Diversification in multi asset portfolios: What role for duration?– *Multi asset products (most notably in the form of 'diversified growth' funds) have become increasingly attractive to pension schemes due to their ability to deliver capital growth with lower levels of volatility than equity markets. However, the return and diversification properties that have allowed multi asset products to achieve these outcomes are not static* ***p38***

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Multi assets focus:

The right time

Tristan Hanson, multi asset fund manager, M&G

Diversification in multi asset portfolios: What role for duration?

Multi asset products (most notably in the form of 'diversified growth' funds) have become increasingly attractive to pension schemes due to their ability to deliver capital growth with lower levels of volatility than equity markets. However, the return and diversification properties that have allowed multi asset products to achieve these outcomes are not static

No investment is a safe haven in all scenarios. Cash is vulnerable to inflation, inflation-linked bonds suffer in a rising rate environment, gold and other commodities can behave in unexpected ways, and illiquid assets can demonstrate their true risks just when you are most in need of safety.

Nor can we expect correlations between different assets to remain constant. Static multi asset portfolios offer the benefit of not having all your eggs in one basket, but over shorter timeframes there is no guarantee that they will demonstrate a stable volatility profile at a total portfolio level. Rather, this overall volatility is reliant upon diverse behaviour between underlying assets, and these correlation patterns are dependent on the environment and the starting point of valuation.

Considering such shifting correlations is important at all times, but could well become profoundly significant in the period ahead. This is especially true today since the diversification properties that many of us have become used to among major assets since the financial crisis have shown signs of changing.

This will clearly have significance for pension schemes' own overall asset management. However, with multi asset investment strategies (including DGFs) a significant element of scheme allocations, such considerations are also of importance to trustees as they select and monitor external managers.

Duration in multi asset portfolios

Active duration management is a key element of our toolkit when managing volatility in multi asset strategies and must be considered in a different way than in fixed income only portfolios. As a measure of sensitivity of bond holdings to interest rate changes, a high level of duration in a fixed income fund can provide an indication of likely volatility when interest rates move. By contrast, high levels of duration in multi asset funds need not mean that fund volatility will be higher in these conditions; rather we must consider how fixed income exposures are likely to interact with other positions.

For example, a multi asset portfolio with material long duration in its fixed income allocation may actually move less in response to changes in bond yields if long-dated bonds can be expected to be negatively correlated with other positions in the short term.

For much of the last 20 years this has indeed been the case, and one might have been forgiven for thinking that rate-sensitive assets, and particularly mainstream government bonds, are a safe haven in all scenarios. Long exposure to duration has acted as an insurance policy in periods of stress in other assets. Not only that, but these safe havens have been an insurance policy that has paid you. Even 'risk free' assets like gilts and Treasuries delivered returns that we might ordinarily expect from apparently risky assets.

But it would be dangerous to believe that this environment can persist indefinitely. This is most obvious in the impact that lower rates have in reducing prospective returns, but is also hugely significant when it comes to correlation patterns.

The importance of regime

What causes correlation patterns to change? For much of the history of financial markets, rate sensitive assets such as bonds and growth-sensitive assets like equity have tended to be positively correlated.

In more recent decades this dynamic has shifted. In an environment in which inflationary pressures have been less telling, and in which global policymakers have placed a greater emphasis upon monetary policy to manage growth, rate-sensitive assets have provided the insurance policy against growth risk to which investors have become increasingly accustomed.

However, as we have seen in periods such as the 'taper tantrum' in 2013 and 2014, as well as the first quarter of 2018, this property should not be taken for granted. In these periods interest rates themselves were a correlating force across asset classes (see figure 1).

In these periods, the flexibility to

adopt outright short duration or relative value positions would have been more useful. Relative value positions can allow funds to remove exposure to broader rate trends by isolating relative moves between different parts of the fixed income universe.

These strategies of course becomes even more significant in a world in which policy direction could well be changing in a more profound and longer lasting manner.

The impact of duration on alternative assets

A key demand of institutional investors in recent years has been for 'uncorrelated' returns. In general, this has been reflected in an aversion to equity beta, but could increasingly come to mean an ability to defend against rising rates.

Many strategies have sought to provide a lack of correlation to major asset classes through exposure to 'alternative' assets. This could mean being prepared to embrace illiquidity or to move into private markets.

However, it remains to be seen how far these assets can be insulated from major shifts in global interest rate dynamics. Many alternatives have only gained popularity in a world of very low policy rates around the world and are themselves offering lower prospective returns than they have for much of their history. Few have been tested in phases in which competing traditional assets become more attractive from a valuation standpoint.

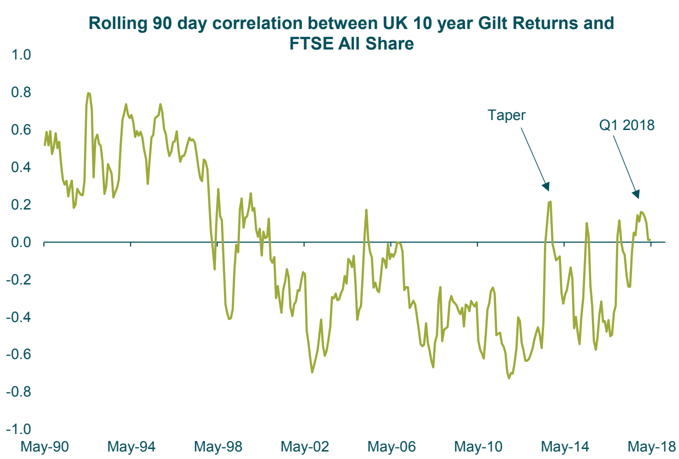
Alternative assets have a meaningful role to play in most institutional portfolios, however multi asset managers will need to demonstrate that they can identify genuine opportunities diversification where it is available as opposed simply seeking to benefit from price illiquidity.

Another alternative: Tactical diversification

With most assets at less-attractive valuations that they were after the financial crisis, the ability to rely on static multi asset allocations to deliver on return objectives is reduced. Instead, the ability to exploit volatility as a source of return generation becomes increasingly valuable.

Most long-term investors are rightly sceptical about strategies that claim to have an edge on 'market timing' and rightly so. However, active management rests upon the opportunities created when short-term volatility creates valuation disconnects, and such disconnects can often correct quickly. An example of this can be found in terms of duration management: in early 2016, US long dated Treasuries provided effective diversification against long equity exposure as investors became fearful of a global recession. However, this episode itself set up Treasuries for subsequent poor returns including behaviour correlated with equity markets in the second half of the year.

Figure 1.



Source: Datastream, 30 April 2018

The need for flexibility and dynamism

Pension fund trustees looking for multi asset strategies to provide equity-like returns with lower volatility in all environments will need to ensure that those strategies are genuinely able to deliver in all environments.

This will likely be challenging, since even traditional multi asset portfolios have benefited from a supportive environment since the financial crisis. However, with very clear signs of a change to this regime, there will a far greater role to be played by active management, including duration management, in order to generate returns should the interest-rate tailwind become a headwind.

www.mandg.co.uk/multiasset

Written by Tristan Hanson, multi asset fund manager, M&G

In association with M&G INVESTMENTS

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.

Summary
- Multi-asset managers face ever fiercer pressures on fees.
- Yet the risk of equities and bonds falling together means pension funds can't ignore them.
- The structure of multi-asset teams is crucial in distinguishing themselves from the crowd.
- Value investing and the margin of safety can still limit volatility and provide outperformance.

A multi-faceted relationship

David Whitehouse reveals how multi asset funds can be just what pension schemes are looking for in a volatile, low-fee world

The father of value investing, Benjamin Graham, once said that it was easier for a man to increase his income than to reduce expenditure. Multi asset managers, faced with a long-term and continuing downward pressure on their fees, face a similar conundrum.

An industry where fee trends are always downward is a hard one to work in, as Ted Williams, senior adviser at Zeus Capital in London, knows well. Williams has spent 38 years in investment management. He was one of the founders of Four Capital, worked at Schroders and Prudential, and has run local authority pension funds. He paints a sobering picture of the future for those running multi asset funds. Multi asset managers, he says, face a "challenging and even gloomy" outlook. Fees are going down, as are margins, even for the large mandates. The costs of fund management, Williams says, are now higher as investment management groups must now pay for research. The process of consolidation of local authority pension funds in the UK, he says, means that local authorities will have "more firepower" and will be in a stronger position to push down fees. They are likely to be tempted to choose passive investment strategies if active managers are not able to demonstrate added value.

"It's much harder than it once was," Williams says. There will be no place, he argues, for closet passive managers charging active fees. Cost-cutting is one option, he says, but this risk affecting performance. Multi asset managers find themselves "between a rock and a hard place."

Strategic objectives

The choice of multi asset fund is critical for a pension fund. Syndicate Room chief investment officer and Fund Twenty8 fund manager, James Sore, points out that the difference between the best and worst performing multi-asset funds in 2017 was huge, ranging from a 0.47% loss, compared with a 25.33% gain. MJ Hudson Allenbridge senior adviser Karen Shackleton argues that the selection key lies in being clear about strategic objectives: is the aim to reduce a deficit, or hedge against a rise in interest rates? She looks the track record of the individual rather than the fund, and favours long experience, particularly as many current fund managers have only operated in a low-interest rate environment.

Much depends on the size of the pension fund that multi asset managers are targeting, Shackleton says. Large, well-resourced funds will likely want to attempt multi asset management themselves. These funds are likely to look outside only for tactical asset allocation and niche expertise, for instance in less liquid securities. In the case of smaller pension funds, outside providers have a bigger part to play. These are unlikely to have the governance resources to handle multi asset strategy themselves. A fund of less than £500 million won't have the governance resources to react to changing markets, Shackleton says.

Aviva multi asset fund manager Brendan Walsh expects that the role of multi asset funds for defined-benefit pensions is likely to grow as funds become more mature and need to tackle funding or cashflow deficits head on. He believes that pension fund trustees should ask whether a fund has "a strong repeatable process that is not dependent on one or two key individuals. Are they able to explain the sources of risk and return consistently?" Past performance isn't very helpful in evaluating a manager, Walsh argues. "You have to really understand what drove that performance, what mistakes were made and how did the manager learn from them." He points out that it's often junior team members that do most of the research and generate the ideas, so pension fund trustees need to meet them. "A manager should be happy to put anyone from the team in front of you."

QS Investors' multi asset portfolio strategist Doug Sue and portfolio manager Mike Labella, agree that diversification is a question of personnel as well as of financial assets. Sue agrees that multi asset funds are "not immune" to fee pressures. But, he argues, the best multi-asset funds are able to provide unique, tailored solutions for pension funds in need of risk protection that a low-cost, passive approach can't give.

Labella and Sue urge pension fund managers to look at the people and teams behind a multi-asset fund. QS, which manages $21 billion including $14 billion in multi asset funds, leans towards a collegiate decision-making framework, and draws on a diverse array of expertise. The chief executive and head of multi asset research are both women, and the firm employs people with PhDs not just in financial engineering but also in maths, statistics and even nuclear physics.

The next volatility event

Walsh believes that the next major volatility event may see equities and bonds fall together. Tactical hedging, he argues, is extremely difficult even for the most sophisticated investors and won't serve pension fund clients who are intolerant of large performance swings. Labella agrees that the outlook for equities and bonds means that "we are in a really hard place right now." He expects that GDP growth in the US, Europe and Asia will be subdued, and that by necessity some risk will be needed to achieve decent returns.

Where can these be found? Arcadian Asset Management director of multi asset class strategies Ilya Figelman makes use of commodities, currencies, and long/short and options strategies to generate returns uncorrelated with market movements. He argues that pension fund managers should use three main criteria when choosing a multi asset manager: the fund should be truly diversified, rather than driven by a couple of ideas or themes; return-seeking in the long term; and provide defensive features. Pension funds need to go for "diversification when it matters": that is, in a severe market downturn.

Rather than being boxed into an active or passive mindset, M&G global head of institutional distribution Ominder Dhillon favours a 'horses for courses' approach. At M&G there is an active asset allocation process, but passive tools may then be used. Dhillon makes the common-sense point that some markets are more efficient than others; it would take unusual skill and insight to outperform the FTSE 100, but emerging market debt may offer opportunities for outperformance.

In a low-interest environment, Dhillon acknowledges, there has been pressure on fees, "and rightly so." However, fee pressure, argues Dhillon, exists for all strategies, not just multi-asset managers. He expresses "a little concern" over a UK charging cap for defined contribution pensions. This, he argues, makes it harder to include illiquid assets in a portfolio. "I can't just go on to Bloomberg and find a lot of private debt," he says. "These investments have to be structured and managed. Potentially a lot of return will be left of the table," due to the cap, he says.

M&G, Dhillon argues, has been able to outperform on a risk-adjusted basis over the long term. Its funds, he says, "do what it says on the tin". This is due, he says, to the company's value-investing ethos. He gives the example of the Japanese equity market which, 12-15 months ago, was offering real expected returns of 8%. This level of return, Dhillon says, has only been available for 5%-10% of the time for which Japanese stock market data are available. There was no fundamental reason for the market to be that cheap; the reasons, he suggests, lie in the domain of behavioural finance. If fundamental reasons do not seem to justify a market valuation, M&G typically draws on behavioural finance expertise embedded in its teams to seek an explanation before making an investment decision.

"We don't try to make forecasts. We ask if there is a margin of safety," Dhillon says. The central tenet of Benjamin Graham's investment philosophy, then, is still at work in our ever-more uncertain 21st century world.

Written by David Whitehouse, a freelance journalist