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Russell Investments

# Protecting your organisation during highly volatile markets

## Multi-Asset Real Return Funds for For Purpose Organisations

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**EXECUTIVE SUMMARY:**

In our Annual Global Market Outlook last year, we forecast the increasing challenge to gain strong investment returns resulting from stretched equity valuations, low bond yields and narrow credit spreads. This reality hit home in 2015. Global equities and fixed income barely posted positive returns for the year and anything related to emerging markets (EM) fared worse[1]. Looking forward to 2016, this year's Global Market Outlook sees the bar continue to rise. It will likely be another year of limited upside potential for investment returns, even though the outlook for the major developed economies is still reasonably robust.

Through 2016 investors will need to balance concerns about stretched valuations against positive economic cycle views and also steer a course through heightened volatility as shifts in sentiment move markets between the extremes of overbought and oversold.

A case in point: in the first week of January 2016, China's Shanghai Composite Index lost 10% for the week, marking its steepest decline since August 21. This sparked volatility globally, with the U.S. market, reporting a 6.7% drop (Russell 1000® Index) for the week. Similarly, the Stoxx Europe 600 dropped 6.7% and Japan's Nikkei 225 Index fell 7%.

*"Through 2016 investors will need to balance concerns about stretched valuations against positive economic cycle views"*

## Looking ahead

Despite global market volatility and larger than expected sell-offs in equity markets in the first two months of 2016, Russell Investments believe markets have over-reacted and should rebound when sentiment improves. However, the recent global market volatility is a reminder to investors that with stretched valuations and questionable growth, market risks remain heightened with global markets very jittery.

Especially in periods of market volatility, it is important to remember that markets rise and fall, particularly over the short term. If you're a long-term investor, it's best to avoid knee-jerk reactions at the risk of 'locking in your losses' - because you don't truly feel the pain of market declines until you sell investments at a low. However, this can be balanced with the fact that sometimes, short-term volatility provides good buying opportunities.

[1] In local currency terms. Global equities on an unhedged basis for Australian equities posted positive returns of 11.5% due to the decline in the Australian Dollar through 2015.

The low-return environment is set to tighten its grip in 2016. Returns should still be positive, but the upside is limited. Carefully managed, active investment choices will be critical to portfolio performance. We see two keys to success in such an investing environment: access to a wide source of investment opportunities and a robust investment process that guides active asset allocations.

These two messages would be of particular interest to many For Purpose boards whose investments are predominantly focused on traditional domestic equities and bonds. Current valuations and market volatility imply that in 2016, this strategy may result in lower returns and much higher volatility than expected and therefore, may not fairly reward the level of risk that will be experienced.

Increasing both diversification and activism, whilst desirable, is not 'free' and generally imparts a significant governance burden in both monitoring the additional asset classes (including more specialised alternatives) and also making more active asset allocation decisions.

## Introducing (multi-asset) Real Return Funds

To provide a solution to achieve a more active portfolio without the added governance burden, a number of Fund Managers have created Real Return Funds or Multi-Asset Real Return Funds (MARRFs).

These funds can be characterised by:

- Targeting a CPI+ return stream[2];
- A more diverse asset allocation than traditional balanced funds[3];
- A more conservative strategic asset allocation (SAA) limiting downside versus a comparable traditional balanced fund;
- Increased trading bands allowing managers to make fast changes to asset allocation intended to:
    - Limit negative returns; and
    - Benefit from buying opportunities.
- A higher additional return target from active management of the total portfolio and underlying strategies;
- A return similar in magnitude to equities but targeting a lower level of volatility.

Given these funds have a longer term focus to provide an inflation plus return stream but targeting a lower volatility, they are an attractive proposition for 'For Purpose' portfolios which also target a combination of real return (i.e. maintenance of corpus), stable income and are sensitive to negative returns.

As an example of how a MARRF is run, Figure 1 illustrates the range of individual investments and asset class groupings that are used in Russell's Australian Multi-Asset Growth Strategy (AMAGS). The table also illustrates the deviations from the strategic benchmark that were in place as at 31 December 2015.

[2] Typically between 3-5%.

[3] Russell's Australian Multi-Asset Growth Strategy (AMAGS) contains exposures to market neutral equities, commodities, volatility strategies, listed infrastructure and property, emerging market (hard and local currency) and high yield debt.

## Figure 1: Asset allocation breakdown for AMAGS 31 December 2015

| Positioning Snapshot | Actual Dec-15 | Design |
|---|---|---|
| Australian Equities | 18.9% | 24.0% |
| International Equities | 17.6% | 30.0% |
| Real Assets | 7.1% | 8.5% |
| Alternatives | 17.6% | 20.0% |
| Fixed Income (includes Absoulte Return) | 17.5% | 17.5% |
| Cash | 21.3% | 0.0% |

**'Design' Allocation Details**

| | |
|---|---|
| **Listed Equities** | **54.00%** |
| **Australian Shares** | **24.00%** |
| Russell Australian Shares (Enhanced Income) | 9.00% |
| Russell Australian Shares (Opportunities) | 5.00% |
| Vinva Market Neutral Australian Equities | 10.00% |
| | **30.00%** |
| Russell Global Opportunities | 13.25% |
| Russell Global Defensive Equity Fund | 3.75% |
| Russell Asia Pac Ex Japan Fund | 1.00% |
| Russell Emerging Markets Equity | 2.00% |
| Regional Developed Market Equity Funds | 10.00% |
| **Real Assets** | **8.50%** |
| Russell Commodities | 2.50% |
| Russell Global Listed Infrastructure | 3.00% |
| Russell International Property Securities Fund | 3.00% |
| **Alternatives** | **20.00%** |
| Russell Emerging Markets Debt Local Currency | 3.00% |
| Russell Global Strategic Yield | 10.00% |
| Amundi Absolute Volatility Global Strategy | 1.00% |
| Russell Multi-Strategy Volatility Fund | 6.00% |
| **Fixed Income & Cash** | **17.50%** |
| Russell Absolute Return Bond | 3.00% |
| Russell Australian Bond Fund | 7.00% |
| Russell International Bond Fund | 6.50% |
| Russell Global Bond Fund Duration Hedged | 1.00% |

Figure 2 illustrates how one of the key investment decisions, the overall equity exposure, was managed during the second half of 2015. The chart illustrates that coming into Q3 when volatility was low,[4] protection was purchased, in the form of a put, effectively reducing the portfolio's exposure to US equities. As such, the portfolio was protected against the declines that then occurred in late August.

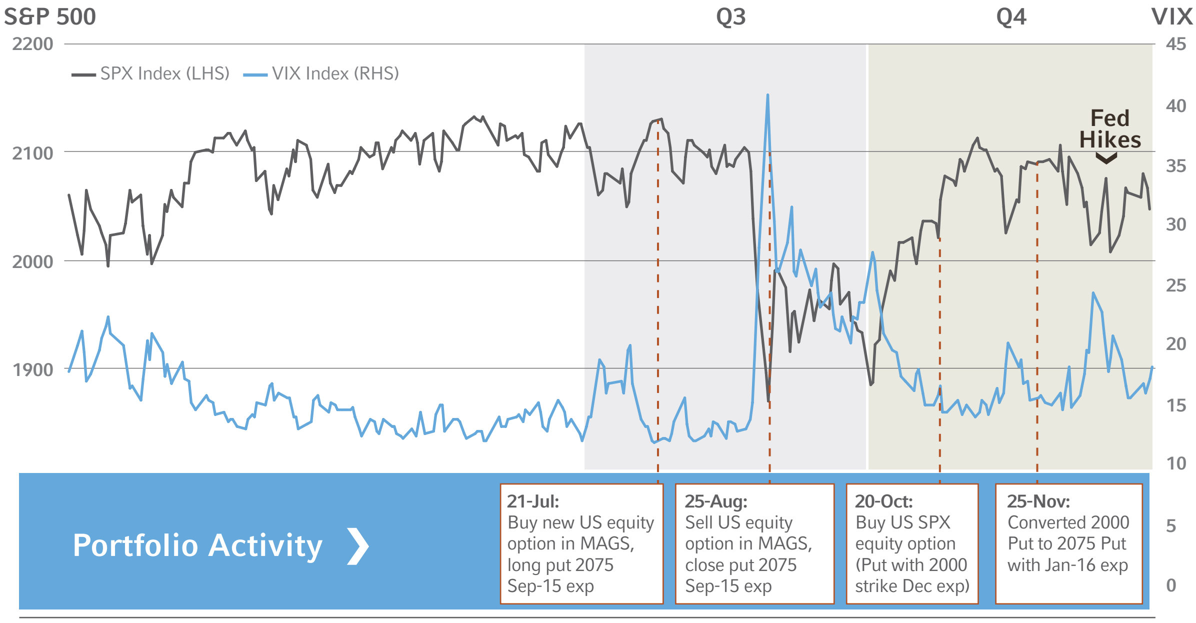
Moving into Q4, volatility fell again[5] and the AMAGS portfolio, being focused on providing CPI+ returns and having a lower tolerance for negative returns, bought further protection and then extended this later in the quarter after the market climbed further. Indeed, coming into 2016, MAGS was actually 20% below its SAA for growth assets, the majority being allocated to cash. This proved to be very beneficial in protecting against the equity market losses posted in January – from January 1 to January 20, US and Australian markets both lost 9% of market value. This underweight position and commensurate higher cash allocation allowed the portfolio manager to opportunistically add additional equity exposure following these initial falls. Whilst still being cognisant of the heightened market volatility and generally high equity valuations the portfolio has reduced its underweight to US equities and increased exposure to specific markets where relative value is seen e.g. Japan. Overall the AMAGS was 65 basis points better off than a similar, but traditional, balanced fund with static asset allocations for 2016 through to 1st February.

This is just one of the many active decisions that are being constantly reviewed in real time by the portfolio management team.

[4] Volatility is measured by the Chicago Board Options Exchange Volatility Index (VIX) and illustrated by the black line (RHS)

[5] When volatility falls the purchase of protection (i.e. insurance) is cheaper

**Figure 2: Equity exposure management (2015)**




## How could you consider an allocation to a MARRF?

Given the multiple positive attributes of MARRFs, how can they be incorporated into an existing portfolio? At first glance, the use of MARRFs could range from a smaller weighting as part of an alternatives or equity replacement allocation, through to 100% of the portfolio in instances where the objective of the MARRF is totally aligned to the overall objective of the investor.

**TABLE 1**

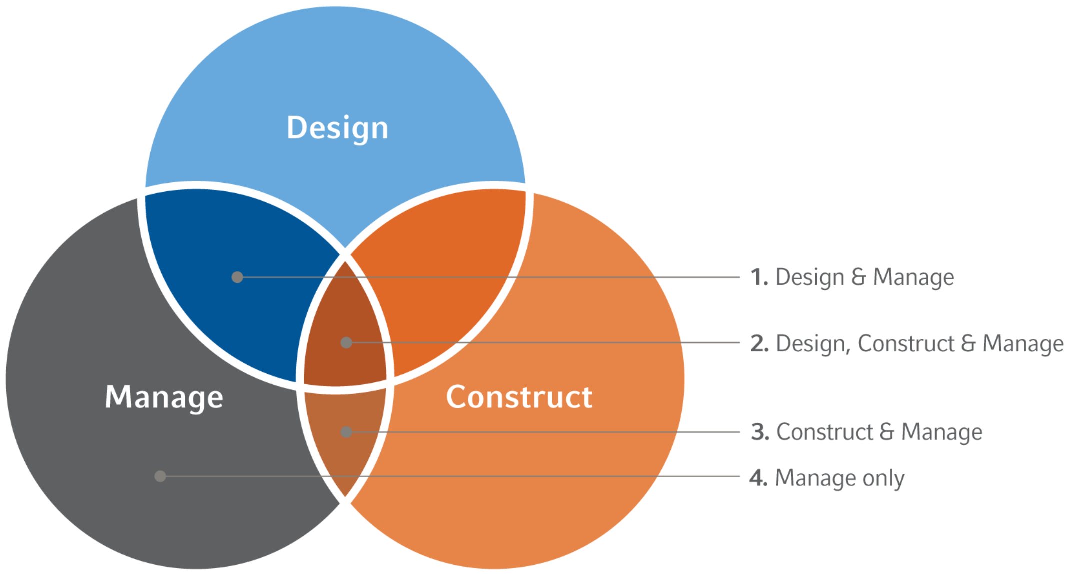
| POSITIONING AND RATIONALE | IMPACT |
|---|---|
| Equity replacement – targeting equity like returns. | Maintains expected return and reduces volatility and reliance on equity risk premium. |
| Replacement of a portion of both growth and defensive assets – targeting a lower volatility. | Increasing target return while maintaining similar risk level. Increases reliance on active management. |
| Alternatives allocation – exposure to alternative allocations and additional active management or tactical asset allocation. | Potential to increase diversification and reduce overall risk. Exposure to equity risk premium may increase. |
| Property replacement – similar CPI plus target return means potentially considered as liquid alternative to property allocation. | Potentially increasing diversification and exposure to active management albeit exposure to equity risk premium may increase. |
| Whole portfolio – diversified asset base targeting appropriate inflation plus return stream. | Exposure to potentially more diversified version of current strategy means similar return expectations for lower risk. |

Taking a holistic portfolio perspective, MARRFs are best considered as an equity replacement or a 'carve out' of both growth and defensive assets. However, it is important for investors to understand the drivers of returns for the specific MARRF they are considering. These products are hetergenous in composition, and the underlying return premia may overlap with the rest of your portfolio and add to equities exposure, rather than reducing it.

## Different types of MARRF

There are a range of alternative MARRFs available in the market which rely on different aspects of the investment process to add value, reflecting the portfolio manager's investment philosophy. Using Russell Investments' Design, Construct, Manage investment process to categorise the levers available in a MARRF we broadly see four different types of funds.

| SOURCE OF RETURN | |
|---|---|
| 1. (Design & Manage) | Largely passive implementation of liquid market SAA with tactical allocations around this. |
| 2. (Design, Construct & Manage) | Active and passive implementation of an SAA with tactical overlay. Alternative asset classes and illiquids may be used. |
| 3. (Construct & Manage) | Less adherence to a traditional SAA, strategy implemented through active and passive strategies with active asset allocation overlay. |
| 4. (Manage only) | Pure tactical allocations. No SAA, purely based on basket of best ideas. Passive exposures to market betas. |




**Design –** Translation of objectives into a strategic asset allocation (SAA)

**Construct –** Access exposures to desired asset classes and strategies through a combination of third party managers and smart beta strategies

**Manage –** Dynamically adjust exposures to changing circumstances, markets and third party managers

## Final word

The primary purpose of an investment into a Multi Asset Real Return Fund is to take advantage of a return from skilled tactical allocation across asset classes and exposures to new opportunities in an efficient manner. Such an allocation should be expected to reduce risk while keeping long-term return expectations stable.

We believe that an allocation of between 10-15% (no greater than 20%) would meet with many For Purpose organisations' objectives and increase access to innovative investment management and opportunities at a lower level of risk.

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