Asset Allocation

THE BATTLE OF THE MULTI-ASSET STRATEGIES: BALANCED VS. ABSOLUTE RETURN

KEY POINTS

- Balanced funds can provide managed, diversified exposure to global equity and bond markets. Often, equity market returns tend to dominate the performance of balanced funds.

- Absolute return strategies aspire to generate positive total returns in all market environments. Consistently delivering on this aspiration is a challenge, as it requires skill.

- Our proposed response is to take a core and satellite approach, blending a balanced fund – the core holding – and using absolute return strategies as the satellite. This combination could give diversified exposure to capital markets and the potential for weakly-correlated, skill-based returns in a single portfolio.

THE BALANCED FUND IS DEAD; LONG LIVE ABSOLUTE RETURN?

In recent years, global allocation and balanced funds – typically blending around 60% equities and 40% bonds – have been heavily criticised. The critics focus on three main arguments:

- While the word “balanced” appears in the name of some funds, often their exposure to equity markets explains over 90% of their risk and returns – hardly balanced.

- Some funds’ rigid asset allocation lacks dynamism, as it is driven mainly by long-term, strategic allocation without the ability to shift nimbly across markets (often referred to as “tactical positioning” or “market timing”).

- The universe of asset classes included in some funds is limited to traditional equities and bonds, without sufficient exposure to alternative investments and sophisticated investment methods.

While these arguments are often valid, they are generalisations and do not apply to all balanced funds. However, they have contributed to the rise in popularity of what are frequently labelled “multi-asset” funds. These supposedly diversify risks across more
than just equity risk; may deploy dynamic asset allocation; and may include alternative investments (e.g.
commodities, real estate) and a wide array of investment instruments and techniques such as derivatives.
While this may be true in some cases, the terminology might be misleading. After all, balanced and global
allocation funds are by definition also “multi asset” as they invest in more than a single asset class. And not all
funds with “multi asset” in their name contain the features mentioned above. Investors should always look
more closely at the portfolio holdings of each fund to understand its investment approach and sources of
return.

One type of multi-asset fund attracting considerable interest is absolute return strategies. While the definitions
of “absolute return” may differ, one commonality of these strategies is the goal of positive total return
irrespective of market conditions. Some funds aim to generate positive performance over a full market cycle
(typically defined as three to five years) while some aspire to generate positive performance every calendar
year – a formidable objective. Often, funds follow an unconstrained approach, without limitations on market
exposure and asset class mix, only defining expectations for return and risk.

The proposition of exclusively positive returns in excess of cash, even when equity and bond markets fall, is
very attractive indeed for any investor – this is the Holy Grail of investing. So, why does everyone not invest in
absolute return strategies?

To try to answer this question, we’ll compare some of the broad characteristics of balanced funds and absolute
return strategies, highlighting their pros and cons and suggesting some considerations investors should take
into account before investing in them. We’ll argue that each type of fund could have a role in investors’
portfolios. The choice should not necessarily be one or the other, but rather how to blend the two to increase
the chances of achieving investors’ objectives. Balanced funds and absolute return strategies can coexist in
harmony.

**ADVANTAGES AND DISADVANTAGES OF BALANCED FUNDS**

Balanced funds typically maintain persistent exposure to equity and bond markets (beta). They are
“directional”, meaning that the performance (or direction) of capital markets explains a large proportion of fund
performance. One advantage of a well-managed balanced fund is that it can provide diversified exposure to
different global equity and bond markets. If the correlation among these markets is sufficiently imperfect
(materially less than 1.0), the fund should benefit from risk-mitigating diversification. Even better, if the fund
includes weakly correlated alternative investments, such as real assets and actively managed strategies, it can
potentially further enhance its diversification benefits.

One challenge for balanced funds is that equity markets are normally riskier and more volatile than other
markets, so the magnitude of their returns is larger than those of other types of investments, such as bonds.
This means that the returns of equity markets typically explain the lion’s share of balanced funds returns
(although conservative funds, with a lower allocation to equities, would logically have a lower exposure to
equity risk).

Institutional-grade funds, however, can use dynamic asset allocation to try to improve performance and
manage risks by allowing the fund manager the flexibility to actively change the fund’s asset allocation, and
they may benefit from active security selection. Successful active management can mitigate equity market risk
and add excess return. Even modest added value from active management can accumulate to a material
positive impact over multiple years.

For investors with long investment horizons and the appropriate risk tolerance, exposure to equity markets
usually makes sense since equities come with a higher expected return compared to most other types of
investments. Balanced funds should not be expected to outperform equity markets over the long term since
Balanced funds can add value in the form of “behavioural alpha.” Diversification comes with the average returns of the assets in which the fund invests. However, through diversification and risk management, balanced funds should outperform equity markets when they fall, and should provide a less volatile journey than that delivered by equities.

While the true risk of investing is downside risk or permanent loss of wealth, some investors have low tolerance for volatility. In some cases, volatility might lead to bad investor behaviour in the form of panic selling at the bottom of the market and missing any subsequent rebounds. Here, the volatility-mitigating characteristics of balanced funds can add value in the form of “behavioural alpha.” This could be seen as a way of buying into a professional, disciplined investment, replacing the emotional, value-destroying investing to which a do-it-yourself approach might lead.

Top balanced funds can provide embedded consulting. Investors in such funds can benefit from transparency into the dynamic holdings of the fund and its portfolio construction, applying the insights and views of the fund manager to their entire portfolio. Simplicity, liquidity and transparency can be an argument in favour of balanced funds: In cases where multi-asset strategies are complex, illiquid and opaque, their investment approach is not easily replicable by investors.

A well-constructed balanced fund could offer the advantage of diversified and dynamic exposure to equity and bond markets, within a risk-managed framework, blending market returns with some manager-generated excess returns. Even when asset allocation is not dynamically managed, properly balanced long-term exposure to different markets has its own merits. In general, balanced funds may be particularly attractive for investors who:

- Do not have a portfolio large enough to diversify it appropriately and to access all the investments that a balanced fund could include
- Do not have the necessary skill to construct and manage a diversified portfolio
- Want to benefit from professional active management

**ABSOLUTE RETURN: WHEN SOMETHING APPEARS TOO GOOD TO BE TRUE, IT USUALLY IS**

For an absolute return strategy to be able to deliver positive returns regardless of whether financial markets rise or fall, two things must happen:

- The strategy must remove its directional exposure to the markets or, to use investment jargon, it should minimise its beta exposure so that it is market neutral. Otherwise, the often large and abrupt movements of the equity markets, in particular, might overwhelm the strategy.

- Because its returns are not driven by broad market exposure, an absolute return strategy relies on the skill of its manager to include positively-performing investments in the right proportions. In other words, skilful investment selection and portfolio construction are critical for success.

A broad definition of alpha would be returns that are not sourced from exposures to traditional capital markets. These can include returns that are not skill-based per se, such as systematic exposures to risks which should be rewarded over time, for example carry, value and momentum – so called “risk premia” or “alternative betas.”
Since absolute return strategies rely solely on alpha, they need skill – and a lot of it

This means that absolute return strategies do not necessarily require someone who is unusually talented or gifted with raw investment acumen to succeed. They could meet their investment objectives with proper portfolio construction and breadth. Nevertheless, smart selection of risk premia and design of portfolios also requires skill.

The order of magnitude of alpha is much smaller than that of beta. The equity market, for example, could move by more than 20% in a single year, in either direction – up or down. A skilled active equity portfolio manager who adds 2% excess return in a year over the index through security selection has done a good job. The beta return in this example is ten times the alpha return. Since absolute return strategies rely solely on alpha, they need skill – and a lot of it.

To overcome this magnitude issue, some absolute return strategies use leverage to augment their returns. Leverage can be implemented either by investing borrowed funds or through using derivatives. There is nothing wrong with leverage per se. However, leverage might introduce some risks (e.g. margin calls) and when the alpha is negative, leverage amplifies its negativity.

Talent does not come cheap. Usually, skilled portfolio managers know they are good and sell their services for a fee matching their skill. The active management industry has been scrutinised for charging high fees without necessarily delivering better results than passive indexing. While this may be true for the average manager, who, after transaction costs and fees underperforms the benchmark, not every manager is average. The key is selecting those who are likely to be at the top consistently.

Absolute return is a pure play on manager talent. One reason, beyond fees, that absolute return strategies are not as popular as they might otherwise have been, is that most have simply not delivered on their return objectives. Often, absolute return providers have boasted “equity-like return with bond-like volatility”. However, over more a decade, what has delivered equity-like returns? The answer is bonds. Many absolute return strategies have failed to match this.

With absolute return strategies, investors should think about the opportunity cost. Say the long-term average expected return of the equity market using a passive tracker is 6% per year. A successful active equity fund could increase that return after fees to 7% or 8% per year. Absolute return strategies typically aim to generate cash plus 3% to 5%. In the current low-yield environment, the more aggressive absolute return strategies could deliver a return in line with passive equities. That is, if the absolute return manager succeeds in delivering.

Investing in equity markets is risky. While the average annual return in the future could be 6%, the returns in each year can swing wildly as the volatility of equities might typically be north of 15%. Most absolute return strategies come with much lower volatility than that of equities. However, low volatility does not necessarily translate to higher chances of hitting investment objectives. History teaches us that, over a sufficiently long investment horizon, taking the investment risk of capital markets has paid off. So investors should carefully consider giving up exposure to equity markets.

While an absolute return strategy has a high hurdle of delivering positive return regardless of market conditions, a balanced fund has a lower hurdle of outperforming its benchmark or delivering its stated outcome, typically returns in line with those of equity markets over a full market cycle, but with lower volatility. Outperforming a benchmark is not easy, but performing positively in any market conditions is harder.
SEEKING TO BENEFIT FROM BOTH WORLDS

Nothing in investing is black and white, and balanced funds and absolute return strategies each have their pros and cons. A sensible approach is to try to benefit from the advantages of each investment, while mitigating its disadvantages. The table below compares the main characteristics of balanced funds and absolute return strategies. Our goal is to combine them to benefit from both investment styles.

Main Characteristics of Balanced Funds and Absolute Return Strategies

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<th>Absolute Return Strategy</th>
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<td>Main Source of Return</td>
<td>Equity market (beta)</td>
<td>Manager skill (alpha)</td>
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<td>Main Risk</td>
<td>Equity market risk</td>
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<td>Low</td>
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<td>Complexity</td>
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<tr>
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<td>Role in Portfolio</td>
<td>Standalone investment giving long-term diversified exposure to capital markets within a risk-managed framework</td>
<td>Source of absolute return, diversifying other sources of risk already present in the portfolio</td>
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We believe that balanced funds and absolute return strategies can harmoniously complement each other rather than competing. A core-satellite portfolio construction approach may be the best way to benefit from both types of strategies.

The core consists of a good balanced or global allocation fund, offering diversified, managed exposure to capital markets. Fund selection is critical. Ideally, the fund should benefit from both beta returns from global markets and alpha returns from tactical asset allocation and security selection. Investors would need the core to work as hard as possible for them. The satellite would consist of one or a combination of absolute return strategies. Here, selection is critical as well, and should include high-conviction strategies that are likely to deliver.

This core-satellite construction could benefit from the long-term positive expected returns of capital markets, with skilful absolute return strategies that could add alpha and diversify the equity market exposure in the core, reducing overall portfolio risk. Since absolute return strategies rely on manager skill, combining a few strategies can mitigate manager risk and access more than a single manager’s talent. Ideally, each absolute return strategy would have a different philosophy and style so their returns would behave differently. With the bulk of the portfolio invested in the core, the investor should be able to control the overall fee budget. More in the core means lower overall fees with more directional exposure to markets. More in the satellite means a higher overall fee with less directional exposure to markets. A good strategist should be able to customise the mix to increase the chances of meeting each client’s specific needs.

The majority of returns should come from the core. The satellite’s chief aim is to perform well when the core does not. As the main risk factor in the core is equity risk, the low correlation between the satellite and the equity markets is important. With this framework, we believe balanced funds and absolute return strategies can live side by side, helping investors to achieve better outcomes from their portfolios.
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