different economic environment. Potentially, you are accessing areas that are slightly less liquid. My view would be that if you do shock interest rates, quite a lot of the areas of alternatives have a fixed income factor embedded within them. We, as a multi-asset team at M&G, focus on liquid asset classes where we can generate the return and manage risk through active asset allocations. We don't tend to have much exposure to infrastructure and other alternatives. They certainly have a role to play; I just caution that some investors are putting too much reliance on diversification. Time will tell.

Peters: You're always relying on someone. You're either relying on the person who runs the model to tell you that it's going to give you diversification, or you're relying on the fund manager that's picking the stocks in the liquid portfolio to tell you that they're going to give you diversification. You have to rely on someone. It's just a question of who you place your reliance on. It comes back to the beginning of the conversation around the purpose of the funds and, in some cases, the purpose of the fund is to give investors access to asset classes that they would otherwise struggle to invest in. In that sense, alternatives can be useful in these funds, but then it poses the challenge around are you going to get the best alternative asset classes?

Where the risks are higher and quite different to mainstream asset classes you have to make that quite difficult call between saying: "I'd like to have the advantages that an alternatives allocation can give me. I couldn't necessarily do it myself, and I am comfortable investing with someone that may be top class in certain asset classes but, perhaps, second tier in the alternative space." That's a difficult decision for some investors.

"Multi asset may not be the perfect solution if income generation is what you want and you are a more unconstrained investor."

Kishen Ganatra, Mercer Investment Consulting

Kishen Ganatra

Ganatra: What does alternative mean? For me it means a more unconstrained way of investing in similar things that you're doing. Say long-short equities, it's just a more unconstrained value in stock selection. You're just able to go short stocks rather than just going long. We've been talking about how we like multi asset because it's unconstrained. For me, alternatives are the most unconstrained version of investing in a certain way, so private markets are being able to be more liquid and certain absolute-return strategies are just being able to introduce things like derivatives or long-short investing which, for me, are more unconstrained versions of what someone may be doing in the long term. With that comes risk and that becomes an issue. How do we think about alternatives in a multi-asset strategy? It's difficult, as we said, because it's a daily dealing vehicle. Being able to access some of these alternatives in a constrained manner may not be the best way of doing it so you've got to make a decision. If I cannot do it outside of multi asset should I bother doing it or not? That's the most difficult decision. There is an argument that some strategies are able to introduce some form of alternative successfully, whether that is directly by doing things like relative value investing, introducing derivatives into the portfolio or outsourcing that by investing in infrastructure. There are some multi-asset strategies that do it successfully, but we're quite cautious about it.

Willis: That part of the conversation has been DB focused, but what do you say to a DC investor that wants a diversified approach to alternatives as part of their growth or accumulation component? That needs to be done in the listed space. Furthermore, that approach to having alternatives in a diversified multi-asset portfolio is credible. It's sensible for long-term investors that are not going to access that pot for decades. Yes, in the short term those alternatives may behave more like equities, but over a 30-year cycle the difference between the behaviour of the real assets and the listed version may not be that significant.

Lynas: We are seeing more and more new funds coming to the market which are just wrapping alternatives together to satisfy people who have become a bit disheartened with DGFs and the performance that they've had over the last three or four years. They say their holding to equities is quite important, let's keep that but use one of these alternative only multi-asset funds to give a little bit more diversification. That's a good solution for some schemes.

Katherine Lynas

"On the whole, all of the gains in January were destroyed in the first couple of weeks of February. Some were destroyed worse than others."
Katherine Lynas, Xafinity Punter Southall

Martin: You've got to think slightly outside of the box to work harder and harder to access different sources of return which you didn't access before. If you rely on the traditional drivers for return, equities and investment grade bonds, you can make an outcome, but the return won't be great going forward. Then you've got few market levers behind that so you are reliant on the equity. The stress is there, the yield is moving up and down on the credit spreads in the investment grade space, but to me it's a question of you have that pool as part of your portfolio, but I may want rental income from property or infrastructure. Think of what's out there and can I get those sources return? Does it help to meet my needs?
Finding: This all ties back to the outset about what is multi-asset investing. Ultimately, it's how much reliance do you put on active management to generate the outcomes you're looking at by freeing the manager up for any particular asset class and some areas of alternatives. Arguably, the best alternative is going to be a pure alpha product, you just don't know how that's going to be correlated. Do you rely on that passive diversified beta or do you say: "Actually, I want active management to play a much greater role going forward in the multi-asset space than perhaps it's done historically." I guess that will vary depending on the end investor at the end of the day.

One for all or all for (n)one?

Daniel Peters, partner and investment consultant, Aon

Getting to the root of multi-asset strategies

Multi-asset portfolios combine assets with different characteristics which behave differently and are often subject to different laws and regulations. In the past we have seen balanced funds offer a simple mix of bonds and equities, which through diversification sought the right balance of risk and return. Since then, they have developed in sophistication and range. Some would argue this now blurs the lines with absolute return funds – those that look to add value in all market conditions.

What trends are we seeing in our clients' portfolios? A common theme is greater focus around the use of multi-asset funds in portfolios. For example, where a diverse approach to credit strategies is the goal, the use of multi-asset credit (MAC) strategies has been a possible answer. If the remit is much broader, it may be diversified growth funds (DGF). The common thread is to widen the opportunity set and in so doing allow access to asset classes that might otherwise be beyond the practical reach of the investor.

Ultimately, the objectives and governance framework of each pension scheme will determine whether multi-asset strategies should be introduced. DGFs are considered by many to be a 'one stop shop' for diversification of all manner of assets, typically to provide equity-like returns with reduced volatility. In an environment of increased volatility, coupled with lower expected asset returns and yields, these strategies will be increasingly tested to perform against this objective. In recent times, when volatility has been low and returns from risk assets have been high, these funds have generally lagged equity markets. For many, they have also fallen short of investors' expectations.

In contrast to the broad nature of DGFs, MAC funds access a range of credit strategies, which can often be part of a risk reduction journey for a pension scheme. This has often been coupled with minimising interest rate and inflation risk through the use of liability driven investment (LDI). Can they offer more value than simple cash based funds though? Indeed the diversification benefit offered by some multi-asset products is not as great as the diversification benefit offered by recently introduced alternative risk premia (ARP) funds, which profit from long and short strategies, rather than just long, through different strategies. With a greater reliance on manager skill and higher fees, it is important these funds provide the value they target.

With a wide range of investment opportunities, it is often difficult to predict income for multi-asset funds. Some even have limited income generating ability alone. As a result, this is rarely a rationale for placing them as part of a portfolio. What they do offer is the ability to balance a portfolio by allocating to a broader range of asset classes. They can achieve growth with lower volatility to help funding and offer liquidity. This is why they are often favoured for operating alongside other funds such as liability driven investments or more illiquid strategies.

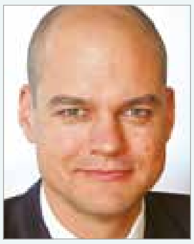
In any event, a common reason for all multi-asset funds is governance. A single manager brings access and oversight to a wider range of asset classes under one roof. With multi-asset funds, investment managers aim to select the most attractive and complementary investments. Whether this provides too much scope is often the challenge. Is it a jack of all trades, master of none scenario? Indeed, even approaches within the multi-asset credit universe can vary significantly. For example, a manager may be skilled at high yield and private debt, but lack expertise within emerging market debt. Does the scheme gain more by having the diverse range of assets even if the fund manager is not first class in all areas? This is an important issue to consider before investing.

In addition, the multi-asset manager will often be tasked with making the asset allocation decision between the different types of assets to which the fund is allocated. Calling the market is a skill that has been notoriously elusive for investors and this is another area of delegation that must be watched carefully. Fund selection is therefore important. Which approach is best depends on a pension scheme's specific circumstances and future direction. Indeed, in many cases the question to be asked is whether the scheme could achieve the same or better results for lower costs without outsourcing all of these elements.

Are multi-asset funds a simple solution to a complex problem? Potentially. But the question of whether they are the right solution is the most critical of all.

How should institutional investors think about multi asset and 'diversified growth' funds?

Tony Finding, fund manager, macro investment business, M&G



The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested.

One of the main benefits of investing in a multi-asset proposition is that clients can choose a solution to meet their specific risk and return objectives. As they are not constrained to a single asset class, multi-asset funds are also well placed to be able to deliver these outcomes over a range of market environments.

However, the range and flexibility of these propositions creates a challenge in that different multi-asset strategies can behave differently with regard to risk and return. The sheer variety of approaches means that assessing the role any single fund could play in an institutional investor's overall portfolio has become more complicated, especially as many have a similar 'cash plus 3% to 5% p.a.' growth target.

Diversified growth, diversified outcomes

'Diversified growth' funds (DGFs) are no different. DGFs are multi-asset funds that originally emerged in the wake of the financial crisis, in response to changing regulations and changing requirements of pension funds.

Although DGFs are typically tailored to meet the needs of institutional investors and have some degree of overlap in terms of what they are trying to achieve, it would be wrong to over-emphasise their similarities. Divergence of performance in recent years has highlighted the extent to which DGFs can have very different characteristics.

For example, many DGFs were originally considered as equity replacement vehicles, with an aspiration to act as part of the 'growth engine' of a pension scheme, but with lower volatility than equity markets. Others have been marketed on the basis that they will also have low correlation to equities, either by holding alternative (typically less liquid) assets or by employing strategies such as relative value trades. Others are more explicitly viewed as having insurance-like properties, offering the potential for positive returns when other risk assets struggle.

These objectives are ultimately different and it may not always be possible to achieve all three. Insurance typically comes at a cost and an emphasis upon protection can entail giving up on delivering 'equity-like' levels of growth. Similarly, an explicit focus on targeting very low levels of short-term volatility or correlation with equity markets can also serve to act as a constraint upon asset allocation. The different priorities that DGFs place on the various outcomes above could mean different return profiles over meaningful periods. Institutional investors will need to be clear about how these differences may manifest themselves in a portfolio context and how much of a role prevailing market conditions can play in the ability of DGFs to deliver.

DGFs in recent market context

It is only in recent years that some of the differences in DGFs have begun to manifest themselves in terms of performance. Prior to 2016, the environment was one in which traditional safety assets (most obviously Western government bonds) delivered ‘equity-like’ returns in their own right. At the same time, fixed income assets also tended to provide portfolio insurance in periods of market stress in other asset classes.

This meant that even traditional multi-asset portfolios with relatively static asset allocations were able to deliver the type of return profile that institutional investors looked for in DGFs. The normal trade-off between short-term safety and longer-term returns was less in evidence than one would normally expect.

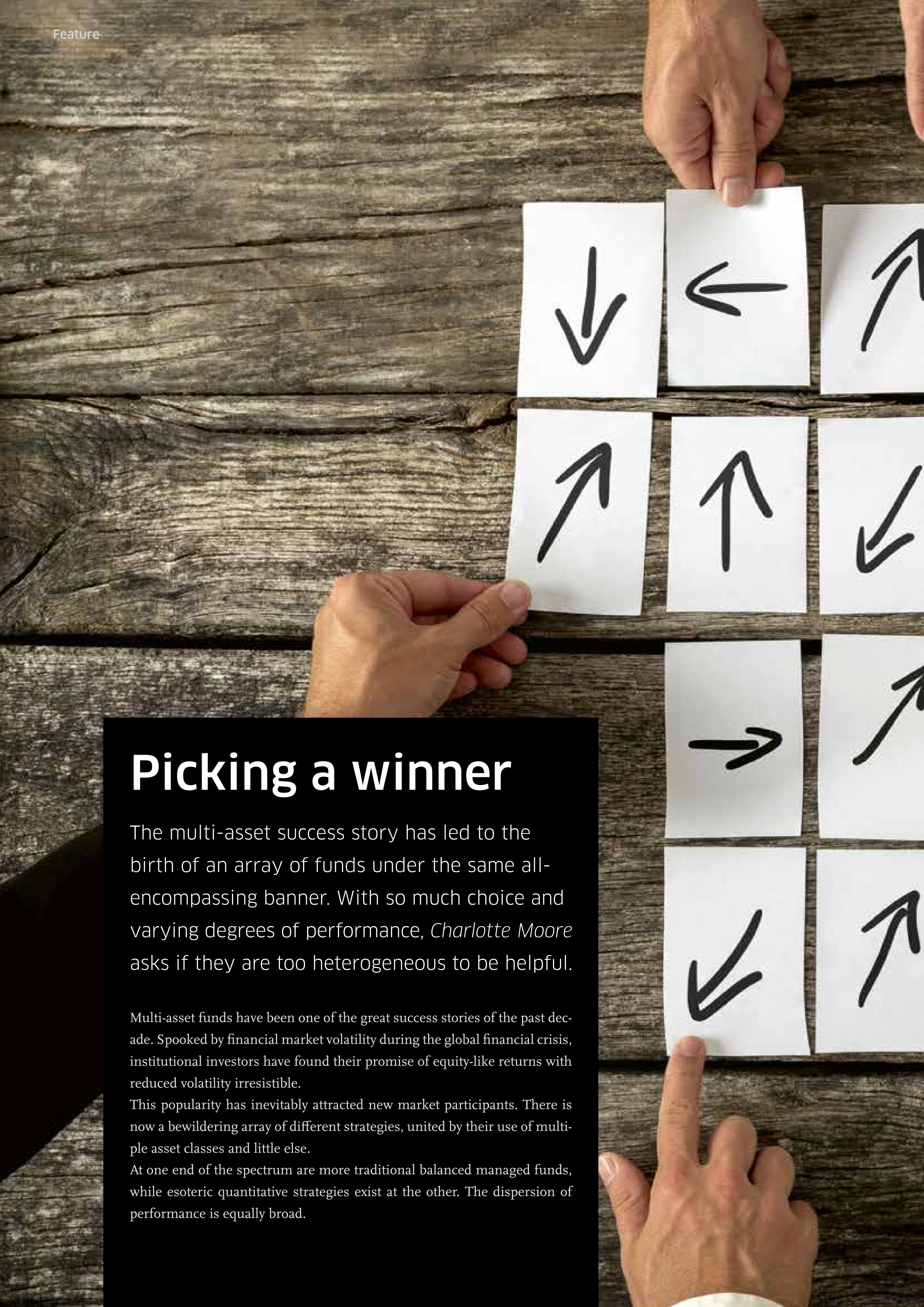
This has changed in recent years. From a low starting point of yields, safety assets have not been able to generate the same returns as they had for much of the period since the financial crisis. Even more recently, fears concerning rising interest rates in the US and elsewhere in the world mean traditional safety assets, like treasuries, have been a source of volatility rather than an insurance policy. DGFs have had to show that they have not simply benefited from market conditions but are truly able to perform in all environments.

Looking ahead

The less constrained nature of multi-asset funds should make them a highly attractive tool for institutional investors, but with this comes an additional requirement to understand the nature of each fund on a case by case basis.

The changing environment of the last couple of years has represented a test for DGF strategies as demonstrated by the dispersion in returns across the DGF universe. If DGFs and other multi-asset funds are to deliver their return objectives in different market conditions they will have to be able to demonstrate their flexibility and ability to navigate the ever-changing investment landscape.

M&G INVESTMENTS



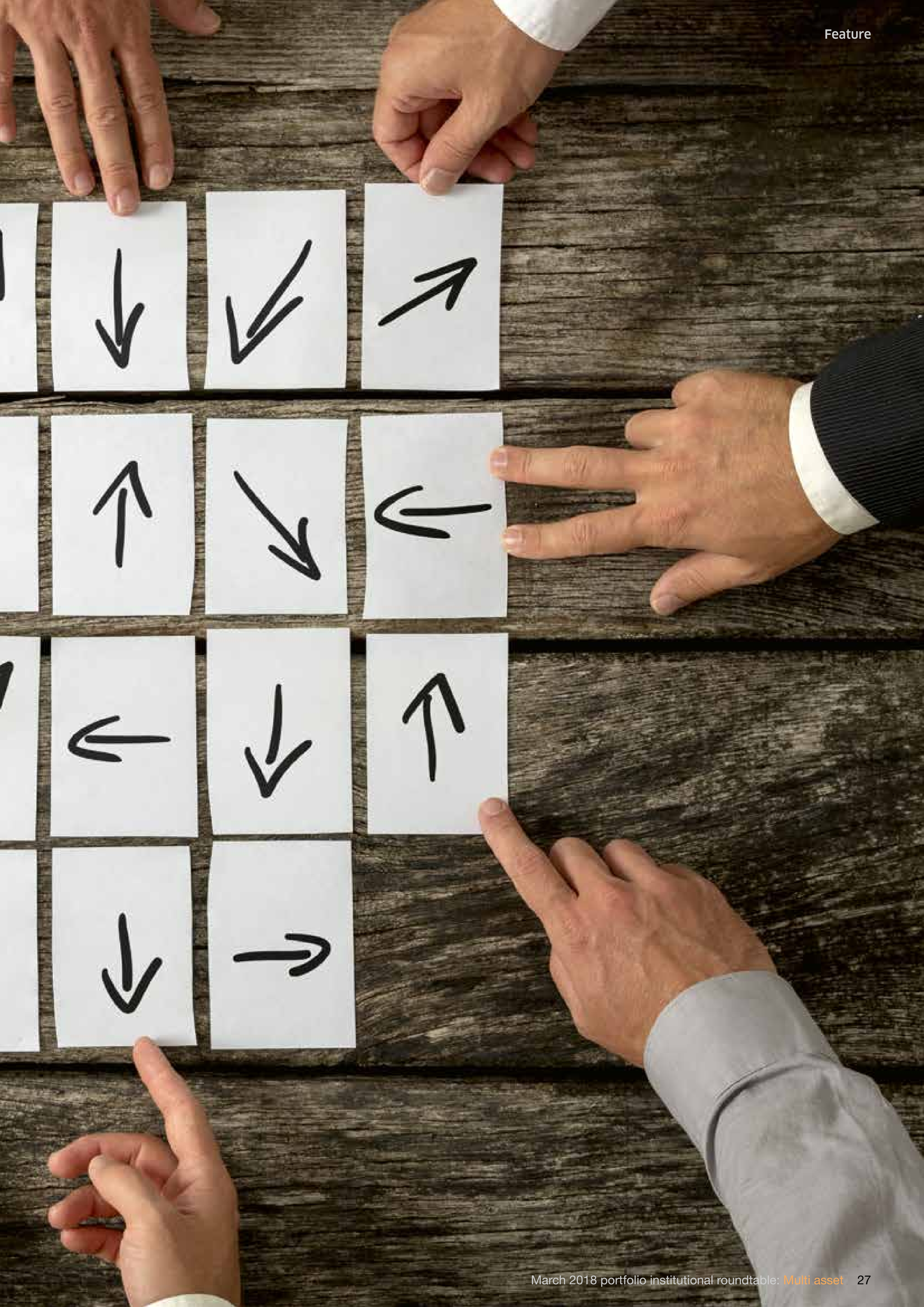
Picking a winner

The multi-asset success story has led to the birth of an array of funds under the same all-encompassing banner. With so much choice and varying degrees of performance, *Charlotte Moore* asks if they are too heterogeneous to be helpful.

Multi-asset funds have been one of the great success stories of the past decade. Spooked by financial market volatility during the global financial crisis, institutional investors have found their promise of equity-like returns with reduced volatility irresistible.

This popularity has inevitably attracted new market participants. There is now a bewildering array of different strategies, united by their use of multiple asset classes and little else.

At one end of the spectrum are more traditional balanced managed funds, while esoteric quantitative strategies exist at the other. The dispersion of performance is equally broad.



Such a heterogeneous approach to multi asset makes it harder for schemes to select the right fund which matches their particular characteristics and investment goals.

Such diverse performance also means there is no guarantee the strategy will meet its target.

MAKING YOUR MIND UP

The only way to find the right fund for a particular scheme is to look at every fund in detail.

Paul Berriman, global head of Willis Towers Watson's funds business, says: "It's important to understand the investment strategy as well as return target for each and what risk measures are being used."

Focusing on the return target and the approach to risk will help the pension scheme to understand whether a fund will deliver to a particular scheme's investment targets, he adds.

This broad choice raises the question of how useful these funds can be to institutional investors and how they should go about selecting the right fund. To make the task easier, it helps to group similar strategies together.

Within the global multi-asset fund universe, there is a group of diversified inflation funds. Kishen Ganatra, senior manager and research analyst at Mercer, says: "These funds are aimed at the US retail and defined contribution (DC) market so are not particularly relevant for the UK."

The second group are risk parity funds – which aim to give an equal risk weighting to each asset class in the strategy. This group is also aimed at the US so is not particularly relevant for UK institutions.

The two classes which are the best for UK institutional investors are core and idiosyncratic strategies. Ganatra says: "Core strategies are the most traditional and straightforward. The most naïve version is a balanced fund."

This strategy relies on traditional market movements to generate the majority of return. Ganatra says: "These strategies aim to give the investor a diversified portfolio of equities, fixed income and possibly alternatives." The asset allocation will be relatively static.

The management of core multi-asset funds has changed in recent years. Traditional diversified growth funds once used active management and investments in hedge funds.

Ganatra says: "The heavy use of active management meant the fees for this type of fund were quite high." In addition, these types of fund tended to be highly correlated to equity markets.

Rather than using higher cost funds with a higher correlation to equity markets, schemes should consider using a fund which uses a passive building block to lower the cost but still offer a diversified strategy.

> **"If efficient market theory is even partially correct, then achieving equity-like returns with half the risk requires exceptional manager skills."**
>
> Paul Berriman, Willis Towers Watson

CORE STRATEGY

When considering a core multi-asset strategy, schemes need to consider what they want to achieve. Chris Stevens, director of diversifying strategies at bfinance, says: "After all, pension schemes are, by their very nature, multi-asset funds." A core multi-asset strategy is designed to provide investors with either all or the majority of their growth portfolio, says Ganatra.

As pension schemes are themselves multi-asset funds, this core strategy should only be used by pension schemes which do not have the governance to be able to maintain their own portfolio. This would only be small DB or DC schemes.

Philip Saunders, co-head of multi asset at Investec Asset Management, agrees: "Schemes which do not have the in-house skills to asset allocate should consider this type of low governance strategy."

Governance is an important issue when it comes to multi-asset allocation because schemes need to be nimble. Stevens says: "If any significant changes have to go to an investment committee, which only meets once a quarter, an investment opportunity could easily be missed."

This can be thought of as effectively outsourcing the chief investment officer role to external fund managers. Stevens says: "Often the best solution is to combine different fund managers in order to have diversification of investment styles."

Larger schemes with a more significant governance capability should create their own growth portfolio rather than using the core multi-asset strategy. Ganatra says: "This gives the scheme the flexibility to design a strategy which suits its particular requirements rather than opt for a one-size-fits-all approach."

In contrast, idiosyncratic funds have a different purpose. Ganatra says: "The aim of these is to introduce different return drivers which currently do not exist." In other words, this fund does rely on market movements of traditional asset classes to provide returns.

Stevens adds: "The role of these types of funds is to introduce diversifying sources of returns which are not highly correlated to equities."

Idiosyncratic funds can be further divided into two broad management styles. The first style relies on a tactical asset allocation. Ganatra says: "It is the dynamic style which provides the returns."

The other style is similar to a global macro hedge fund strategy. Ganatra says: "These funds generate returns through relative value or well-timed derivative trades."

These funds are a way to access a hedge fund-style strategy in a more institutional-friendly manner. Unlike core, it makes more sense to pay a higher fee for an idiosyncratic manager.

Ganatra says: “These managers are bringing something different to a pension scheme’s portfolio, which could be a more dynamic form of management.”

As the aim of having this type of manager in the pension fund’s portfolio is to introduce new forms of return drivers, the scheme needs to decide what it wants to access. Ganatra says: “Is it about including asset allocation skills, macro-type relative value or long-short equity?”

Mercer’s preference is for schemes to consider allocating to hedge funds when looking at these types of return drivers. Ganatra says: “This is the most unconstrained investment style and enables schemes to access the widest range of returns possible.”

But if a scheme is unable to pay high fees, has liquidity concerns or insufficient governance budget then an idiosyncratic multi-asset fund is a good alternative. Ganatra says: “Schemes are comfortable with these strategies because they have reasonable fee levels and liquidity and are offered by large institutional firms.”

Pension schemes are also becoming more comfortable with more systematic approaches to multi-asset investing. Stevens says: “Investing in a hedge fund used to be the only way investors could access these sources but risk premia funds offer a cheaper alternative.”

EQUITY-LIKE RETURNS

Risk premia funds identify well-established sources of return such as momentum, value and carry across multiple asset classes. “The transparency of this strategy is part of the appeal,” Stevens adds.

The narrative of these strategies is relatively straightforward and easy for investors to grasp. Managers also work hard to communicate clearly about the fund’s performance. “When the strategies don’t work, managers provide good explanations about why they have failed,” Stevens says.

For example, following the election of Donald Trump many of the investment factor-based long-short equity strategies performed badly because there was a reversal in equity momentum. “This was clearly explained to investors which gave them comfort,” Stevens says.

Systematic funds are only one area of innovation in the multi-asset universe. And while this innovation offers schemes a broad variety of funds, very few of these new approaches have the necessary track record.

This compounds an existing problem: even traditional multi-asset funds do not have a sufficiently robust track record.

Saunders says: “The early dominance of the absolute return-type multi-asset offerings, especially GARS, reflected a post-bear market belief that acceptable returns could be achieved with modest volatility and very constrained drawdowns, despite the lack of performance evidence.”

> **“After all, pension schemes are, by their very nature, multi-asset funds.”**
>
> Chris Stevens, bfinance

The case for absolute return multi-asset funds delivering equity-like returns with low volatility 10 years on remains unproven, he adds.

For example, the largest absolute return fund, Standard Life’s GARS, has for some time missed its return targets. Saunders says: “This raises the question if it’s possible to achieve 4% to 5% growth in excess of cash returns from strategies which depend overwhelmingly on manager skill.”

The popularity of the absolute return multi-asset fund could start to wane, especially given the recent poor performance of some high profile funds. Saunders says: “Investors are starting to question whether the risk and return expectations behind their original allocation decisions were correct.”

But it is understandable why investors found the risk-return profile of these funds so attractive. “Every scheme would like to achieve equity-like returns as these are the default return-seeking assets and most have a deficit they would like to close,” Berriman says. But the downside of equities is its long-term volatility of 18%: in other words, this asset class will see its valuation fall by 40% from time to time. “That’s why a strategy which says it can dampen this volatility is so appealing,” says Berriman.

While the stated goal of multi-asset funds is appealing, it is hard to achieve. Berriman says: “If efficient market theory is even partially correct, then achieving equity-like returns with half the risk requires exceptional manager skills.”

Some think this goal is misleading and problematic. Stevens says: “What does ‘equity-like return’ mean and does making this the goal potentially mislead investors about the risk they are taking?”

If the key objective of a multi-asset fund is to be diversified across a number of assets classes, then in strong periods of equity returns, this fund is likely to underperform. “Investors who selected a fund because of its equity-like returns could feel disappointed,” Stevens says.

The equity-like objective has to be framed over a full market cycle: after all, more diversified approaches prove their worth when equity markets fall. Stevens says: “Rather than using equities as a reference it would make more sense to frame the objective as providing real returns with a smoother return profile.”

Instead of focusing on equity-like returns, schemes should think more carefully about what risk-return profile they need in order to meet their objectives. “Pension schemes do not fully appreciate how difficult it is to match a particular investment to achieve their precise goals,” Berriman says.

portfolio institutional

Editor: Mark Dunne

Contact:
John Waterson or Rhianna McCullough-Bray
Phone: +44 (0)20 7822 8522
j.waterson@portfolio-institutional.co.uk

Rhianna McCullough-Bray
Phone: +44 (0)20 7822 8522
r.mccullough-bray@portfolio-verlag.com

Printer: Page Bros (Norwich) Limited
Pictures: Brendan Corr
Layout: portfolio Verlag

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:

Are you interested in participating in future roundtable discussions?

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

Contact **John Waterson** to find out more:
Phone: +44 (0) 20 7822 8522
j.waterson@portfolio-institutional.co.uk

Topics for upcoming portfolio institutional roundtable discussions:

May 2018 – ESG
June 2018 – Factor investing
July 2018 – Responsible investing
September 2018 – Diversified growth funds
October 2018 – Fixed income
November 2018 – Property
December/January 2019 – Multi asset or Alternative credit

portfolio
institutional