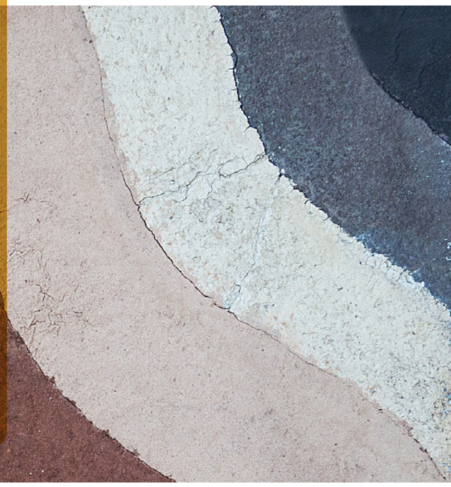

Effective diversification for a changing world

As market conditions change, investors not only need to look beyond traditional asset classes, but also to be more flexible and dynamic in their asset allocation approach.

Until recently, fund managers had grown increasingly focused on benchmarks rather than investor outcomes. Labels such as ‘cautious’ or ‘defensive’ sometimes reveal little about what is going on beneath the surface of a fund’s headline.

The regulator responded and LGIM followed suit. It saw the need to match risk more closely to client requirements and sought to build its range to focus on outcome-orientated solutions. In 2013, it built a nimble and dynamic fund range (Multi-Index), which uses the full range of its risk targets, while employing regular rebalancing to ensure they stay within these targets. For Andrzej Pioch, fund manager in the Asset Allocation team, this played to the group’s existing strengths. The team runs over £50 billion* in assets and uses dynamic asset allocation in many funds as a way to deliver returns over time.

> “Post RDR, the concept of risk-targeted funds grew very quickly. The key factor was the ability to match the risk profile to the client more accurately to ensure suitability.”

However, there were still problems. Many multi-asset funds were highly concentrated, which over the long-term further distorted client outcomes. While designed to be multi-asset, there were often significant weights in US equities, for example, or a major home-country bias.

Some managers took a very one-sided view of risk targeting and only focused on the maximum allowable level of volatility. The danger, says Chris Teschmacher, also a fund manager on the team, is that a fund manager may keep taking less and less risk: “There are always scary scenarios out there and something to worry about, from Trump to Italian politics. It is easy to tell investors there is less risk in the fund in light of upcoming events. But if you do that year in, year out, you will end up not taking enough risk to hit the return targets.”

> “With limited risks, there can only be limited rewards. We label it ‘reckless prudence’.”

More recently, financial markets created some further problems. It was clear that at a time when bond and equity returns were lower, and potentially more highly correlated, greater diversification was necessary. Multi-asset managers needed to look beyond traditional assets. For example, LGIM has recently added frontier markets and commodities to its Multi-Index range. It believes investors need to be more nimble and dynamic in the way they approach asset allocation – particularly important now market volatility has normalised from persistently low levels.

In this environment, the LGIM Asset Allocation team saw demand for a purer ‘go-anywhere’ expression of its asset allocation ideas – the result was the L&G Multi-Asset Target Return fund.

*Source: LGIM as at 31 March 2019

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‘LGIM has designed the approach with the needs of clients and today’s regulatory environment in mind.’

According to Teschmacher, the fund was built for three types of clients. The first were those who had a shorter time horizon than was needed for full market exposure. He believes that being unconstrained allows the fund managers to work with a shorter-term horizon and deliver a lower returns volatility.

The second group are those clients looking for diversification or alternatives in their broader portfolio. For these investors, the multi-asset target return approach is seen as complementary to their wider portfolios, bringing in new, less-correlated sources of return.

The third are those seeking to mitigate equity drawdowns and could benefit from the hedges the fund has in place. That said, Teschmacher believes strongly that targeting the lowest possible volatility is not the best approach: “Since launch, the lower limit of risk has been more important to manage the fund than an upper limit of risk.”

“We see some of our peers taking too little risk and not pursuing enough opportunities as a result.”

The fund aims to provide performance competitive with equities, with a returns target of 5% above the Bank of England base rate per year over rolling three-year periods. It is built on four key components: diversified market exposure, alternative strategies, and tactical strategies and risk management.

In terms of how this works in practice, Teschmacher gives the example of a recent position in Mexican equities. The team believed there was value in Mexican equities. In the Multi-Index portfolios, exposure to emerging markets is taken via an equity index fund, which tracks the entire universe. To take exposure to Mexico, they introduced a future on the Mexican index to sit alongside this broad exposure.

In the Multi-Asset Target Return fund, they took this one step further. Teschmacher says: “In this fund, we can make the exposure larger and add bells and whistles to the trade. For example, there were some sector issues in Mexico that we wanted to negate and we could do that.”

Pioch is clear that LGIM has designed the approach with the needs of clients and today’s regulatory environment in mind. Increasingly, the historic approach to asset allocation looks anachronistic. This is the brave new world of unconstrained investing.

Contact us

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