

An alternative approach to multi-asset investing

June 2010

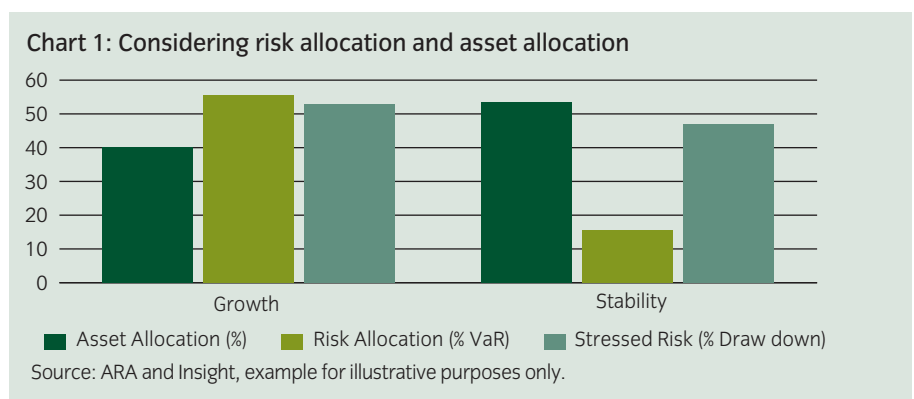


Multi-asset investing has traditionally been viewed as a means of spreading risk in a portfolio, based on the premise that periods of poor performance in some asset classes would be offset by stronger performance in others, meaning that returns should generally follow a smoother trajectory than with single-asset funds. Yet while multi-asset funds did still outperform most equity funds in 2008, the theory was severely tested, as everything apart from government bonds and cash fell dramatically in the second half of the year.

The time when investors most needed the benefits of diversification was exactly the same time that correlations rose and much of the benefit from spreading a portfolio across asset classes was lost. Chart 1 shows that while historical measures imply that the value at risk (VaR) of 'stability' assets such as corporate bonds is lower than 'growth' assets such as equities, the actual drawdown can be very similar under stressed conditions. With this backdrop in mind, we at Insight believe that risk allocation and asset allocation should not be viewed in the same vein. This article looks at Insight's approach to multi-asset investing and how it aims to preserve capital even in times of severe financial and economic stress.

Idea generation

A multi-asset portfolio that is well-diversified both in terms of asset allocation and risk begins with thorough and continuous idea generation: deciding what ideas to include before going on to select our optimum way of implementing them. For us, that means identifying asset class opportunities,



long-term themes across asset classes and geographies, and total return strategies. Asset class opportunities should be chosen on the basis of current valuations in a long-run context and weightings should be appropriate for the economic climate. Within long-term themes we particularly look for those which stand to benefit from both positive demographic and also structural global change, and therefore have the potential to offer significant long-run returns. The former, for example, has led us to seek opportunities in healthcare and agriculture, which should benefit over time from the growing basic needs of expanding emerging market

populations. In the field of global change, we currently favour exposure to Asia and green energy, which stand to gain from the shift in economic leadership from the West to the East and the move towards more renewable energy sources respectively. The benefits of making good use of total return strategies also deserve a mention in light of current market conditions. When selected and deployed successfully, not only do they have the potential to provide a positive source of return in all market environments, but they also can exhibit very low correlations with other strategies, which helps maintain diversification even in stressed economic conditions.

Focused implementation

Once an idea is identified, multi-asset investors typically have a range of implementation methods at their disposal, such as best-in-class managed or passive vehicles or direct investment to capture the specific strategy, asset class or thematic opportunity. Whilst active vehicles clearly offer the potential for outperformance, it should be remembered that there is a cost in investing in them and therefore they should only be invested in when one is confident of outperformance. For example, if within a specific theme there are large discrepancies in valuation between specific stocks or sectors, then it would probably be worth paying for an active manager who can position their fund to profit from the mispricing. If this is not the case, however, then a cost-efficient passive fund would probably be the best way to provide exposure to the idea. In many cases, we might look to isolate the expected alpha when implementing ideas. This requires the use of derivatives to remove unwanted market or other factor risks from the selected vehicle to focus our exposure more closely. A recent example of this has been buying an actively managed European fund but selling short an equal amount of the broader market through futures, meaning that we still have exposure to any outperformance from the active

manager without taking on overall equity market risk. Chart 2 below clearly shows how this position has gained as the European manager has continued to outperform his benchmark.

Structuring market exposure

When taking market exposure in multi-asset investing, we favour a structured approach using simple, liquid derivative overlay strategies to achieve an asymmetric pay-off profile from market direction. In practice, this means fixing exposure such that the investment participates in any upside from the asset class, but that any losses from market falls are limited. This can be especially effective in markets which tend to move rapidly on the way down but more steadily on the way up. The current situation in the UK equity market provides an ideal example of where this approach can be used to smooth returns in multi-asset investing. The FTSE 100 is currently only around 1200 points away from all-time highs, but is some 2200 points higher than the recent low. A structure which reduces sensitivity to the downside risk, but provides full exposure to any gains above the highs looks appropriate, meaning investors gain some insulation from a market crash in the event of a double-dip recession but participate

fully in gains should markets enter a secular bull phase.

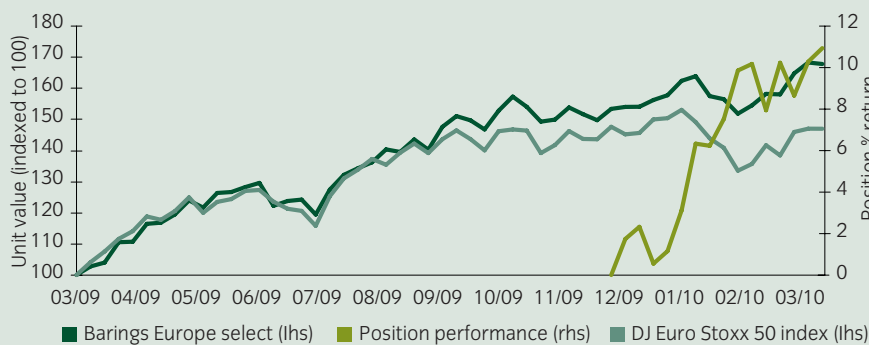
Sophisticated position scaling

As multi-asset investing is designed to provide clients with a smooth returns path, it seems prudent that investors should look for funds which have a degree of protection against times of distress in financial markets. Given that correlations across asset classes are liable to increase at exactly these times, multi-asset funds should not rely on asset class diversification alone to protect returns. Positions should also not be only scaled according to VaR calculations. Although a valuable guide in normal market conditions, VaR calculations tend to underestimate potential losses when severe economic and financial events occur, looking only to historical observations to see how far investments can fall. Managers should look to scale fund positions according to absolute weightings and maximum potential drawdown, as well as liquidity expectations at times of stress.

'Stop think' in portfolio positioning

A manager with a traditional approach to diversified investing may be happy to see certain investments in some asset classes underperform as long as investments in other asset classes are performing well to offset the losses. A manager like Insight, however, with a process which focuses on limiting downside on every position, aims to have a much higher degree of downside protection embedded into portfolios. We therefore may be better placed to deliver smoother returns even if conditions of financial stress return and asset class correlations increase. Embedding some downside protection by using a strong risk monitoring process, which necessitates

Chart 2: Profiting from position outperformance



Source: Insight.

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a thorough review of any position that hits a pre-determined tolerated loss level, seems appropriate for today's multi-asset investors. Furthermore, there is merit in loss levels being revised upwards only on a daily basis to allow strong investments to run, but make sure that any change in performance is quickly highlighted and can be acted upon. Chart 3 gives a recent example of how we have used this process to good effect, with our position reviewed as its performance falls below the red 'stop think' level. As mentioned earlier, a structured approach to market exposure, the removal of market risk from key themes and careful position scaling also help to control risk in a portfolio.

Pooling specialist investment resources

Since many multi-asset teams are relatively small in terms of numbers, having a strong team of specialists as a resource to draw upon can give multi-asset fund managers a crucial edge in what is becoming an increasingly attractive sector. While clearly it is imperative that a multi-asset fund manager has an in-depth and broad investment knowledge base, it is also important to have regular interaction with specialist equity and credit fund managers, as well as strategy specialists. Strategy professionals may for example be used to give a macroeconomic view and as a sounding board to check that

Chart 3: Using 'stop think' levels to monitor portfolio positions



Source: Insight.

the overall investment allocation is appropriate for the current economic climate. Here at Insight, we have broad range of in-house specialists, including a pool of fixed-income analysts and managers, as well as equity, derivatives and strategy specialists.

Investing across a range of strategies, themes and asset classes can indeed offer clients a consistent way of generating strong returns in all market environments, but only if consideration is given to how downside will be managed in times of financial and economic stress. It is ideal to have strong idea generation and to capture these investment opportunities; but it is also crucial to have some downside protection embedded into the portfolio, which means that all positions need to be robustly monitored and highly liquid, so they can be exited quickly, regardless of market conditions.

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