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Multi-asset focus:
Assessing the landscape

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Eric Lonergan, fund manager, in M&G's multi-asset fund range and multi-asset research

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Regime change

Eric Lonergan explores what neo-nationalism could mean for multi-asset investors

The chairman of my first firm in the 1990s, a well-respected and experienced investor, once declared: "I would never invest in a government bond!". His comment echoed the views of many in the industry: fixed income was considered a very dangerous asset class.

Fast forward to today and many investment firms and regulators implicitly (and sometimes explicitly) equate adding fixed income assets to a portfolio with de-risking. What brought about this huge change in perceptions of an entire asset class?

The short answer is 'experience'. The wealth destroying effects of bonds from 1960s to the early 1980s were still a painful memory by the early 1990s, whereas many investors today have experienced nothing but growth-like returns and useful insurance from most fixed income assets. [Figure1]

Investors need to be aware how different economic regimes can influence asset classes to behave differently at different times. An economic regime is dictated by the structure of economies: the balance between labour and capital, the nature of industry, demographics, and, importantly the policy-making ideology. Today we could be seeing another significant regime shift and understanding this will be critical because it is regimes that determine the risk properties of assets.

Era 1: The economic regime of the Cold War era

Between the 1950s and 1980s, the prevailing economic ideology in developed Western countries was that of a Keynesian mixed economy. The threat of communism and the presence of large young, working class populations put pressure on capital to defer to labour. Wages were frequently indexed and fiscal policy played an active counter-cyclical role. Combined with a less open global trade environment, oil price shocks, and a greater emphasis upon manufacturing, the result was an environment of significant inflation. [Figure2]

Inflationary pressures proved to be a key determinant of asset class risk properties. Not only did inflation shocks ravage the long-term real returns on government bonds, but they also tended to negatively impact both bond and equity prices in the short term. During this period, the bond-equity correlation was largely positive.

This meant that not only did government bonds turn out to be highly risky in terms of returns, but their capacity to reduce overall volatility as part of a multi-asset portfolio was also far lower than in the recent past.

Era 2: 'Neo-liberalism'

Political and economic eras end with significant disruptions to the political order, typically brought about by crisis. It was the collapse of communism and the stagflation of the 1970s, which resulted in a rejection of the broad Keynesian consensus in Western economies.

In its place came both a greater faith in the free market and a general consensus that the use of interest rates to control inflation would be the primary source of intervention in the economy. With this came globalisation and an efficient economic system which ultimately brought about the low and stable levels of inflation that have characterised the last couple of decades.

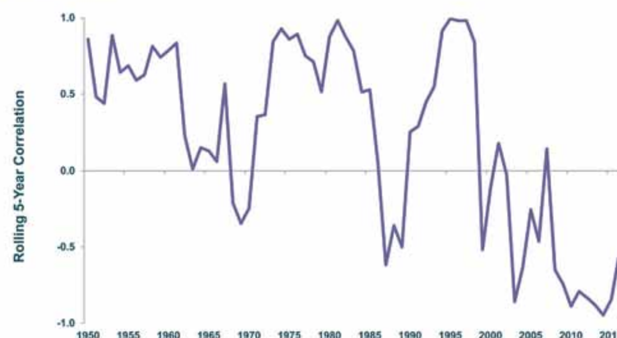
The transition from high to low inflation brought strong returns, and the propensity for interest rates to be cut in response to weaker growth meant that government bonds also tended to do well when equities struggled.

The resultant negative correlation between equities and bonds over this period, combined with strong returns from bond markets in their own right, proved to be a fantastic environment for the use of portfolios blending bonds and equities to deliver lower volatility without giving up on returns. [Figure3]

Figure 1: The changing risk and return properties of Gilts
Total returns rebased*

1 Source: M&G, Barclays Equity Gilt Study 2017 *Rebased as at 1950 for Gilt returns **Rebased as at 1990 for Gilt and equity returns

2 Source: M&G, Barclays Equity Gilt Study 2017.



3 Source: M&G, Barclays Equity Gilt Study 2017.

Era 3: 'Neo-nationalism'

The financial crisis of 2008 represented the challenge to the consensus of the 'neo-liberal' era. It directly discredited the assumption that boom and bust had been conquered, it challenged the notion that inequality was a price worth paying for the benefits of globalisation, and it illustrated that policy makers could no longer rely on interest rate policy alone to manage economic growth.

The legacy of the crisis is still being felt, but current events illustrate a significant shift, which will dictate the risk properties of assets from here. One consequence of the era of neo-liberal consensus was a perceived loss of political and economic identity. Today politicians are seeking to forge new identities through the various forms of 'neo-nationalism' and 'populism', which are a direct challenge to economic policy orthodoxy.

What does this mean for the risk properties of assets?

These political developments seem likely to have a range of influences on the risk properties of assets from here:

1. We cannot rely on a persistence of recent correlation trends.

The challenge to the monetary policy consensus, criticism of free trade and increasing calls for active fiscal policy mean that some of the pro-bond trends that have been in place could be challenged. This could be significant; even investors with almost ten years' experience have yet to experience an increase in UK interest rates, and risk models may not be equipped to deal with any profound structural change.

2. Global investors may have to consider diversification differently.

'Populism' has taken very different forms from one country to the next, while few movements have a coherent economic ideology. Achieving global diversification will need a far more active assessment of the economic and policy backdrop, even among developed economies.

Avoiding simplistic forecasting assumptions

History can be a useful guide as to how assets are likely to behave in the future - but only insofar as we expect the economic regime to resemble what has gone before. Quantitative risk models would have given you very different results in the early 1990s than they do today, while conflating two very different environments and looking at averages over the whole time period would be very misleading. Investors can never avoid making a judgement on what economic regime is likely to prevail in the future but it seems like a particularly dangerous time to bet on a continuation of what we have just seen.

For more information visit: www.mandg.co.uk/multi-asset

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Summary
• A key building block in asset allocation, typically multi-asset funds are prized for having levels of returns and volatility that sit between equities and bonds.
• Increasing use of more asset classes can be seen at the start and at the end of the glide path. Multi-asset funds can be blended to achieve a risk return outcome commensurate with what the glide path is trying to achieve at a certain point of time.
• Such funds will play a key role in retirement as income drawdown products come onto the market.
• For DB funds, multi-asset is a controlled way of accessing growth.

The utility player

Drawing on experience of the UK and Europe, David Rowley reports on how pension funds are deploying multi-asset funds

In the current mood of scepticism about active management, the ability for a multi-asset fund to offer a clear story about how its process works has become more important. Such funds came out of 2008 looking like the least worst option, despite not having an easy to understand investment process. It made their reputation and yet it is no longer enough to say 'don't look under the bonnet'.

Clarity has become more important too as pension funds have become more precise in how they use multi-asset funds. A key building block in asset allocation, typically they are prized for having levels of returns and volatility that sit between equities and bonds.

DC glide paths

The greatest uniformity of opinion is on the worth of a multi-asset fund in de-risking a defined contribution plan into income drawdown. Here growth assets are incrementally replaced by units in a multi-asset fund each year from age 50 or 55, until the chosen date of retirement.

The larger fund and governance budget the more complex this process can be. BlackRock head of UK DC investments Claire Finn, says: "You tend to see increasing use of more asset classes at the start and the end of the glide path. Different types of multi-asset funds can be blended to achieve a risk return outcome commensurate with what the glide path is trying to achieve at a certain point of time."

There is also recognition that such funds will play a key role in retirement as income drawdown products come onto the market.

M&G Investments global head of distribution Ominder Dhillon says: "You could live another 20 to 30 years at the point of retirement so you should probably be investing in a mixture of assets that can deliver a steady income."

A third common use of multi-asset in DC is wherever an employer is concerned about the impact of volatility on employees' sentiment. Here Newton head of defined contribution Catherine Doyle sees allocations in the accumulation phase in the 20 to 30 per cent range, in part because of the limitations of the charge cap. "There is a recognition that this is an area where it makes sense to spend fee budget because you are concerned about protection," she says. "One of the first questions I get asked is will this fund lose me money."

DB

For defined benefit funds multi-asset is a controlled way of accessing growth.

Dhillon says: "Funds may have a portfolio of liability matching assets in LDI or a mixture of different pooled fixed income funds with perhaps some alternative matching assets. And then they will have a growth pot where they must take some risk to close the deficit."

In Germany, France and Belgium pension funds are turning to multi-asset due to lower yield from fixed income. Finn says: "Fixed income is at the bedrock of their strategies and it can be a first step out of bonds or cash for a lot of those institutions. With yields being low they are looking for other areas to deliver growth, but they are also very low risk in nature."

Large funds

Where a governance budget is small, the use of a multi-asset fund is obvious,

Different approaches to the same result

While pension funds have several common purposes for multi-asset funds, it is remarkable how different the processes of the actual funds can be, as the following four funds demonstrate.

BlackRock has 10 different multi-asset strategies that covers volatility constrained funds, diversified funds and tactical asset allocation approaches. The most original is its multi-factor fund that alternates weightings of stocks between quality, momentum, growth and size bias depending on how much each is over or under played in the market.

The BNY Mellon Global Real Return Fund explains its approach firstly as an intention to mitigate the downside. Beyond a core layer of corporate bonds and equities, it uses government bonds and gold to stabilise when markets fall.

The M&G Episode Allocation Fund takes a value based approach with a focus on how behavioural biases among investors lead to these asset classes, sectors and stocks being fundamentally over or under valued. Such mispricing can occur from rapid price movements to a single piece of news. Such behaviours it seeks to capitalise on include irrational anchoring biases to certain yields or prices; confirmation bias that comes from reading too many similar opinions to your own; over-confidence bias about a manager's abilities; and herding behaviour by investors. The fund seeks to express these views as cheaply as possible and can use derivatives.

For those looking for a highly process driven approach there is the Nordea Diversified Return Fund. It analyses the range of risk premia available from a range of asset classes to create an optimal uncorrelated mix. To achieve this, it will sometimes use derivatives to create the right risk/ return. The portfolio is designed to do well in both risk on and risk off environments and therefore does not rely on a lot of tactical switches or bets on macro events. Ultimately, it is designed to preserve capital.

but where a fund has its own chief investment officer and internal team it is less so.

Some of the large funds in Scandinavia have started using multi-asset funds where they have identified a unique source of return not being accessed by their in-house team. Often this return has lower risk than equities.

Nordea Investment Management head of institutional and wholesale distribution UK and US Thomas Nehring says: "You have some big pension funds that want to take a bet on the equity side where they think it is appropriate to use a sleeve of a Nordea multi-asset fund and maybe bring down the equity exposure a bit."

Among Dutch schemes where there is a tradition of outsourced CIO mandates the multi-asset fund serves its purpose.

Finn says such funds often play a role of unique sources of capital preservation. "It might be looking for a multi-asset strategy that has a low correlation with other assets, in that case you would be looking for a strategy does not rely on beta."

In Italy, reports BlackRock, multi-asset funds have profited from a growth in the range of asset classes managers are permitted to use and funds have sought to pass the governance burden for allocating between those to a single manager.

The use of multi-asset funds within a pension scheme investment structure is key therefore in providing returns that equities and bonds at times struggle to provide. It remains to be seen whether their popularity will continue to grow but the signs are all pointing in the right direction at this moment in time.

Written by David Rowley, a freelance journalist

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