special report
Q2 2015

Multi-asset

Alcentra

Insight INVESTMENT

Mellon Capital

NEWTON The Power of Ideas

STANDISH

BNY MELLON

Introduction

The past decade has seen rapid growth in the multi-asset investment sector, with a plethora of new products offering global investors exposure to an increasingly diverse and attractive range of asset classes.

While precise definitions of multi-asset investment can vary widely, portfolio managers employing this broad approach can invest in a growing universe of securities, funds and other assets in order to diversify their investment holdings, take advantage of specific asset allocation and investment strategies and minimise risk. Multi-asset funds are generally designed to balance potential market upside against potential losses.

The multi-asset approach embraces a broad range of investment techniques - including passive and active management - sometimes employing the use of derivatives and other complex market instruments managed to pre-agreed risk levels.

In the current low yield, low interest rate environment - where the appetite for income is unrelenting - investors are increasingly attracted to the diversity and potential returns offered by multi-asset portfolios. As such the strong market growth of these products looks set to continue in the months ahead.

However, the sheer scale, number and complexity of multi-asset investments available today can sometimes present a bewildering proposition to investors unfamiliar with the market. Successful investment in this sector demands clear objectives and at least some degree of specialist knowledge.

While the multi-asset approach offers a strong degree of flexibility, it is important investors carefully consider their requirements, fully understand what their funds actually invest in and identify the likely return profiles of their underlying assets. It is also crucial for both fund managers and their clients to assess their overall appetite for risk and manage this accordingly.

Here, BNY Mellon Investment Management explores the latest market trends in this dynamic sector, outlining the types of strategies and instruments applied within multi-asset portfolios, with accompanying comments and opinions from managers across our range of investment boutiques.

The rise and rise of multi-asset

The growth in multi-asset investment offerings has been immense but the asset class remains difficult to define, according to BNY Mellon's Matt Oomen and Newton's Jon Bell.

Multi-asset investing is a growth industry. According to UK trade publication Professional Adviser, assets under management of multi-asset funds in the UK alone have grown from £21.5bn to £126.5bn in the past decade alone, an increase of 490%.[1] Likewise, in a questionnaire carried out by FundFire, a Financial Times publication, three quarters of the 177 US companies polled said they offer multi-asset class products, with more than half saying they have launched a multi-asset product within the past five years. According to data provider eVestment, total US-domiciled assets in multi-asset products reached US$883bn by the end of 2014. As the baby boom generation eases into retirement, it seems, multi-asset investing has been on the up.

[1] Professional Adviser: Multi-asset survivors: The six funds still loved after a decade, 12 May 2015.

About BNY Mellon

BNY Mellon's multi-boutique model encompasses the skills of 13 specialised investment managers. Each is solely focused on investment management and each has its own unique investment philosophy and process.

Alcentra
Located in London, New York and Boston, Alcentra is a global asset management firm focused on sub-investment grade debt capital markets in Europe and the US.

Insight Investment
Insight is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.

Mellon Capital
Mellon Capital Management Corporation offers investment capabilities ranging from indexing to alternatives with the infrastructure and skill to transact in all liquid asset classes and securities.

Newton – The Power of Ideas
Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies.

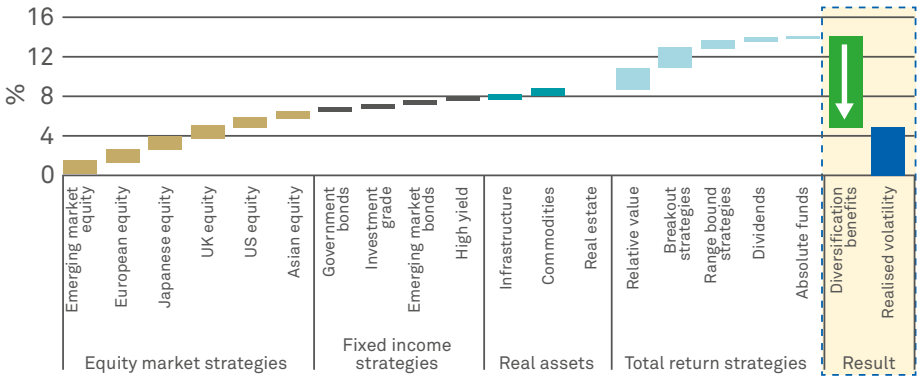
Standish
Headquartered in Boston, Massachusetts, Standish is a specialist investment manager dedicated exclusively to active fixed income and credit solutions, with a strong emphasis on fundamental credit research.

For Matt Oomen, head of distribution for EMEA at BNY Mellon Investment Management, the growth of multi-asset investment is a story that goes back decades. He notes how the development of balanced funds and with-profits funds in the UK in the 1980s were early iterations of the approach – but says the concept has evolved significantly since then.

"At its heart, multi-asset investment is founded on the notion that asset allocation is one of the most significant drivers of returns," he says. "But since the days of balanced funds, we've moved on from the idea of someone just taking your asset allocation decisions for you. Today's multi-asset funds can be far more complex than that." Jon Bell, investment leader multi-asset at Newton Investment Management, takes up a similar theme, noting how multi-asset investing has gone in and out of fashion over time as interest in other approaches to asset management has waxed and waned. In the years leading up to the global financial crisis for example, he says advisers favoured greater specialisation – and this resulted in managers and funds having an ever narrower focus. At the same time, an over-reliance on forecasting from a short-term data-set created a false sense of security. This ultimately served investors poorly. "The crisis revealed the limitations of this more specialised approach," he says. "It created silos where investors could be exposed to the full force of a market downturn."

> **At its heart, multi-asset investment is founded on the notion that asset allocation is one of the most significant drivers of returns.**
>
> Matt Oomen, BNY Mellon Investment Management

PROFILE OF A DIVERSIFIED MULTI-ASSET STRATEGY



Source: Insight as at January 2014. For illustrative purposes only.

Little wonder, then, that in the immediate aftermath of the crisis, multi-asset investing boomed once more, with a glut of new product launches and inflows into UK-based multi-asset funds peaking in 2010.[2] Much of this could be down to plaudits multi-asset funds have received as a way of diluting risk and as a way of balancing out possible upside with potential losses.

Definitional challenge

But what constitutes a multi-asset approach? It's fair to say the term 'multi-asset' is a slippery one, encompassing as it does everything from relatively straightforward long-only funds to more sophisticated strategies using derivatives to hedge against losses. Cash, equities and bonds are the traditional backbone of the multi-asset approach but other more esoteric elements such as exposure to real estate or commodities are also prevalent. Today multi-asset funds are increasingly multi-dimensional with a broad opportunity set.

For Bell, the question of what should – or can be – in a multi-asset strategy is a complex one and depends on client expectations. For the majority of Newton's multi-asset range a more traditional approach is taken, investing primarily in bonds, equities and cash. However, the Newton Multi-Asset Diversified Return strategy is, as the name suggests, diversified and seeks to benefit from a more diverse source of returns profiles, including many alternative asset classes.

Measuring up

Another problem is the lack of a single benchmark and peer group – and this means it can be difficult to compare multi-asset funds with their peers when it comes to past performance.

In the UK, industry trade association the Investment Association (IA) does have a definition for the multi-asset market place (see marketplace figure on page 3), but, tellingly, for many multi-asset products these definitions are too narrow. As a result many such funds have instead ended up in the 'Flexible' or 'Unclassified' baskets, which contain a broad mix of offerings. "Unclassified" funds now make up almost one-tenth of UK fund holdings by assets, according to the Financial Times.[3]

The situation is similar in Europe's classification of such funds. Defined by data provider Lipper as funds with a strategic diversification in variable income and fixed income securities along with ancillary liquid assets, it classifies multi-asset funds by risk – conservative, balanced, aggressive and flexible –as well as currency and geography. As of June 2015 the four risk-defined Lipper Global sectors had a combined 5,981 constituents with combined assets under management of US$2.3 trillion.[4]

2 Financial Times: Multi-asset funds promise all-in-one toolkit, 21 November 2014.
3 Ibid.
4 Includes US$ and EUR-denominated funds across the entire Lipper universe, including US, Asia and Europe, as of 5 June 2015.

Comparisons

One solution has been for multi-asset funds to set themselves a specific rate-of-return goal, generally versus LIBOR or a similar cash benchmark or sometimes versus the Consumer Price Index (CPI). Another option is risk targeting, where a fund's level of risk is externally certified.

For Bell, while this kind of outcome targeting may not help much with comparing actual performance between peers, it at least helps to make it clear whether or not a fund is delivering on its goals.

"The comparison between products is incredibly difficult in the multi-asset space," he says. "At least, for the funds benchmarked against LIBOR or the CPI it's quite clear cut. Either they achieved their return or they didn't."

This idea of benchmarking funds by their ability or failure to meet their own stated performance goals is also one that chimes with Oomen. He comments:

"The multi-asset marketplace has evolved to fit accumulation, preservation and income outcomes and I believe we'll see more of that. So, perhaps trying to compare multi-asset funds in a like-for-like peer group is missing the point. Perhaps the best chance we have of understanding what is a fast-evolving and complicated space is to work out which funds are giving the investor a predictable outcome and which manager is delivering their stated outcome."

An alternative suggestion for 'cleaning up' the multi-asset market space, says Bell, is to create a separate peer group category for those structured as funds of funds. "Often, when people think of multi-asset investing they think of fund of funds – this especially seems to be the case in the US. But they are something we've tended to avoid at Newton. As sophisticated as an asset manager might be, we feel there's always less clarity about what you're invested in with a fund of funds approach. You're essentially relying on third parties for all your reporting. There's also often the potential for layering of costs even if your manager has negotiated a pretty mean deal."

Looking forward, Oomen is confident there will be no let-up in the evolution of multi-asset investment vehicles or in the rise of their popularity, especially given the Europe-wide trend for governments to push for retirement provision to be in the hands of the individual.

> **The comparison between products is incredibly difficult in the multi-asset space.**
>
> Jon Bell, Newton

> **Multi-asset funds continue to be all over the press and there seems to be a continual run of new product launches. I don't see any signs of their popularity abating.**
>
> Matt Oomen, BNY Mellon Investment Management

"You could have a whole range of conversations about where the multi-asset story's going depending on the channel, the problem and the solution," he says. "Multi-asset funds continue to be all over the press and there seems to be a continual run of new product launches. I don't see any signs of their popularity abating," he concludes.

THE MULTI-ASSET MARKETPLACE DEFINED BY IA SECTOR

IA Mixed Investment: 0-35% Shares
49 funds

IA Targeted Absolute Return
77 funds

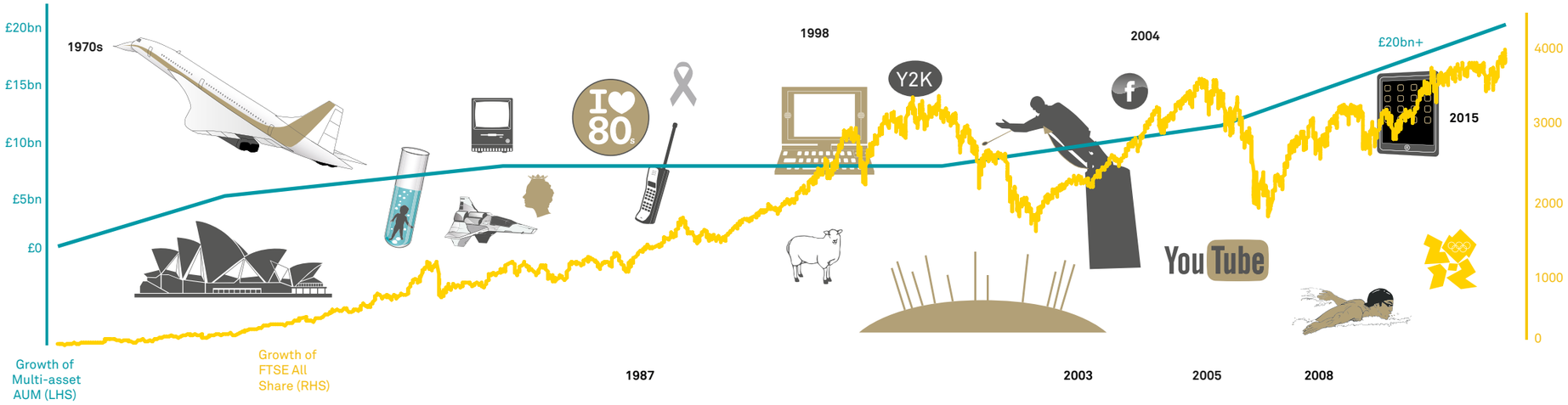
IA Flexible Investment
132 funds

IA Mixed Investment: 40-85% Shares
132 funds

IA Mixed Investment: 20-60%
143 funds

Source: Lipper IM. As of 31 May 2015.

THE DEVELOPING WORLD OF MULTI-ASSET



Source: Newton. December 2014.

Building value: infrastructure investment

Private, direct infrastructure investment is open to a wide range of investors including large institutions, medium sized and small investors as well as wealth managers. While large institutions have the size and scope to invest directly in infrastructure projects, investing in listed infrastructure equities – such as UK utility suppliers Centrica and Severn Trent – is one way of gaining exposure to the market.

Some investment companies, such as UK-based private equity and venture capital company 3i, also specialise in infrastructure, providing listed funds which are open to a wide range of investors. There are dedicated infrastructure funds, although these tend to be in a closed-ended structure. Investment trusts focused on the infrastructure and construction sectors are a popular route to the sector while companies specialising in infrastructure-related debt (infrastructure bonds) are a specialist option.

In addition a number of portfolio managers, such as Newton Investment Management, include infrastructure in multi-asset portfolios as part of a broader basket of investments. This affords the end client with indirect exposure to the asset class. In the UK market, the development of the Private Finance Initiative (PFI) partnership between private and public sector since its launch in 1992 has also spawned a growing range of dedicated investment companies which enable investors access to PFI contracts.

PFI has been applied most extensively in the UK but similar Public-Private Partnership (PPP) projects have been used by governments in the Netherlands, Canada and Australia. Investors can also access opportunities in the fast growing UK renewable energy sector through various Enterprise Investment Schemes (EIS) which, in some cases, offer inflation-linked government subsidies or tax breaks in their early stages. Regardless of the size of the investor – or their expertise – the appeal of infrastructure is typically the same in terms of the income-generating, non-correlated aspects of the asset class.

Managing risks

Risk management remains a crucial aspect of any investment strategy. Here Insight Investment fund manager, Steve Waddington, explains why managing investment risk across multi-asset portfolios requires thinking in multiple dimensions.

As some investments work best (or, indeed, worst) in different environments, a multi-asset strategy needs a broad mandate and the flexibility to take advantage of such opportunities can enhance its return potential.

When managing a multi-asset portfolio, it is crucial to understand the risks embedded within that portfolio and to ensure it is sufficiently diversified. This sometimes involves thinking beyond historic statistical relationships: inter-relationships and correlations can change over time.

It is important to have not only an accurate picture of overall portfolio risk (measured by volatility, value-at-risk (VaR) and other appropriate risk metrics) but also to appreciate the decomposition of risk among portfolio positions. If risk were inappropriately skewed, portfolio adjustments would need to be made to secure more balanced risk distribution. This could then ensure the portfolio had sufficient diversification from a fundamental perspective.

The benefits of diversification can be illustrated by showing the contribution to risk of the various strategies deployed within a diversified multi-asset portfolio and then comparing the aggregation of these individual positions with the realised volatility of the overall portfolio. The difference between the two can give a sense of the benefits that can be derived from a diversified multi-asset approach to return generation.

This kind of multi-faceted approach to risk management provides confidence that a broad opportunity set can be used to further improve the distribution of portfolio returns.

Risk v returns

Potential sources of return can be split into broad categories. For example, they could vary between the following categories:

- Fixed income: alpha and beta
- Equity: mainly beta
- Real assets: alpha and beta
- Total return strategies: mainly alpha

The most volatile elements within a multi-asset portfolio dominate the portfolio's risk/return characteristics. As such it is reasonable to anticipate asset class exposures will be an important contributor to aggregate portfolio risk and the most volatile assets (equities and commodities) are likely to be at the top of that list.

Biases towards these asset classes can be driven by a fundamental understanding of how they are influenced by macroeconomic factors, such as monetary policy, fiscal policy, growth and inflation.

Looking at a range of valuation indicators in the context of an assessment of the macroeconomic environment, alongside indicators of market positioning, is one way of forming a view on their likely performance. But how much exposure is finally incorporated into a portfolio should also be guided by risk considerations.

A changing picture

Approximately 50% of a portfolio's returns might be derived from asset allocation and the remainder from investment selection, although these proportions could vary over time. When conditions are conducive for beta to perform, one might expect a strategy to run more directional risk and beta would be likely to contribute more than half of portfolio returns. Conversely, when conditions are more challenging (and beta is less attractive), there may be more opportunities for the portfolio to generate returns from alpha.

As such managing investment risk across such a portfolio requires thinking in multiple dimensions:

- At a portfolio level to ensure appropriate levels of diversification.
- At an asset class level, specifically, being mindful of drawdown risk when running directional exposure.
- At an individual position or strategy level to ensure that risk is not overly concentrated and that downside in the event of extreme moves is within tolerance levels.

When managing directional risk, some form of downside protection is sensible for assets with material downside potential. When it comes to managing individual positions and strategies, and also overall portfolio risk, incorporating strategies that involve non-directional sources of return, we believe, can consequently help deliver a better distribution of returns.

Duty of care: ESG

As the sustainable dimension to investing assumes greater importance, investors are becoming increasingly aware that ignoring such considerations can result in financial risk, according to Sandra Carlisle, head of responsible investing at Newton. Equally, they are conscious that, by taking into account environmental and social aspects as well as governance and ethical concerns (where they might conflict with the investment goal), they can influence the behaviour of the companies they hold. In that way that they can exert a beneficial influence that can translate into long-term financial performance. By acting in a sustainable way, companies can generate long-term value for their shareholders as well as fostering the conditions for a sustainable economy that can avoid having, say, a detrimental impact on the planet (climate change).

Within multi-asset portfolios, environmental, social and governance (ESG) considerations can be embedded in the analysis of investment opportunities and risk, with ESG becoming a natural extension of the investment process. Analysis of the management of environmental, social and other business risks can give fund managers an indication of the quality of a company's overall management. For investors, events, such as BP's oil spill in the Gulf of Mexico in 2010, underscore the importance of ESG for risk management. Investing globally in a multi-asset portfolio means having to contend with the complexity of different governance regimes and disparate levels of disclosure and transparency.

Investors can exert their influence on companies via their investment managers or collaboratively with other investors. Engagement can mean meeting with a company in which a fund manager is invested to raise points of concern and to discuss why the company should be concerned as well. A company can be held to account if necessary or acknowledged for doing things in a way that sets a positive example for its sector.

The United Nations-supported Principles for Responsible Investment (PRI) initiative (launched in 2006) aims to contribute to a more sustainable global financial system. The PRI initiative – designed to be compatible with the investment styles of large, institutional investors that operate within a traditional fiduciary framework – serves to bring responsible investing to a wider audience and achieve broader acceptance. It has 1,325 signatories (asset owners, investment managers and service providers), representing more than US$45 trillion under management.

Multi-asset is like a box of chocolates...

From risk-rated to multi-manager and risk targeted funds, multi-asset portfolios come in a variety of shapes and sizes. Here, Newton's Paul Flood, Alcentra's Simon Perry and Standish's Raman Srivastava explore the structure of multi-asset and multi-sector portfolios in order to smooth returns.

Multi-faceted structures

The multitude of multi-asset portfolios available today and the assortment they come in has served to make investor choice increasingly difficult and complex. Hundreds if not thousands of investment strategies are labelled multi-asset these days but the variance is broad; some are heavily exposed to derivatives, some are just a blend of equities and bonds in either a single market or globally, while others are funds of funds and others still make great use of esoteric instruments.

The same can be said for multi-sector as some managers blend varying numbers of sub-asset classes typically within a bond fund, seeking a similar risk/return profile of multi-asset funds and the generation of a 'smoothed' return.

Structures

Some multi-asset funds are structured to either target a set level of risk or are built to produce a specified volatility band; in doing so some are single managers while others are funds of funds.

Risk-rated funds are those constructed to produce a risk/return profile within a specific categorisation or a rating provided by a third party agency.

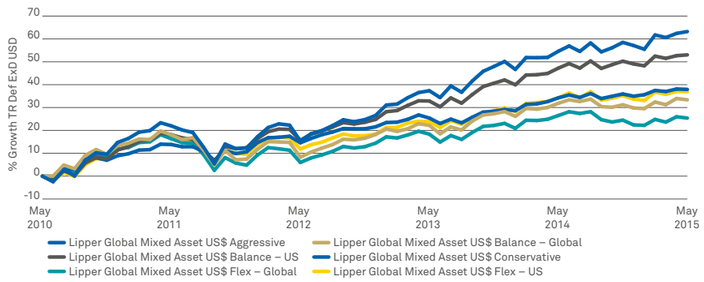
The manager of a risk-rated fund looks to generate a return within guideline asset allocation limits. Risk ratings on funds can change and because those that convey such ratings do not have a standardised approach, users need to be clear on the rating methodology.

Paul Flood, multi-asset manager at Newton, doesn't negate the value of any one approach but does question the assignations of risk-rated funds. He argues many of those rated low risk may be heavily exposed to one asset class – bonds – yet at times of rising interest rates, such a strategy could be considered high risk. "I don't like to think of any single asset class as being high or low risk, instead the potential benefits of multi-asset means a smoother return profile can be built. Each asset class poses a different level of risk to capital at different points in the cycle."

Risk targeting strategies, often seen as a one-stop shop, are another type of multi-asset fund which have grown in popularity and presence in recent years. It may seem as if these are only marginally different from risk-rated funds. However, a rating assessment can be given to a risk-targeted fund.

According to European independent financial research company Defaqto, the mandate of a risk targeted fund requires its manager to stay within a guideline risk range, normally measured by a volatility band. "This means the manager will normally have to reduce exposure to riskier assets if the upper volatility band is hit and to add to risk assets if volatility moves to the lower band. The guideline tolerances are manager-specific, and therefore the investor, or their adviser, needs to know the investment approach to staying within the relevant volatility band.[1]"

PERFORMANCE OF LIPPER GLOBAL GROWTH US$ MULTI-ASSET SECTORS OVER FIVE YEARS TO 31 MAY 2015



Source: Lipper IM. 31 May 2015.

Along the same lines there are also risk allocation funds, portfolios managed in accordance with an investment process that starts with risk-parity (whereby each asset is equally weighted by contribution to overall portfolio volatility) as its neutral position. In its description of such products, Defaqto says: "Advocates of risk parity say all asset classes perform equally per unit of risk over the long-term and therefore have the same Sharpe ratio. In practice this means risk allocation funds will have more in low risk assets, such as high quality bonds and cash and less in equities than a traditional 'balanced' multi-asset fund.[2]" Importantly some of these products use high levels of leverage, something exposed during the taper tantrum and the resulting bond sell off.[3]

Then there is the more old-style 'managed' approach. **Managed funds** have been around for far longer than multi-asset, even though the two are somewhat synonymous. In the UK, managed funds, once popular classifications in the trade association's sectors, are those that used to invest in a mix of cash, bonds and equities.

Over time the European directive known as UCITS (Undertakings for Collective Investment in Transferable Securities) broadened the scope of acceptable investments in a single portfolio, enabling managed funds to start to hold ever more diversified assets. From 2001 UCITS III enabled exposure to derivatives for investment purposes as well as for hedging or shorting purposes. This paved the way for **absolute return funds**.

While some absolute return funds may be multi-asset not all are. Some are regional and some target single assets classes. **Diversified growth funds** (DGF) are yet another variation of multi-asset, many of which also have an absolute return target. DGFs are perhaps best known in the defined contribution pension world and are typically described as being invested in a wide variety of asset classes in order to deliver real capital appreciation over the medium to long-term. The difference between these and the risk-oriented funds described above is they usually aim for a certain level of absolute return – a return over inflation or above cash with a reasonably long time horizon, 12 to 36 months to determine their success.

Multi-manager v single managers

Another characteristic to consider when eyeing multi-asset products is how they are managed. All of the types of products described above can generally be found in one of two forms: single manager-led or fund of funds.

The argument for a fund of funds strategy in this space is that no single manager can possibly understand all the assets to which such a fund can have exposure. As such managers invest in specialist funds, opting for exposure to say a biotech fund, a property portfolio or a gold product alongside more traditional equity and bond fund allocations. Even in the latter a fund funds manager can allocate between global portfolios and individual markets.

1 Defaqto.com: Risk targeted versus risk-rated versus risk allocation funds, May 2015.
2 Ibid.
3 Wall Street Journal: Fashionable 'Risk Parity' Funds Hit Hard, 27 June 2013.

special report

Loan stars: sub-investment grade corporate credit

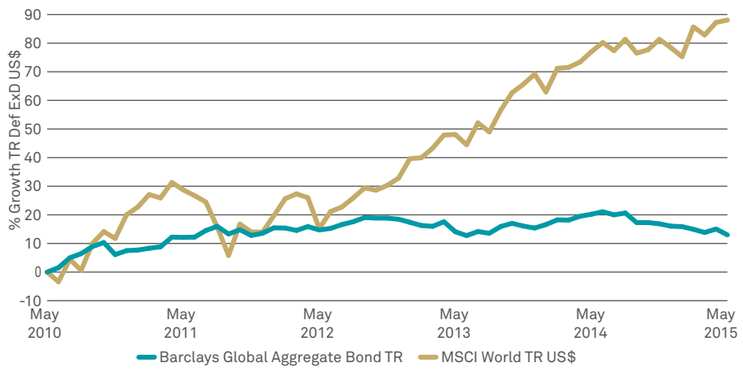
Specialist investment manager Alcentra believes that the sub-investment grade corporate credit markets can provide risk adjusted returns at a time when equity markets have proven to be volatile and influenced by government policy and when the yield on more traditional fixed income asset classes like sovereign and investment grade corporate credit has been compressed by the weight of capital attracted to these sectors.

However, sub-investment grade corporate credit is a less familiar asset class than equities or traditional fixed income and is comprised of a number of different, but interconnected markets, including high yield bonds, secured loans, structured credit and distressed debt. Relative value in each of these markets varies as a result of macroeconomic and technical factors, favouring different markets at different times and specialist investment expertise is required to fully exploit the benefits of exposure to this sector.

The sub-investment grade corporate credit market has recently witnessed the launch of a number of "Multi Credit Solutions" which give experienced credit managers, used to dealing in these markets on a daily basis, the flexibility to allocate between the various components of the credit markets and the freedom to adjust that allocation over time.

"In a low return world, corporate credit can provide predictable returns. Investor appetite for assets within this sector varies widely. Some investors prefer to hold the majority of their portfolios in alternative debt assets such as direct loans and structured credit while others prefer a mix of more liquid assets with their alternative holdings. US loans and US high yield assets are currently benefiting from benign market conditions, though we do offer exposure to less liquid instruments to investors seeking potentially higher returns from investing in these assets," adds Alcentra.

BOND VERSUS EQUITIES: BARCLAYS GLOBAL AGGREGATE V MSCI WORLD IN US$, FIVE YEARS TO 31 MAY



Source: Lipper IM As at 31 May 2015.

However, the flip side of this argument is by selecting funds, the costs can be higher due to a double layer of charges, says Flood. In addition there may be overlap with respect to the underlying holdings. Investors may end up with multiple exposures to a single company, not just in its equity either but in its debt. Importantly, the manager of a fund of funds also may not have the same flexibility or responsiveness in extreme market events particularly when there are differing liquidity terms across holdings.

Flood says multi-asset portfolios that do not invest in other collectives can actually have greater flexibility. But what about the argument of expertise? Can a single manager invest in bonds, equities and alternatives on a global basis? Flood says yes, as managers such as he can draw on the resources of other managers and analysts within their teams.

Not only do single managers have the ability to select from a broad universe of assets, they can also choose how they want to take exposure to an individual company. Flood looks at all parts of a capital structure, from conventional bonds to convertibles, equities and preference shares. "Certain capital structures may not get carried along with a rally or market fall, not moving in synch with the main asset," he says.

For example, he cites a position he once had in a UK construction company. Although the company was set to benefit from an uptick in construction, it had a lot of potential losses in its back book of business, Flood explains. The company's equity would be a risky way to gain exposure, due to the low margins and volatile earnings of construction companies. And its debt was less attractive but Flood says the company's preference shares looked mispriced. The company subsequently struggled and announced a cut in its dividend but the income for the preference shares was unscathed and performed well throughout.

Uncorrelated assets

With respect to defining what constitutes multi-asset comes the question of how many different types of assets are needed – can multi-asset or multi-sector consist of just two asset groups? For some, yes. But just because a fund is only invested in two asset groupings, leading to debate over the multi part of the moniker, does not mean the manager isn't taking other steps to diversify returns, as evidenced by those that look across capital structures.

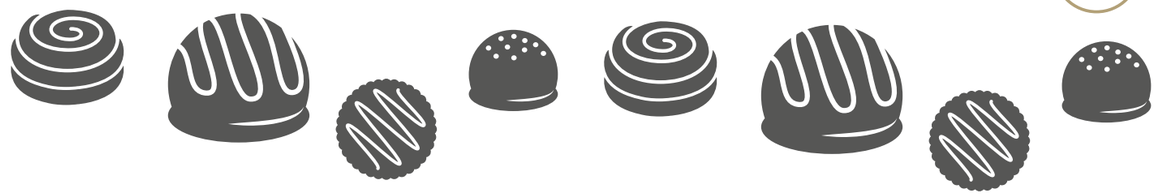
However, for many, the heart of multi-asset is that portfolios are constructed using non-correlated assets, so when one goes down there are others that fare better or rise in value. The problem is, what constitutes non-correlated?

Flood, as with many multi-asset managers, looks at multiple asset classes in constructing a portfolio, namely areas such as renewables, infrastructure and commodities such as gold. Typically asset classes such as infrastructure do not move in unison with say, equities. However, there are times when it can – such as what happened in the autumn of 2008. "At that time everything moved together," Flood says. "However, eventually traditional correlations resumed, you just had to look through the noise. In such periods of heightened correlations all you can do is know the characteristics of the assets in which you are invested. It shouldn't be about a historical model or how an asset class has traditionally performed anyway, it's about understanding what you own and why you own it."

To this end Flood is an advocate of following what you know as opposed to what others may be chasing. Clarity of process helps in this regard as it equips managers with the ability to filter out noise that may otherwise interfere with an investment management style, he says. For him that process is a focus on income-producing assets.

"Our primary objective is to find companies with sustainable business models that can pay and grow their dividends over the longer term, irrespective of the economic backdrop. Doing all this within a single portfolio enables a good understanding of the overall portfolio risk and ensures there are no unintended or secondary risks."

Raman Srivastava, manager of a global, multi-sector fixed income fund at Standish, agrees: "World markets do not move in unison so by having the ability to diversify and seek income-producing opportunities on a global basis means we can effect a smoother income path. Not beholden to any one market for yield, we can seek to take advantage of varying levels of global performance."



Broad exposures

Diversification is not just about the number of investments held in a portfolio. Instead of just ensuring you do not have all your eggs in one basket it also means choosing the right baskets at the right time and not necessarily having an egg in every one, says Flood.

Standish's Srivastava makes the same contention with respect to global exposures. "By going global a manager has a broader set of opportunities, giving them greater flexibility to find what offers the best risk/reward for any given macroeconomic backdrop. Not only are other countries in a different space with respect to monetary policy, so too are they on a technical basis. For example, European corporate bonds have a shorter duration than US corporate bonds, by a few years. The market make-up of different countries also means there may be a broader selection in some market sectors abroad or differing company opportunities."

Diversification, Flood observes, can be of particular help in times of liquidity crunch. It also speaks to the problems some volatility-oriented funds may face.

Flood points out many managers speak of how long it could take to dis-invest an entire portfolio as a way of highlighting its liquidity. However, he feels the question in the multi-asset space should be: how much can be liquidated without changing the risk profile of the fund? "When markets fall and fund outflows occur, managers can end up selling the assets that have held up the best as they are the most liquid; leaving behind a portfolio of stocks with downside momentum."

LIPPER US$ MULTI-ASSET CATEGORIES – NUMBER OF ACTIVE FUNDS MELLON CAPITAL

	31/05/2015	31/05/2010
Mixed Asset US$ Aggressive	262	205
Mixed Asset US$ Bal – Global	239	144
Mixed Asset US$ Bal – US	175	128
Mixed Asset US$ Conservative	171	115
Mixed Asset US$ Flex – Global	146	39
Mixed Asset US$ Flex – US	213	90

Source: Lipper IM. As at 31 May 2015.

Multi-sector

In the fixed income market there is another version of multi-asset taking hold – multi-sector. Alcentra's Simon Perry says single asset/sector fixed income funds can hamper returns. Like Flood's point about capital structure, Perry says different fixed income assets from the same company, can offer different risks and returns. For example, he cites a global media company that issues bonds and loans, rated high-yield, in Europe and in the US. "Each one of these trade at different valuations in each of the markets – even though it is the same borrower with the same credit risk, each instrument delivers different returns."

Also managers looking at a single market in isolation can result in no relative value judgement being taken between individual investments in different markets. This, Perry says, could lead to investment in a borrower or sector in one market that may not be as attractive as an allocation overlooked in a better yielding market.

Still, one big difference between multi-asset and multi-sector is that credit markets are inherently correlated. Perry notes weakness in the high yield bond market is likely to be mirrored by weakness in the loan market. "However, a multi-sector approach aims to optimise credit exposures rather than simply diversify. This is done by taking advantage of relative return opportunities within credit and ensuring the desired exposure to credit is taken in the market and in the instrument that delivers the best return for a given risk."

Like multi-asset, multi-credit approaches also provide the potential to enhance returns due to their more opportunistic stance, he adds. Standish agrees. Srivastava says the varying degree of volatility in global interest rates can lead to pronounced differences in a country's fixed income returns year to year, offering the benefit of diversification, but also the opportunity for adept active managers to benefit from country rotation to increase returns.

> **Certain capital structures may not get carried along with a rally or market fall, not moving in sync with the main asset.**
>
> Paul Flood, Newton

Measure for measure

The sheer range and scope of multi-asset portfolios can present challenges in the measurement and comparison of performance. Given this challenge, what should advisers look for and what questions should they be asking when analysing such portfolios?

Just as there are (apparently) many different ways to skin a cat, there is a multitude of ways to construct a multi-asset portfolio. It is this that makes it so tricky to measure and compare their performance.

Questions to ask your multi-asset manager:

- Has the fund met its objective?
- What are the return expectations and risk profile of the fund?
- What is the maximum drawdown they have experienced?
- What is their investment time horizon?
- Does the manager have a proven track record through different market conditions?
- Is the team stable and who ultimately makes the decisions?
- How do they generate the returns and how much of it comes from a limited number of holdings?

In November 2011 the Investment Association (then the Investment Management Association) concluded a sector review which saw its Managed Sectors become the 'Mixed Investment Sectors'.

According to the industry body, the nomenclature was designed to harmonise with the names of the Association of British Insurers' sectors and to "improve outcomes for users by improving clarity and consistency across both sets of sectors.[1]" But not all multi-asset funds are housed within those sectors and not all are created equal.

Steve Waddington, fund manager in the multi-asset strategy group at Insight Investment, a BNY Mellon company, says the starting point for an investor must always be consideration of what they or their underlying clients are really trying to achieve.

"What is the client's need, what are they looking for and how do you want a manager to run money in order to deliver that objective? These are the questions investors should be asking," he says.

Suzanne Hutchins, portfolio manager in the Newton Real Return team, says if the initial focus is on objective then the second consideration is how an investor wants to achieve it and how they would define their risk appetite?

"In analysing a fund, ask yourself is this fund doing what it says on the tin? This is particularly important in the absolute return space where it should be much less about peer to peer comparisons and comparative benchmarks.

"Additionally, how did the fund manager or the team say it was going to achieve its performance, and did they stick to that?" she asks.

Understanding client needs

As a manager of both absolute and relative return multi-asset funds Waddington thinks understanding the client's expectation of the characteristic of returns is crucial. How dynamic do they want the strategy to be and do they recognise how the manager is handling exposures to various investments?

He adds: "It is important for the manager to be able to convey to investors what

> **What is the client's need, what are they looking for and how do you want a manager to run money in order to deliver that objective? These are the questions investors should be asking.**
>
> Steve Waddington, Insight

they will be doing with their money and what they can expect to see within the portfolio. On top of that, it is not enough to just accept returns blindly, ideally the manager will make it clear to investors what it is that is driving those returns and their expectations for the future return profile of the fund."

As an industry we are constantly reminded past performance is not a guide to future performance and yet there is still a considerable emphasis on it when it comes to fund selection. If it is going to form part of fund analysis Waddington says investors need to assess how a manager makes decisions and how robust their decision-making process is. He says it is also vital to ask if a manager has managed to replicate performance successes throughout the economic cycle and if not, why not?

1 "Harmonising the IMA Managed Sectors and the ABI Mixed Investment Sectors", November 2011, IMA and ABI.

Key characteristics

He points to maximum drawdowns and volatility as particularly important characteristics of the return profile to evaluate. This is because "the most volatile elements within a multi-asset portfolio can dominate the portfolio's risk/return characteristics. So it is reasonable to anticipate asset class exposures will be an important contributor to aggregate portfolio risk and that the most volatile assets (traditionally equities and commodities) are likely to be at the top of that list".

Hutchins agrees it is impossible to divorce risk from the performance equation: "Multi-asset investing is trying to diffuse the amount of risk taken by providing diversified returns and it is such an eclectic group that even ratings agencies have trouble putting categories together. That is why it is important to do your homework and dig beneath the bonnet. With markets distorted the way they are currently it is even more important to question how a strategy has delivered superior returns and the risks a manager may have taken to achieve them. Is it repeatable and does the investor understand it?" she asks.

Additionally, she says, you cannot ignore fees, which are best measured through total expense ratios (TER), according to Hutchins, since "if a strategy uses a fund of funds approach then the additional fees would be built into the TER".

Ultimately there is no easy fix for comparing multi-asset funds like-for-like as it is often akin to comparing apples with pears, but armed with the right set of questions investors can gather the information they need to aid their selection process.

> **If a strategy uses a fund of funds approach then the additional fees would be built into the TER.**
>
> Suzanne Hutchins, Newton

A view from the bridge: fund selector analysis

Commenting on multi-asset, Dan Kemp, chief investment officer for Morningstar's Investment Management group, EMEA, says:

Where multi-asset differs from other investment strategies is that there is no universally agreed benchmark, which means there tends to be a proliferation of them from various different bodies. Despite the array of benchmarks it is pretty universally agreed that if you add more risk into a portfolio then over the long-term it should generate better returns. With this in mind, investors should look out for managers running deliberately aggressive portfolios in the hope of higher returns than the peer group and those taking a higher level of risk to do so.

For me the most important measurement to look for in multi-asset portfolios is not the return but the 'risk-adjusted return'. How much risk is the manager accepting on your client's behalf? The problem comes in that most risk-adjusted return comparisons look at historic volatility, which is a very poor measure of risk. Clients are typically concerned about how much money they could lose in a crash and they get very little information about that from volatility. It is perfectly possible for 'fund A' to have a lower level of historic volatility than 'fund B' but to suffer worse capital loss in the event of a market correction.

So how do you measure performance? I would compare it to the fund's objective rather than to other funds. The problem here is a lot of multi-asset funds have very woolly objectives (perhaps even deliberately woolly) because they would rather be measured against the peer group or an artificial benchmark. Watch out for that and try to find funds with a clear and relevant risk and return objective.

Pay attention to the maximum equity exposure, maximum risk asset exposure and maximum loss estimate. You have to understand how those returns are generated and how the manager thinks about risk. Do they have a genuine investment philosophy or strategy? You ideally want to see a contribution to risk and expected returns from lots of different sources. If all the risk and return is concentrated in one asset class, is it really a multi-asset fund? When looking for a fund with a risk level aligned with that of your client, you can immediately discount all the funds which do not match up regardless of their performance.

VARIANCE OF ASSET CLASS RETURNS

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Non-US stocks 26.96%	Real estate 25.89%	Real estate 15.5%	Gold 23.96%	Non-US stocks 38.59%	Real estate 30.41%	Cmdities 22.54%	Real estate 34.35%	Gold 31.59%	Bonds 19.91%	Cmdities 33.33%	Cmdities 29.96%	Bonds 16.04%	Real estate 20.14%	US stocks 28.93%	Real estate 25.77%
US stocks 20.87%	Bonds 16.66%	Corp Bonds 10.70%	Cmdities 23.04%	Real estate 38.47%	Non-US stocks 20.25%	Gold 17.12%	Non-US stocks 26.34%	Cmdities 20.56%	Gold 3.41%	Non-US stocks 31.78%	Gold 27.74%	Gold 11.65%	Non-US stocks 17.32%	Non-US stocks 18.19%	US stocks 11.73%
US housing 8.24%	Cmdities 11.06%	US housing 7.72%	Bonds 15.21%	US stocks 28.36%	US housing 14.6%	US housing 14.66%	Gold 23.92%	Non-US stocks 11.17%	Cash 1.37%	Gold 27.63%	Real estate 27.58%	Corp Bonds 7.51%	US stocks 15.89%	US housing 11.7%	Bonds 10.32%
Cmdities 7.28%	US housing 9.78%	Bonds 5.5%	US housing 10.63%	Gold 21.74%	Cmdities 11.21%	Non-US stocks 13.54%	US stocks 15.61%	Bonds 10.13%	Inflation -0.02%	Real estate 27.45%	US stocks 14.82%	Real estate 7.28%	Corp Bonds 10.37%	Real estate 7.07%	Corp Bonds 7.34%
Cash 4.64%	Corp Bonds 9.13%	Cash 3.39%	Corp Bonds 10.17%	US housing 10.66%	US stocks 10.74%	Real estate 8.29%	Cmdities 13.51%	US stocks 5.48%	Corp Bonds -6.82%	US stocks 25.94%	Corp Bonds 9.52%	Inflation 3.02%	US housing 7.22%	Inflation 1.51%	US housing 5.04%
Inflation 2.68%	Cash 5.82%	Inflation 1.6%	Real estate 5.22%	Cmdities 8.86%	Corp Bonds 5.41%	US stocks 4.83%	Cash 4.73%	Corp Bonds 4.64%	US housing -18.35%	Corp Bonds 19.76%	Bonds 8.47%	US stocks 2.1%	Gold 5.68%	Cash 0.06%	Gold 2.29%
Gold 1.18%	Inflation 3.44%	Gold 1.41%	Inflation 2.48%	Corp Bonds 8.31%	Gold 4.97%	Inflation 3.34%	Corp Bonds 4.38%	Cash 4.35%	Cmdities -23.75%	Inflation 2.82%	Non-US stocks 7.75%	Cash 0.05%	Bonds 2.89%	Corp Bonds -1.16%	Inflation 1.30%
Corp Bonds -1.89%	Gold -6.26%	US stocks -11.65%	Cash 1.6%	Inflation 2.04%	Bonds 4.51%	Cash 3.15%	Inflation 2.52%	Inflation 4.11%	US stocks -36.55%	Cash 0.15%	Inflation 1.43%	US housing -3.73%	Inflation 1.76%	Bonds -6.6%	Cash 0.03%
Real estate -6.48%	US stocks -9.03%	Cmdities -16.34%	Non-US stocks -15.94%	Cash 1.01%	Inflation 3.34%	Bonds 3.05%	Bonds 1.88%	US housing -8.42%	Real estate -37.34%	US housing -2.45%	Cash 0.14%	Cmdities -10.49%	Cash 0.09%	Cmdities -8.55%	Non-US stocks -1.62%
Bonds -8.32%	Non-US stocks -14.17%	Non-US stocks -21.44%	US stocks -21.97%	Bonds 0.31%	Cash 1.37%	Corp Bonds 1.97%	US housing -0.28%	Real estate -17.83%	Non-US stocks -43.38%	Bonds -10.82%	US housing -3.75%	Non-US stocks -12.14%	Cmdities -1.49%	Gold -24.83%	Cmdities -8.15%

Source: BullionVault.com

Tools of the trade

Multi-asset investing offers a growing range of opportunities across a wide pool of investment styles and sectors. The one thing they may have in common is their overarching aim – to achieve a specified outcome, be it risk- or returns-based, through the combination of a wide range of diversified asset classes.

However, the current low return, low interest rate environment presents a range of challenges and opportunities for investors in multi-asset portfolios. Against this backdrop we asked investment specialists at Newton, Mellon Capital, Standish and Alcentra for their views on the market and the strengths of the various asset classes and the investment opportunities they present.

Paul Flood, lead manager multi-asset income fund, Newton

Paul Hatfield, chief investment officer, Alcentra

Suzanne Hutchins, real return strategy portfolio manager, Newton

Jason Lejonvarn, global investment strategist, Mellon Capital

Raman Srivastava, co-deputy chief investment officer, Standish

> **We believe the market also faces a benign environment in that corporate performance is good. We have seen no recent defaults and, in our view, there are unlikely to be any.**
>
> Paul Hatfield, Alcentra

Which asset class do you favour most in the year ahead and why?

Paul Flood: Indian equities should perform well if we see continued structural reform led by a pro-business national government with Prime Minister Narendra Modi at its head. One significant challenge may come from the fact 2015 is an El Niño year which could result in major climate events including significant droughts leading to high inflation in commodity prices. This might present an issue for India and could potentially result in its reforms taking a back seat. However, in the longer term, the country has favourable population dynamics and a strong government reform agenda.

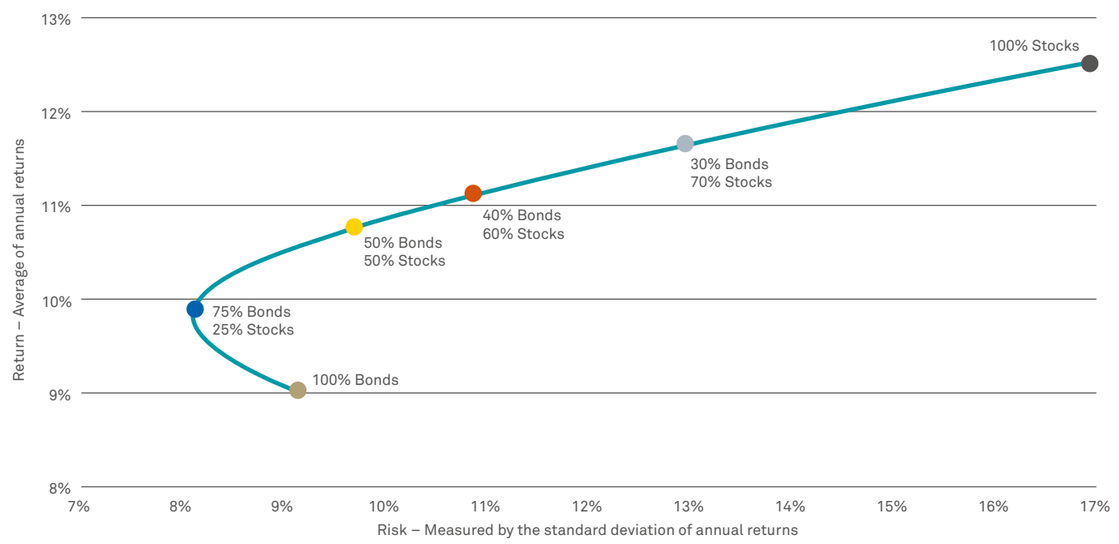
Suzanne Hutchins: A lot can happen over 12 months, especially against such a distorted market backdrop. All things being equal, then decent cash flow generating companies with deep 'moats', strong competitive positions with good capital discipline whose market worth is at a discount to intrinsic value, should fare best against other asset types. In our view, valuations drive returns over the longer term. What investors and the 'herd' believe in the shorter term will drive market action however detached from fundamental reality. We are taking a balanced approach. Our expected returns analysis indicates that most risk assets (including bonds) will yield similarly very low single digit returns from current price levels.

Raman Srivastava: We believe many sectors in fixed income are fair to expensively valued at this stage including many developed government bond markets and parts of higher rated credit markets. That said, we do find value in certain local emerging bond markets in Latin America including Brazil and Mexico as well as high yield corporate credit and segments of the securitised markets. With developed markets, we find the government debt of Australia and parts of the European periphery attractive versus the US or Germany. We favour a moderate long US dollar position versus other developed market currencies.

Jason Lejonvarn: We still think equity markets present strong opportunities. We have lowered our long positions in US equities and we have put more into what we would call core European equities – where we still see some substantial value and opportunities between now and the end of the year.

Paul Hatfield: We favour US high yield at the moment. By today's standards you have a decent level of spread at around about the 430 basis point level. We believe the market also faces a benign environment in that corporate performance is good. We have seen no recent defaults and, in our view, there are unlikely to be any. The yield and spread offered by US high yield investments are also still attractive compared with other offerings. High yield has proved a resilient asset class in certain instances and performed very well in the recent bond blip when German Bunds lost value.

AN EFFICIENT FRONTIER: THE POWER OF DIVERSIFICATION



Source: Young Research & Publishing 2012. Data covers 1977-2011.

Probably cash/cash like investments in the short-term given our view on low expected returns and the current risks inherent in too much duration (bonds) and high corporate earnings expectations.

Suzanne Hutchins, Newton

Which asset class do you think will be most effective in smoothing returns/providing diversification over the next 12 months and why?

Paul Flood: Renewable energy assets – due to their strong cash flow generation, high payout ratios and high government subsidy support. The combination of these three factors means you have very favourable stable cash flows with a high degree of certainty around them. While they do not necessarily offer fantastic annual returns they do deliver solid stable returns and an attractive return compared with prospective government bonds, yet a significant proportion of their cash flows effectively come from the same place. In our view, the robustness of the cash flows, which aren't correlated to the economic backdrop, and the dividends they throw off, will provide strong support to the asset class irrespective of the economic outlook.

Suzanne Hutchins: Probably cash/cash like investments in the short-term given our view on low expected returns and the current risks inherent in too much duration (bonds) and high corporate earnings expectations. A US rate increase from such a low base, however small, will likely unhinge markets and cause volatility in both bond and equity markets. When real rates rise few asset classes can protect capital and provide diversification in the very short term. Apart from cash, the Japanese yen is a good, less correlated diversifier to risk assets and of course actual derivative protection in the form of index options and futures can help preserve capital and smooth returns.

Raman Srivastava: We believe volatility remains at relatively low levels in many interest rate markets which allow for the use of options to help smooth return streams in portfolios that can utilise them. We also feel that a long US dollar position would limit overall volatility if credit spreads or interest rates rise on the back of an initial policy tightening move by the US Federal Reserve later this year. Parts of the securitised markets, particularly Asset-Backed and Commercial Mortgage-Backed Securities offer diversification and lower correlation to equities or corporate credit spreads as well.

Jason Lejonvarn: Our view would be active currency. We run investment categories called 'diversifying strategies' that are basically the same as many absolute return strategies as the aim is to carry only limited market risk. They have no beta and are, for all intents and purposes, market neutral and have an effective correlation of zero to the major equity and bond markets. We currently hold a long/short currency position which has been very effective in the last six months, providing strong returns in markets where both the bond and equity markets were falling. From a currency perspective we are seeing interest rates beginning to normalise, though it is still too early to know when the US Federal Reserve (Fed) will raise rates. But if you look at short-term forward rates across the UK, US, Europe, Japan Australia, we expect to see US and UK rates increasing. That would be good as it could drive a divergence across short term cash rates and more divergence in currency markets.

From a currency perspective we are seeing interest rates beginning to normalise, though it is still too early to know when the US Federal Reserve (Fed) will raise rates.

Jason Lejonvarn, Mellon Capital

Paul Hatfield: We don't expect to see significant defaults in the short to medium term. The yield and spreads offered by US high yield investments are also still attractive compared with other offerings. High yield has actually proved a resilient asset class in times of rising interest rates and performed very well in the recent bond blip. We would probably favour loans in the US because although supply is somewhat constrained by the leveraged lending guidelines, the credit quality of current issuance is very strong. If we do see interest rates go up this year that would also provide a fillip to the market.

special report

Gold plated

Gold has had a bumpy ride over the past few years, but holding a 'real' asset such as gold can act as a useful hedge against unexpected market events.

Suzanne Hutchins, portfolio manager in the Newton Real Return team, says the precious metal has been a historic and important component of the strategy, particularly during times of uncertainty.

The commodity is a good diversifier, she adds, especially in a world where Newton believes there is pressure to debase currencies in order to boost competitiveness.

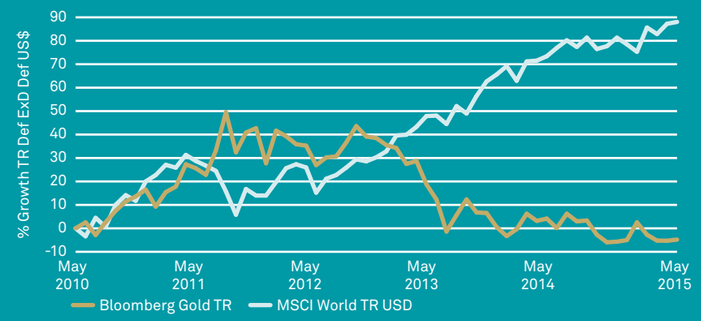
"We find that over time gold retains its purchasing power, while the same cannot be said of fiat money."

Gold does not always come out stellar: since 1975 it has topped UK asset class performance only five times, and has come behind other major asset classes (cash, bonds, equities and residential property) 15 times, according to Bullion Vault, an internet peer-to-peer gold-and-silver-bullion exchange formed in 2005. But it has traditionally performed in an uncorrelated fashion compared with other asset classes, which is why some multi-asset managers find it a valuable element in portfolio construction.

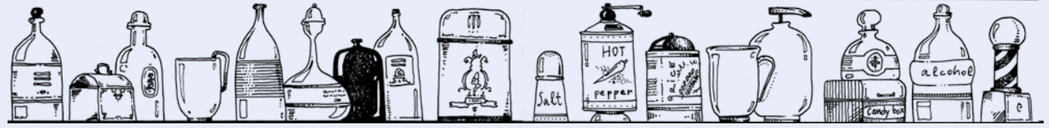
For a strategy with a stated aim of preserving capital and beating a cash benchmark the devaluation of currencies can pose a problem, says Hutchins. "Paper currencies including the yen, renminbi and the euro are being devalued through quantitative easing, or money printing, which means there is not a finite supply. In contrast there is a finite supply of gold, which can be dug out of the ground."

Since it is priced in US dollars, a stronger dollar is said to be negative for gold, while inflation is often considered to be bullish for the metal. This means the current environment is something of a conundrum for gold investors because the US dollar has generally been strong but continued quantitative easing in Japan and Europe could stoke global inflation. Either way, the Real Return team believes it is prudent to hedge and diversify against unpredictable markets by maintaining a small holding through both an exchange-traded commodity, which mirrors the underlying price of gold as well as investing in the gold miners that extract the metal.

PRICE OF GOLD VERSUS MSCI WORLD INDEX OVER FIVE YEARS



Source: Lipper. As at 31 May 2015.



special report

Alternative options

Amid a fragile market environment, with central-bank policymakers enjoying limited choices that are likely to result in uncertain outcomes, the demand for strategies that hedge against large negative returns has increased since the global credit crunch.

Although balanced multi-asset portfolios have become more diversified over time through the addition of new asset classes, the interdependence and correlation of asset classes has increased at times of elevated volatility given the heightened systematic risks and increased globalisation.

Faced with these challenges, investors are looking for new ways of managing and limiting risks that has resulted in an increase in the demand for option-based derivative strategies. Within multi-asset funds, derivatives can essentially be used for three main objectives: managing investment risk with the aim to reduce volatility and to preserve capital, generating yield and expressing an investment view.

Newton Investment Management falls into the first camp, preferring primarily to use derivatives for the purpose of managing risk, according to Aron Pataki, who acts as the risk strategist for Newton's Real Return team. This is rather than using derivatives as instruments with the primary aim of generating returns. Neither are complex derivatives nor exotic strategies deployed. There is always a preference for exchange traded derivatives (if available and liquid enough) to minimise counterparty risk.

In the 2008 financial crisis, some investors experienced problems using derivatives, selling tail protection for premium and in the process incurring large losses. So key to any approach, according to Newton, is to have clear rules and limits in place that define permitted strategies and outline risk management policies to minimise risk. In particular, there are rules for European retail funds that exclude borrowing money to implement any derivative strategies or implementing short strategies with unlimited potential losses.

Volatility impacts

It is worth noting that during a long period of low market volatility before the credit crunch (volatility is a key driver of option prices) Newton could buy simple put options on developed equity market indices for a reasonable insurance cost, says Pataki. In contrast, after the credit crisis, there have been periods of marked equity market volatility and when volatility in general has gone up substantially. This has resulted in the cost of outright put option protection becoming prohibitive, observes Pataki. Offsetting the increase in the cost of protection can be achieved by selling some option premium.

Within the equity space, combined equity index strategies can be implemented that would involve buying a long put providing portfolio insurance and at the same writing some premium, writing a put at a lower strike and a short call at a higher strike, notes Pataki.

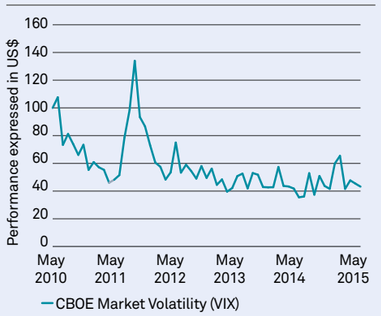
Not a risk management strategy but another possibility is to use covered call overwriting, which can entail writing call options on stocks already held, when implied volatility is high with the aim of generating income from option premiums.

Active currency positions – created through physical assets or synthetically through derivatives – can be used to manage indirectly equity and credit risk. Some currency pairs tend to display high and stable negative correlation with risk assets and end to move in the opposite direction to equities and credit spreads during market stress. Typically, currency options trade at a lower implied volatility level than equity protection and can offer significant cost savings. However, basis risk and correlations need to be considered. The logic, say, behind the short Australian dollar-long US dollar forward is that the Australian dollar is a risk-centred high yielding commodity currency that typically comes under pressure during market sell-offs and amid growing risk aversion. The Australian dollar will weaken, while the US dollar – perceived as a 'safe-haven' currency – typically strengthens.

When implied volatility of government bond futures is low, call options on bond futures can provide a cost effective hedge against deflationary risks as yields tend to fall (and the price of government bonds rise) in a deflationary environment, comments Pataki.

The risk of embedded leverage requires monitoring, says Pataki. Leverage occurs when the economic exposure created by the use of derivatives is greater than the amount invested,

VIX 3-YEARS



Source: Morningstar as of 31 May 2015.

resulting in potential exposure to greater loss than the initial investment. Newton eschews the use of uncovered short derivatives to lever portfolios.

Counterparty risk could result should the entity with which business is conducted becomes insolvent, resulting in financial loss. This risk can be reduced by collateral management. In order to minimise counterparty risk, Newton has a preference for exchange-traded products rather than over-the-counter contracts.

A question of risk

Downside risk management is complex and requires understanding the nature of volatility and the cost involved in hedging against it, says Pataki. Detailed security analysis and effective portfolio construction should be the first step in any risk management process.

While derivatives can be used to reduce risk in multi-asset portfolios, they can also be deployed to express investment ideas or to hedge investment exposure, according to Sonja Uys, portfolio manager at Insight Investment. The combination of traditional assets and derivatives is a powerful tool to help to build a highly diversified portfolio.

A user of multi-asset products could seek to identify whether derivatives are used by the investment manager primarily to express investment ideas or to hedge risk exposure.

Derivatives can also be used to gain asymmetric risk exposure, offering the potential to capture the upside of a market, while seeking to eliminate downside risk, notes Uys.

Using a derivative to express an investment idea could entail expressing a broad market view or seeking to gain beta exposure. For example, this might be achieved by outright long or short exposure to the S&P 500 Index.

Focusing risk exposure on specific factors or alpha exposure is also possible with derivatives. A market neutral strategy can use derivatives to hedge out the market or sector risk within a specific stock, meaning that the performance of the resulting trade is a result of stock-specific factors rather than broader market trends.

Derivative advantage

Derivatives offer the advantage of allowing an investor to gain access to otherwise inaccessible assets. For an investor who wants exposure to the S&P 500, for example, it will typically be too costly, inefficient or simply take too much time to buy or sell all shares in the underlying constituents of the index. A derivative can provide the same exposure through a single instrument.

A US investor might, for example, wish to invest in a euro-denominated bond but seek to avoid exposure to currency risk. The impact of US dollar (US$) versus euro (EUR) exposure can be hedged out by using a US$/EUR forward contract. Another investor could use such a forward to gain exposure to the performance of the US dollar versus the euro.

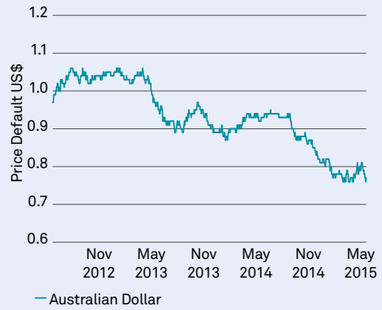
A derivative is a contract between two parties, where the value of the contract is derived from the price of an underlying asset. A derivative therefore introduces counterparty risk to a portfolio, namely, the risk that the counterparty to a derivative contract fails to fulfil their agreement under the terms of the contract.

It behoves the user of a multi-asset product to ask how the portfolio manager deals with counterparty risk and specifically whether derivatives are collateralised daily and the number of counterparties used. The more counterparties, the more likely it is that the portfolio manager will obtain the best pricing for a particular contract.

Derivatives are typically collateralised daily, which can materially reduce the risk that the counterparty does not fulfil their obligations under the derivative contract.

In respect of over-the-counter derivative versus exchange-traded, the former are typically contracts that are tailored for specific exposure; the latter are typically more liquid.

AUSTRALIAN V US DOLLAR



Source: Lipper IM of 31 May 2015.

The maximum leverage that a portfolio manager is allowed to use is a pertinent question for a user of multi-asset products, comments Uys. An investor need only put aside enough capital to cover the collateral requirements under the derivative contract. This means that investors can use derivatives to increase the potential returns of their portfolio but this would typically lead to an equivalent increase in risk.

Asset class diversification may reduce risk but some assets are no longer obvious hedges in an environment distorted by the policies of central banks, observes Pataki. Active flexible multi-asset approaches that combine core protection with hedging tail risks are likely to be the most effective in avoiding significant portfolio losses during severe market stress, while generating stable attractive long-term returns.

Get the balance right

While both passive and active investment strategies can co-exist within multi-asset portfolios, each approach offers potential pros and cons. But how can fund managers and investors best assess the relative merits of each approach?

The passive versus active investment debate has proved one of the most enduring industry talking points of recent decades, intensifying as passive management has grown in popularity with both institutional and retail investors.

Traditionally active managers – particularly those using more sophisticated investment instruments or techniques – have charged more than their passive counterparts. Their fundamental appeal lies in their potential to outperform recognised indices and benchmarks over agreed time periods in order to generate real alpha.

Passive managers offer the more straightforward appeal of tracking indices and this approach can be applied across a range of assets including equities, fixed income and real estate. The passive beta-based approach can also offer lower fees, provide a surprising degree of flexibility and can even help reduce risk when markets are volatile via the use of tactical passive investment positioning.

Multi-asset portfolios can invest in a wide range of instruments – from equities and bonds to alternative investments, private equity, property and infrastructure and even commodities such as gold.

Whichever investment strategy is used within these portfolios, strong performance is the ultimate goal, and robust performance measurement is crucial in monitoring this. According to Mellon Capital global investment strategist Jason Lejonvarn, multi-asset portfolios commonly use simple benchmarks such as a 60% stocks/40% bonds measure – the so-called 60:40 benchmark – to gauge performance.

Commenting on the various use of active and passive investment strategies to outperform such a comparative index he adds: "When weighing up the use of active versus passive investment strategies within multi-asset portfolios investors should carefully consider their potential to deliver performance and outperform the agreed measurement and the levels of cost and complexity they bring to the management of the fund. Each one of these factors is a potential trade-off."

Market transparency

According to Lejonvarn, clear and detailed transparency on performance and costs is critical in establishing which approach should be adopted at any given time and in any specific area of the fund's investment activity, with care taken to consider any potential trade-offs.

"The level of underlying costs is a critical issue for funds – particularly in the current low return, low interest rate environment – where these can erode assets under management – but sometimes apparent headline cost benefits can disguise deeper issues. While passive investing tends to be significantly cheaper than active management, active managers can often outperform in falling markets, which index trackers cannot.

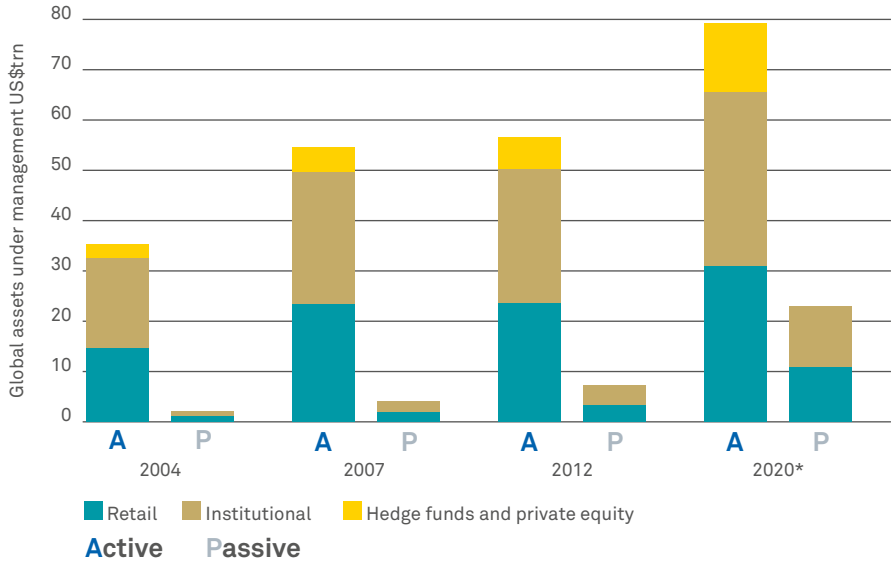
These strategies also offer limited scope for diversification and may not provide the degree of volatility controls and drawdown protection provided by active managers, who often employ stringent stock loss rules and volatility management targets.

"Investors adopting passive management typically give up some performance for lower costs. With this in mind investors should carefully consider their investment needs and options. Obviously if a fund is underperforming and overcharging, over time it should suffer and its viability as an investment will most likely fall into question."

Lejonvarn adds that while investors do need to be cost conscious it can be hard to quantify investment costs and value across every single asset class. "Substantial value per cost can come across a wide range of asset classes but is not always linear. Instead of direct returns certain assets could provide useful diversification or demonstrate other helpful behaviours in financial crisis type situations. The exact definition of value and real costs in such cases can be difficult to quantify," he adds.

Transparency and the complexity of investment strategies are other factors investors should take into account. Commenting on the choices investors face in an active versus passive investment scenario, Lejonvarn adds: "In terms of transparency/simplicity, in general, most passive strategies are very simple and easy to understand. If you are looking at something more active – particularly more sophisticated alternative or hedge fund style investment strategies – then you need to make a judgement call as to whether you are comfortable with the style, method and level of complexity on offer."

ASSETS IN ACTIVE V PASSIVE



Source: The Economist. 03 May 2014.
*Forecast.

Alpha shortage

With genuine market alpha in increasingly short supply, Lejonvarn adds investors should beware of managers who claim to invest actively while effectively shadowing or "hugging" benchmark indices. He believes a number of these managers are proving only pseudo alpha or "schmalpha" at questionable cost, though he adds investors have become increasingly aware of this practice in recent years.

"The market went through a phase where a lot of closet index investors were charging active fees for sub-optimal performance which merely provided pseudo alpha. There are a lot of tricks of the trade that can be employed to achieve this, such as buying into high beta stocks just as the market is rising.

"What has happened since is that a lot of sophisticated investors have got wise to the methods of the industry. Now everybody is using pretty sophisticated attribution tools such as value benchmarks for value managers and active share for closet indexers. Thankfully the industry is becoming more aware of the "schmalpha" generators, though many investors end up switching from these types of managers into direct passive strategies," he adds.

According to Lejonvarn, a growing number of large global investment funds, such as the US public pension system the California Public Employees' Retirement System (CalPERS), are also developing highly refined stewardship principles designed to hone their performance objectives and specifically focus on value for costs. "While this degree of management has not been universally welcomed there is no doubt investment boards are increasingly shedding new light on costs in areas such as passive investment," he adds.

Despite the popularity of passive investment, active strategies can offer significant benefits to multi-asset portfolios – including the ability to outperform market indices and the potential to offer a degree of downside protection in falling markets. Unlike passive investing, active management is not tied exclusively to beta strategies and can generate significant alpha for underlying portfolios. In some more complex alternative investment sectors accurate passive replication may not even be possible, leaving active investment as the only viable option.

While a huge variety of long only and alternative active investment strategies exists, multi-asset portfolios have seen particularly strong growth in the use of absolute return and market neutral strategies over the last decade. From an investor perspective, absolute return funds may potentially offer the prospect of steady, lower risk returns regardless of prevailing market conditions.

Absolute appeal

Commenting on the appeal of absolute return funds, Lejonvarn says: "Within the multi-asset world most of the big funds include some type of absolute return category. If managed effectively, this investment style can offer an important source of return and diversification to funds – particularly in falling markets.

"There will be certain periods where both bonds and equities will go down and you cannot rely on the negative correlation of bonds and equities. At some point they will be correlated positively at others they will both drop down at the same time. When that happens on the passive side you just have to ride the wave. On the active side you can try to smooth out that wave so you can limit losses in that type of situation."

The level of deployment of active management, passive management or blend of both within multi-asset portfolios ultimately depends on the overall objectives of the fund manager and their underlying investors agreeing investment time horizons and desired outcomes.

While both active and passive approaches can offer their own distinct advantages, Lejonvarn says it is critical investors know what they are buying into and study the cost and complexity of the funds they invest in accordingly.

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Jason Lejonvarn, Mellon Capital