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Made to Measure: Q&A

SUMMER 2016

Volatile markets present challenges to a wide range of global investors and make it difficult for managers to identify areas where they can generate returns and avoid losses.

In the current low-yield, low-interest-rate environment, intelligent tactical asset allocation is increasingly important as the hunt for return intensifies.

Here, we ask investment specialists at Newton Investment, Mellon Capital, Insight Investment[1] and the BNY Mellon Investment Strategy & Solutions Group (ISSG) their views on the market and the strengths of the various asset classes and investment opportunities in the market.

Keith Collier,
investment strategist , Investment Strategy & Solutions Group, BNY Mellon Investment Management

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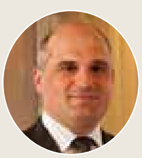
Suzanne Hutchins,
Real Return strategy portfolio manager, Newton

NEWTON Investment Management



Vassilis Dagioglu,
managing director and head of asset allocation portfolio management, Mellon Capital

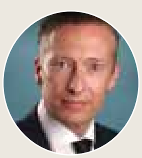
Mellon Capital

Peter Hensman,
global strategist, Newton

NEWTON Investment Management

Paul Flood,
multi-asset income manager, Newton

NEWTON Investment Management



Steve Waddington,
multi-asset manager, Insight Investment

Insight INVESTMENT

1. Investment advisory services in North America are provided through four different SEC-registered investment advisers using the brand Insight Investment: Cutwater Asset Management Corp, Cutwater Investor Services Corp, Pareto New York LLC and Pareto Investment Management Limited.

Which asset class do you favor most in the year ahead and why?

Keith Collier: As the U.S. economy moves through the economic cycle, oil prices stabilize, and the labor market continues to improve, we are starting to see upward pressure on expectations for inflation. These indicators, combined with investor sentiment that increasing inflation is a very minor threat, makes inflation-sensitive assets, such as commodities and global natural resources equities, attractive to us in the year ahead as part of a "barbell" strategy of inflationary and deflationary assets.

Peter Hensman & Suzanne Hutchins: We believe U.S. Treasuries have the greatest return potential in the next 12 months. While the market remains focused on the likelihood of interest rate normalization and higher yields along the length of the yield curve, we view the repeated failure of central banks' forecasts as indicative of the inaccuracy of their demand-driven models. Instead, cheap finance has spawned an extraordinary level of competition, distorted perceptions of risk and encouraged even greater levels of indebtedness, which in turn increases financial and economic fragility. As profitability and market liquidity face ever greater pressures, and the prospect of Fed policy tightening melts away, the certainty of the (low but positive) returns available on Treasuries will likely push yields down, not up.

Vassilis Dagioglu: We believe major developed market large-capitalization equity indices such as in the U.S., Eurozone and Japan offer more potential value than some other indices. Given there is still a little uncertainty about economic and earnings growth, we are taking a somewhat more moderate position compared to the past, but we still believe the global economy is not falling into recession and we remain in a moderate growth environment. TIPS and U.S. high yield bonds have had a very good run of late and we favor those assets at this time.

Steve Waddington: We expect moderate growth in the key developed markets as domestic conditions improve and the slowdown in China stabilizes, but the risks appear skewed to the downside. We also expect a pick-up in volatility, driven by higher levels of economic uncertainty and market-specific factors. Given this uncertainty, we are focused on areas of value. While we do not have a single favorite asset class, we believe emerging market debt is starting to look attractive. We also consider dividend futures to be attractive, particularly in Europe—where fair value discounts are largest in some tenors.

Which asset class do you think will be the most effective in smoothing returns/providing diversification over the next 12 months and why?

Paul Flood: Infrastructure is an asset we feel will be helpful in smoothing returns in the months ahead and believe it continues to offer steady, cash-generative returns and is a well-understood asset class that holds broad appeal. Infrastructure assets have the advantage of not being dependent on the economic cycle. Ultimately, we look to balance out the risks across the portfolio and find securities that can help smooth some of the risks that offset the opportunities and we are always very cognizant of what has been priced into the securities in terms of the different risks. From this perspective, we think infrastructure presents a good proposition.

Keith Collier: Given the mixed economic signals that investors are seeing in the economy today, the strategy we are employing to smooth returns going forward actually combines inflationary and deflationary assets as opposed to a single asset class. As volatility increases in the markets, we believe it is important to understand how asset classes hedge one another within the portfolio as a way to manage risk within boundaries as opposed to increasing single sources of active risk.

Peter Hensman & Suzanne Hutchins: We view Treasuries and gold as likely to be the most effective at providing portfolio diversification. Both have a low correlation with risk assets given they have been viewed by the market as unnecessary and detrimental to generating returns since the consensus of market participants expects that our financial systems are returning to "normal." This is unlikely to change in the period ahead.

Vassilis Dagioglu: In terms of smoothing returns within a multi-asset portfolio, we would look to Treasuries—which we believe are comparatively cheap and still negatively correlated to a range of other growth assets. In a low-yield environment, Treasuries can provide a positive and attractive yield. Currently, they are also cheaper than other alternatives such as other non-U.S. government bonds like bunds or even Japanese bonds. For diversification we also look to some other assets, including some "haven" investments, such as a long exposure to the Swiss franc.

Steve Waddington: Generally speaking, our economic outlook suggests government bonds should remain a reasonable diversifier to risk assets unless rate expectations become unanchored or inflation expectations move sharply higher. We also expect curve flatteners to perform well in core markets: these should perform well in both a rate-hiking scenario, where short rates rise, and in an environment of structural weakening, which would weigh on long-term yields.

Measure for Measure: Fund Sector Comparison

A perennial challenge facing the multi-asset sector is the lack of a natural benchmark or peer group allowing for reliable comparison between individual multi-asset funds.

Organizations such as investment research specialist Morningstar have worked to define multi-asset in recent years. Still, the investment industry offers only limited direct comparison between funds, although rapid evolution of the sector could allow for greater ease of comparison in the future.

According to Mellon Capital's Dagioglu, the sheer diversity of multi-asset investing means, for now, the industry is still some way off creating meaningful benchmarks. He adds that this places an onus on investors to take particular care when considering their objectives and risk tolerance.

"I don't think we are any closer to developing universal benchmarks across the multi-asset fund sector because it contains such a wide variety of assets. This means it is really up to the individual investor to understand how their strategy is structured, how it looks at different asset classes and how it manages the risk. Every fund will have its own different levels of risk and different ways of managing risk and so we have not come to a universal benchmark yet."

Newton's Flood believes the relative lack of benchmarks within the sector should not discourage investors. It gives fund managers the scope to move beyond the short-termism of much benchmark investing to deliver longer-term gains, he notes. He also feels it pays to take a more nimble approach in a market heavily influenced by unconventional central bank policy.

"In some ways it doesn't matter what benchmark you give people, a fund manager's job will be to outperform it. However, investors need to move beyond short-term thinking. In the current market environment it pays to adopt a more long-term view to deliver sustainable performance. The backdrop of QE creates conditions where asset prices can move based on the whims of what policymakers decide, but you cannot invest based on what you think a policymaker is going to say. You have to take a longer-term view and make sensible investments."

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