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Multi-asset strategies focus:
Connecting the pieces

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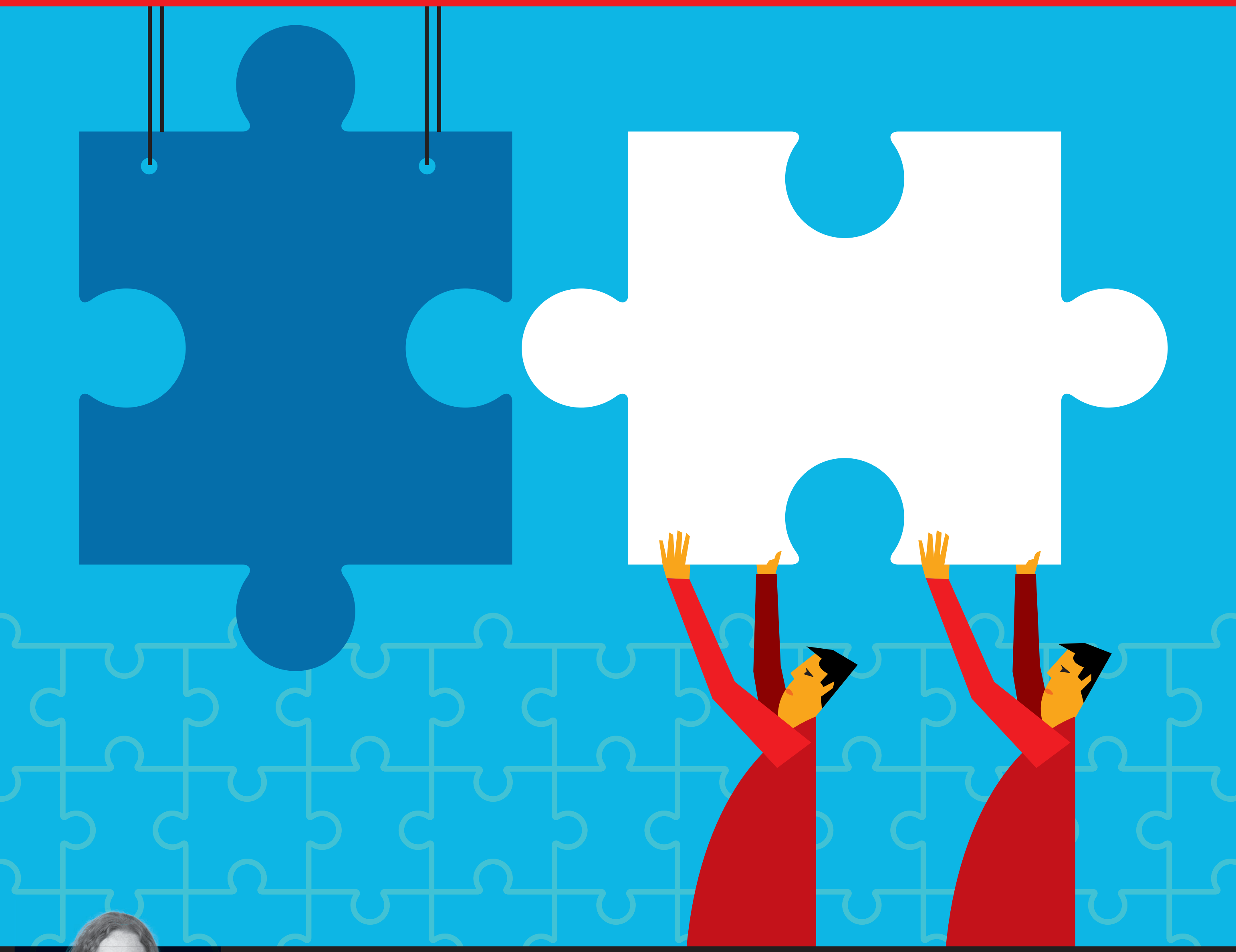

Written by Georgina Taylor, product director of multi-asset at Invesco Perpetual

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Dynamic markets require a flexible investment approach

Georgina Taylor explains how to diversify exposure by going beyond traditional asset types and labels

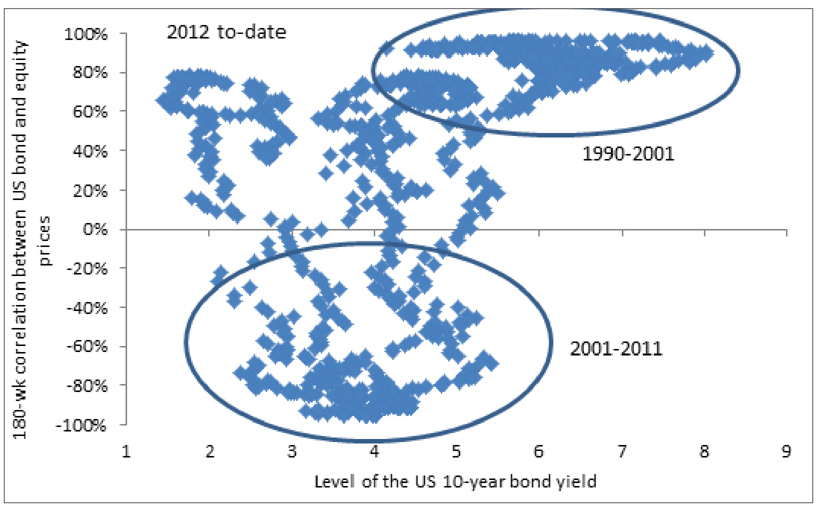
Quantitative easing and extraordinary policy measures have underpinned both equity and bond markets since the financial crisis. With bond yields at incredibly low levels and equities in many markets at, or very close, to their peak, the positive correlation between the two asset classes in recent years could pose a problem as we move through a major turning point in the interest cycle.

A number of central banks are now openly discussing when interest rates will start to rise, which poses a serious risk for multi-asset portfolios, and how diversification can be achieved going forward. The correlation between equities and bonds is not static and has been constantly changing over the past few decades, therefore for multi-asset funds to meet their return and diversification objectives a more sophisticated and flexible approach may be necessary.

Pre-2001, bond yields were on average a lot higher than they are now. When bond yields rose during the 1990s, equity markets responded negatively because the higher level of bond yields was not being fully offset by higher growth. However, in 2001, after bond yields followed base rates to historically low levels, the relationship between equities and bonds changed significantly. When bond yields rose equities also headed higher because the higher bond yields generally reflected stronger economic growth, which more than offset the increase in the cost of equity.

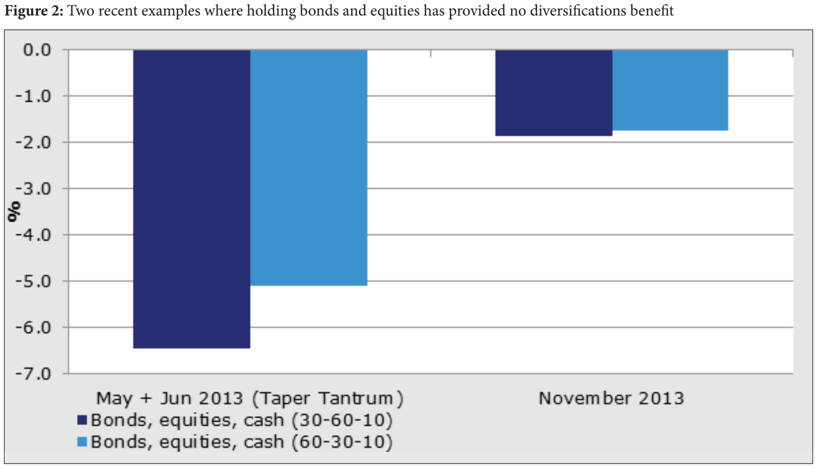
We have now been in a multi-year period of low bond yields and once again the relationship between equities and bonds seems to be changing. Since the start of 2012, a positive correlation between bond and equity prices has been seen once more. For much of the period that was because falling bond yields, partly as a result of central bank bond purchases, also acted to push up equity prices. In the second quarter of 2013, however, bond prices fell and yields rose at the same time as equity markets weakened.

Figure 1: The correlation between US equities and US bonds has moved in three broad phases since the 1990s



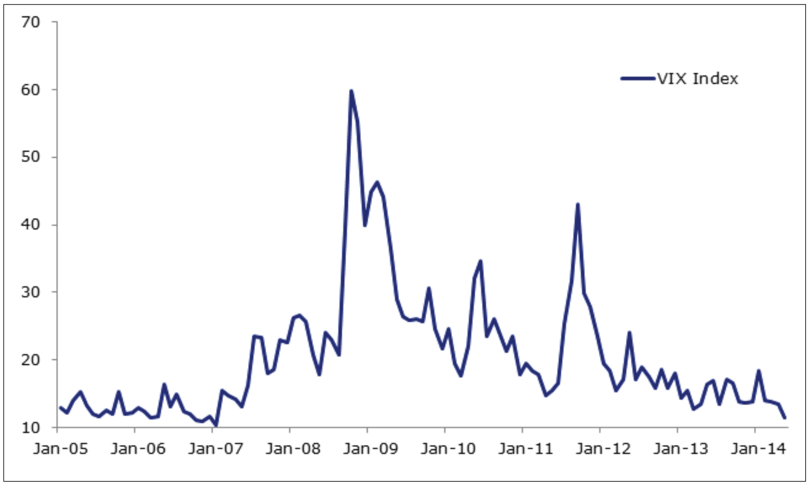
Source: Datastream, as of 7th April 2014.

Figure 2: Two recent examples where holding bonds and equities has provided no diversifications benefit



Source: Datastream, 14th February 2014. Bonds (10-year gilts), equities (UK total market index), cash (3-month LIBOR)

Figure 3: Quantitative easing has kept equity volatility low



Source: Datastream, as of 20th June 2014.

These changing correlations underline the importance of a diversified portfolio that is able to pinpoint exposure within markets to isolate key macro themes without being restricted by asset class labels, which is what drives our approach.

Our investment approach is to find good investment ideas without being constrained by asset labels. We believe that an unconstrained research agenda gives us the freedom to achieve true diversification, which, in our view, is necessary to negotiate the changing dynamics of global markets and to generate positive total returns long term.

Once we have looked across asset classes and geographies for good long term investment ideas, the next step is to apply robust risk management tools in order to bring the ideas together into a single, risk-managed portfolio. The key is how all the ideas work together and importantly how they interact with each other to reduce the overall risk of a portfolio.

For example, across the developed world, we expect monetary policy to remain accommodative and one idea the team has focused on is the Australian interest rate market and how it currently is pricing in interest rate rises.

The Reserve Bank of Australia (RBA) has its work cut out as it resides over a transition in the economy from one that has been highly dependent on commodities for growth to one that is more services led. After lowering its policy interest rate to 2.5 per cent in August of last year, the RBA suggested it did not expect to cut rates again imminently, which led to a broad expectation that it had reached the end of its rate cutting cycle.

However, there are now some dissenters who believe growing unemployment could provoke a further rate cut as mining capex drops off later this year. When we first implemented this view the two-year interest rate swap yield was 2.9 per cent and the expectation of the two-year swap rate yield in two years' time was 4.2 per cent. Our view was that growth pressure was unlikely to alter in the near future and therefore we bought a two-year forward, two-year swap, which even if rates remained on hold, we believed it would fall towards current two-year swap levels and contribute a positive return. The current level of the two-year swap rate yield in two years' time has now fallen to 3.5 per cent and we think it could have further to go.

Another opportunity is in the European financials sector, where we believe corporate bonds offer some value. The current regulatory environment suggests banks, which dominate the financials index, will continue to need capital to further bullet-proof their balance sheets while defaults seem highly unlikely. Especially as central banks, including the ECB, seem committed to 'saving' the banking system from past excesses.

At the same time, we believe the current spread of senior financial credit already reflects the regulatory environment and the sector's low earnings visibility and, therefore, spreads could narrow. This makes us comfortable taking a long position on European senior financial credit.

We combine this trade with a long volatility position on the Euro Stoxx Banks Index. The slow pace of both economic growth and change in the European banking sector has led to low earnings visibility, which means bank equity may come under pressure in the years to come. This coupled with the currently low implied volatility of European banking stocks represents, in our view, an attractive entry point and adds some defensive qualities to the trade. Whereby, if things do go wrong in the sector and credit spreads rise to reflect increased risks, equity volatility levels will most probably increase.

Both of the examples here show how we isolate a specific theme and act on it, rather than needing to be exposed to particular markets or asset classes through traditional asset allocation. In addition, the use of volatility (see figure 3) as a source of potential returns acts as another great example of how to diversify exposure by going beyond traditional asset types and labels.

Written by Georgina Taylor, product director of multi-asset at Invesco Perpetual

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Summary

- The current level of growth in equity markets is impacting the relative appeal of multi-asset approaches.
- The term 'multi-asset fund' can cover a variety of strategies with different constructions and objectives.
- Schemes remain interested in multi-asset strategies as they look for returns in the low rate environment.
- Relative performance can be hard to measure, but manager skill and strategy selection are the main common drivers.

Finding the right blend

As equities continue their strong performance, multi-asset strategies do not have the same obvious appeal as they did when the market was exceedingly volatile. Lynn Strongin Dodds reviews some of the strategies in the market and the value they offer

Multi-asset funds gained prominence during a period of high volatility but today's scenario of rising equities and calmer markets is putting them to the test. Successfully navigating their way through these less choppy waters will not only require astute timing but also a wide berth of asset classes and strategies.

Changing environment

"The current environment is challenging for these funds because if investors think they can get a double digit return with single digit volatility each year from equities, they will invest in equities," says Invesco Perpetual head of multi-asset David Millar. "However, the current environment can't last forever and then we will be able to see how robust the construction really is of all the new entities. The focus will be on whether they have performed well from investing in equity proxies or from true diversifiers."

Millar believes that: "The best suited funds will be those that have access to as many sources of diversification as possible. We, for example, have an unconstrained research approach and have the widest possible view to investing across in different asset classes, geographies and markets."

BlackRock managing director multi-asset strategies Sara Morgan adds: "After three years of particularly strong returns from equities, some trustees feel regret risk is a major challenge of investing in diversified growth funds. However, over the longer term these vehicles offer a tighter range of outcomes and have the ability to adapt to changing market environments – something that is attractive to institutional investors as market volatility picks up and dispersion both across and within asset classes increases."

In fact, fears over volatility are never far from the surface as witnessed by a recent study by Baring Asset Management. It found that 83 per cent of 64 investment managers of UK pension schemes include multi-asset funds in their portfolio mix mainly to smooth the ride. This is up from 65 per cent in the same survey conducted a year ago. A separate report published by Morningstar supported this by showing that despite the popularity of equities, many European institutions also took the alternative and more diversified route to mitigate risks and level out returns. This perhaps explains why multi-asset strategies (or allocation funds as the research firm describes them) accounted for the lion share at €95 billion of the €274 billion inflows last year.

According to Aviva Investors fund manager multi asset funds Nick Samouilhan there are several drivers behind their growing popularity. "The underlying backdrop of continuing low yields, particularly in Europe due to the recent interest rate cut from the European Central Bank means that investors are looking for new strategies to deliver returns. The other reason is regulation and the burden of governance has become too much especially for the smaller schemes. Finally there is a pressure for trustees to understand what the scheme needs, how to achieve it and monitor it."

Volatility

Handing the responsibility over to a third party though can be an equally daunting task as there are several products sitting on investment shelves with the multi-asset label. "One of the problems is that there is a big variety in the market and no standard definition," says J.P. Morgan Asset Management global multi-asset group portfolio manager Bob White. "Multi-asset funds are often used interchangeably with diversified growth funds in the UK and absolute return funds. We look at them as non-benchmark funds but the flexibility and design can vary widely. Also institutions use them in different ways, with some for example having DGFs as an anchor and taking active decisions around that while others who have broad expertise may execute multi-asset strategies that complement the overall portfolio."

Mercer Investment Consulting director macro currency and commodity research Simon Fox notes the approaches will depend on a fund's size, resources, funding levels and requirements. "We are basically seeing two different types – one in which smaller schemes or defined contribution favour core diversified strategies that are low cost and more beta driven. They rely on exposures from bonds and equities with some diversification. The others are more idiosyncratic, active and use tactical asset allocation. They are typically the satellite holdings and focus more on individual or basket of stocks or specific exposures. They are geared for larger schemes that have sophisticated equity and bond managers who are looking for different sources of returns."

Credit, for example, has become one of the most prevalent diversifiers. M&G Investments director of fixed income Annabel Gillard notes: "We are seeing institutions using multi-asset credit strategies as an alternative to absolute bond funds. At the moment, volatility is low and spreads have become tighter and tighter as the economic outlook has improved. Credit offers a large range of opportunities but the return has to compensate for the risk."

Redington vice president, manager of research Aniket Das believes that the 'absolute return relative value' strategy will become one of the most popular in the coming year. Risk allocation versus asset allocation as well as tighter risk management form an integral part of the investment process. "It moves into the territory of global macro hedge funds, which similarly employ a range of long and short relative value positions while utilising options and other derivatives. There are a number of drivers such as these funds can add greater value but their success will be down to skill, fees, capacity, transparency, appropriate vehicles and client servicing."

Performance is harder to gauge because it is difficult to make direct comparisons. For example the Investment Management Association divides multi-asset funds into four categories with each group determined by the level of equities. Others vary in the range of asset classes they plug in. The list is never ending and can include real assets such as infrastructure and real estate to derivatives, options, currencies, credit solutions and commodities. The result is different funds with varying degrees of targets and timeframes.

Manager and strategy selection

Despite the differences, research shows that the main common diver of performance is the acumen of the manager and the strategies selected. While a strong equity rally has been a major contributing factor recently, taking advantage of the right entry and exit points is more than good luck. For example, data from FE Analytics shows that a total of 27 retail multi-asset funds out of the 411 reviewed returned 100 per cent or more over a five year period from March 2009 to March 2014. During the same time frame the FTSE 100 index soared 71.6 per cent while UK 10-year gilts are still higher in price

terms than in March 2009 in spite of the recent declines.

The institutional world is different. As Morgan points out: "It is difficult to assess performance given only a small number of funds have proven track records through the downturn of 2008. There have been a large number of new launches since the financial crisis and although there are over 40 funds now available, the vast majority of assets under management remain concentrated with around eight to 10 managers."

A factor common to both is cost. "It is one of the biggest overriding considerations when choosing a fund" says Aberdeen Asset Management senior investment manager Fiona Gillespie. "Investors have to be aware that the costs may be higher if they are using a multi manager house that uses different funds from different fund managers versus a single fund manager who has internal funds. They need to look under the bonnet at the engine in order to assess the various structures."

Written by Lynn Strongin Dodds, a freelance journalist

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