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First State Investments
Colonial First State
Global Asset Management

Investing in a low growth environment.

The Investment Report.

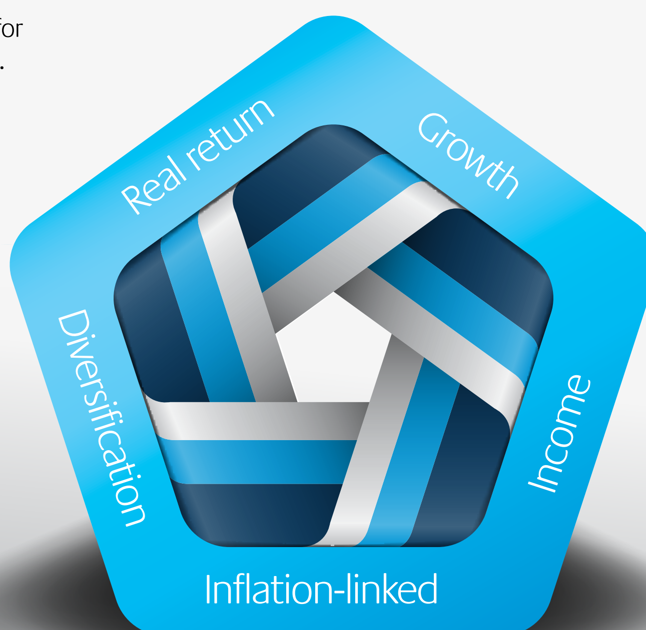
Multi-Asset Solutions

Getting real about returns

We are in an economic climate of sub-trend growth, modest inflation and low-to-negative interest rates. In this environment, traditional low-risk investments – such as government bonds and term deposits – may no longer provide sufficient income nor capital growth to adequately protect against inflation. Moving up the risk spectrum into equities, the strong demand for high-yielding, high-quality stocks has created unattractive (at best) valuations in many segments of the global equity market.

In this environment, objective-based multi-asset strategies have a distinct advantage over a 'set and forget' approach. Objective-based strategies ensure investment decisions are made with the ultimate goal of consistently delivering a particular return, while minimising the chance of failing to meet objectives. While returns can never be certain when taking investment risk, we seek to balance the trade-off between upside potential and downside risk, which we believe can generate consistent results.

As a manager of 'real' return funds, we focus on consistently delivering a particular return outcome and preserving purchasing power. Beating a benchmark index means little for investors if the markets fail to deliver returns above inflation.



Alpha beta building blocks

To achieve our investment objectives, we have two building blocks available to us to; Neutral Asset Allocation (NAA), and Dynamic Asset Allocation (DAA).

NAA sets longer-term asset allocations and provides *beta*. The process of determining NAA incorporates the return objectives, constraints, time horizon, economic climate, prevailing market conditions, valuations of financial assets, and political and market risks. This process occurs formally on a semi-annual basis, although specific events with potential longer-term implications, such as the Brexit referendum, can invoke an off-cycle review.

DAA, meanwhile, allows us to exploit short-term opportunities in markets and provides *alpha*. Our DAA process takes into account shorter-term market dynamics to help deliver additional returns and abate portfolio risks. This part of our investment process, which includes our investment signals and qualitative overlay, is formally reviewed each week and considers market events and fundamental data to take advantage of possible dislocations.

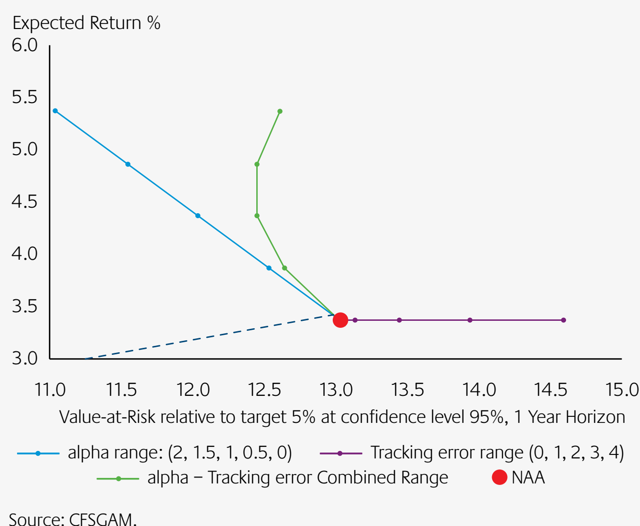
Getting the right mix

It is becoming increasingly evident that relying solely on market returns (beta) may not be sufficient to meet real return objectives. By adding an uncorrelated return source (alpha) we can improve the portfolio's likelihood of meeting its investment objective. This is where we adopt our DAA process to take into account shorter-term market dynamics to help deliver additional returns and abate portfolio risks.

The combination of NAA and DAA requires the careful consideration of existing allocations to avoid unwanted additional risk. We consider a variety of risk metrics including tracking error along with the expected return, when assessing the portfolio's ability to meet its investment objective.

The ability to add scalable alpha to portfolios via DAA provides flexibility to deliver on the investment objective, even in a lower return environment. Chart 1 illustrates the impact that both tracking error and alpha can have on the risk and return characteristics of the portfolios on the efficient frontier.

Chart 1: Combining DAA (alpha) with NAA (beta)



Source: CFSGAM.

Adding uncorrelated alpha without any tracking error – represented by the blue line – to any portfolio increases the expected return and reduces the 'Value at Risk'. Conversely, adding tracking error without any alpha – represented by the purple line – has no impact on the expected return but only increases the 'Value at Risk' for the portfolio. Of more interest is the combination of adding alpha and tracking error, which is represented by the green line.

Putting it in to practice

Earlier this year (and again after Brexit) we reviewed the NAA for our objective-based strategies. We considered our positioning against an economic backdrop of divergent central bank policy, negative interest rates, lower commodity prices and low inflation, coupled with weakness in China's growth trajectory. Against this background we have a US equity market at all-time highs and global bond valuations at historically high levels. Needless to say it was an interesting time to be reviewing our asset allocations.

The net result of this review? On a forward-looking basis, we expect lower returns across all asset classes. Consequently we increased allocations to both domestic and global equities amid marginally-lower return expectations.

We factored in a normalisation of interest rates over the long-term. However, the pace at which this occurs is expected to remain slow, and with an equilibrium rate at levels lower than historical yields.

Despite the slower pace towards higher rates, we maintained the bias to minimise duration exposures, with the following distinctions:

- No allocation to global bonds. This is perhaps not surprising given the lower level of yield on offer from developed markets bonds and the increasing asymmetric risk of rising yields, particularly over the five year investment horizon.
- While there is no allocation to global bonds as part of NAA, we can still allocate to these securities from time-to-time via DAA.

We increased allocation to high yield corporate bonds in the US and Europe. This allocation was introduced to the portfolio at the last semi-annual review and has performed well. This allocation implies that we are moving along the risk spectrum within fixed income assets. However, at this point in the cycle, we see high yield corporate bonds as a lower-risk alternative to equities, while delivering a higher return profile.

The allocation to local currency emerging market debt, was also maintained. They offer higher yields than developed market bonds and provide diversification to the overall currency exposure.

It is important to remember, however, that actual portfolios will reflect both our NAA and DAA views. In our funds, the NAA provides the fundamental framework, off which we hang our DAA tilts, both at a cross-asset level and within each asset class.

We have the flexibility to increase the DAA tracking error risk budget (alpha) to ensure we maximise the likelihood of meeting investment objectives. Adding any uncorrelated alpha to the portfolio increases the expected return and reduces risk. The flexibility to adjust the DAA risk budget can be particularly advantageous in today's low growth environment.

Furthermore, there is scope for us to add protection strategies, should we deem the overall risk setting of the portfolio too high for the returns available, or simply to protect the portfolio from a specific event risk, such as the upcoming US Presidential election.

While these are indeed challenging times, even in a lower return environment we still have confidence that our investment process will deliver on our client's real return investment objectives, through the dynamic blending of our alpha and beta strategies.

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