



## **Making headway in portfolio management**

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Today's world of low expected growth and extreme market volatility means building a diversified portfolio with a long-term outlook is more important than ever

In the current financial crisis, mainly triggered by the sovereign debt crisis in Europe and the debt ceiling issue in the US, uncertainty, nerves and fear are driving market volatility, and building portfolios for investors is not an easy task.

What is the best strategy? Is it to try and step back from the short-term chaos and focus on the back-to-basics, fundamental trades? Or is it about preserving capital? And are these two concepts in conflict with each other?

"Today, portfolio management is about weathering the storm and preserving capital rather than searching for yield," says Markus Taubert, head of private banking at Hamburg-based Berenberg Bank.

This approach may not lead to an optimal portfolio allocation today, he says, but to keep on buying and holding investments is no longer possible. "You definitely have to implement a tactical allocation to adapt to the market turmoil," he says.

In these macro-driven markets, where stocks, in particular, are not moving in line with fundamentals, the only solution is to reduce risky assets. "Over the past two to three months, we have reduced our equity quota by 50 per cent, mainly in the eurozone," says Mr Taubert.

In this extended period of uncertainty, it is also important to focus on so-called safe haven assets, even if they are "highly overvalued", such as government bond markets in Europe.

And volatility is not a bad thing, explains Mr Taubert. "We are protecting portfolios either by buying put options or selling call options."

But even in a crisis, it is important to stick to the principle in portfolio management of dividing clients' wealth into two different pockets, one invested in liquid assets for short-term needs, and the other allocated to more illiquid assets to meet client needs in the longer term.

The proportion of a client's portfolio that can be invested into illiquid assets varies greatly on client needs. It can be as low as 5 per cent up to a maximum of 30-50 per cent. In addition to private equity, real assets such as infrastructure, property, forest, agricultural investments or shipping are attractive and can generate "great returns" over the longer term. Real assets are also a valid hedge against inflation.

“In a moment in time like now, it is probably best to really focus on covering your bets,” argues Thomas Becket, CIO of Psigma Investment Management. “I don’t think it’s a time to be taking extreme asset allocation moves in any direction.”

Given the unprecedented number of outcomes that are possible from the current market chaos, investors need to embrace the concept of portfolio diversification now more than ever, while also looking beyond the crisis, he says.

“My general thesis at the moment is to really try and encourage investors and clients to see through the current nonsense that is happening in markets and focus on those fundamental themes or investments that can really generate the best possible returns over the next five years,” says Mr Becket. “Trying to second guess what might happen in markets in the next five weeks or months is really difficult.”

These investments should be a mixture of relatively defensive low volatility trades. “Our key trade would be short duration high yield corporate credit,” he says. After the recent sell off in high yield credit markets, these are attractive, particularly now that 10-year German Bunds and US Treasuries are trading below 2 per cent.

Inflation protection is also important. While government index linked bonds have benefited from the flight to safety and now they look pretty expensive, high quality corporate inflation linked issues are more appealing. “You can get an attractive pickup in a corporate inflation linked market, which will ultimately give you better protection than government bonds over the next five years or so. If we do get an inflation spike, you will see government index linked bonds potentially suffer,” says Mr Becket.

Focusing on asset classes that can offer the best recovery potential is also a good strategy. The best value equity market in the world is the Japanese market, according to Mr Becket. “Japan has been a disastrous investment for the last 10 years but I think it might have better prospects going forward.” Japan is attractive because it almost offers an asymmetrical pay off. “I would estimate that the upside for Japanese equities is 100 per cent, whilst the downside is probably only 10 per cent over the next five years or so.”

The recovery theme in equity markets could also be seen in other markets around the world, as good stocks have been sold off with bad stocks over the last few months.

Having been underweight in equities, moving to a neutral stance is the way forward, he says. “If you can really try and encourage your investors to have a longer term outlook, volatility presents opportunities, if market volatility picks up and you see asset pricing falling. Over the next five years, equities will almost definitely be the best investment, so maintaining a decent weighting is probably sensible.”

Asian currencies are also a good bet. “Strong government balance sheets, rising rates to combat inflation and an increasing financial influence over the world will see Asian currencies rise against their beleaguered developed world cousins in the next decade,” states Mr Becket.

What is really important is to adhere to the principle of a truly diversified portfolio, reinforces Jean-Louis Nakamura, CIO of asset allocation at Lombard Odier Investment Managers. The problem, he says, is that traditional balanced portfolios are not truly diversified, because they are just allocating different weight to different asset classes.

“What you have to take into account is the move in relative volatility between asset classes to keep your portfolio truly diversified. This is a portfolio where you slice the total risk you are ready

to take between different asset classes, and the different slices depend on the level of volatility of each asset class,” says Mr Nakamura.

In a lasting and persistent crisis, such as the one we are facing today, the equity risk relative to other asset classes, and especially bonds, is spiking up at a very high pace and exposure to risky assets must be reduced quickly, says Mr Nakamura.

“This is not the time to have a valuation-driven allocation process, you should stick to a risk driven allocation process.”

The contribution of different asset classes to total volatility is monitored on a daily basis on a short-term risk matrix and risk observation. Lombard Odier has been offering this kind of “systematic and disciplined approach to portfolio rebalancing”, which the firm calls risk parity approach, for the past three years, mainly through segregated mandates for small institutional investors or funds for private clients. Total assets managed under this approach amount to around SF5bn (€4.1bn).

“In our risk parity portfolio, the allocation to equities was more than 40 per cent in early 2011, but it has been constantly reduced to less than 20 per cent in response to a significant increase in equity volatility,” says Mr Nakamura.

The equities markets with the lowest contribution to volatility are the Japanese equity market, the Swiss market and to some extent the US market. The rest of the portfolio is mainly allocated to long duration bonds with high liquidity, such as the US, the Japanese and the German markets, as well as some French long duration bonds.

The portfolio is rebalanced any time the gap between the optimal portfolio, given the risk environment, and the actual portfolio is beyond a certain threshold. In order to keep the trading cost down, the instruments used are mainly listed derivatives, especially futures contract on index. As at early September, the risk parity portfolio has delivered positive performance year to date, says Mr Nakamura.

## **UNCERTAIN OUTCOMES**

In a world with lower expected growth and high underlying volatility – in terms of economic volatility, policy error risk and geo political risk – the spread of outcomes remains very wide. And this makes dynamic asset allocation even harder, says Robert Brown, chairman of the global investment committee at Towers Watson.

“If you want to be dynamic and get it right, you need to have a view on the expected returns of the various asset classes and very different return drivers. But there is just a lot of uncertainty about what those numbers are, and so you have got to have very high confidence in your signals to make the strategy work. Technically it is easy to do, but profiting from it is generally much harder.”

Investors need to make sure they achieve their “long-term mission” and their portfolios should be as robust as possible to different economic and financial environments. “Investors need to be adequately diverse in terms of the assets they hold. And they need to have a broad spread of drivers of return in their portfolios, so they are not dependent on any one outcome, because today the spread of outcomes just remains very wide,” he says.

It is important investors understand what risk they are taking. Stress testing and an in-depth analysis of how portfolios look in different scenarios is also key to deciding whether they should run a lower level of risk.

Holding cash may be a good strategy. Today real rates on cash are negative because of inflation but over the very long-term cash has broadly matched inflation. "Cash provides investors with ammunition to take advantage of distressed valuation," says Mr Brown. "If investors are concerned and want to preserve capital, running a low risk portfolio and holding more cash is perfectly reasonable."

In certain areas there may well be assets that look interesting, he says. In the early part of August, given the falls in stock markets, some equity markets were starting to look modestly attractive, such as emerging markets. "But if you are going to go down that route, you have to be prepared to very high volatility and potentially some not very pleasant outcome," warns Mr Brown. "If there is a big stress in Europe, you could still see equity market downside of 15-20 per cent."

Cesar Perez, head of investment strategies at JP Morgan Private Bank for Emea, says he is "constructive" about today's markets.

"Even if we are living at the centre of the hurricane, we continue to believe there are good investment opportunities. Corporate profits are good. We expect the equity markets to grow in line with earnings, by about 8 to 10 per cent for the year. We are on target for that," he says.

"Our two biggest convictions in the world for this year have been the US and Germany," says Mr Perez. Despite the rise in market volatility – which has also affected the German equity market from mid August, volatility that some commentators ascribe partly to the German authorities' decision to ban short selling – the calls have proved right year to date.

The problem is that investment horizons today are much shorter, says Mr Perez. "While we make tactical trades to benefit from volatility, we look at dynamics in the countries to make long-term calls, over two to three years, which we might change if economic fundamentals change."

## **GERMAN SUCCESS**

Germany is structurally a positive story. The country has greatly benefited from export growth. This is also demonstrated by China's recent agreement on importing €15bn manufacturing products from Germany, out of the total €20bn from Europe. Improvements in the country's employment rates and the trend of German companies bringing production back to the homeland, coupled with growth in domestic consumption are all factors driving the German economy. "I am expecting earnings growth in Germany and the MDax by around 20 per cent this year," says Mr Perez.

If this is the bull case in Germany, there are going to be difficult times for domestic companies in Europe, especially at the periphery, as countries implement austerity programmes. "The message we are giving to clients is to have less risk than we would normally have in these circumstances and to include some assets in portfolio to protect from tail risk, such as gold or dollar. We are overweight the US, underweight Europe and overweight Germany. We have been completely out of the peripheral sovereign bonds, but at some point we will have to look at the valuations and how low they can go."

In the US, a segment that is very undervalued, compared to historic levels, is that of large cap growth companies. This is because of the prevailing short-termism in markets, as the focus is on the results of the quarter rather than the growth prospects for the year.

“The large cap growth companies will do better than the market, especially in the US,” he says. The technology sector in particular is very attractive, as companies look for pricing power and after 10 years of under-investment in technology, they will finally start investing.

The other big theme is dividend growth. As interest rates will continue to be low in the US for some time, people will need to look for alternatives. Companies with sustainability of dividends, dividend growth and low leverage are to be favoured, recommends Mr Perez.

“More than ever, the market is driven by macro factors rather than valuations, so that’s why some of the stock pickers are having a tough time, and that’s why having the call right on Germany has been more important than getting the company specific,” he says.

In the current environment, the emphasis on macro and political risk is generally completely opposed to an approach based on fundamental valuations, but this is wrong, said Giordano Lombardo, Group CIO at Pioneer Investments, speaking at the European Colloquia Series in Iseo.

“We believe any investment decision, be it about the active selection of assets or securities or about the cost of hedging and protection, should also have an element of fundamental valuation,” said Mr Lombardo.

“Reconciling these two investment approaches, value and macro, will be key to survive and succeed in the new risky and political world ahead of us.”