MARKET INSIGHTS

Why a dynamic multi-asset approach matters during volatile markets

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EXECUTIVE SUMMARY

For the past year, we've espoused the benefits of *managing* risk, more so than *taking* risk

On 5 February 2018, the Dow Jones Industrial Average plunged 1,175 points,[1] marking an exceptionally volatile day for financial markets around the world. The 4.6% drop was the biggest decline since August 2011, and caught many market participants by surprise.

Our stance spoke to the valuations within markets as well as low starting yields in bonds, but was also driven by what we saw as a more seminal aspect to managing risk. In a previous blog post, we discussed that protecting against the downside in markets just may get you more bang for your buck. While the power of compounding through losing less on the downside is relatively easy to understand in theory, to execute that strategy means being willing to reduce risk as markets move higher than your expectations—and doing so in a robust way. **Put another way, the time to prepare for a perfect storm is not when the wind is tearing the roof off your house, but before the storm hits.**

So how do you prepare. We're a multi-asset shop, so we may be biased. But we take our approach because we believe it's ideally suited for our uncertain times.

While the objectives of multi-asset strategies may vary, our portfolio management team talks a lot about giving clients the returns they require at a risk level they can survive. A multi-asset approach may help achieve these goals through three main processes:

1. The *design process, where we establish* strategic positioning;
2. The *construct process, where* manager selection and strategic factor positioning takes place; and
3. The *manage process*, where tactical tilts, through dynamic management, help exploit near-term opportunities and avoid uncompensated risks.

I’d like to focus on the *manage* process. Dynamic asset allocation can include managing a portfolio of physical securities, such as stocks or bonds, or implementing overlay-based strategies—including, but not limited to, options, currency forwards and futures. And *dynamic* is the key word right now, because we believe nimbleness and dynamism is most beneficial during periods of market dislocation, where the elapsed time between idea and implementation is critical. Because, as February 5 reminds us, markets don’t work on quarterly cycles.

Another case in point: In early February 2018, our multi-asset portfolios were defensively positioned with significant equity replacement strategies within the Australian equity space. This *equity replacement* position is complex, so let me break this down into steps:

1. The position meant a short in Australian equity futures, while simultaneously buying call options to give the portfolios upside.
2. Because volatility had been so low, costs for this option were small (relative to history).
3. We funded the call options by harvesting gains from equity market exposure in December 2017/January 2018 prior to the market sell-off.
4. In addition to purchasing call options, the proceeds from selling equity exposure raised liquidity in the portfolio. Thus, we are in the fortunate position of being armed with cash to deploy through options, futures or our active managers across multi-asset portfolios as opportunities arise in the market in a timely manner. We like being in this position, as a *liquidity provider*—buying when others choose (or are forced) to sell.

As recent events show, the ever-evolving manage process of our multi-asset investing approach enables us to prepare our portfolios for uncertain markets—and dynamically adjust as the cycle, valuation and sentiment in markets evolve. If the recent uptick in volatility is a sign of things to come, we believe that having this dynamic ability will continue to prove essential going forward. Because another correction day will come. And no one knows when.

1 Source: http://money.cnn.com/2018/02/05/investing/stock-market-today-dow-jones/index.html

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