For Investment Professionals only

Four reasons why asset allocators will need to be more dynamic

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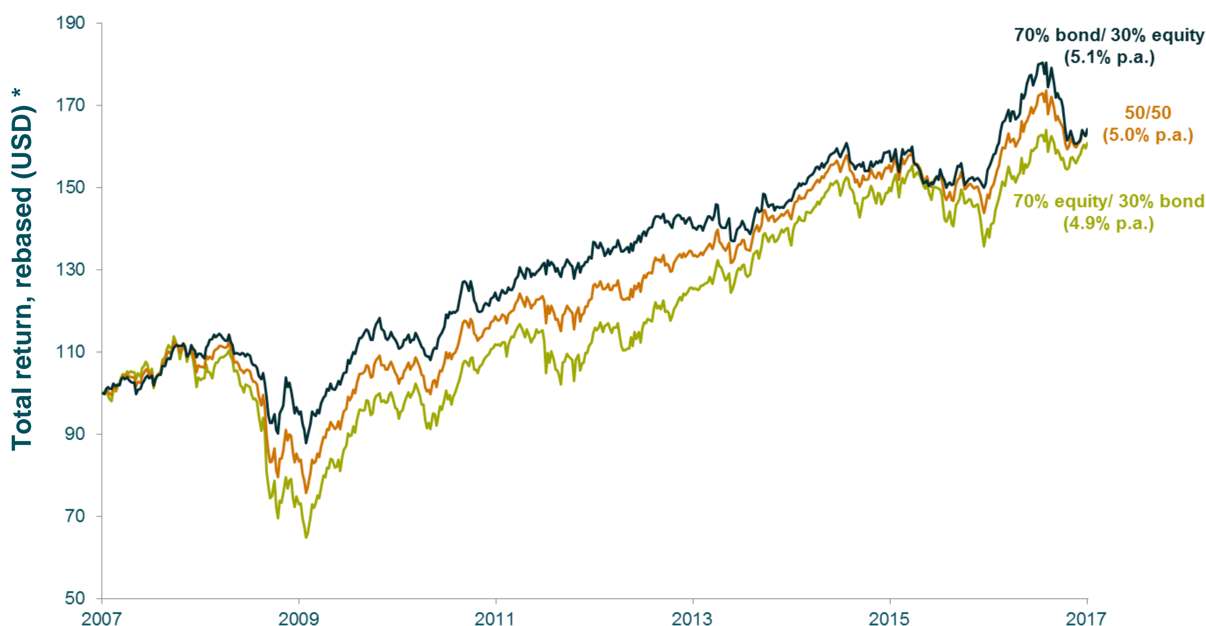
The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is included, please note that this is not a guide to future performance.

- For much of the last ten years, multi-asset approaches have been able to deliver strong "equity-like" returns with low volatility through static allocations to traditional safe havens.
- However, macroeconomic and market developments in 2016 indicate that the investment environment is changing and investors may need to adapt to achieve similar outcomes for clients.
- In our view, the period ahead will present opportunities but only for investors willing to adopt a highly flexible, dynamic approach to asset allocation.
- We identify four reasons why investors will need to allocate more actively going forward.

Since the 2008 financial crisis, widespread intolerance of volatility has intensified a multi-decade decline in government bond yields that have driven performance more commonly associated with risk assets. Structural decline in interest rates and inflation since the 1970s and, latterly, heightened risk aversion has meant that passive, low volatility strategies have been very successful.

Ten-year global equity and bond performance



Source: Datastream, 8 February 2017. *Rebased as at 7 February 2007. MSCI AC World and Citigroup World Govt. Bond Index (10Y+), US Dollar terms

Over the past decade: almost any mix of equity and bonds has delivered reasonable returns with reduced volatility

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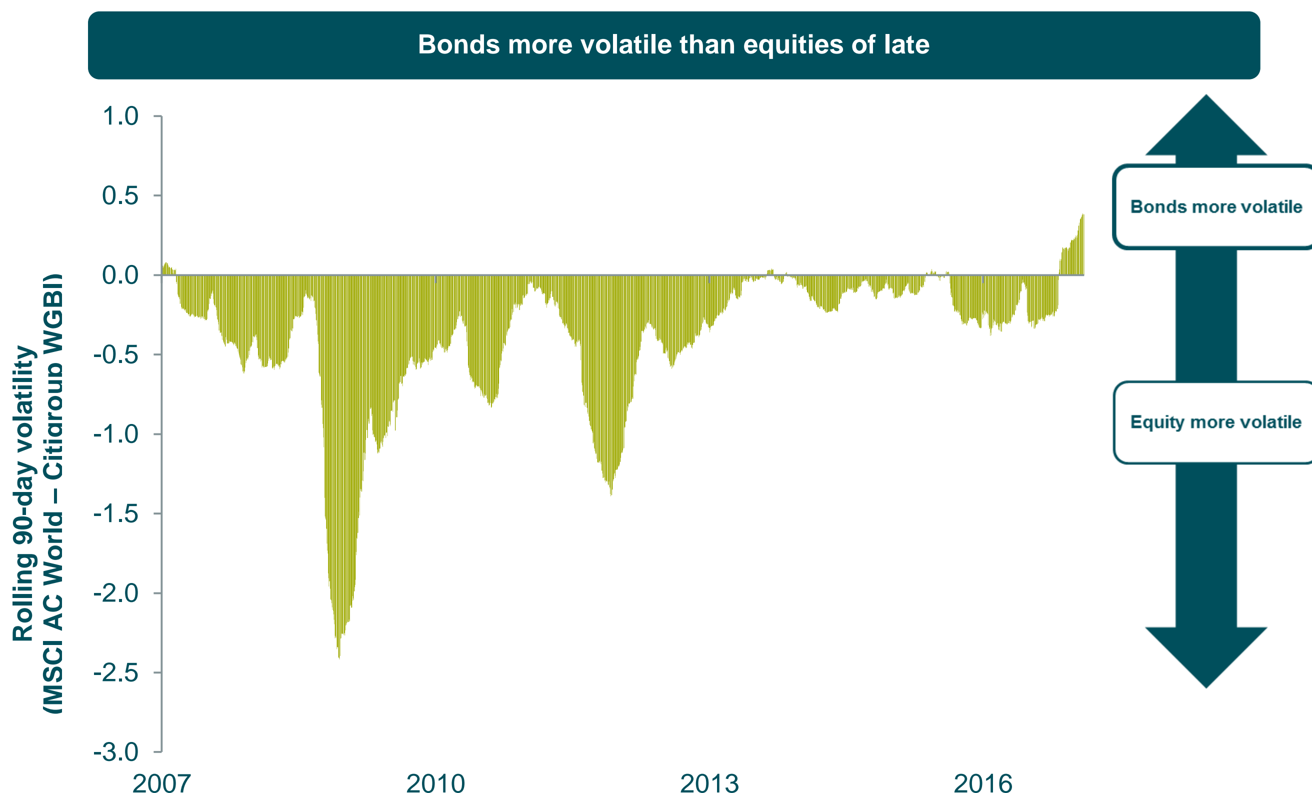
However, a number of market and macroeconomic developments seen in the latter half of 2016 suggest that we are at a tipping point, a pivotal moment for investors in terms of the market treatment of risk, and the macro and policy making regime. If this is the case, the period ahead is likely to require a more active approach to generate the kinds of returns that institutions will require. We maintain that there are four clear reasons why investors will need to take a more active, valuation-based approach to investing.

1. Volatility and correlation patterns could be changing

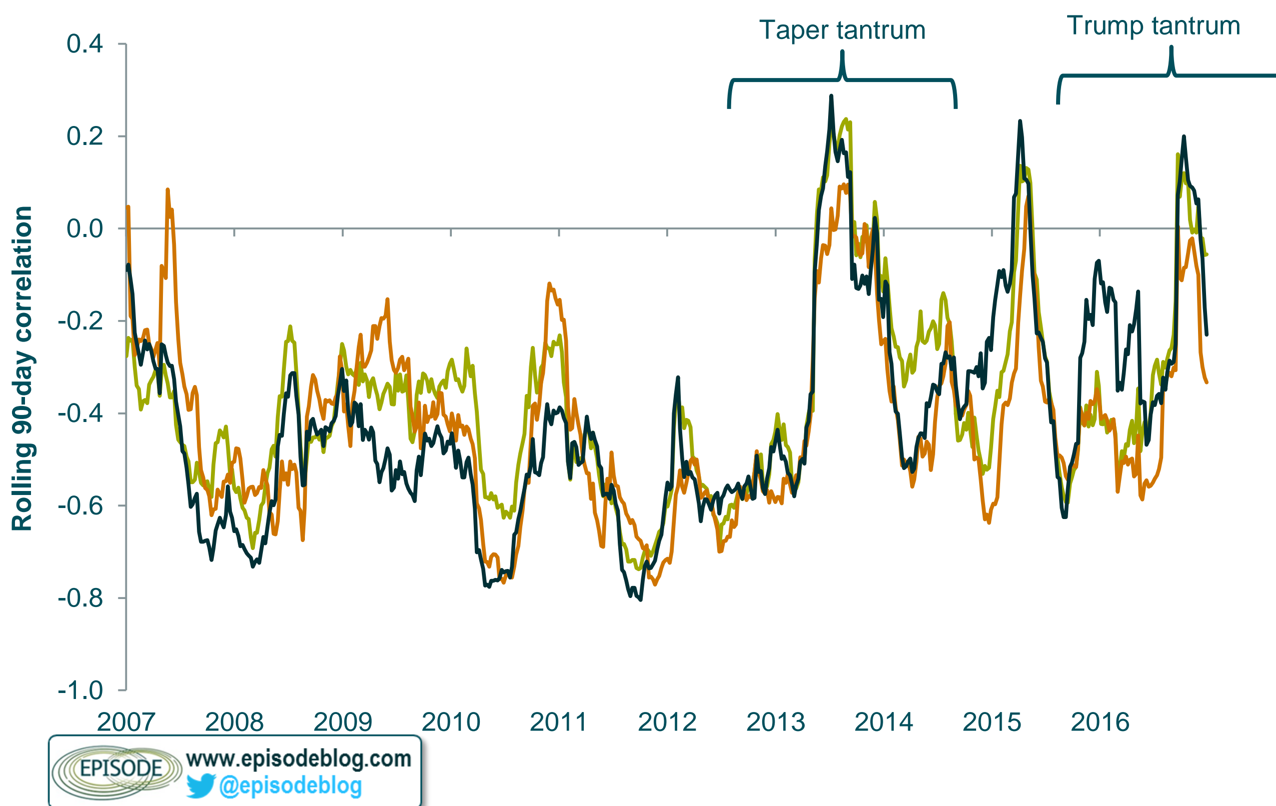
A static mix of equity and bond allocation has been conducive for risk management because bonds have been less volatile and government bonds and equities have tended to be negatively correlated. However, as the charts below illustrate, this dynamic did not hold in 2016.



Source: Datastream, 8 February 2017. MSCI AC World volatility – Citigroup World Government bond (10Y+) volatility

It is also the case that correlation patterns can, and do, change over shorter periods. The taper tantrum in 2013 provided a dry run of how bonds and equities can easily become positively correlated. Rising rates or increasing inflation pressures in the absence of profits growth can pressure both equities and bonds.

Correlation patterns less helpful



Source: Datastream, 8 February 2017. Rolling 90-day correlation between equity and ten-year government bonds

Recent positive correlation patterns have been less helpful to traditional allocations

2. Bond valuations are in uncharted waters

It is true that interest rates and bond yields may have been at similar levels in the distant past (particularly in real terms). But the fact is that in the modern history of finance and in the histories used by most models on which strategic / passive asset allocations are based, yields have never been so low.

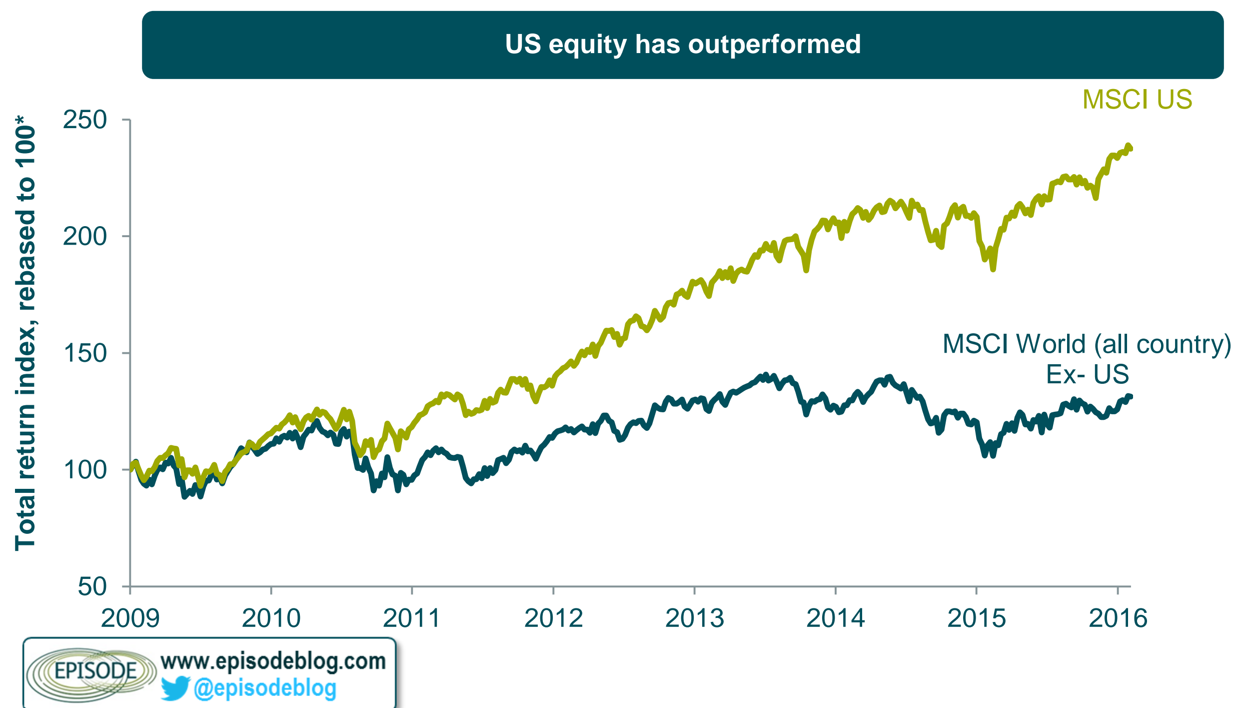
This in itself does not imply significant losses from government bonds in the period ahead; the same argument could have been for much of the last three years. However, it is the case that strong capital gains from bonds will be “borrowing” returns from the future and lower yields increase the vulnerability to changes in the regime.

The past could well be even less relevant as a guide to the future than normal and this will challenge simplistic rules of thumb, such as the idea that risk averse investors should hold more government bonds, or that a portfolio can be “de-risked” by holding less equity.

3. Equity valuation could become a tailwind rather than a headwind?

Since the financial crisis, the US stock market has outperformed most of the rest of the world. It has benefited in the most part from superior earnings delivery and partly through greater weighting of stocks with “bond proxy” characteristics.

Since the US represents 60% of the MSCI World, this means that it has been harder to beat the MSCI World through country selection, without having a significant proportion of a fund’s overall assets in US equities.

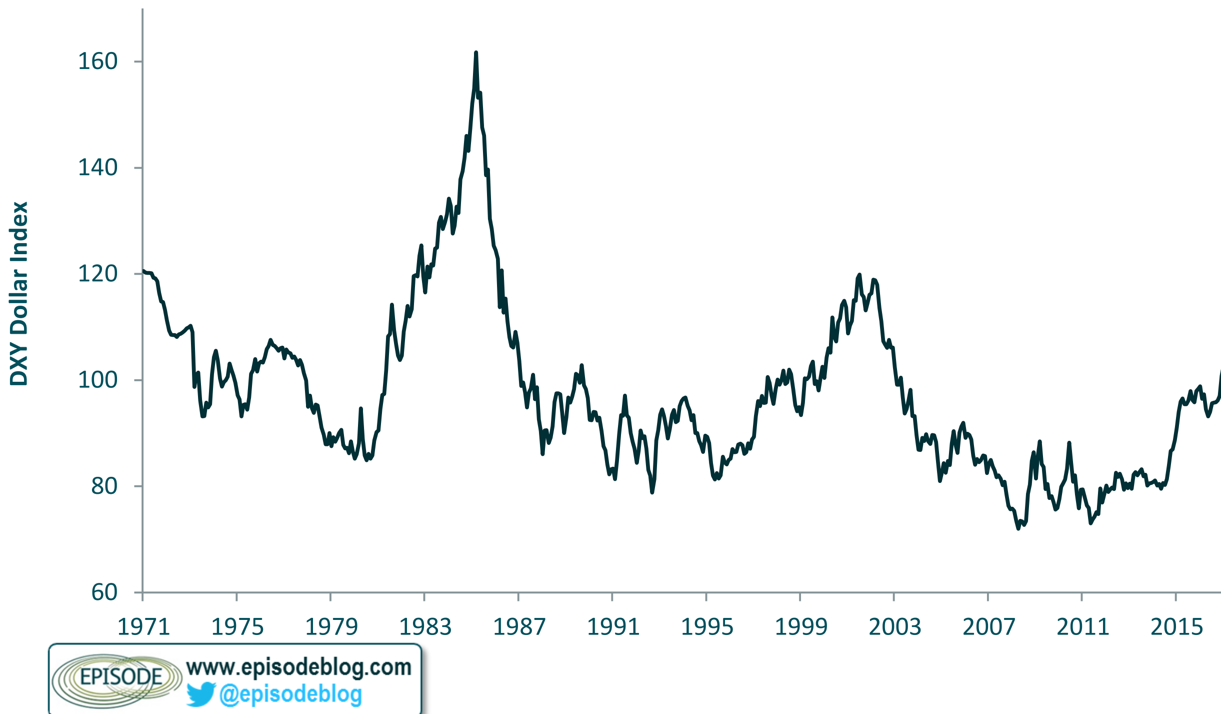


Source: Datastream, 2 February 2017. *Rebased as at 31 December 2009. MSCI US and MSCI AC World ex-US, total returns, rebased

Our view today is that the US market is fairly valued rather than expensive, but there are areas of the market that have been re-rated simply because earnings have been stable, rather than growing. Avoiding these areas should the regime shift, will require a more targeted, high conviction approach.

4. Divergent policy could prompt even larger currency shifts

Since 2014, there have been meaningful shifts in the currencies of major economies. This comes after a period of relative stability, in which the world’s central banks have shared a common, inflation-targeting policy approach.



Source: Datastream, 4 February 2017. US Dollar Index

Brexit illustrated the surprising return and correlation dynamics that large currency moves can cause. Moreover, big shifts in currencies such as those seen in the second half of the twentieth century do not only impact the returns to overseas investors directly through translation effects. They also influence a country's inflation dynamics, policy responses and the earnings of multi-national companies. Understanding the interplay of these forces could well be vital and require a more active approach to currency management than has been required since the financial crisis.

Looking ahead

The central issue in the period ahead is whether the moves we saw in the second half of the year develop into a more sustained shift in the investment environment. In the first half of 2016, bond yields reached new lows as volatility increased, correlation patterns shifted, and the monetary policy-making consensus became challenged. In the second, the mood improved considerably and asset prices broadly recovered.

It has been convenient to explain these moves entirely as a "Trump effect." However we believe that this would be over simplistic, ignoring the fact that moves began prior to the election and were in no small part an unwinding of price moves earlier in the year. The observable improvement in global macro data and an apparent shift in the policy-making consensus (from monetary to fiscal) also seem to be significant influences, and could prove to be persistent.

Should this be the case, the ability of static allocations to achieve the sort of outcomes required by investors will be under threat and a far more active and flexible approach will be required. We believe that value investors willing to actively express high conviction views could prevail over those that hold fast to simplistic assumptions about the risk / return profile of "risk assets" and continue to rely on historic models of correlation.

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