Multi-Asset Total-Return Investing

By Valentijn van Nieuwenhuijzen
Head of Strategy, Multi Asset
ING Investment Management

In today's environment of low rates and investor behavior that is driven both by fundamentals as well as sentiment, an actively managed multi-asset total-return strategy can help deliver attractive returns while at the same time avoiding large drawdowns. A multi-asset total-return investment approach typically provides diversified exposure and dynamically allocates across assets that behave differently in different market environments. Returns generated by such a strategy are less dependent on single asset classes and often less benchmark oriented. As such, a multi-asset total-return strategy can serve well as the core of investors' portfolios who have the need for attractive and stable total returns and are not concerned with benchmark comparisons, but focus on achieving a certain target return. The objective of a total-return solution is to generate attractive returns over time and in different market circumstances without being restricted by specific benchmark constraints. Total-return strategies target returns over cash, whereby the targeted excess return being a function of the available risk budget.

Timing skills can add value

Returns for different asset classes significantly differ over time (see chart). The dispersion in returns implies attractive investment opportunities for multi-asset investors that have the skills to allocate to the performing asset classes at the right time. Dynamic Asset Allocation (DAA) adjusts the asset mix in a portfolio in an attempt to profitably exploit the value-add potential arising from differences between asset classes and markets. In the same way as investors benefit from diversifying their portfolio over many asset classes, we are convinced that diversification over various alpha-generating strategies (top-down, bottom-up) will increase the return that can be generated for a given amount of risk.

It goes without saying that top-down asset allocation is a challenging task in today's rapidly changing environment which is more interlinked than ever. Responding quickly to changes in fundamentals or behavior is essential to add value by top-down asset allocation.

View generation and the never-ending need to generate new knowledge

Our knowledge of how the economy and markets work has increased considerably in the past few decades, but new developments always create new uncertainties. The credit crisis impinged on the fundamentals of the market economy. Quantitative models developed to convert uncertainties into measurable risks have created imaginary certainties. Under the influence of human emotions, particularly fear and greed, markets appear to be gripped by herd-like behavior and disruptions. Emotions can have such a radical influence that markets can no longer function. Due to the credit crisis, the results of economic research on efficient market theory as a source of knowledge have come under heavier pressure.

Investor and markets behavior increasingly drives returns

ING IM's tactical asset allocation approach is different from the way it was before the credit crisis in a number of ways. There are major imbalances in the global economy, so it is consequently less able to absorb any shocks that may occur, such as a financial crisis or a sharp rise in oil prices. Economic cycles have become shorter as a

Returns for different asset classes significantly differ over time

Yearly Asset Class Performance (in Euro)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Cash	4.3	4.6	3.4	2.4	2.1	2.2	3.0	4.1	4.5	1.0	0.5	1.2	0.4
Corporate Credits	6.2	6.4	8.5	6.8	7.5	4.0	0.5	0.0	-3.8	15.7	4.7	1.5	13.6
EMD (HC)	12.8	-0.4	16.0	22.5	12.0	9.2	7.6	4.7	-13.5	29.4	11.6	7.4	16.8
Global HY	-9.1	1.0	-0.1	30.0	12.3	3.0	8.4	0.2	-28.8	65.4	13.6	2.9	17.7
Euro Treasury (AAA)	7.2	5.4	9.6	4.0	7.3	5.3	-0.2	1.7	11.3	2.8	4.6	7.1	7.5
Global Equities	-7.3	-12.3	-32.0	10.7	6.5	26.2	7.4	-1.7	-37.6	25.9	19.5	-2.4	14.0
Emerging Equities	NA	2.7	-20.4	29.6	16.5	54.4	18.2	25.7	-50.9	72.9	27.1	-15.7	16.4
Commodities	40.9	-15.1	6.7	3.6	0.6	39.9	-8.4	5.1	-32.7	15.8	25.3	-10.6	-2.8
Real Estate (US)	20.1	13.2	-9.5	-8.9	6.1	37.5	4.6	4.8	-2.2	-19.0	21.3	17.8	8.6
Best-Worst	49.9	28.3	48.0	38.9	15.9	52.2	26.6	27.4	62.2	92.0	26.6	33.5	20.5

Source: ING IM, data as of end of December 2012

consequence. If you want to beat the market, you need to be quick to respond to opportunities that arise. Due to the greater vulnerability of the economy, opportunities can soon disappear. Risks can quickly increase. This does not mean that the longer term can be ignored, but that more attention is given in recent years to current dynamics in the market and to factors that explain investor behavior.

Some examples of information which gained more weight in our process are: What are the empirical trends in a market? Which investors operate in a market, are dominant and what is their role? In what direction are global capital flows moving? Are cash holdings larger than average?

Getting to know a market as closely as possible and to understand the emotion that is in the market is essential. Relying largely on innovative proprietary research, both quantitative and qualitative of nature, we have been able to adapt to changing circumstances in global markets and added value to our clients' multi-asset portfolios. Using fundamental analysis remains important, but decision-making processes based on market evolution and behavior need to weigh heavier than in the past.

Take as many informed positions as possible

The market risks have decidedly increased in recent years, but if we only looked at the risks, we would have little chance of succeeding in adding value for our clients. Of course we keep a close eye on the risks, but we don't ignore the opportunities either. Apart from paying more attention to behavioral factors, we also include more different tilts in our portfolios. We remain alert and quickly wind down our positions if our analyses suggest that it is necessary. Because the cycles have become shorter and at the same time more vulnerable to shocks, our tactical asset allocation is geared to the shorter term.

An important element of our current tactical allocation is that we can take positions in a much wider range of categories and subcategories than was the case a few years ago. We no longer take only equity positions versus fixed income securities. Depending on our analyses of the market situation and the fundamentals, we also bet on real estate stocks, commodities and commodity subgroups, such as precious metals and industrial metals, and – more specifically – on a particular metal, gold for instance. We can also take positions in equity sectors and equity regions and in the higher risk fixed-income categories, such as (high yield) corporate bonds, and in currencies.

The more positions we take based on our analyses, the greater is the chance that we will outperform our benchmark or our targeted return and thus earn money (or limit the loss) for our clients. All in all, the current investment process offers many more options for focusing on specific sections of the market in order to make use of the opportunities that we see. We can also underweight the parts of a market in which we see above-average risks. That gives us plenty of opportunities to spread the risks and to beat our benchmark or safeguard returns.

Take risk when you can expect to be rewarded

We all know that in investing there is no way to earn a return without also bearing the risk that goes along with it. In "traditional" investment products that are closely linked to a benchmark, the risk in a portfolio will be mainly driven by the market risk in the benchmark. As such, portfolio risk is a derivative of market risk and fluctuates heavily. We strongly believe it makes more sense to take the risks if you believe the pay-off is attractive. In other words, investors should increase the risk in their portfolios if they believe there are more opportunities around and reduce the risk if they believe opportunities are less abundant. If expectations do not change, the risk budget should be kept constant instead of fluctuating with the market.

Being conscious about risk also needs an acceptance of the uncertainty in your measure of it and a strong objective to be as forward looking as possible. In this respect it is key to realize that underestimating risk is worse than overestimating it. Instead of relying only on historical data, it is essential to realize that all risky assets move south when a crisis breaks loose. The diversification effect that normally lowers portfolio volatility is typically never there when you need it most. A dynamic asset allocation process built around a well defined risk framework can help investors navigate through these challenging times.

valentijn.van.nieuwenhuijzen@ingim.com
www.ingim.ch