WHITE PAPER

UNLOCKING THE TRUE POTENTIAL OF MULTI-ASSET INVESTING

How Asset Class Diversification Delivers Greater Risk-Adjusted Returns and AuM Growth

THE FUTURE OF FINANCE IS OPEN

CONTENTS

INTRODUCTION

Asset managers are under pressure to deliver performance and find new sources of alpha in today's low-growth, low yield environment. This often necessitates diversifying into new asset classes to seek out alternative risk premia to deliver uncorrelated returns.

But, how easy is it to extend into new asset classes? What are the main operational challenges? What techniques and tools are needed to effectively hedge risk and manage a diverse array of exposures?

Ultimately, taking a multi-asset approach to investing is no easy task. It requires the right systems and technology infrastructure to support fund managers in such a way that allows them to pivot into new markets and trade new instruments with minimal disruption—not to mention provide front-office teams with sophisticated analytics required to run portfolios that span the spectrum of traditional securities (government bonds and equities), high-yield bonds (eg, emerging market debt), corporate bonds, convertibles, IRS, index and single name CDS, REITS, private equity and commodities.

In order to have the confidence to trade multi-asset portfolios with differing liquidity and risk profiles, global asset managers are reassessing the technology capabilities of their operating models. Optimizing the fund strategy's risk-adjusted returns with sophisticated hedging techniques requires real-time automated workflow processes, not excel spreadsheets, as these typically create more operational risk, key-man risk and, moreover, a lack of scalability. Instead, these sophisticated hedging techniques can help drive trading insights that might previously not have been possible.

In this report, produced on the back of a webinar hosted by Finastra on 8 November 2016, the above issues are explored in detail. The views contained herein are attributed to the following people, who kindly gave their time to participate in the panel discussion:

- Jason Whitaker, Buy-side Strategist: Finastra
- Malcolm Jones, Investment Director, Absolute Return and Multi-Asset Investing: Standard Life Investments
- Olivier Blin, Senior Vice President, Cross-Asset Solutions Team: Unigestion
- Brian R Wimmer, Senior investment Strategist: Vanguard

There is no doubt that investors value multi-asset funds. A recent Schroders multi-asset survey[1] found that two-thirds of respondents were currently using multi-asset funds, with 69% citing their ability to deliver real returns with lower volatility than global equities as the main objective.

Moreover, since 2010, UK assets in Diversified Growth Funds (arguably another name for multi-asset funds) have grown almost fivefold, from GBP25 billion to GBP117 billion.

With the macro environment set to remain a challenge, the ability to provide multi-asset solutions to institutional investors could become a key differentiator.

1. "Schroder Multi-Asset Survey – November 2015

A Changing Investment Landscape

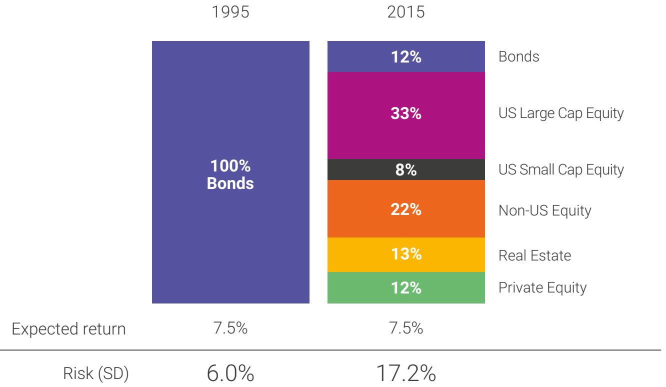
In recent years, the macro environment has been shaped largely by central bank intervention rather than economic fundamentals, driving bond markets to historically low interest rates. This has been a benefit for fixed income investors, but so profound has been the effect of yield compression that Japan currently operates a negative interest rate policy while in Europe the ECB's benchmark rate is also negative.

> "20 years ago, an all-bond portfolio had an expected return of 7.5% with a 6% standard deviation or associated risk. Today, to achieve that same level of expected return, asset managers need to diversify into a much wider array of asset classes."

The US, a market that is showing signs of sustained growth, only has a 0.75% benchmark interest rate, following Janet Yellen's decision to raise rates by 0.25% on 14 December, 2016.

As the below figure from the WSJ reveals, 20 years ago, an all-bond portfolio had an expected return of 7.5% with a 6% standard deviation or associated risk. Today, to achieve that same level of expected return, asset managers need to diversify into a much wider array of asset classes. Not only does this bring additional portfolio management complexity, it manifestly increases the amount of risk.

Fig. 1 Achieving a 7.5% return in 1995 and 2015



Source The Wall Street Journal

"Yields have fallen across all bond assets, not just government bonds, which has created favorable tailwinds for investors for 30+ years," commented Jason Whitaker. "Post-crisis, there has been unprecedented central bank intervention in financial markets through quantitative easing and this has taken this trend to new extremes. At one point recently, there was USD15 trillion globally of negative yielding developed world sovereign debt, over a third of the global government bond market". He stated that today's environment makes it very difficult to generate returns. This is forcing many asset managers to re-examine their strategies. How do you generate competitive risk-adjusted returns while trying to maintain good margins for your business? Investing in more asset classes has now become a must for many.

"The beta tailwind has to come to an end soon. At some point people will stop buying bonds at such low yields and this is going to make things even harder for asset managers as bond yields start to rise," added Whitaker.

Brian Wimmer is part of the investment strategy group at Vanguard. The group's main responsibility is to help clients and prospects understand what Vanguard thinks about a range of different portfolio-level investment issues. It runs a range of multi-asset investments: both active funds and passive multi-strategy funds offered through its LifeStrategy range.

Discussing the macro backdrop, Wimmer admits that lower interest rates and current equity valuations are creating challenges for investors seeking returns over the long term.

"When we think about multi-asset investing we aim to produce a certain return and combine asset classes—stocks or bonds or a broader range of asset classes—to try and offset some of the risk.

"How much risk we take on depends on investors' goals but the ultimate rationale for multi-asset investing remains the same: when we look at equities they are a growth engine relative to fixed income.

"The real benefit of fixed income to a portfolio is diversification. When we look at high-quality fixed-income, during the worst periods in equities that is when those assets can really shine," explained Wimmer.

He said that the value of combining equities with lower correlating high-quality assets such as investment-grade fixed income allows for a great combination "for investors to find a specific balance of risk and return that makes sense for their long-term goals".

Equity-Like Returns with Lower Volatility

Malcolm Jones is Investment Director, Absolute Return and Multi-Asset Investing at Standard Life Investments (SLI). One of the funds that SLI offers to investors is the Enhanced Diversification Growth Fund, a product that aims to generate equity market-like returns over a market cycle with two-thirds of equity market volatility. Unlike other Diversified Growth Funds, SLI uses dynamic asset allocation that broadens the portfolio beyond traditional assets (such as equities, credit, commodities, real estate).

Jones said that with respect to global equities and bonds there are still moneymaking opportunities, "albeit you are now being starved in a low yielding world. Our overall approach is that there is a much broader suite of transitory risk premia: investment opportunities that can make money in a three-year timeframe and diversify against more traditional investments such as equities".

The Enhanced Diversification Growth Fund has been running for approximately three years. In many ways it is well-equipped to cope with the low-rate, low-yield challenge of today.

As Jones explained: "For the majority of multi-asset funds, over the last decade they have done a good job of reducing volatility but they perhaps haven't delivered on the equity-like returns. When we analyzed this issue, the crux of our solution was that there was not enough return-seeking risk on the table to try and deliver the return that investors wanted.

"The only way you can keep within an investment risk budget while at the same time putting more investment risk on the table is to find investment opportunities that will make money and add diversification to the portfolio. By utilizing a wider investment universe, we feel we have enough investment returns in the portfolio to potentially deliver equity-level returns but within a low risk budget over a three-year timeframe and this has largely been achieved".

Is There a Better Way?

> “We try to route every decision we take—either through systematic signals or on a discretionary risk taking basis—within a macroeconomic regime framework. This can be applied to any multi-asset portfolio.”

Olivier Blin
Senior Vice President, Unigestion

Olivier Blin is a portfolio manager for Swiss-based asset manager, Unigestion. Blin is part of the cross-asset solutions team that manages a mix of segregated mandates and commingled multi-asset funds. Specifically, Blin focuses on systematic strategies and portfolio construction, something he was doing previously for five years at Lombard Odier Investment Management.

Blin explained that the team’s approach is to build risk-based diversified portfolios combining assets with diversification properties. “We try to route every decision we take—either through systematic signals or on a discretionary risk taking basis—within a macroeconomic regime framework. This can be applied to any multi-asset portfolio,” said Blin.

On idea generation and position building, Blin continued: “We can use a mix of systematic strategies to decide whether or not to move around our asset allocation in tandem with discretionary risk taking. We think that in today’s environment, sitting on long beta exposures is probably not going to work in terms of delivering smooth risk-adjusted returns. We need to be even more proactive in terms of dealing with ever-changing markets and rising yield environments. We can do this two ways: by diversifying through active management, including shorter-term opportunistic trades and by pursuing alternative risk premia ie, long/short strategies that can offer a defensive aspect or a carry opportunity aspect”.

Rather than worry about active investing and needing to devise new ideas, Vanguard takes a passive approach where the focus, said Wimmer, is on “controlling the controllable.” He thinks that passive portfolios can still add value through beta returns.

“For us that starts with a focus on diversification; what is our broad asset allocation and can we set that in such a way that gives us the best chance for future success?

“In respect to risk, we wouldn’t say that the markets are perfectly efficient but we do tend see a pretty accurate pricing of risk in the marketplace. If you’re moving somewhere for greater income and the potential for higher investment returns that’s fine, we think investors should make that decision with their eyes wide open, but expectations of finding higher investment returns and noticeably lower risks are much harder to find and much less likely today,” opined Wimmer.

Alternatives Strike a Chord
Jones sees a lot of ideas emanating from liquid alternatives. In this context, he is referring to a range of opportunities in the currency, interest rate and long/short equity marketplace.

"There is a whole range of opportunities that exist within liquid alternatives, even in bond markets," suggested Jones. "In Australia, for example, there are opportunities to make money at the 10-year point and two-year point of the rate curve that behave quite differently to equity markets in terms of shorter-term behavior. In the world of interest rates yields are quite low, but you can still identify countries at different parts of the economic cycle where you can play one market versus another".

The attraction of alternatives is something that chimed with the webinar audience. During the session, the audience was asked to vote on the following question:

"There is a whole range of opportunities that exist within liquid alternatives, even in bond markets."

Malcolm Jones
Investment Director, Standard Life Investments

Which asset class/strategy do you need to invest in to support your firm's growth plan in the next 12-18 months?

Some 46% of listeners voted for alternatives, with 23% voting for ETFs, 15% for emerging markets and 8% for fixed income.

The above result is also in line with Unigestion's view that alternatives will increasingly become important to multi-asset portfolios.

"We don't expect investors will be able to make the same risk-adjusted returns just from investing in bonds and equities," said Blin. "Historically, your growth engines were equities and high-yield bonds and diversification came from safe haven assets such as government bonds that provided protection in case of equity drawdowns as well as positive yield; that positive yield is barely there today and the downside protection component is less robust, especially if we enter a reflationary period where interest rates rise and stocks and bonds both fall at the same time".

Lately, Blin noted, the team has been looking for solutions to deliver good yield or carry while still being uncorrelated to equity markets; alternative risk premia fit into that bucket.

"And more and more, to hedge against specific events or macro themes, we are looking to protect portfolios by implementing options strategies and FX strategies that can provide more diversification benefits than bonds," added Blin.

Optimizing a Multi-Asset Portfolio

> "It's all about how you trade different asset classes efficiently with as few systems as possible to manage everything consistently. People are moving away from using best-of-breed systems and looking for a more integrated solution."

Jason Whitaker
Buy-side Strategist, Finastra

One of the biggest benefits of a multi-asset portfolio is the ability to generate a diversified range of returns, yet equally this can also be its Achilles heel. Too much diversification can lead to increased correlation at the position and asset class level. Striking the right balance is therefore crucial, just as any fund-of-hedge-fund manager will tell you.

Vanguard offers a variety of straightforward investment choices within its LifeStrategy range for long-term investors. An investor might choose to have a 20:80 equity/fixed income portfolio, 40:60, 80:20 or, if their risk appetite is high enough, 100% equities.

Wimmer said that the choice depends on the goals or objectives of the investor using the product. Depending on whether the fund is a core holding or part of a wider portfolio, they can decide on how much risk they want to take.

"Maybe the investor belongs in an 80:20 equity: fixed-income product or they change the way they want to save and think about the rest of their portfolio and opt instead for a 60:40 product.

"We work with investors to determine the right asset allocation and diversification balance at the portfolio level using specific passive funds that target beta exposure across a range of markets," explained Wimmer.

For those who are thinking about evolving their business models to run multi-asset portfolios, the diversification point not only means that they need to ensure that robust risk management processes are in place; it also means that the more asset classes a portfolio manager invests in the more strain it will place on the overall operations team.

Whitaker pointed out that it is not simply a case of being able to trade different asset classes at the top of the technology stack and account for them at the bottom. "It is a question of being able to properly analyze those investments in terms of individual performance and risk and also how they affect the exposures and risk of the portfolio as a whole," he said, adding: "We've come across some managers who have had to spend upwards of USD1million and 12 months to move into a new asset class.

"It's all about how you trade different asset classes efficiently with as few systems as possible to manage everything consistently. People are moving away from using best-of-breed systems and looking for a more integrated solution. Clearly, the last thing managers want to do is throw more bodies at the problem when margins are under pressure and there is an overall trend to move towards a Straight-Through Processing environment".

The second question offered to the audience was the following:

What is the biggest barrier to asset class diversification?

The choices were:

- Regulation and risk oversight
- System inoperability
- Spiralling costs
- Partial data and delayed information
- Capital treatment

The response was an even split between regulation and risk oversight and system inoperability.

System agility is important as one expands into more exotic asset classes, said Blin. “They need to give you an accurate picture and appropriate representation of your risk exposures. Otherwise, you won’t be able to properly manage a multi-asset portfolio in today’s environment”.

This echoes Whitaker’s comment on the need for sophisticated systems to properly manage multi-asset portfolios.

At SLI, Jones remarked that the team has developed its systems over a decade and remains on an “ongoing journey”. “One investment might consist of many lines of derivatives that we need to track through the system to measure its performance and risk. We’ve not found an off-the-shelf system that can handle this,” said Jones.

Wimmer noted that every one of the above choices to the second polling question during the webinar can have a tremendous impact and that a balance always needs to be struck. From an investment perspective, if costs get too high, they can quickly eat away at investment returns. Equally, regulation or system problems can prevent managers from releasing quality products while partial data can negatively impact the performance of the fund.

Efficiently Hedging Your Exposure

“We monitor risk daily. We don’t solely rely on our proprietary model however. We also use off-the-shelf models to challenge our model to make sure everything checks out and that we are well aligned in our risk management.”

Olivier Blin
Cross-Asset Solutions, Unigestion

One of the most effective ways to reduce risk in a multi-asset portfolio is to devise effective hedging strategies, many of which will typically involve the use of derivatives. Some managers will opt for plain vanilla derivatives that are exchange-cleared and provide daily price transparency; others will look towards more esoteric OTC instruments that allow them to tailor their credit and duration risk, for example.

Whatever the approach might be, using derivatives requires significant infrastructure. This is necessary for comprehensive policies on counterparty selection and management, to devise a proper approach to collateral management and so on.

“The use of derivatives might only be a small portion of a manager’s portfolio but they are very important for hedging different aspects and you need to correctly understand what you are doing and how are you using them,” cautioned Whitaker. “Some clients might only be holding a very small percentage of assets in the form of derivatives in their portfolios but this small percentage may cause nearer 60% of the problems in their operations.

“Our FusionInvest solution allows portfolio managers to put a target in (with respect to expected return) and it will accurately determine and calculate what derivative contract(s) they should buy in the most cost-effective way”.

At Unigestion, Blin noted that they have developed their own proprietary tools to monitor portfolio risk and individual strategy and position-level risk across asset classes.

“We don’t think volatility is completely appropriate (with respect to risk management). We developed a model to take into account more dimensions of risk such as valuation risk, distribution of returns (fat tail risk), and liquidity risk. This is important in a low-yield environment because it leads to a lot of distortions in terms of risk estimates.

“We monitor risk daily. We don’t solely rely on our proprietary model however. We also use off-the-shelf models to challenge our model to make sure everything checks out and that we are well aligned in our risk management,” confirmed Blin.

Defining a Target Operating Model

Real-Time, Multi-Asset IBOR

There are no hard and fast rules on the type of operating model one should have in place to optimally run a multi-asset portfolio. It will depend on many factors, including the size of the fund, the manager's pre-existing technology stack, the types of asset classes and instruments—and indeed the number of positions—the manager intends to trade in the portfolio, and so on.

However, as a general rule, one of the most important aspects to any operating model should be the ability to have a near real-time Investment Book of Records (IBOR) in place that captures all asset classes the firm trades, as this will give the asset manager a comprehensive, aggregate view of the portfolio based on consistent data.

Whitaker is in no doubt about its importance: "A true IBOR keeps everything up-to-date for the portfolio manager. The more complex the investment strategy, the more important an IBOR becomes. You might have stocks that are out on loan; various margin requirements; you might not be optimizing the collateral that you are posting; different asset classes might be analyzed on different systems meaning you get slightly different position updates and derived analytics; some of the legs of a hedge might have been updated whilst others have not, which can impact the efficacy of a hedging strategy. Has 'cash' updated at the same time as positions.

"Achieving true exposure for their IBOR in as close to real time as possible is something that our clients are increasingly asking for".

As well as thinking about the present, portfolio managers have to think about the future. What might their risk exposures look like if commodity prices rise, or the US dollar falls? Running these "What if…" scenarios, and moving from a present to a future investment state adds a further level of complexity. How can one calculate how you get to a target future asset exposure without truly knowing the starting point of the exposure that you have now? Hence why near real-time IBOR is so important today for many managers running complex strategies.

Not all asset managers though. "We are happy with once a day," remarked Jones, "as we are longer-term investors. Operationally, we have a dedicated team of risk specialists that work with SLI's investment managers to better understand the risks they think they have and alert them to risks they might not be fully aware of. We also have a team of implementation specialists that sit between the traders and portfolio managers to manage order flows".

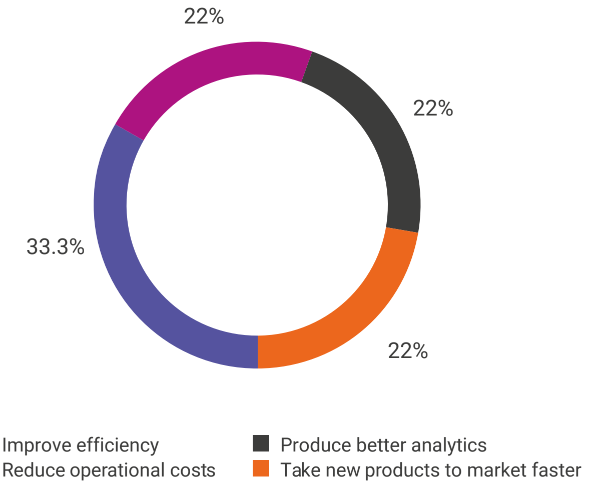
“Efficiency is a big part of our passive strategies. Making our trading more accurate and cost-effective ultimately benefits our investors.”

Brian R Wimmer
Senior investment Strategist, Vanguard

The third and final question asked to the audience was:

How can modern technology best help investment managers diversify their asset class coverage?

The results were:



Wimmer would choose ‘improve efficiency’ above anything else. “Efficiency,” he said, “is a big part of our passive strategies. Making our trading more accurate and cost-effective ultimately benefits our investors”.

Technology is vital in the pursuit of returns—either with existing products or new ones—which depend extensively on reliable data sources and portfolio management systems. Regardless of whether the portfolio manager is active or passive, to be successful requires knowing at any point in time the composition of the portfolio and its risk exposure: Do you have enough collateral to cover margin calls? Do you need to reinvest dividends? The whole chain has to be completely reliable to manage the portfolio efficiently.

“Having solid systems is vital for operations and risk staff for pre-trade checks to avoid breaching regulatory or investor constraints in the Investment Management Agreement,” said Blin.

Main Impediments to Running Multi-Strategy Funds:

Organizational buy-in
The first hurdle to overcome is more of a holistic, operational question. If an asset manager is thinking about moving into a strategy that the firm has no prior experience in, there has to be a top to bottom appraisal before moving forward, said Wimmer. "Do you have the investment expertise and talent? Do you have the systems in place to manage risk? Do you have people in the organization to talk about the product and sell it effectively? It can require a complete change in mind set.

"As we continue to look for places to expand at Vanguard, it isn't just an investment question or just a technology question; it goes to the highest levels of the organization and determining whether we can support such a strategy".

Internal compliance
Compliance is a major consideration. Asset managers today need comprehensive audit trails of every aspect of the investment process, every decision made, when it was made and why, and by whom. This is something that global regulators are paying closer attention to and therefore needs to be factored in when thinking of expanding into new asset classes.

Over at SLI, Jones said that in terms of new instrument development, "We need to pass internal compliance and determine whether or not we can apply the proper risk management. Who will the counterparties be and how many? Do we understand the asset and can we price it? It can be a very long process. When we ask our portfolio managers what they think the biggest impediment it is, they typically respond, 'Our own internal compliance'," said Jones, slightly tongue in cheek.

CONCLUSION

You have to be strategically committed to multi-asset investing. It is definitely something that can help you achieve better risk-adjusted returns.

There are many advantages to multi-asset investing. They provide potentially lower volatility profiles and diversification benefits whilst offering equity-like returns but they are not something to be pursued without careful consideration—and perhaps most importantly, robust operational models that are capable of giving portfolio managers the required level of data integration, position-level risk and look-through capabilities to trade new assets confidently and in a timely fashion.

As Whitaker concluded: "You have to be strategically committed to multi-asset investing. It is definitely something that can help you achieve better risk-adjusted returns. However, it requires a significant rethink to how you manage the investment process today to ensure operational costs, and the resources required to run the strategy, are kept under control".

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James Williams is the News Editor at Hedgeweek, a fully digital newswire wire service that covers all aspects of the global hedge fund industry. James joined Hedgeweek in June 2010, where he reports on key developments spanning fund performance and strategy, legal and regulatory issues, technology and risk management. In addition, James has contributed articles on the hedge fund industry and capital markets to the likes of the Financial Times, International Financial Review Asia, and Dow Jones Financial News. Prior to joining Hedgeweek, James lived in Hong Kong between 2001 and 2010 where he plied his trade as a financial copywriter. Before leaving Hong Kong, James worked at JP Morgan Treasury & Securities Services as an in-house editor.

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About Finastra

Finastra unlocks the potential of people and businesses in finance, creating a platform for open innovation. Formed in 2017 by the combination of Misys and D+H, we provide the broadest portfolio of financial services software in the world today – spanning retail banking, transaction banking, lending, and treasury and capital markets. Our solutions enable customers to deploy mission critical technology on premises or in the cloud. Our scale and geographical reach means that we can serve customers effectively, regardless of their size or geographic location – from global financial institutions, to community banks and credit unions. Through our open, secure and reliable solutions, customers are empowered to accelerate growth, optimize cost, mitigate risk and continually evolve to meet the changing needs of their customers. 48 of the world's top 50 banks use Finastra technology. Please visit **finastra.com**

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