

Challenging the Traditional Asset Allocation Model

15 June 2018 | Mark Houghton, King Tide Asset Management

The 'balanced' portfolio has become an institution in the financial world. Equities and bonds are the main ingredients and the 'mix' determines the categories of balanced funds commonly used. Words like conservative or capital preservation signal a low weighting to equities, around 20% to 30%, while 'balanced' usually means 40% to 60% in equities, and 'aggressive' or 'growth', can be as high as 90% in equities.

The equity component is the main determinant of the return and volatility of 'balanced' portfolios. Property is another asset class often used, but generally speaking this will consist of listed property companies, and I would argue listed property companies are just a part of the equity market. Cash is of course another asset class, but for the purpose of this article, I will assume cash is part of the bond allocation.

Equities provide high long term returns, but are volatile. Losses in equity markets can be severe, leaving investors in the red for years on end. Bonds provide more predictable returns because they (the returns) mostly come from regular interest payments called 'coupons'. These payments remain the same throughout the life of most bonds. Lower risk bond prices fluctuate based on interest rates, but the fluctuations are much lower than equities. Investment grade corporate bond volatility is around 2% p.a. versus 12% to 15% for equity markets.

Traditionally advisors and institutions manage portfolio risk by their bond/cash weightings. The more conservative the investor, usually based on age and circumstances, the lower the allocation to equities.

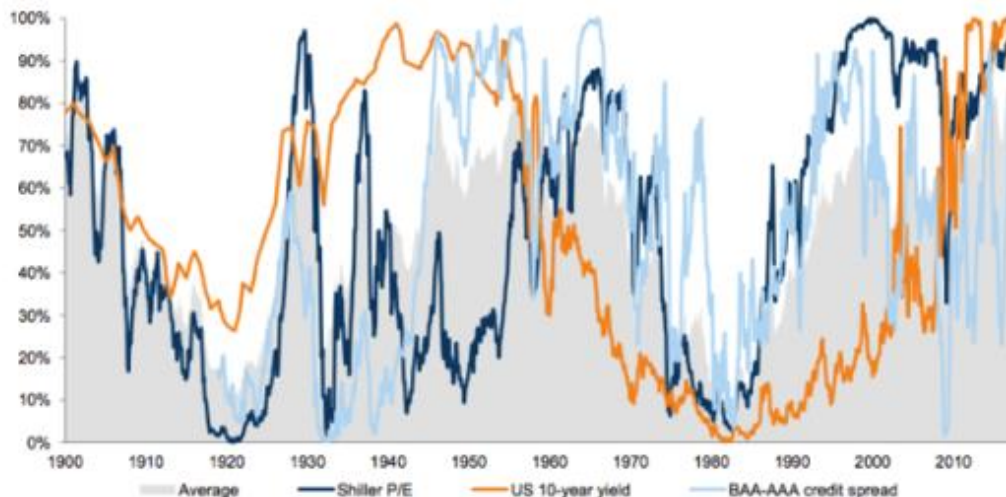
The logic behind this approach is based on the fundamental principle of diversification. Diversification depends on an asset's behaviour in certain market conditions, particularly when losses are involved. When you have an asset that is losing money, something that provides 'diversification' will be making money or at least losing far less, and this pattern is strong, that is, you can rely on this inverse relationship.

Among other things, the chart below shows the Schiller P/E, a measure of how expensive equities are, and the US 10-year yield inverted, showing bond market valuations.

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Over the last 100 years, bonds have been a great diversifier. The exception is the period 1960 to 1980 when 'real' bond prices fell -26.2%, and equities rose just 74.3%, or 2.7% p.a. These were the inflation years, and while equities rose, they became increasingly cheap.

Exhibit 12: Valuation frustration - both bonds and equities appear expensive
Valuation percentile (since 1871 for S&P 500 & US 10-year yields, 1919 for BAA spreads)



Source: Shiller, Goldman Sachs Global Investment Research

What is particularly interesting for us, is that in most people's 'investing lifetime' (post 1980), we have been in a golden age for bond/equity portfolios. By the early 1980's both were extremely cheap. Since then, bonds have not only steadily appreciated in value but have also spiked in value in all three major equity market downturns, 1987, 2000 and 2008, providing an excellent 'hedge'.

The question is, how will a bond equity mix work going forward, when both are expensive? Not since the 1920's have we seen both asset classes so stretched. I believe investors who remain wed to the 'balanced portfolio' approach of bonds and equities may have to accept a long period of considerably lower returns than what they are used to, even lower than those experienced in the inflation years mentioned above.

Let's imagine three scenarios for a 'balanced' portfolio going forward.

Scenario one, a crisis which disrupts global growth causing interest rates to fall and bonds to rise. Equities would fall but bonds would increase in value and soften the blow - another chapter in the bull market for the 'balanced portfolio' but you would still lose money. Also, most bond portfolios are set up for rising interest rates so are weighted towards shorter maturities. This ensures smaller losses if interest rates rise, but also limits gains when interest rates fall.

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Scenario two, the status quo with continued steady to strong economic growth leading to 'normalisation' of interest rates globally. Bonds underperform, with losses in capital value partially offsetting the already very low coupons. As the 'discount rate' rises, equity valuations face a headwind and valuations become more difficult to justify. Both bonds and equities underperform and the diversification benefit is limited.

Or thirdly, we see inflation rise more quickly than expected, sending interest rates sharply higher, which would probably lead to a correction in equity markets. Both bonds and equities lose money.

Unfortunately, many investors who have only ever been in a world where this strategy has worked, believe it will always work, and many have built business models which depend on it.

So what options do investors have in a world where both bond and equity markets are expensive?

The answer is simple and is based on the same principle which popularised the 'asset allocation' model, the principle of diversification. If you are prepared to look beyond traditional equities and equity funds, you will find a world of 'alternative' investments. Within this universe of 'alternatives' are strategies which can be relied upon to respond differently to a given development in the environment.

Dr Chris Gerczy, Associate professor of finance at Wharton School writes, *"Investors need to rethink their overall approach to portfolio construction and start thinking in terms of risk diversification and getting exposure to as many different and non-correlated types of risk they can-building a portfolio based on risk exposures, not just 'asset classes'.*

Many of the funds we invest in can be broadly categorised as 'equities', only the strategy adopted by the manager produces returns which bear little resemblance to equity market returns. Some strategies we invest in tend to make more money when equity markets fall than when they rise. Others will lose far less than the market, leading to meaningful long-term outperformance.

Unlike most traditional equity funds, alternatives depend very much on the skill of the manager rather than the market for their return. Manager selection is of course critical. Just as you ought to conduct in depth research when selecting companies and bonds, so you should apply the same rigour when selecting alternative managers. You can manage this risk by diversifying across multiple strategies and managers, just as you manage company risk by diversifying across multiple shares and bonds.

This approach is not new. In McKinsey's 2015 report, "The Trillion Dollar Convergence" they write, *"Institutions are beginning to abandon traditional asset class definitions and embrace risk-based methodologies, a trend that repositions alternatives from a niche allocation to a central part of the portfolio."*

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In a December 2014 Natixis survey of institutional investors they report, *“The challenge of generating alpha is leading institutional investors to implement alternative investments and non-correlated asset classes to their portfolio strategies.”*

You don’t need to be a wealthy investor to access great alternative funds. Australia has a large number of very talented and skilful managers offering funds which focus on ‘risk’ rather than replicating the market, and which provide a compelling alternative, pun intended, to a traditional ‘balanced portfolio’.

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