Hour of truth comes for the flexible funds industry

***Tarek Issaoui** on why diversification benefits will matter less and how to enhance flexible allocation processes*

Since the outbreak of the Great Financial Crisis, flexible multi-asset funds have caught investors' attention, causing assets to pour into the segment's blockbusters. There is no need to go over the catalysts in detail; they have been well discussed enough: traditional benchmarks did not protect investors from deep losses. The resulting un-benchmarked flexibility meant that the emphasis shifted to drawdown management and the preservation of capital. Without necessarily promising absolute returns – since flexible investment processes have a long-only participative bias – managers focused on absolute risk.

So far, except for a few minor bumps in the road, flexible funds have lived up to investor expectations. The average Sharpe ratio of a European flexible allocation fund is estimated at 0.42 over the last five years[1]. For sure, part of this performance is linked to factors that can be deemed exceptional. This may now place the industry at a crossroads. Indeed, these past years have been characterised by central bank 'intervention', much of it targeted directly at financial assets. There can be no question that quantitative easing (QE) has helped multi-asset funds post positive performances, with a significant share coming from the appreciation of bonds. Even a passive investment in European government bonds has returned an annualised 6,3%[2]. An equally critical contributor to the positive track record of flexible multi-assets funds was the diversification gain from equity and fixed-income markets: both gained over the past five years, though at different times. For instance, the correlation between the EuroSTOXX 50 index and the 10-year German Bund Future contract was -0.45 over the same period. Such a market environment has surely played a part in the impressive Sharpe ratios by many diversified products.

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CROSS-ASSET CORRELATIONS OVER THE PAST 5 YEARS

	US Equities	Euro Equities	EM Equities	US Sov	All Sov	EM Sov
US Equities	1	0.63	0.47	-0.43	-0.31	0.34
Euro Equities	0.63	1	0.59	-0.41	-0.45	0.41
EM Equities	0.47	0.59	1	-0.24	-0.24	0.59
US Sov	-0.43	-0.41	-0.24	1	0.64	0.06
All Sov	-0.31	-0.45	-0.24	0.64	1	0.05
EM Sov	0.34	0.41	0.59	0.06	0.05	1

Source: THEAM Calculation, from August 2011 to August 2016
US Equities: S&P 500 Index **Euro Equities:** Euro Stoxx 50 Index **EM Equities:** MSCI Emerging Index
US Sov: US 10Y Future Contract **All Sov:** German Bund 10Y Future Contract **EM Sov:** JP EMBI Core Index

Looking ahead, many of these patterns appear stretched. Safe-haven fixed-income assets have become riskier than ever (what's left of the 'risk-free' asset concept?). And cross-asset correlations are vulnerable to spikes, for example, in a scenario where US interest-rate rises or QE tapering elsewhere would trigger a correction both in equity and fixed-income markets. The traditional buffers in times of market turbulence would be less effective. The last 30 years or so have been marked by disinflation and lower long term rates, a trend that cannot be repeated ad infinitum. In other words, the easy times might be ending. Relying on diversification will become a necessary, but not sufficient condition for flexible investment processes.

In such a context, coming months and years will most probably see more differentiation between the performance of flexible funds. As diversification benefits become less important, drawdown management will develop into a key element of underperformance or outperformance over the peer group. Faced with potentially more adverse conditions, there is room for process improvement towards what could be coined 'enhanced flexibility'.

At THEAM, we have been offering investors risk-based multi-asset products since 2009 over a seven-year period that has allowed us to reflect on these issues. We are applying disciplined risk budgeting portfolio construction using a proprietary approach named 'Isovol', which was developed using BNP Paribas Investment Partners' research capabilities. This contains any drawdowns by cutting the exposure in more volatile markets. We have now begun introducing portfolio features aimed at improving the asymmetry of our performance profile.

As an example, we have added an optional strategy overlay: a limited options premia budget can be used to hedge the portfolio against specific events or potential corrections. In 2015, this helped smooth the impact of the Chinese currency devaluation on performance: we had bought put options on the US and Japanese equity indexes. As market behaviour is now affected more by herd behaviour and pro-cyclical portfolio adjustments, options overlays can be an answer to volatility spikes. Markets run the risk of becoming complacent when boosted by extraordinary stimulus measures by monetary authorities, reducing the cost of hedging tools. In an adaptive manner, an overlay can be dynamically adjusted depending on the price of volatility and early indications of a market inflection point.

Another lever for action is to be found in the investment universe itself. Investors often associate flexibility with flexible exposures – putting more or less of the same asset in a portfolio. In parallel, fund managers may also adapt to a changing opportunity set, as markets and economic agendas evolve, pushing managers to look beyond the usual switch between developed equities and developed government bonds. So our investment universe is flexible too. Early in 2016, for instance, we added precious metals as a diversification asset. In a quest for true decorrelation, gold is often perceived as a 'barbell play', outperforming in troubled times as well as in inflationary episodes. In 2015, we had bought Australian government bonds to diversify the fixed-income bucket of the portfolio, while better protecting the portfolio against a possible slowdown in China.

Such portfolio moves, among other factors, have helped the portfolio weather the impact of market turbulence over the past year. As central banks begin switching their monetary policy towards less quantitative easing, market volatility has made a comeback, which translates into a more challenging and discriminating environment for asset allocation funds. Many of the factors that triggered this change are here to stay and could even grow in importance. This might present the flexible funds industry as a whole with a first reality test. More than ever, forewarned means forearmed for managers.

FOOTNOTE
[1] Sharpe ratio of Morningstar Europe EUR Flexible Allocation – Global, from August 2011 to August 2016
[2] As measured using the JP Morgan GBI EMU Unhedged Loc index, from August 2011 to August 2016

Past performance is no guarantee of future returns. Opinions included in this material constitute the judgment of THEAM at the time of publication and may be subject to change without notice.

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