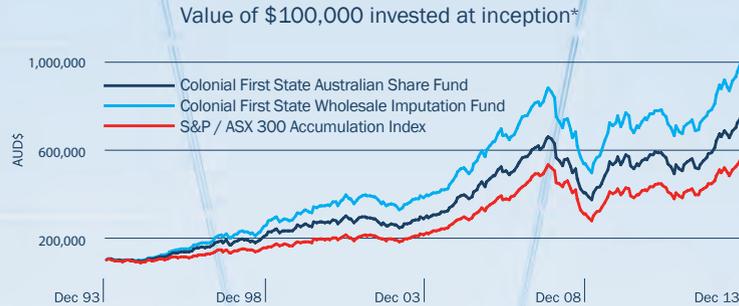


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Brendan Swift asks just how much the industry has learned some six years after the market catastrophes that defined 2007-08.

eye on the **ASSET PIE**

The global financial crisis (GFC) forced the wealth management industry to reconsider long-held tenets about portfolio construction and the role of strategic asset allocation.

The world economy is beginning to recover and the US Federal Reserve has begun tapering – reducing its market-supporting bond-buying program, known as quantitative easing (QE) – presenting investors with a new set of challenges.

“Tapering is an example of the seismic events that have been going on since the GFC; and to us it is a perfect example of why strategic asset allocation has to change a lot more,” says Mark Wills, head of State Street Global Advisors (SSgA) Investment Solutions Group for Asia Pacific ex-Japan.

“For example, we look at a lot of institutional funds – they have the same asset allocation they had before the GFC, they had the same asset allocation during the GFC and they had the same asset allocation after it. If they did move it, moving it a couple of per cent didn’t really move the dial.”

MORE ACTIVE APPROACH

Strategic asset allocation forms the bedrock of modern portfolio theory: by diversifying across various asset classes, risk (more precisely defined as volatility) can be substantially lowered. However, diversification proved little defence against plummeting asset prices across the board and has since prompted investors to question their previous strategies.

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THE LESSONS FROM THE GFC MAY HAVE FINE-TUNED THE APPROACH OF INSTITUTIONAL INVESTORS, BUT IT HAS NOT OVERTURNED THEM

Wills says investors need to take a more active approach to asset allocation, particularly to manage equity market volatility. SSgA is a key player in asset allocation services, managing about \$95 billion in strategic asset allocation accounts and about \$32 billion in tactical asset allocation accounts – where short-term shifts are made more often to try and take advantage of market mispricing.

The lessons from the GFC may have fine-tuned the approach of institutional investors, but it has not overturned them, according to head of investment outcomes at JANA Investment Advisers, Steven Carew. Most balanced institutional funds maintain their 60-70 per cent allocation to growth assets, such as shares and property; and new strategies, which vary between funds, remain at the margins while true short-term tactical asset allocation strategies are rarely employed.

“They don’t have the skills to do it and consultants tend to take a longer-term approach because doing shorter-term trading is not how we’re built; and the governance structure of super funds doesn’t really allow them to take a tactical approach,” Carew says.

Stronger Super legislation has forced institutional investors to both justify and report to the prudential regulator the impact of asset allocation decisions, while return targets are moving toward more measurable targets – something which is being mirrored in the retail sector.

“A trend we’re seeing in our side of the industry at the moment is this shift from strategic-asset-allocation-based funds to more objective-based investment strategies,” says executive manager investment sales at Colonial First State (CFS), Laird Abernethy,

noting a rise in the number of products that aim to outperform the rate of inflation, rather than a more volatile market index.

“There’s a lot of noise and product proliferation around those strategies,” he says.

Retail investors have naturally shorter time horizons than the decades-long view that super funds take, and are more prone to try and time the markets, although it remains an extraordinarily difficult strategy to execute.

A study published last year in the CFA Institute’s Financial Analysts Journal recommended active investors employ concentrated stock-picking funds – or combine them with inexpensive index funds – for the best returns. However, it was particularly damning about tactical asset allocation (or what it calls factor bets): the average actively-managed mutual fund making sector bets lost 1.72 per cent against its benchmark.

“High tracking error is not desirable because funds that focus on factor bets underperform, and even concentrated managers who combine active stock selection with factor bets have not outperformed,” wrote the study’s author, Antti Petajisto (who later joined index manager BlackRock).

MORE DIVERSIFICATION

Carew says JANA, which advises on approximately \$245 billion in funds, has been recommending funds increase their diversification in the face of uncertain markets.

“If nothing looks particularly cheap, then you just diversify your portfolio a little bit more into the alpha-based investment

strategies where you're not as reliant on market beta to generate a return," he says.

While most asset classes are no longer looking cheap, they're still not looking expensive, and that diversification has been achieved across various non-equity assets such as credit, property and alternatives. (Other popular asset classes among larger institutional investors include illiquid assets, such as direct real estate and private equity – a factor attributed to those funds outperforming over the long term, according to a 2012 report by APRA.)

However, it remains challenging for retail investors to assess the underlying risks of alternative investments, as well as absorb the higher fees, which can quickly erode performance. Several studies have cautiously backed hedge fund performance. For example, a 2007 survey by René Stulz (*Hedge Funds: Past, Present, and Future*) found that hedge fund returns at least cover their extra costs; and a similar broad review of private equity by Metrick and Yasuda (*Venture Capital and Other Private Equity: A Survey*) in 2011 found that "the evidence on whether venture capital and buyout funds achieve excess performance is mixed".

Carew says JANA has been doing some research on multi-asset-class strategy products, where the fund manager is given responsibility to make calls on the prospects for various asset classes.

"Some funds are looking at those sorts of strategies as being a way of investing part of their portfolio a little bit differently and also getting access to other sorts of asset allocation views," he says.

For example, the \$2 billion WA Super's investment in the AMP

Working with client biases

Behavioural finance theory has upended the once-accepted view that developed markets are efficient. Common errors made by investors include putting too much weight on recent events, being overconfident and preferring the status quo.

They are irrational biases that financial advisers face every day, no more so than when the GFC decimated returns, leaving many investors shocked. The fundamental question for advisers remains: should they attempt to moderate clients' in-built investment prejudices or construct a portfolio within the clients' comfort levels, which adapts to those biases?

US-based wealth management adviser Michael Pompian recommends advisers take two factors into account: the client's level of wealth and what is driving their biases.

He says advisers should moderate a client's biases if those tendencies are likely to jeopardise their standard of living. This is likely to lead to adapting to the sort of biases exhibited by wealthier clients, and identifying whether the bias is cognitive or emotional.

"Because cognitive biases stem from faulty reasoning, better information and advice can often correct them," he co-wrote in a paper, *The Future of Wealth Management: Incorporating Behavioural Finance into Your Practice*.

"Conversely, because emotional biases originate from impulsive feelings or intuition – rather than conscious reasoning – they are difficult to correct."

Whatever the approach, it relies on empathy, education and the ability to communicate on a client's terms rather than relying on the jargon and yardsticks that the financial services industry is accustomed to.

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POST THE FINANCIAL CRISIS, INVESTORS AND ADVISERS ARE MORE OPEN TO A FOCUS ON ABSOLUTE RETURNS AND RISK

Capital Dynamic Asset Allocation Fund more than doubled to \$133 million in the 12 months ended June 30, 2013. The AMP fund returned 13.01 per cent after fees for the year ended February 2013 against its benchmark of 11.98 per cent. Its growth-defensive asset allocation remains overweight 84:16 against the neutral benchmark of 60:40. Its overweight growth assets include Australian shares, global shares, emerging markets and global REITs, while it is slightly underweight global high-yield credit and commodities.

CFS is another major fund manager entering the sector with the Colonial First State Multi-Asset Real Return Fund, which has been incubated for the past 14 months and aims to outperform the rate of inflation by 4.5 percentage points.

“Post the financial crisis, investors and advisers are more open to a focus on absolute returns and risk and looking at these strategies,” CFS’s Abernethy says. “While they have a lot of merit, the retail industry is still working out how we incorporate these into client portfolios...because they are quite different in their construct to the traditional multi-asset solutions that are out there.”

Carew says retail investors considering such products need to be particularly aware that such products can differ radically from each other with regard to absolute-return style benchmarks and frequency of portfolio shifts. He also cautions against other strategies that are being explored, such as smart-beta or alternative market indices.

“You have to be a bit cautious about some of those strategies – building a portfolio based on some sort of factor or how things may have performed in the past,” he says. ■

ETFs

Australia’s exchange-traded fund (ETF) market has exploded in recent years with almost \$10 billion now invested in the sector across 95 products. However, the Australian market forms just a small segment of the \$US2.3 trillion, 5300-product global market.

Financial advisers have been slower to embrace the sector. A report by ETF provider BetaShares and Investment Trends found that only an extra 1000 ETF investors influenced by a financial adviser joined the 69,500 total ETF investors in the year ended 2012. Almost three-quarters of those 69,500 ETF investors did not use a financial adviser.

The *Future of Financial Advice* (FoFA) regime is likely to encourage greater take-up: low-cost index ETFs are now accepted as transparent, easy-to-trade products for investors, even if they do not sit on a platform. Another likely factor will be the launch of new products mixing institutional asset allocation services with ETFs.

SSG’s Wills says the company recently launched six ETF model portfolios on OneVue’s Unified Managed Account investment platform, which will bring its institutional asset allocation services to the retail market. Meanwhile a small industry super fund has recently provided seed capital for one of SSG’s Retirement Lifestyle Solution funds (which also employ ETFs with active and alternative asset management) on the netwealth investment platform.

The “sub-advised” market is a particularly big one in the US, and Australian firms are beginning to follow suit, given that asset allocation decisions underpin the bulk of a portfolio’s returns.

“We’ve been very impressed with the level of innovation from these companies that have come to us,” Wills says.

“We don’t get the sense that people will do ‘me too’ things; it’s going to be much more nuanced.”

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