Towards Dynamic Strategic Asset Allocation

By Roy Hoevenaars and Gerlof de Vrij

We live in turbulent times. Large swings in asset class valuations question the effectiveness of static asset allocation. Low yields and a multi-decade allocation experience make the case for rethinking existing frameworks. Has the time for a dynamic approach finally come?

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Since 2008, global markets had to cope with several severe deflationary shocks, despite an unprecedented effort by authorities to stabilize and reflate the global economy. Market volatility was driven by a banking crisis, a loss of confidence in the euro periphery, a tsunami in Japan followed by an all in stimulus program, an unstable Middle East and worsening international relations with Russia. Now the Fed is carefully approaching policy normalization, while China’s slower growth trajectory is sending shivers through commodities and emerging markets. This highlights that markets are not and will not be stable, but highly dynamic with large cyclical swings, fast changes in valuation and regime shifts. In the meantime, the appetite for volatility and losses has shrunk.

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So far one winner stood out: risk parity. This approach seeks to exploit diversification through risk scaling of asset classes. A major feature is leverage to increase the risk allocated to low volatility assets like fixed income. In the post 2008 era, monetary policy easing and QE pushed down yield curves to historic lows in combination with negative correlations against risky assets. In this ‘search for yield’ environment risk parity fared particularly well. However, its widespread adoption now coincides with safe haven bonds trading in negative yield territory. Leverage can be very useful, but levering expensive assets is an accident waiting to happen.

At low yields, the defensive property of traditional safe havens in the next bear market is debatable. Also, cash offers close to zero yields, well below inflation, leaving few places to hide. Even most equity factor investing and ‘smarter’ beta approaches remain exposed to equity downturns. While long-short strategies enable more market neutrality, they offer a different risk distribution and some leverage. Under stressful circumstances, loading up on complexity and illiquidity will likely also prove

Rethinking Asset Allocation

Over the years, several avenues have been explored to hedge and diversify away portfolio sensitivity to the growth cycle. In the 80s, 90s and early 2000s, the evolution was to move away from a 60/40 home-biased equity-bond weight. Global diversification was followed by the endowment model with more focus on absolute return strategies and illiquid categories like private equity, natural resources, infrastructure and real estate. Following the 2008 crisis, the illiquidity premium lost popularity as it added to losses during tail events.

Figure 1: Falling yield and the ‘happy’ correlation structure after 2000

Source: Bloomberg, Blenheim Capital Management B.V.
painless. We believe better or additional answers can be found in dynamic asset allocation.

**BE DYNAMIC**
Our approach combines multiple insights into a dynamic framework. The portfolio construction builds on diversification, return drivers and risk balancing. Valuation analysis and capital preservation add dynamics to a portfolio and help to side-step severe downturns. Rules are used to ensure discipline and are never implemented blindly. We think of rules as the result, not as a replacement of thought and exploration.

**FOCUS ON FUNDAMENTAL RETURN DRIVERS**
Rather than using assets to build a portfolio, we prefer to look at the underlying ‘return drivers’. An asset is a bundling of exposures, each with their own fundamentals. Deconstructing each asset to its fundamental components allows for a more effective and efficient portfolio to be built. Return drivers reveal common exposures embedded in assets and factors. Unintended exposures can be eliminated, improving a portfolio’s efficiency, because intended exposures can be more precisely targeted.

The return driver perspective can be illustrated by dissecting the fixed income asset class. Safe haven duration is embedded in all fixed income instruments, whether we look at inflation-linked bonds, emerging market debt or investment grade corporate debt. The drop in safe-haven yields across all maturities has translated into low yields everywhere. This causes the overall yield to look unattractive, but other components of the yield (for example the credit spread) might represent good value. The blending of return drivers clouds the ability to assess the attractiveness of its components. It also limits the ability to invest in or avoid specific areas. By using plain vanilla derivatives such as interest rate swaps, inflation swaps and CDS’s, one can disentangle the underlying exposures.

We suggest valuation filters and capital preservation rules to manage these exposures separately.

By analyzing return drivers, one can also better evaluate why an asset deserves a place in a portfolio at all. Some assets actually lack a positive return driver. Return drivers, like inflation, dividend, term premium and credit spread, can also be analyzed in different regimes and used as anchors for valuation. Insights about style premia such as valuation and carry can be better understood from a return driver focus.

**INFLATION-LINKED BONDS (ILB’S) AND CURRENCIES**
An example of an asset not contributing to the portfolio return is inflation-linked bonds. In these, investors actually pay the inflation risk premium in exchange for insurance against inflation realizing above implied. The remaining exposure is just similar to a nominal bond. In our view it is better to capture this insurance component independently through an inflation swap overlay, only to be activated when the insurance is attractively priced.

The role of currencies in asset allocation is another frequently discussed topic that most of the time has been neglected or improperly addressed. In our opinion, currencies do have a return driver - the real interest rate differential. Furthermore, a reliable valuation analysis can be built when a currency is mature and has a stable inflation.
background. Currencies are liquid and can offer high returns and diversification benefits. However, in a capital allocation framework, currencies are often inherited from the underlying global asset mix and, therefore, the exposures often do not reflect intended portfolio views. Hedging is often limited to the largest exposures, effectively keeping open a sizeable FX carry trade without a view on its attractiveness. The better approach would be to only take currency exposures if a return driver can be detected at attractive valuation levels. Around 2012, emerging markets were believed to be more solid than developed markets. EM sovereign spreads shrank to historic lows and allocations shifted towards EM local debt, adding the EM FX carry exposure, just at the time that EM currencies were highly expensive and offered no real yield spreads.

ADDRESSING A VACUUM
Dynamic asset allocation has been a subject of intense debate over decades. Still, few institutions have embraced it. The success lies in two factors: governance and building a top-down framework. DAA falls in ‘no man’s land’ between strategic allocation and active ‘alpha’ management. These gaps need to be addressed.

A FRAMEWORK
In our view, a next generation asset allocation framework should be built on the insights gained over the years, while making use of the ability to invest more consciously using the return driver perspective. The framework should be strategic, not tactical, relying less on market timing and more on structure, discipline and rules. This enables a dynamic response to cyclicality and regime shifts. Valuation analysis and capital preservation should be geared towards reducing exposures where return premiums are absent or exhausted. We believe this approach can control drawdowns better, add value in normal times and fully participate in bull markets.

A transition to a dynamic asset allocation framework will take effort and time. There often is fierce resistance against active management and dynamic asset allocation decisions often dwarf bottom-up stock-picking returns. This is why having the right governance is essential. Steadily building the required trust, infrastructure and skill are key to insourcing a dynamic asset allocation capability. Partnering with best-in-class DAA managers will help speed up the process. Implementation techniques, valuation filters and capital preservation rules can then gradually be understood, adopted and implemented. Moreover, such a set-up increases continuity and broadens the resources dedicated to the dynamic asset allocation project. A framework stimulates pro-active decision making and also mitigates ad hoc actions during crises.

We opt for an investment approach that inherits the structure and discipline of institutional investment policies while, at the same time, it embeds dynamic rules and adapts to valuation. Transparency about the intended exposures can build a pro-active understanding of the portfolio balance and dynamics. We feel that asset allocation can then address both liquidity provision and capital preservation in bad times, and side-step major bear markets. To us, there seem to be plenty of reasons to start building dynamics into asset allocation. «

- Long-term survival requires discipline and the ability to adapt
- Return driver analysis reveals overlapping and unintended exposures
- Improve asset management by adding capital preservation, risk allocation and valuation
- If diversification fails, dynamic rules provide an extra layer of defence
- Integrate currency exposures in the allocation framework

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