Multi-Asset Strategies:
Giving asset owners peace of mind in today’s uncertain investment environment

Facing a world of still-low interest rates, political uncertainty at home and abroad and capital markets that are arguably expensive, institutional investors are looking for strategies that can navigate these choppy waters. That’s where multi-asset strategies come in. In this round table, James Macey, portfolio manager for Franklin Templeton Solutions, Ashwin Alankar, global head of asset allocation and risk management for Janus Capital Group, and Michael J. Kelly, global head of multi-asset for PineBridge Investments, discuss what multi-asset strategies can deliver, what they can’t deliver and how investors can use them to help meet their return objectives.

P&I: How do you define multi-asset investing? How do you compare or contrast it with strategies such as risk parity and global tactical asset allocation (GTAA)?

JAMES MACEY: Multi-asset investing is generating investment returns primarily through asset allocation, across global equity, fixed income, currency, commodities and alternative investment markets. We view global tactical asset allocation as a sophisticated form of multi-asset investing, with a focus on absolute returns vs. a benchmark. Risk parity does not necessarily rely on the same or any strategic asset allocation or tactical asset allocation process that would be leveraged for traditional multi-asset portfolios or GTAA strategies.

ASH ALANKAR: Many individuals define a multi-asset strategy simply as one that holds more than one asset class, akin to traditional ‘balanced’ portfolios. However, a key component of multi-asset investing in today’s marketplace is the ability to be dynamic and nimble.

Because both risk parity and GTAA satisfy those necessary and sufficient conditions, we would categorize them as such — despite the former being focused on providing stable strategic beta returns, while the latter is focused on tactical returns, one could argue. But these are not the only goals of multi-asset investing. We, for example, believe that the focus should be on improving extreme returns, as it is the big losses and gains that can have the greatest impact on investors’ portfolios.

MICHAEL KELLY: We see multi-asset as helping fulfill an investor’s two basic needs — capital preservation and capital appreciation — with two basic types of product sets. So an evolution beyond relative return investing — old-fashioned balanced — toward new-fashioned multi-asset seeking return objectives like inflation plus 5% or plus 3%. Those are objectives, however; multi-asset is not a relative return product.

P&I: Why is now a good time to be discussing multi-asset investment strategies?

ALANKAR: In today’s low-rate environment, the risk premiums of all asset classes fall. Ten-year bonds are
ofering yields lower than 3%, which in turn leads to a low expected return on equities of near 5%, based on the long-term empirical spread between bond yields and equity earnings yield. In such a low-return environment, it’s mathematically impossible to get the 7% to 8% annual return institutional investors expect with a static/strategic portfolio. Hence, multi-asset is particularly important, because the only way you can transform a static portfolio that is yielding well below 7% is by dynamically managing that static portfolio to enhance your return to bring it within that 7% to 8% range.

**MACEY:** Multi-asset investing is more important now than it has been in the past. In recent years, what’s happened with government bonds and U.S. equity performance is that both of those asset classes have done phenomenally well. So the concept of diversification really didn’t apply. Basically, if you had any allocation to U.S. government bonds and U.S. equities, you would’ve generated spectacular returns. But it’s unrealistic to expect the same levels of performance in the future.

**KELLY:** Many investors are expecting beta returns to be substantially lower going forward. A key component of alpha in multi-asset investing is beta selection, or moving between betas. That sort of alpha can be achieved over and above that from security selection. Managers will have to fill the gap between what beta used to deliver and what it needs to deliver going forward.

Many developed government bonds are richly priced and global equity valuations elevated; if the correlation between equities and developed government bonds turns positive over the longer term, utilizing a bespoke multi-asset approach to investing is essential.

— JAMES MACEY, Franklin Templeton Solutions
The political and economic environment in the U.S. is highlighting select U.S. equity sectors as attractive, including financials and small cap companies that should benefit from tax cuts, along with value equities.

— Michael J. Kelly, PineBridge Investments

KELLY: Traditional approaches still follow cap-weighted benchmarks and measure risk on a tracking error basis. Meanwhile, markets increasingly call for a need to look beyond noise and actively manage against downside risk, while delivering total returns regardless of derisking or rerisking markets. Traditional methods of allocation have increasingly come under pressure, and preferences have shifted toward total returns and outcome-based objectives found in multi-asset investing, such as absolute return target or downside protection and lower volatility.

While hedge funds were able to fill the void of total returns in the past, we believe their poor performance, high fees and lack of transparency are bringing an end to the dedicated hedge fund allocation. By using a blend of absolute return and multi-asset products, the new ‘total return’ allocation offers lower effective

P&I: What are the macroeconomic factors or issues today that lend themselves to a multi-asset approach as opposed to a single-asset approach?

ALANKAR: Interest rates are a key factor. When you have a few macroeconomic factors driving all asset classes, as interest rates have been and continue to do, idiosyncratic risk becomes systematized. Beta risk will be less stable when driven by one or two macro factors, like we see today, and will ebb and flow as these factors ebb and flow. These ebb and flows present opportunities to enhance returns and control risk via beta selection or multi-asset investing.

MACEY: When I think about any forward-looking asset class return or any forward-looking performance or volatility numbers, internationally, the first thing that comes to mind is currences. If you’re on the wrong side of the currency, and you’re not hedging out the currency, you can unintentionally destroy any performance that you seek to obtain. And when you think about the performance of certain currencies and you think about even the U.S. dollar, you’re generating equity-like performance from currencies. So currency is definitely something that’s foremost in our minds right now.

KELLY: When markets are transparent and investors are confident in both their and the world’s long-term prospects, single-asset approaches make some sense. But the biggest macroeconomic factor driving markets today is the opposite of clarity; we are seeing tremendous political and economic uncertainty around the world. When investors lose that long-term clarity, they look for managers with a demonstrated ability to select the right mix of assets for that environment.

P&I: What can multi-asset strategies deliver that traditional or hedge fund approaches can’t?

MACEY: Multi-asset strategies aim to achieve their objective with a predetermined annualized volatility range. Absolute return strategies can aim to offer improved predictability because they target a consistent and precise volatility range each year. They target a consistent minimum annual return. Consistency is important to building confidence when setting goals, and may also give investors greater peace of mind during periods of market uncertainty.

Given the broad toolkit and opportunity set available to multi-asset investors, we feel that these strategies have a better chance of achieving their stated objectives more consistently. The freedom and flexibility to allocate broadly and adjust tactically when market conditions call are key to delivering outcomes for clients.
Investors have persistently underestimated the frequency of severe losses in the markets — the actual frequency occurring 72 times more than expected.*

Mitigating material losses and participating in large gains is key to maximizing terminal value. Our adaptive solutions dynamically allocate to account for the changing risks of the marketplace.

Seeking to manage portfolios that more accurately reflect the risks in the real world.

Learn more at janusinstitutional.com

---

ALANKAR: A traditional strategy generally is anchored to a benchmark. And once you’re benchmark-sensitive, it’s very difficult to protect against large losses and to position a portfolio to participate in large gains. A benchmark-sensitive investor essentially ignores beta risk and only focuses on alpha.

A hedge fund approach, on the other hand, one could argue, is not benchmark-sensitive, it’s benchmark-agnostic, and so it isn’t handcuffed. An issue with the hedge fund approach, though, is that hedge funds often take positions in illiquid instruments to earn a liquidity premium. So whereas they are not sensitive to a benchmark, they unfortunately are somewhat handcuffed in their ability to be nimble and flexible.

MACEY: Clients should first look for a multi-asset manager who will collaborate with them to help uncover their real portfolio needs and one who is willing to iterate on the portfolio design until the right solution is found. They also need a multi-asset partner who has competencies across allocation, selection and risk management from specialized teams. Each competency needs to be competitive on its own, but the manager should also excel at connecting these broad competencies into a cohesive multi-asset strategy for clients.

SPONSORED ROUND TABLE

---

* S&P 500® Index returns from 7/1/1960 – 12/31/2015. Based on a normal distribution of returns. Severe loss is defined by a 30% loss in any rolling 65-day period. Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value. Janus is a registered trademark of Janus International Holding LLC. © Janus International Holding LLC. Janus Capital Management LLC serves as investment adviser. S&P 500® is a registered trademark of Standard & Poor’s Financial Services LLC.

WHAT YOU CAN’T SEE.
We like equities in Japan as they deliver higher returns in local currencies compared to their downside risk. We think peripheral Europe offers very good upside. We think the rise of the center-right really does have the potential – just like you saw with Brexit and in the U.S. – to unleash policies that are pro-growth and pro-flexibility, not that the eurozone is going to break up anytime soon.

ALANKAR: We take those reasons to say we think peripheral Europe offers very good upside. We think the rise of the center-right really does have the potential – just like you saw with Brexit and in the U.S. – to unleash policies that are pro-growth and pro-flexibility, not that the eurozone is going to break up anytime soon.

KELLY: We like assets that are undervalued compared with their cash flows over the next five years. We also look for assets whose fundamentals over the next nine to 18 months are highly likely to improve. We believe that we can put together a portfolio of about 12 to 18 asset classes that have both of those characteristics. That is what one might think of as a high-active-share multi-asset portfolio. We don’t want to own everything all the time; we only want to own asset classes that are in their ‘magical moment’ or that have strong value propositions and improving fundamentals.

Currently, the political and economic environment in the U.S. is highlighting select U.S. equity sectors as attractive, including financials and small cap companies that should benefit from tax cuts, along with value equities. We are also focused on equities from regions exhibiting structural growth, such as India and Indonesia. In fixed income, we like Brazilian and Argentine local currency debt.

P&I: How do multi-asset portfolio managers determine which regions, assets and sectors are currently the most promising and the riskiest?

ALANKAR: We don’t focus on expected returns, but instead we focus on what we consider to be the single most important factor of an asset, and that is its tail properties. We look for assets where the potential for tail gains is very high and the potential for tail losses is low and assess that ratio of tail gains to tail losses. This is what we refer to as a tail-based Sharpe ratio, which aims to assess the unexpected.

Based on current ratios, we see equities as the most attractive asset class, as their upside potential relative to their downside risk is very attractive.

Additionally, a theme we see unfolding quite violently is that of ‘the safe becoming the unsafe’ as we are seeing with bonds and low vol/low beta stocks. We see this theme unfolding next within European equities where we see more opportunity to peripheral Europe than we do core Europe, i.e., Germany. We believe this theme will be a key driver of global capital market performance and behaviors throughout 2017.

Real rates are very low and inflation is beginning to normalize, encouraging people to spend, which presents a very fertile ground for growth. As a result, we also expect the Fed to raise rates quicker than most expect. This rate normalization is good for active managers.

MACEY: We think equities are going to outperform other asset classes right now. You have global equities that continue to have tailwinds from central bank policies from the [European Central Bank] and the [Bank of Japan]. Short term, you might have some headwinds for the U.S. and in emerging market countries, given the Fed’s rate hike cycle. But we think that’s going to be a slow and cautious route, which will keep us not too far away from zero interest rates, at least for the time being.

We also think emerging markets are going to generally deliver higher returns in local currencies compared with developed markets over the coming seven-year period. From an equity standpoint, we like Japan as well. We’ve had economic indicators that have been improving due to, again, rising inflation, industrial production, positive economic surprises.

Developed market government bonds have never appeared more expensive. We continue to anticipate low global GDP growth and low inflation relative to the history that we’ve had in the past.

But we are underweight in Europe and in the U.K. On the European side, economic indicators have improved, but you’ve got upcoming elections in Italy, France and Germany. You’ve got the right of the right that basically is manifesting and creeping in there, and that’s definitely presenting geopolitical risks relative to the region.

KELLY: We like assets that are undervalued compared with their cash flows over the next five years. We also look for assets whose fundamentals over the next nine to 18 months are highly likely to improve. We believe that we can put together a portfolio of about 12 to 18 asset classes that have both of those characteristics. That is what one might think of as a high-active-share multi-asset portfolio. We don’t want to own everything all the time; we only want to own asset classes that are in their ‘magical moment’ or that have strong value propositions and improving fundamentals.

Currently, the political and economic environment in the U.S. is highlighting select U.S. equity sectors as attractive, including financials and small cap companies that should benefit from tax cuts, along with value equities. We are also focused on equities from regions exhibiting structural growth, such as India and Indonesia. In fixed income, we like Brazilian and Argentine local currency debt.

P&I: Is there any way to measure the performance impact of a multi-asset strategy in relation to the overall institutional portfolio? Should investors be looking at performance at that level?

KELLY: We’re an advocate of measuring multi-asset managers vs. objectives.

These are not benchmarked, relative return products, and they shouldn’t be. They should be objective-based products that are measured against those objectives. Some examples of objectives include CPI plus 3% every year, or plus 4% every three years, or CPI plus 5% over every five years.

MACEY: Benchmarks for multi-asset portfolios are often ambiguous and not uniform, so it’s hard to compare managers to one another. It’s important to first evaluate the multi-asset portfolio against the client’s risk and return objectives, and then determine whether the portfolio delivered within those risk and return expectations.

The second step is following an absolute review. Investors should measure the performance vs. the fund or strategy’s official benchmarks to evaluate the value add that the selection and asset allocation contributed above the benchmark return, sort of a
performance attribution. The third step is evaluating against other multi-asset portfolios with similar objectives to give you a sense of how the investment stacks up against other options.

**ALANKAR:** I would add that we think about the benefits of the multi-asset portfolio more in terms of improving that compound return and getting investors closer to meeting their objectives.

We like to look at measures such as your realized return over your maximum drawdown, or over your realized tail loss, because drawdown risk is what investors ultimately care about. The hope is that one’s multi-asset investments improve this ratio. We like to tell clients that it’s important to also understand the paths that could have unfolded, not just the one that did. We look at the potential distribution of outcomes that could have happened and how your multi-asset methodology and process could help skew those outcomes more to the benefit of the portfolio to generate higher compound returns. The benefit that is most important is reducing the overall plan’s left tails, yet proportionally retaining more of the right tails, thereby enhancing skew.

**P&I What do you see as the next evolution of multi-asset investing?**

**MACEY:** We’re going to focus on outcome-oriented objectives, instead of the typical focus on risk and return. I think you’re probably going to see a rise in the use of risk premia and alternative derivatives-based investment strategies, and income generation from different sources. For example, covered call writing. Investors want to have conservative ways to generate income without exposing them to unnecessary risks.

**ALANKAR:** I think the next evolution of multi-asset investing is providing a complete tail risk resolution that not only pays attention to the left tail, but also pays attention to the right tail. Right tail risk, and failure to participate in that right tail gain, became a much greater concern to the investing community in 2013 when global equities were up 40%. However, many plan sponsors don’t have fond memories of 2013 because they were underinvested. Hence, they failed to participate in that right tail. We need to acknowledge this failure to participate as a source of risk just as we view suffering a large loss as a source of risk.

**KELLY:** I think the total return allocation can grow from what used to be — 10% of many institutional investors’ portfolios — to maybe even double that with lower fees, greater transparency and greater liquidity. Also, I think many investors will start to view multi-asset as a talent pool from which to draw new ideas.