Balancing growth, diversification, downside risk and liquidity

*Investors today face a conundrum: how should they pursue future capital growth while maintaining diversification and seeking to limit downside risk, given current market valuations? Wellington Management's **Evan Grace** looks at the options that investors can take in a multi-asset portfolio*

Investing in the traditional asset classes – stocks and bonds – is today fraught with challenges.

Equity markets remain buoyant but are starting to look stretched on valuation measures, implying a potentially muted future return profile. Bonds have a mediocre to negative return profile, given the tremendous yield compression they have experienced since the onset of the global financial crisis. An asset class such as commodities can generate significant returns in certain environments but should theoretically provide only a cash-like return in other periods. And with interest rates globally still mired at multi-decade lows, the returns on cash currently lag inflation in many countries. So what can investors do to attempt to generate capital growth in the future? Should they look to alternatives such as illiquid assets?

We believe that investors can pursue the joint objectives of capital growth and capital preservation most effectively by using a different approach to asset allocation. Our view is that portfolios should be constructed using an asset-allocation framework that focuses on contribution to risk, emphasising potential alpha through a diversity of sources, while seeking to maintain good levels of liquidity in a wide variety of market conditions. This should be done so that all undesirable concentrations of risk are avoided. As we show in Figure 1, we believe one of the flaws in traditional portfolio construction is that it relies on the allocation of capital across asset classes, without an adequate focus on the generation of alpha or the relative risk of one's holdings. We believe that this does not fully account for all the risks involved.

In a traditional balanced strategy, for example, the majority of the risk comes from the exposure to equities, and can overwhelm the diversification properties of the bond holdings – a result of equities being generally much more volatile than bonds. We think it is important to rethink the toolkit available to investors by combining a variety of assets and strategies in a portfolio according to a risk-budgeting framework. Having such a framework enables us to construct a multi-strategy portfolio that should show less susceptibility to equity-market drawdowns. By allocating according to risk, investors would obtain a portfolio with a smaller allocation to traditional asset classes but meaningful exposure to alternative beta and diversified sources of alpha. We think that using this risk-allocation process can create a portfolio that is potentially more robust across a range of economic environments.

Figure 1: Rethinking the toolkit

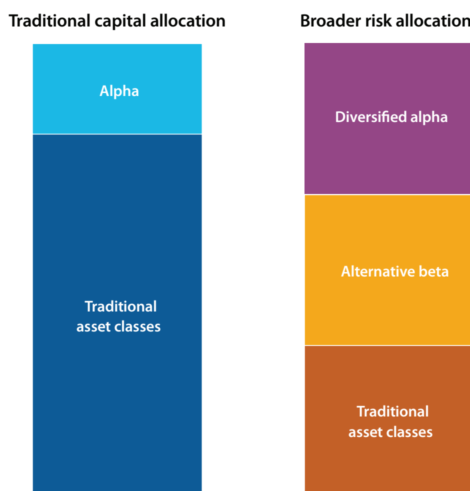

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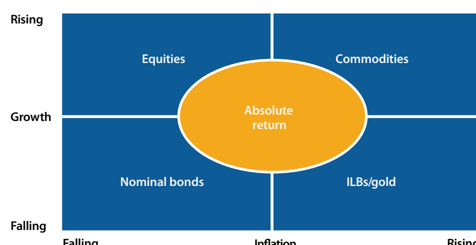
Figure 2: Our Think Function, Not Form framework



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Rethinking the toolkit

We advocate allocating to a variety of different asset classes so as to address every economic scenario – a framework that we term "Think Function, Not Form" (TFNF) (Figure 2). This framework enables us to think about how to create a portfolio that contains truly diversified sources of potential growth depending on whether inflation and economic growth are rising or falling. For example, nominal bonds are likely to provide outperformance when growth is low and inflation is falling, whereas equities tend to fare best when growth is rising but inflation is low or falling. When inflation is rising and growth is falling, inflation-linked bonds or precious metals tend to perform well, whereas commodities may be the assets to choose when both inflation and growth are on the rise. Absolute-return strategies that focus on alpha have the potential to provide returns in every type of economic scenario.

Using this risk-allocation framework to apportion assets on the basis of economic environment also addresses concerns such as the need to manage market exposures and mitigate downside risk in a variety of economic scenarios. This is because it allows for the expression of active views and seeks to provide some coverage in every type of environment. Since we are

Figure 3: Create balance according to economic scenarios

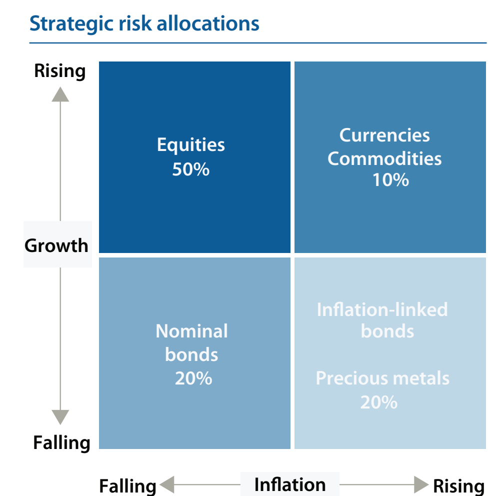

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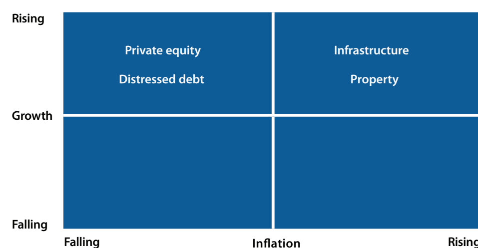
Figure 4: Rethinking illiquid assets



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seeking to grow capital over time, and because the world experiences a growth state most of the time, where economic growth is rising but inflation is modest, a risk-allocation strategy that apportions 50% of a portfolio to this area (Figure 3) is consistent with this long-term objective. Reflecting the fact that other economic environments produce tailwinds for certain asset classes like commodities, we should also allocate some of the risk budget to the infrequent but wealth-eroding occurrence of high-inflation scenarios in which commodities tend to outperform. Similarly, weak-growth scenarios are less frequent than growth scenarios but it is still prudent to have some exposure to nominal and inflation-linked bonds or precious metals to provide assets that may perform in such environments.

Of course, the framework needs to account for the fact that each of these environments could be in force for extended periods of time, and that valuations and other factors play a role in what outperforms. Therefore, this framework is also designed to be flexible enough to allow for significant deviations from these strategic risk allocations.

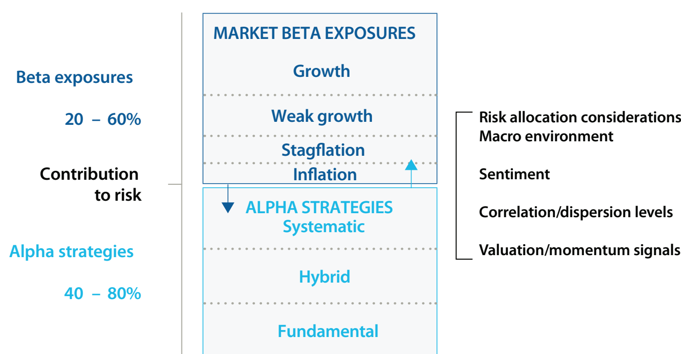
Rethinking illiquid assets

The illiquid assets of private equity, distressed debt, infrastructure and property may currently seem like useful alternatives to liquid assets such as equities or bonds. However, within our TFNF framework, these assets are revealed to lie within the growth quadrants (Figure 4). This makes them imperfect alternatives to traditional market assets because they behave like growth assets, and so they may not offer broad economic diversification. They can perform a useful function as return-seeking assets, but their illiquidity and other risks must be considered, as it may make them unsuitable for investors with specific liquidity requirements.

Alpha sources should be more prominent

To provide a properly diversified risk-allocation portfolio in today's environment, we would suggest using alpha sources much more prominently, so that they actually dominate the portfolio's risk budget. Additionally, beta within the portfolio ought to be balanced across asset classes so as to achieve more robust diversification than traditional portfolios. This leads to a portfolio that could have alpha strategies making up as much as 80% of the contribution to risk,

Figure 5: More potential alpha, diversified beta



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and market betas just 20%. Within these alpha sources there are myriad potentially suitable strategies that can be included. In Figure 5, we suggest how market exposures can be limited in favour of alpha strategies, leading to an asset allocation that looks very different to a traditional balanced portfolio, and which we believe can provide more robust characteristics.

Employ specialist managers

We think that the use of specialist alpha managers maximises the likelihood of achieving consistent, diversified alpha over time. The skills required to produce alpha within each asset class are different, and so we think it is unlikely that a single portfolio manager can be consistently effective in all of them. Rather than a structure in which a single portfolio manager attempts to add value by making security-selection decisions within all asset classes, we would advocate having multiple potential alpha sources at work in the portfolio at any one time. This provides for a potentially robust degree of diversification among alpha sources in a variety of market conditions. This practice would extend diversification across time horizons too, as different investment ideas may come to fruition at different rates.

Be mindful of liquidity

Lastly, all the investment ideas chosen must be investable in order to ensure that the portfolio has a degree of flexibility; hence it is crucial to monitor liquidity across each of the asset classes in which the individual strategies invest. It is also critical to have look-through at all levels of the portfolio to ensure that the underlying exposures neither double up, nor cancel each another out.

We believe a risk-allocation process that combines specialist managers focusing on alpha generation through liquid investment ideas while actively managing market betas can help investors seeking consistent returns and true diversification. Against today's uncertain backdrop, we think that these elements are critical to pursuing capital growth at the same time as portfolio diversification in all economic environments.

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