Next generation multi-asset investing

Matthew J. Bullock explains why investors should focus on defining objectives when constructing multi-asset portfolios, instead of starting from an 'asset classes' base

Long-accepted economic theories have been tested and found wanting in today's markets that have been distorted by central bank purchases and negative interest rates. As a result, we need to challenge traditional portfolio construction methods and be open to more innovative ways of reaching investment targets, be they growth, income or capital protection.

Portfolio construction has historically been based on available asset classes, with portfolios built up from there. This has created a bias in portfolios towards what investors are most familiar with, which tends to be equities and bonds. We believe that this historical bias has left investors holding significant market risk (beta) in their investments, which may not be desirable in an environment of increasing market volatility and geopolitical concerns.

With bond and equity valuations stretched, unusually at the same time that the outlook is uncertain, we don't believe that relying on market direction is a viable way for investors to drive returns. Beta-driven approaches that have worked well in the past may not prove so successful in the future. As a result, we believe it's essential that investors understand what exposures they hold in their portfolios and how these are likely to react in different market conditions. This goes beyond a simple analysis of portfolio constituents and requires delving into how exposures have been combined.

Furthermore, investors may not be able to rely on the complementary profiles of equity and bond markets to protect their capital. This was the premise on which traditional multi-asset funds were conceived — bonds should perform well when equities fall, and vice versa, which would protect the portfolio overall against sell-offs. In the current environment, market distortions may heighten the risk of equities and bonds losing value together. This means that investors looking to diversify risk can't trust that an inverse relationship holds between equities and bonds.

We are now in a world of solutions-driven investing and, as a result, we believe investors should no longer consider asset classes as the starting point for portfolio construction. They should instead refocus on their desired objectives, and the strategies that can best achieve those outcomes. Achieving the objective must be the primary objective, while the mix of assets used to get there is a secondary consideration.

For example, we designed our flagship multi-asset strategy from the starting point of an objective to provide consistent and sustainable long-term growth across the cycle. We seek to smooth out market variability by targeting three sources of return that have low correlations to each other. This enables us to create a strategy with a low overall correlation to markets:

- Alternatives: Markets can be inefficient and this seeks to capture inefficiencies that result in markets and sectors over/underreacting to events and creating opportunities in, for example, relative value and momentum.

- Manager alpha: Some markets and sectors are more inefficient than others (we believe examples include the under researched Japanese equities market) and this seeks to isolate return opportunities through in-depth security selection.

- Market exposures: While the overall portfolio targets a low correlation to traditional asset classes, this doesn't mean we avoid them. This source of return provides dynamic exposure to diversified assets to seek to capture the general tendency of markets to rise over the long term.

To learn more about our approach to multi-asset investing in this new market environment, visit www.wellington.com/nextgeninvesting

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