Three Concerns Facing Asset Allocation Committees

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

September 2019

Thomas Poullaouec
Head of Multi-Asset Solutions APAC

Wenting Shen
Multi-Asset Solutions Strategist

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.

> …when it would be useful for correlations to be positive, they are often negative, and when it would be useful for the correlation to be negative, it is often positive.
>
> — **Thomas Poullaouec**
> *Head of Multi-Asset Solutions, APAC*

T. ROWE PRICE BEYOND THE NUMBERS

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. 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.

> "...a better approach may be to gain a deeper understanding of how correlations shift over time and adjust portfolios accordingly.
>
> **— Thomas Poullaouec**
> *Head of Multi-Asset Solutions, APAC*

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.

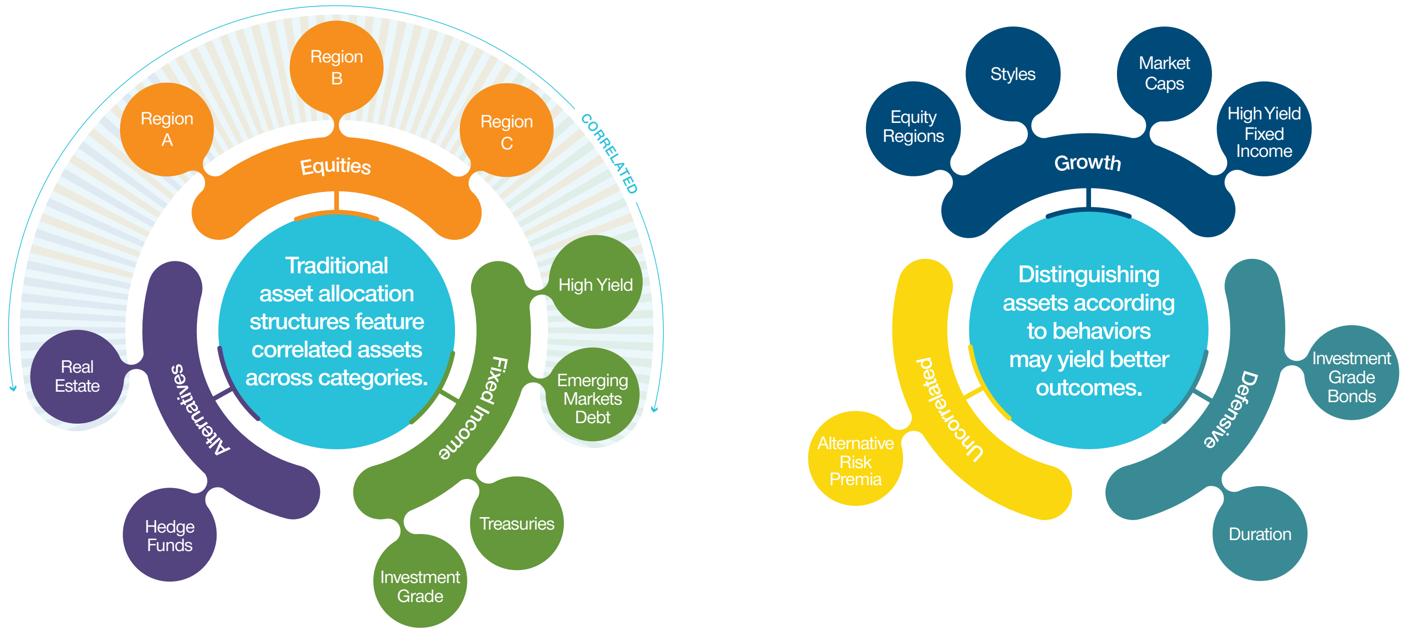
2. The Problem With Building Portfolios Using Labels (Rather Than Drivers)

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.

> …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.
>
> **— Thomas Poullaouec**
> *Head of Multi-Asset Solutions, APAC*

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.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice®

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

APAC-PAN-0895
201909-942168