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ASSET MANAGEMENT

No such thing as passive investing in multi asset

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Trevor Greetham, Head of Multi Asset at Royal London Asset Management, discusses the role of active management to build portfolio resilience in a new era of geopolitical risk.

The rise of passive investing

One of the most striking changes in fund management over the last few decades has been the inexorable rise of passive investing. What started as a convenient way to access a diversified equity portfolio at low cost has broadened. An entire industry has grown offering simple risk-targeted 'balanced' portfolios that automatically rebalance passive stock and bond allocations to preset weights. These solutions make sense in a world in which stocks and bonds only ever go up, but that's a major call to make against the backdrop of the most expensive US stock valuations since the dot com bubble, a disruptive US President upending the world economic order and inflation fears dogging the bond markets. In our view, the return of macro volatility makes the broader diversification and responsive management to be found in active multi asset funds more important than ever.

Passive approaches are still an active decision

There's an undoubted attraction in not having to assess manager skill when choosing an investment solution and making the choice primarily on the basis of cost. However, anyone recommending a passive balanced approach is in fact making four important active decisions that may or may not pay off:

1. **"Stocks and bonds are the only two asset classes worth investing in."**
   Broader diversification including commercial property or commodities can improve risk-adjusted returns. Unlike Bitcoin, these assets have been around forever, so there's plenty of data to support this view.
2. **"Bonds always diversify equities."**
   This assumption is called into question by the stagflation shock of 2022 when stocks and bonds both lost you money. True diversification that year came from commodities.
3. **"Rebalancing to fixed weights is the best way to control risk."**
   Business cycle analysis suggests otherwise. Each asset class has its time in the sun.
4. **"Nothing is to be gained from security selection."**
   But passive strategies also operate security selection, always investing most in the largest and most expensive stocks – a painful experience when valuation bubbles burst.

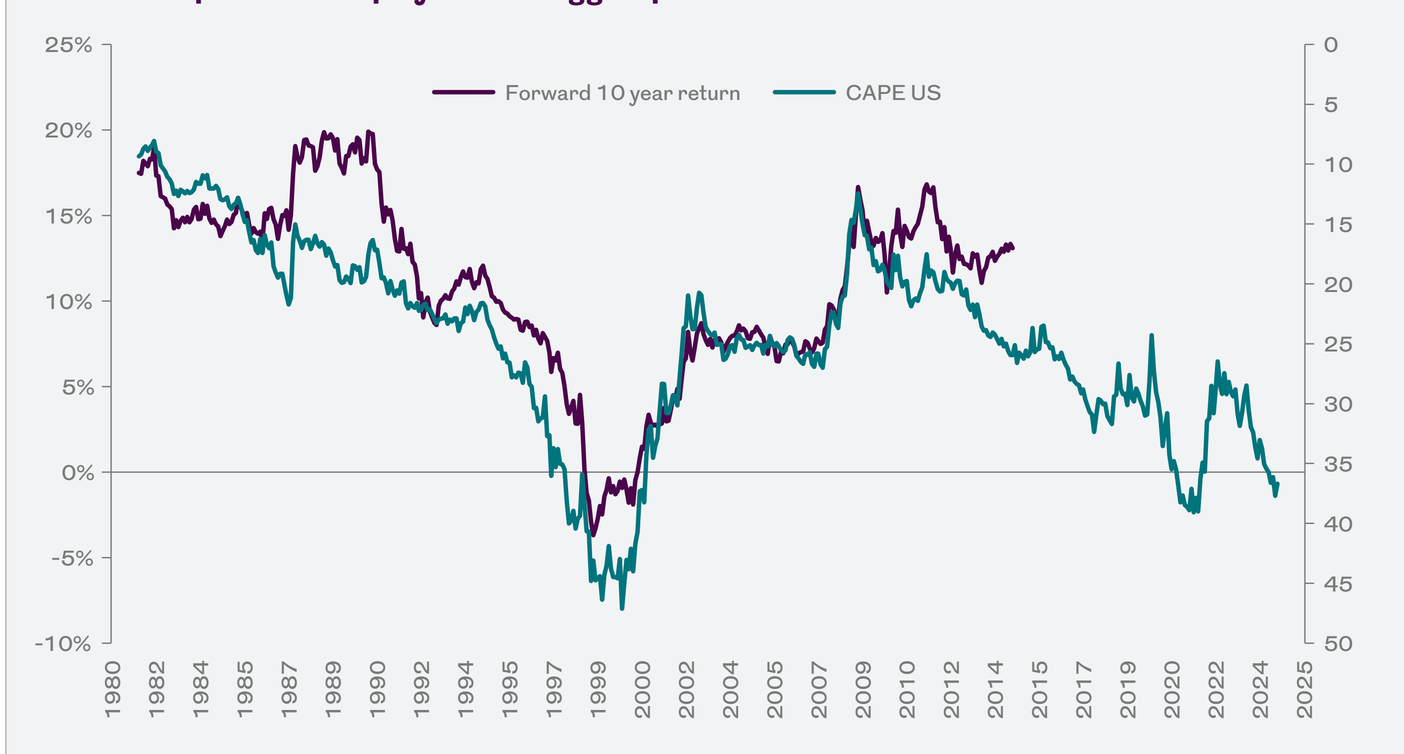
Active management key in uncertain markets

Cost matters, especially when compounding returns over the long run, and it's natural that it becomes an increasingly dominant driver of strategy selection the longer a bull market goes on. Why pay for an active manager, the argument goes, when the market is great and you can get those returns almost for free? But this is looking in the rear-view mirror and we face an uncertain future.

There's a lesson from 1970s when the post-war boom dominated by 'Nifty Fifty' mega-cap growth stocks came to a shuddering halt amid geopolitical stress, oil shocks and economic malaise. Gilt and US treasury yields peaked at over 15%, causing stock markets to de-rate aggressively. Neither asset class kept pace with inflation.

For professional investors, not suitable for retail clients.

Chart 1: Expensive US equity market suggest poor medium term return outlook



Source: RLAM. US cyclically-adjusted price earnings ratio ('CAPE') and subsequent 10 year average total returns for the MSCI USA equity index.

Cheap valuations provided fuel for the long bull market in stocks and bonds that followed. Inflation dynamics changed dramatically for the better over the 1980s and 1990s as the fall of the iron curtain brought significant commodity capacity onto world markets and China became the workshop of the world. Formal inflation targets became the norm, with independent central banks willing to raise interest rates to counter inflation. Bond yields set lower lows with every business cycle, with developed governments seeing ten-year yields trough between minus 1% and plus 1% around the time of the Covid-19 lockdowns in 2020. Equities enjoyed strong returns over this period, with infrequent recessions and bear markets, and valuations expanding as discount rates fell.

Does history repeat itself?

It's hard to argue we will see the same again over the next decade. The cyclically-adjusted price to earnings ratio for US equities was below 10x in 1981. Today, the same measure is 37x, a level only previously seen before the 1929 crash, during the dot com bubble of 1999/2000 and just ahead of 2022's bond-induced bear market.

Expensive markets can get even more expensive in the short term, of course, but valuation is the best predictor of medium-term returns (chart 1). While lower valuations are available elsewhere in the world, a passive buy and hold equity strategy weighted heavily towards the US may not end well.

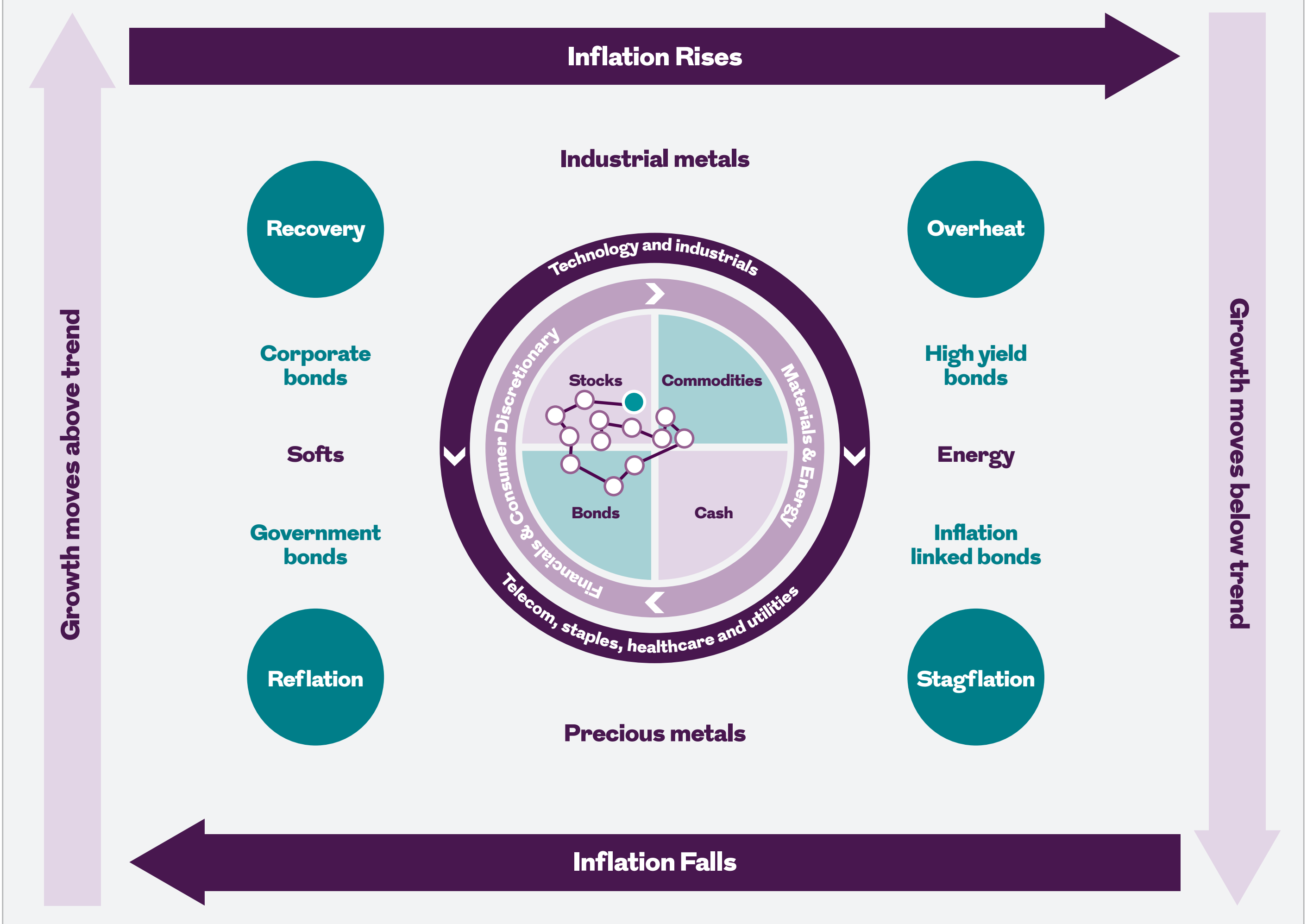
Meanwhile, the secular bull market in bonds also appears to be over, with higher yields likely to pose a challenge for equity valuations. The pandemic marked the start of a new era of what we call 'spikeflation' in which periods of low inflation are interrupted with sudden price level shocks. The regime shift was triggered when massive fiscal and monetary stimulus was left in place for far too long as a supply-constrained world economy re-opened. The inflationary impulse got a second leg when Russia's attack on Ukraine led to a surge in energy prices. Inflation has gradually returned to more normal levels as a higher base level of prices came into year-on-year comparisons – but this is also what we saw in the 1970s and in the inflationary periods around the two world wars, only for further shocks to arrive.

Structural changes that make us more vulnerable to inflation in the mid 2020s include geopolitical instability, populism, deglobalisation and climate change. Overarching everything, extremely high levels of national debt give governments an incentive to inflate away debt. A second Trump presidency only serves to underline and increase these risks.

The US has rejected any pretence of fiscal conservatism while threatening tariffs at levels not seen since the 1930s, raising the spectre of an inflationary trade war. De facto Federal Reserve independence is also in doubt for the first time in living memory.

Spikeflation has important investment implications. A more inflation-prone and unstable world means two-way risk for government bonds. It also suggests a higher frequency of recessions and equity bear markets as central banks are periodically forced to hit the brakes. We believe that this backdrop calls for an active approach to asset allocation.

Chart 2: The Investment Clock links asset allocation to the global business cycle



Source: RLAM. Trail shows monthly model readings based on global growth and inflation indicators with the teal dot the current reading.

An active manager can build resilience to shocks by casting the net more widely when deciding which asset classes to include in a fund. Commodities provide a real time and liquid inflation hedge that can be flexed higher or lower as required at little cost. Depending on liquidity preferences, private assets like property can play a role in diversifying the long-term growth engine away from expensive listed stocks. UK commercial property famously sailed through the dot com crash as the tech-lite British economy avoided recession.

Active tactical asset allocation between and within asset classes can be particularly beneficial in shorter, more pronounced business cycles.

Our Investment Clock model helps to guide asset allocation as global growth and inflation cycles rise and fall. Different asset classes offer their best returns at different times. A disciplined model-based framework allows the manager to take advantage of this phenomenon, rather than passively rebalancing exposures.

Active management in multi asset funds

Active multi asset is most effectively delivered in fund format, rather than as a model portfolio. The manager can let strategic exposures to less liquid asset classes like property drift within limits, rather than incurring unnecessary rebalancing costs and they can make use of futures, forwards and swaps to implement tactical changes in a timely and cost-effective manner. As an added benefit, capital gains within a fund generally don't incur tax.

With all of this in mind, it makes sense that many financial advisers choose to use a range of risk-targeted multi asset funds as their central investment proposition. Some blend several multi asset funds together to achieve diversity by manager and firm. A few look to achieve the best of both worlds, using one or more multi asset funds as core holdings in a model portfolio.

With the world a more unpredictable place than ever, staying on auto pilot with a passive balanced approach is not the only answer. There's no way to avoid investment decisions, making active funds that can adapt with the times a serious contender for part, or all, of a portfolio.

Investment risks

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

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Contact us

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Royal London Asset Management
80 Fenchurch Street,
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

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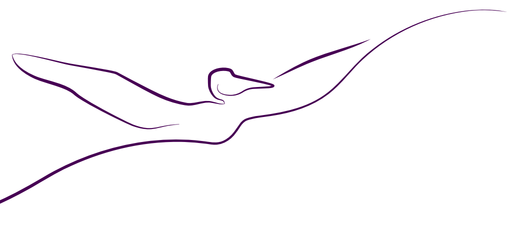

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