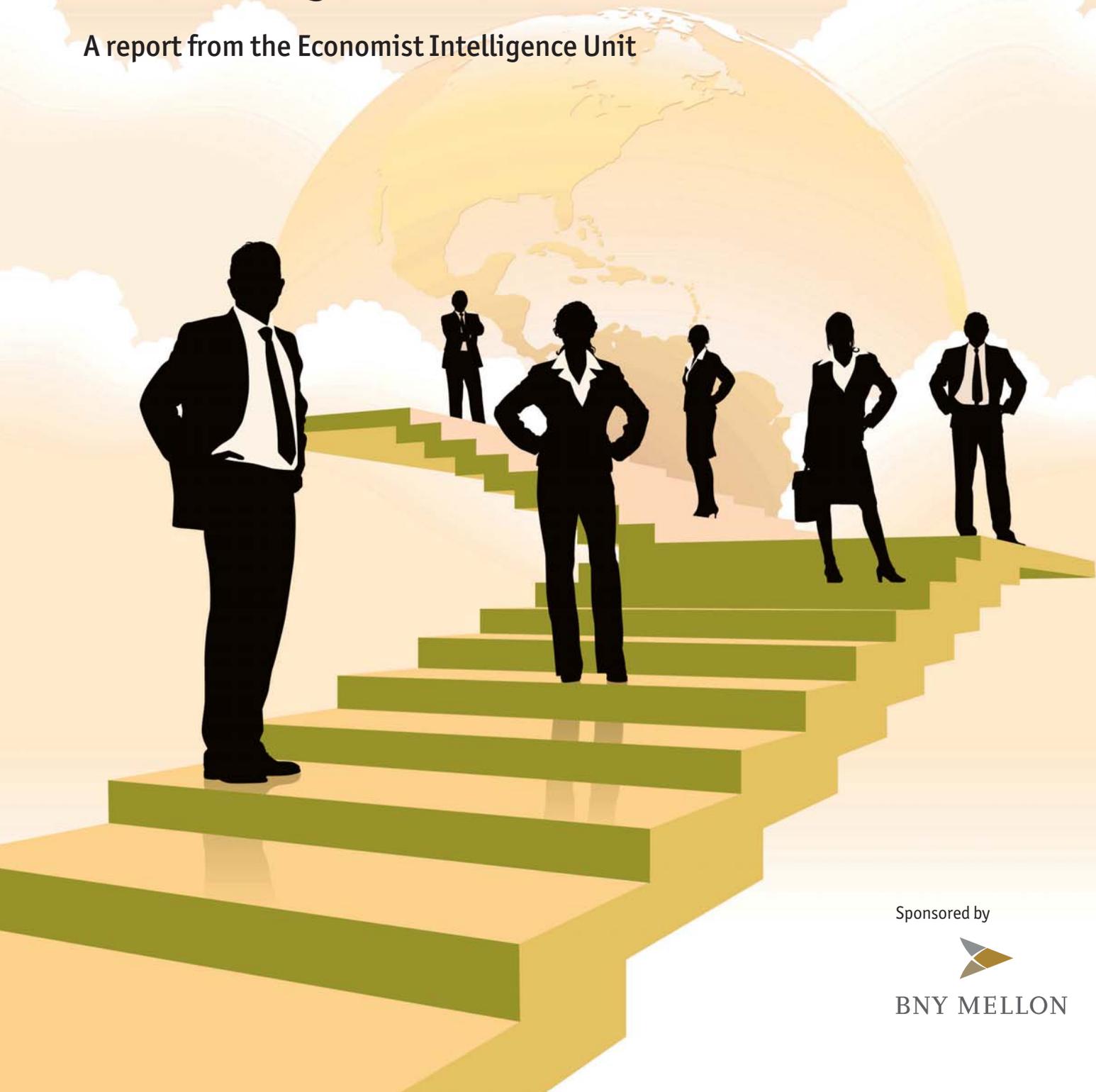


The search for growth

Rethinking asset allocation

A report from the Economist Intelligence Unit



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Contents

Preface	2
Introduction	3
Rethinking asset allocation	4
Diversification and liquidity: a tense partnership	5
Understanding the underlying risk	6
Potential and perils of more dynamic portfolio management	7
The active versus passive debate	8
A more qualitative approach to risk assessment	10
Conclusion	11



Preface

The search for growth: Rethinking asset allocation is an Economist Intelligence Unit research report, sponsored by BNY Mellon. The findings and views expressed in the report do not necessarily reflect the views of the sponsor. The author was Rob Mitchell and the editor was Annabel Symington.

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Introduction

The outlook for the global economy is uncertain. A historic downgrade of US debt by Standard & Poor's, a major credit ratings agency, and rising concern about the future of the euro zone have led to violent swings in equity markets. At the heart of the downturn is an erosion of confidence, brought on by signs in the developed world of slowing growth, continuing high unemployment, worsening sovereign debt problems and political stalemate.

Even before the onset of the latest round of fears, *The search for growth*¹ report published in June 2011 highlighted some of the challenges facing investors. Although investors recognised that the volatile market environment presented new opportunities to outperform the market, many were reluctant to make bold moves in light of major downside risks. The survey conducted for *The search for growth* report in March 2011 highlighted a growing recognition that the debt overhang created by 30 years of easy credit will require a long and painful deleveraging process that will weigh on economies and markets for years to come. Volatile markets and investor uncertainty appear to be among the few constants in that scenario.

This uncertainty has inspired institutional investors and their managers to do some soul-searching. Long-held tenets of investment strategy are now under scrutiny. Asset managers are rethinking their risk management practices. Approaches to diversification are being overhauled, liquidity and counterparty risk are being carefully monitored and the use of quantitative models is being supplemented with more judgment-based, qualitative techniques.

1. *The search for growth* report, written by the EIU and sponsored by BNY Mellon, examined the prospects for economic and market growth from the perspective of both institutional investors and corporate executives. Based on a global survey of almost 800 respondents and a series of in-depth interviews with leading investors and experts, the report explores the potential for growth across a wide range of sectors, regions and asset classes. Rethinking asset allocation is the first of two follow up papers to *The search for growth*.

About this research

In this report, produced by the Economist Intelligence Unit and sponsored by BNY Mellon, we highlight the development of key trends in asset allocation and risk management in response to the current economic

climate. This report is the first of two follow-up papers to The Search for Growth report published in June. Our research is based on a series of in-depth interviews with experts in the global asset management industry. Our thanks are due to all the participants for their time and insight.



Rethinking asset allocation

“Diversification remains the best risk management tool there is.”

Wylie Tollette, senior vice-president of investment risk, Franklin Templeton

Asset allocation used to be a relatively simple matter. For many years, institutional investors would focus on a 60/40 mix between equities and fixed income, with some perhaps small portions allocated to cash and alternatives, such as commodities and real estate. But in the wake of the dotcom bubble, when a collapse in technology stocks wiped out US\$5trn in paper wealth from the Nasdaq over two years, a new approach emerged. The so-called Yale endowment model advocated much broader diversification than had traditionally been applied, particularly to illiquid alternative assets, such as private equity and hedge funds.

The 2007-08 global financial crisis exposed the shortcomings of this approach as well. Portfolios that were supposedly diversified across uncorrelated asset classes were found to contain more common risk factors than previously thought. Every asset class, with the exception of government bonds and cash, performed badly. Returns that had been diversified on the upside were massively correlated on the downside. In short, diversification failed at the precise point when investors needed it most.

Even so, the argument for diversification—both within and across asset classes—remains strong, emphasised by everyone interviewed for this report, as does the need to gain exposure to new asset classes as part of a well-managed portfolio. “Diversification remains the best risk management tool there is,” says Wylie Tollette, senior vice-president of investment risk at Franklin Templeton.



Diversification and liquidity: a tense partnership

“Investors underappreciated the speed with which liquidity can dry up.”

Wylie Tollette, senior vice-president of investment risk, Franklin Templeton

The financial crisis taught asset managers an important lesson about diversification: a portfolio can not be called diversified if its assets are not liquid. As markets collapsed in 2008, many investors were forced to sell assets to meet margin calls but found that, in many cases, they could not find willing buyers. The problems were particularly acute for investors that were highly leveraged and exposed to illiquid asset classes, such as hedge funds, real estate and private equity. “Liquidity risk was broadly undervalued,” says Mr Tollette. “Investors either thought they were liquid or underappreciated the speed with which liquidity can dry up.”

During times of market stress, liquidity gives investors the comfort of knowing that they are well placed to ride out a difficult period. “If you have the cash to deal with immediate liquidity demands, then you have the luxury of being able to wait until markets start behaving normally again,” says Mr Tollette. “If you’re not liquid, patience is a luxury you probably can’t afford.” This flexibility ultimately needs to come from having a diversified portfolio rather than from hoarding cash. However, this is where liquidity and diversification prove to be unhappy bedfellows.

While investors look to diversify their portfolios into new asset classes to boost returns and reduce risk, the asset classes they are turning to are often illiquid. “We’re all exploring new areas of asset management and some of those areas are by their very nature illiquid,” says Robert Higginbotham, chief executive officer of Fidelity International’s European business. “There is a tension between the need for diversification and liquidity, and the responsibility can only sit with the asset manager to make sure that it is not providing apparent liquidity to an asset class that is fundamentally illiquid.”

One way around the problem is to invest in exchange-traded funds (ETFs), which in theory are more liquid than the underlying asset classes. For example, an ETF that replicates a hedge fund strategy should be easier to sell than underlying hedge fund assets because it can be traded just like stocks. But in April 2011, the Financial Stability Board, a global regulatory watchdog, released a report warning investors about the potential liquidity risk associated with ETFs. It argued that the on-demand liquidity that ETFs in theory offer could create acute redemption pressures on certain types of ETFs, which would in turn affect the liquidity of providers. Recent innovation in the ETF market has also led to the development of more complex products that call into question the liquidity advantage that they are meant to offer.



Understanding the underlying risk

“We run through a lot of scenarios to ensure that our allocation is resilient across different points in the economic cycle.”

David Chapman, director of risk management, Catholic Healthcare Investment Management Company

The challenges of getting diversification right are encouraging some investors to adopt a model that relies more on identifying underlying risk factors than on traditional asset class definitions. In a regime-based approach to asset allocation, investors build a portfolio around the underlying macroeconomic risks, rather than asset classes. So instead of spreading a portfolio across equities, fixed income, cash and alternatives, regime-based institutions focus on “risk buckets”, which might include growth, inflation and deflationary hedges. By building portfolios in this way investors hope that they will be more resilient across the entire economic cycle.

Ascension Health, a US-based Catholic healthcare system, is one early adopter of a regime-based approach. A single asset class may be divided across multiple categories, depending on how specific underlying investments behave, explains David Chapman, director of risk management at Catholic Healthcare Investment Management Company (CHIMCO), a subsidiary of Ascension Health. Rather than placing all its hedge fund investments under the alternatives banner, for example, CHIMCO allocates them according to their underlying risk factors. “We now split hedge funds into those that are higher volatility and more directional, which can go in the growth category, and those that are absolute return and might therefore belong in the deflationary bucket,” says Mr Chapman.

A rigorous approach to stress testing and scenarios ensures that CHIMCO understands the impact of historical market events on regime-based asset allocation. “We run through a lot of scenarios to ensure that our allocation is resilient across different points in the economic cycle and to specific events, such as a sovereign default or credit bubble,” says Mr Chapman.



Potential and perils of more dynamic portfolio management

“There’s a lot of potential in using asset allocation to pick up opportunities that are more transient in nature.”

*Brent Beardsley, principal,
Boston Consulting Group*

According to more traditional asset allocation, investors set their strategic allocation over a relatively long timeframe, often three years or more, and rebalance only occasionally. But in today’s highly volatile, “risk on/risk off” market, a growing number of investors are advocating a more tactical approach, whereby proportions allocated to specific asset classes are frequently adjusted in response to market stimuli.

This top-down approach is based on the long-held recognition that asset allocation, rather than manager selection or some of the more granular investment decisions, is the main driver of investment returns. “Investors are realising that there’s a lot of potential in using asset allocation to pick up opportunities that are more transient in nature,” says Brent Beardsley, a principal at the Boston Consulting Group. “They are finding that this can yield much greater benefits than focusing their attention on individual securities within an asset class.”

But there are challenges associated with tactical asset allocation. One is transaction costs. If investors are tilting their portfolios more frequently, they may need to execute hundreds of transactions. This consumes management time and costs money in fees that must be outweighed by the benefits of the tactical shifting. Investors must also be able to make decisions on asset allocation and execute the necessary trades quickly to ensure that they capture the opportunity before it fades.

Successful tactical asset allocation assumes that investors will make the right changes: altering overall asset allocation is a major decision that could lead to significant swings in performance. Although tactical asset allocation strategies have allowed some managers to deliver value to investors, many investors see them as a risky investment strategy. “If you try and change asset allocation in an environment like this, you’re quite likely to get it wrong,” cautions David Miller, a partner at Cheviot Asset Management. “Our view is that it is better to have a fairly stable asset allocation based on the client’s objectives and then to be more active under the surface with security selection.”

Some investors also worry that the trend towards dynamic asset allocation may do more to serve the interests of those selling the products than the clients themselves. “Timing markets like that is very tough and I worry that the number of people who say they can do it is much greater than the number who really can,” says Mr Higginbotham.



The active versus passive debate

“Our ability to match the level of risk to the environment is more quickly and effectively achieved through passive investment.”

David Chapman, director of risk management, Catholic Healthcare Investment Management Company

In the wake of the 2007-08 global financial crisis, active asset management strategies were criticised for failing to offer investors protection against falling markets. In the past few years, passive products, such as index funds, have grown steadily in popularity as investors question the ability of active managers to outperform the market. “We want to pay for skill where we believe we can find it, but we also recognise that our ability to match the level of risk to the environment is more quickly and effectively achieved through passive investment,” says Mr Chapman. “Growth or equity risk is the biggest factor in our portfolio and using passive equity exposure is the easiest way for us to dial that up and down.”

An increased focus on passive products among some investors is coinciding with downward pressure on active management fees, with investors increasingly unwilling to pay for lacklustre performance in a low return environment. There is evidence that the traditional “two and 20” fee structure used by many hedge funds, where investors are charged a 2% annual management fee and 20% on profits, is also coming under pressure.

But despite this trend, some investors interviewed for this report express doubts about the advantages of a passive approach. Mr Miller suggests that the sheer volatility of financial markets in the current environment means that investors need to make active decisions in order to achieve superior performance. “If you have a period of change such as this, the idea that you should be passive just seems to be wrong,” he says.

Although passive investment might seem like the “safer” option, Mr Tollette argues that passive investments may be riskier than they first appear. Consider an investor who has bought a government bond index fund, hoping to get exposure across a broad selection of countries. “If you look under the covers, you’ll notice that the countries that have issued the most government debt also have the largest representations in the index,” he says. “That means that these funds are skewed towards Japan, the US, Italy, Spain, Greece and Portugal, which accounts for why they are performing so poorly.”

The ETF market has also grown rapidly in recent years in response to the growing need to find cost-effective ways to develop a diversified portfolio. On the surface ETFs offer the benefits of index-linked products and the liquidity of individual stocks. In the US, the value of assets invested in ETFs grew by 26% in 2010 and has nearly trebled since 2005, according to Boston Consulting Group. “ETF providers have done a very good job of creating niche products that allow investors to get exposure to certain asset classes in a very cost-effective way,” says Mr Beardsley.



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But ETFs have their critics. A 2010 report from the Kaufman Foundation argued that ETFs are radically changing markets to the point where these products—not the trading of underlying securities—are effectively setting the prices of stocks in small-cap companies. This can create significant systemic risks and could trigger market mayhem similar to the “flash crash” of May 2010, when the Dow Jones Industrial Average plunged by 1,000 points in a matter of minutes.

Recent innovation in the ETF market has led to the development of more complex—and opaque—products, leaving investors to ensure that they are not exposed to risks that they had not anticipated. However, according to the Financial Stability Board these so-called synthetic ETFs represent only 3% of the current market..

Allocation towards passive investments may be increasing, but it certainly does not mean that investors have given up chasing alpha entirely. Often, investors are allocating a slightly larger proportion of their portfolio to passive products, but are also increasing their allocation to alternatives and esoteric asset classes in a “barbell approach”. “We have increased our strategic allocation to cash but have also, in order to make the trade-off for the return opportunities, focused more on alternative assets,” says Mr Chapman. “But given the lack of liquidity in those asset classes, we implement a lot of our public market exposure synthetically so that we have the ability to turn those exposures on and off at a day’s notice.”



A more qualitative approach to risk assessment

“Models are useful but they are inherently flawed. That becomes the jumping-off point for a more qualitative dialogue.”

David Chapman, director of risk management, Catholic Healthcare Investment Management Company

Ongoing volatility in financial markets and major macroeconomic challenges such as the debt crises on both sides of the Atlantic serve as a potent reminder that risk is constantly evolving. “Investors are always told that past performance is not indicative of future results,” says Mr Tollette. “But they also need to be aware that past risks are not necessarily indicative of future ones.”

Investors face a wide range of potential risks, from asset price bubbles in emerging markets and commodities to a stalemate in global governance. These threats require investors to look at risk management in new and innovative ways, and to ensure that they have understood the interdependencies across their entire book. “It is essential to look at risk across all the different portfolio managers, particularly around concentration risk in terms of counterparties,” says Mr Beardsley.

Lingering uncertainty in the economic environment has encouraged asset managers to complement their traditional model-based approach with a qualitative dialogue between risk functions and investment professionals. “Models are useful but they are inherently flawed in some way,” says Mr Chapman. “That becomes the jumping-off point for a more qualitative dialogue.”



Conclusion

Traditional approaches to asset allocation are coming under growing scrutiny and pressure. The lessons from the financial crisis, and a recognition that economic and market uncertainty are likely to persist, is encouraging an increasing number of institutional investors and their managers to rethink their approach. One trend that is gaining traction is to construct portfolios around risk factors, rather than asset classes. The hope is that this will prove more resilient in times of market stress, and lead to improved returns across every point in the economic cycle.

This is not to say that the fundamentals of asset allocation should be forgotten. That diversification failed during the financial crisis is not an argument for abandoning it. Instead, it merely highlights how diversification can sometimes be illusory and that investors need to pay closer attention to possible correlations across different components of their portfolio.

Capturing the upside of growth and minimising the downside will require investors to adopt a range of strategies and tactics in their asset allocation. Some of these will be tried-and-tested, while others will be less familiar. But whichever combination investors use, the key in all situations will be to identify early warnings, remain flexible and respond quickly to material changes in the external environment.

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