Three Concerns Facing Asset Allocation Committees

A number of long-standing assumptions no longer hold true.

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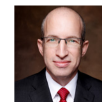
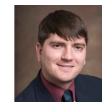


Yoram Lustig
Head of Multi-Asset Solutions, EMEA



Andrew Armstrong
Solutions Strategist, Multi-Asset Solutions

KEY INSIGHTS

- The lack of consensus on when the next economic slowdown will arrive poses a challenge for asset allocation committees.
- Further complicating their task is the fact that a number of long-standing assumptions about asset allocation are proving to be less reliable than in the past.
- Asset allocators seeking to position their portfolios for a potential downturn may benefit from adopting a different approach based on active country and sector allocation and duration management.

The prevailing view is that the global economy is in the late stage of its economic cycle and a recession might be on its way. However, there is no consensus on when the slowdown will arrive. This presents a challenge for asset allocation committees, which are faced with the unenviable task of positioning their portfolios for an eventual downturn while simultaneously ensuring they do not completely miss out on any market gains that occur in the meantime.

Further complicating their task is the fact that several long-standing assumptions about asset allocation are proving to be less reliable than in the past. Old habits die hard, and it can be tempting to fall back on tried-and-trusted methods when faced with difficult challenges. However, in order to effectively position their portfolios for the period ahead, it may be time for investors to reconsider some of their core beliefs about asset allocation. Below, we identify three key current concerns with traditional approaches to asset allocation.

1. Average Correlations Are Not Very Informative

It is common for asset allocators to have used historic average correlation figures when seeking to predict how different elements of their portfolio will perform in relation to each other. However, the evidence suggests that correlations change substantially in the left and right "tails" of performance distribution—i.e., when equity markets are performing either very well or very poorly. Generally speaking, the rule of thumb seems to be that when it would be useful for correlations to be positive (i.e., when equities are performing very well), they are often negative, and when it would be useful for the correlation to be negative (i.e., when equities are performing very poorly), it is often positive.

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...a better approach may be to gain a deeper understanding of how correlations shift over time and adjust portfolios accordingly.

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The Advantage of In-House Research

One of the advantages of working at a company like T. Rowe Price is that we can draw on the excellent research being conducted within the company. For this article, for example, we were influenced by the work of our colleague Sébastien Page, head of Multi-Asset and chair of the Asset Allocation Committee. His 2018 paper *When Diversification Fails* delves into the vexing problem of how diversification seems to disappear just when investors need it the most. One of Sébastien's main arguments—that many investors still do not fully appreciate the impact of extreme correlations on portfolio efficiency—helped to shape our thinking in this article.

To be more precise, it seems that the key determinant of whether correlations are positive or negative at any given period is whether the *dominant influence* on the market at that time is the economic cycle or monetary policy. When the economic cycle is the dominant factor on markets, the relationship tends to be negative: heading into a recession, equity prices tend to fall while bond prices rise; heading out of a recession, equity prices tend to rise while bond prices fall. However, there are periods when asset prices are impacted more by factors such as inflation and central bank actions than by the economic cycle. During such times, equity and bond prices tend to be positively correlated—falling in tandem during periods of high inflation, for example, and rising together when central banks are expected to ease policy.

Given this, it is easy to see why using average correlation figures will be ineffective in certain circumstances and that a better approach may be to gain a deeper understanding of how correlations shift over time and adjust portfolios accordingly. If you believe, for example, that recession concerns will weigh on asset prices, you may choose to be overweight bonds and underweight equities. If, however, you believe that the main influence on prices will be central bank rate hikes, you may decide to reduce your allocations to both asset classes. Developing a more sophisticated approach that factors in how correlations can shift will be much more complicated than using simple average correlation figures, but it is likely to be worth it in the long run.

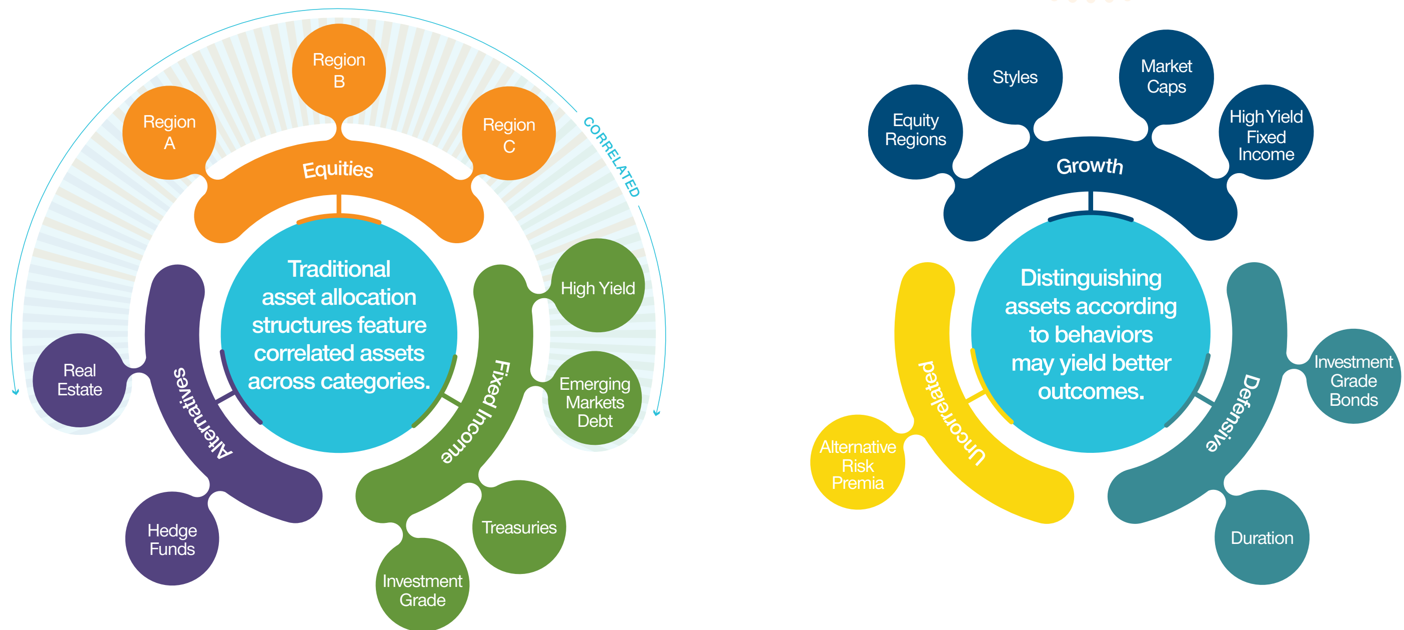
2. The Problem With Building Portfolios Using Labels (Rather Than Drivers)

Traditionally, multi-asset investors divided assets into three broad categories: equities, fixed income, and alternatives. Over time, however, a number of additional labels emerged within each category: In equities, separate labels arose for different countries and regions; fixed income became divided into sovereign debt and investment-grade, high yield debt, and emerging market local currency debt; and alternatives bifurcated between hedge funds and property funds. However, some of the new categories within fixed income—for example, high yield debt and emerging market debt—are more correlated to equities than to government bonds.

This creates difficulties because if assets that behave more like equities are included within bond allocations, overall portfolio performance will be skewed. For example, if an investment manager who claims to be running a traditional 60/40 portfolio is invested heavily in high yield debt and is therefore effectively running a portfolio with much more than 60% equity risk, they will likely outperform other managers when equities are rallying but underperform when equity markets slump.

(Fig. 1) Traditional Labels Do Not Work

Focusing on asset behavior provides more insight



Source: T. Rowe Price.

To avoid this, it may be necessary to move away from the traditional labels of equities, bonds, and alternatives and adopt new labels that focus on how assets behave—for example, "growth," "defensive," and "uncorrelated" (see Fig. 1). Growth assets are likely to include Japanese, European, and U.S. equities and high yield bonds and local currency emerging market debt; defensive assets would typically include core government bonds and investment-grade bonds; and uncorrelated assets would include equity long/short and other hedge fund strategies.

3. Fixed Income Might Not Be What You Think It Is

The final challenge for asset allocators is that even traditional fixed income assets such as sovereign bonds may no longer perform as they have done in the past. Historically, developed market sovereign bonds have generated fairly low overall returns while maintaining low duration (price sensitivity to changes in interest rates), meaning they have been far less volatile than equities and equity-like assets. More recently, however, yields have collapsed at the same time as duration has increased. If the performance of sovereign bonds were replayed over the past 30 years using present-day levels of yield and duration, the asset class would have been 30% to 40% more volatile.

When duration was low, a 5% change in yield would have only a limited impact on the value of the bond. Now, because duration is much higher, a similar change in yield would have a much bigger impact on the price. What this means is that sovereign bonds are far riskier than they were in the past—however, this won't be visible in simple models that do not reflect the current much higher levels of duration.

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Adopting a More Sophisticated Approach

Asset allocators seeking to position their portfolios for a potential downturn in the global economy may benefit from abandoning some of their traditional assumptions and adopting a different approach based on active country and sector allocation and duration management. Times like the present, when countries across the world are at very different stages of their interest rate cycles, provide a good opportunity to build portfolios that are diversified across countries and markets, comprising assets with low correlations to each other. We believe this approach may be the most effective way of navigating what could be a volatile period ahead.

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