Natural Selection

Financial Services Forum

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Reconstructing portfolios with a target return focus

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What does target return mean?

- A focus on investor outcomes, not peers or "convention"
- An absolute return mindset, albeit accepting we will be on average "long beta" through time
- Very active asset allocation – risky in a "peer group" sense, lower risk from a customer viewpoint
  - Going to zero allocation in an asset class becomes a low risk, rather than a high risk decision
- A range of quite different strategies in the category, exploiting different skills and market inefficiencies

Why CPI+ target return

Super/Retirement

- Inadequate savings, but
- Limited downside risk tolerance

Insurance

- Keep up with a WACC
- Need for liquidity
- Lighter on capital charges than equities

Other

- Grow a pool of capital in real terms
- Desire to manage downside risk
- Simple governance

Traditional portfolios – key issues

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11.00%
10.00%
9.00%
8.00%
7.00%
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%

Allocation / 10
Standalone risk contribution
Risk contribution

- Cash
- Aus bonds
- Global bonds
- Absolute return
- Infrastructure
- Property
- Private equity
- Global equities
- Aus equities

Source: Pendal risk model. Pro-forma allocation used

A more even spread of risk helps to increase the benefits of diversification

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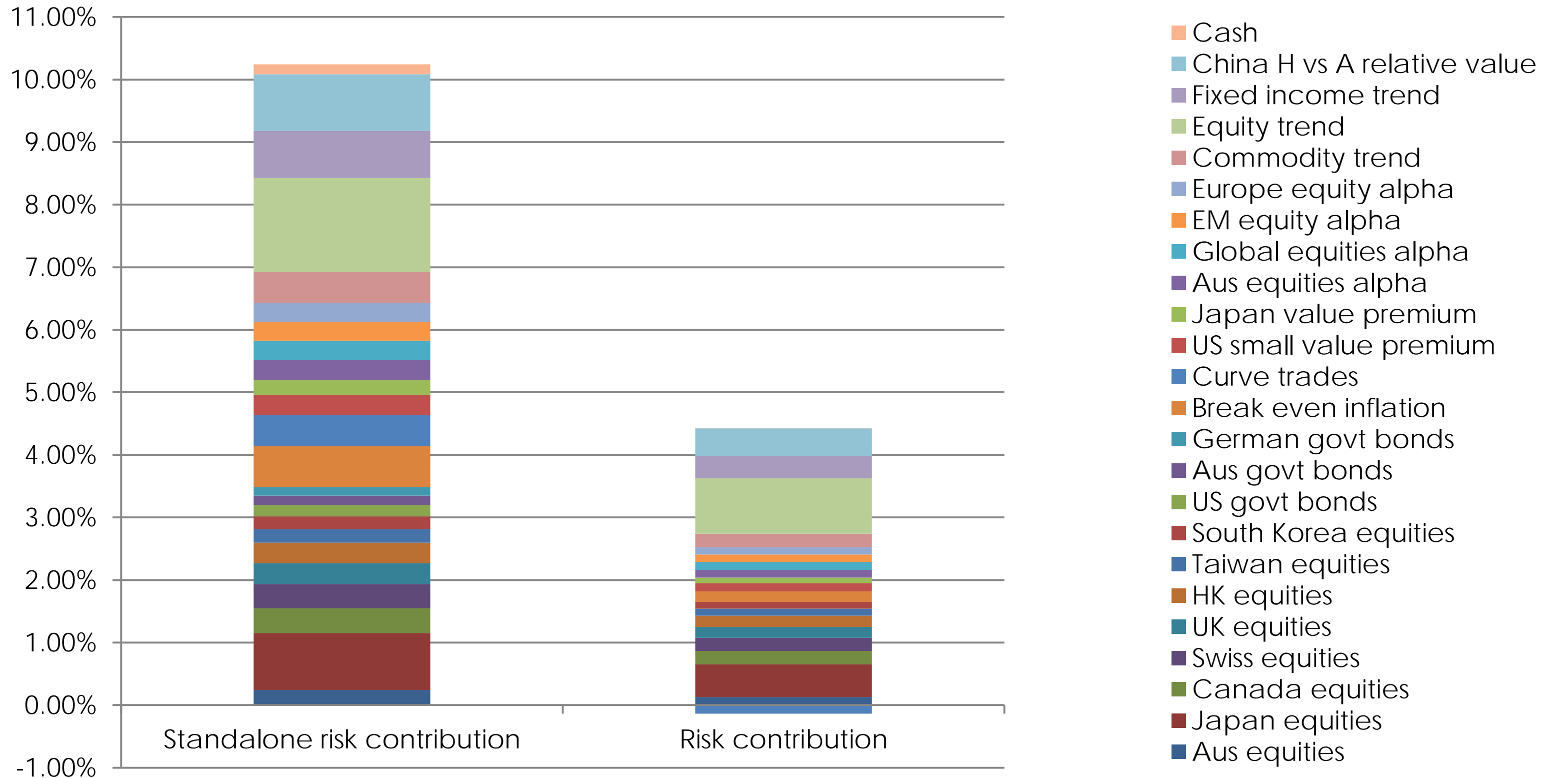

Source: Pendal risk model. Pro-forma allocation used

Not all investors are long term

Long term

Shorter horizon

Pro-cyclical regulators & clients

Equities win in the long run

Managing cash outflows

Illiquidity premium

Optionality from being liquid

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Example strategy performance in down months for Australian equities

Australian equities average in down months = -2.9%;
Blended strategy average in those down months = -0.2%

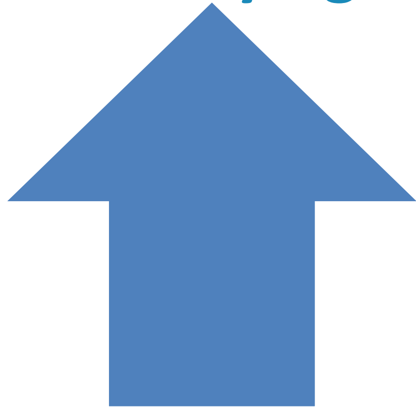
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%

Nov 10, Apr 11, May 11, Jun 11, Jul 11, Aug 11, Sep 11, Nov 11, Dec 11, May 12, Mar 13, May 13, Jun 13, Nov 13, Jan 14, Jun 14, Sep 14, Nov 14, Mar 15, Apr 15, Jun 15, Aug 15, Sep 15, Nov 15, Jan 16, Feb 16, Jun 16, Aug 16, Oct 16, Jan 17, May 17

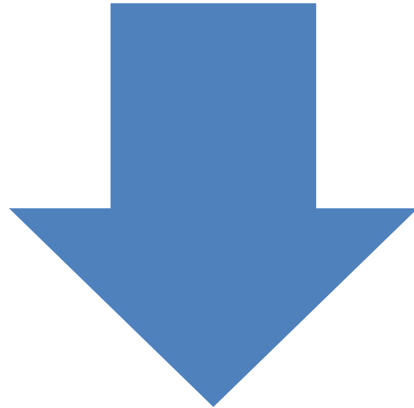
ASX200 | Blended Target Return Example

Source: Bloomberg, S&P, First State Super, Perpetual Ltd website, Pendal

But, you are relying more on manager skill



More reliance on “macro alpha”



Less reliance on equity risk premium

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Does "Asset Allocation Skill" Exist?

Macro & Trend Following Hedge Funds - Rolling 5 year net alpha

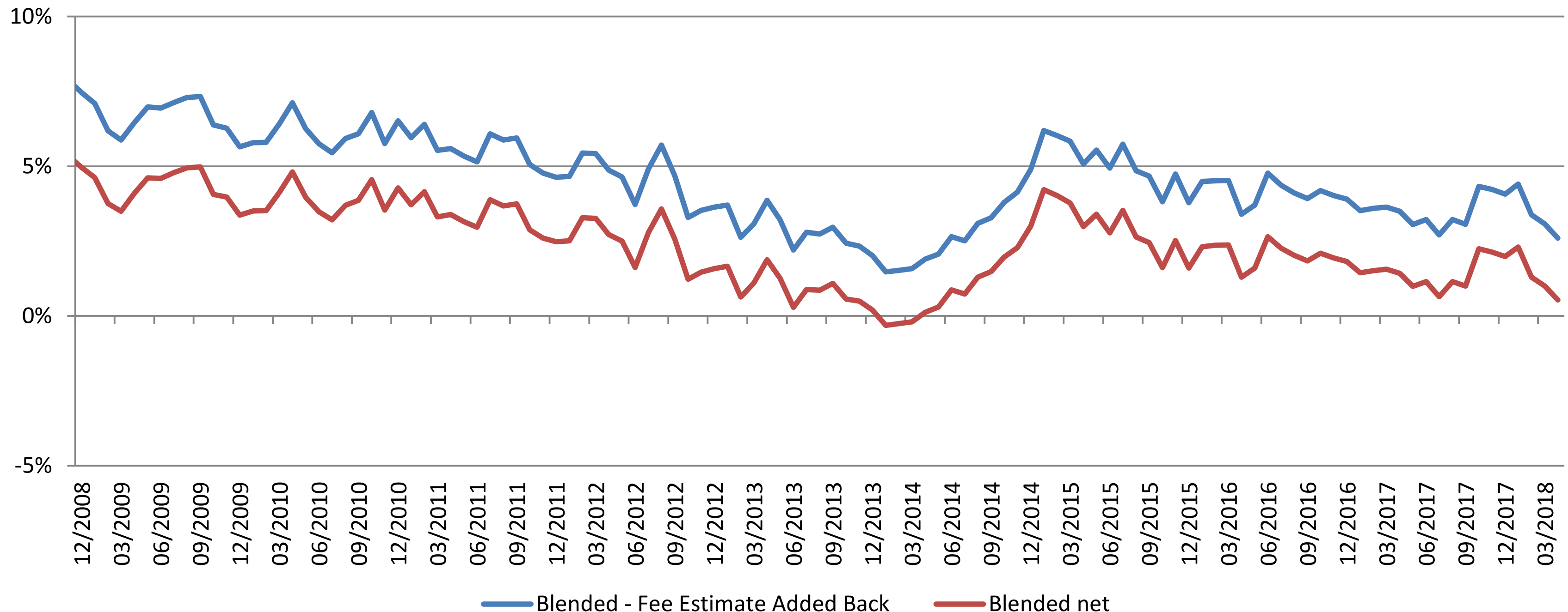
10%
5%
0%
-5%

12/2008 03/2009 06/2009 09/2009 12/2009 03/2010 06/2010 09/2010 12/2010 03/2011 06/2011 09/2011 12/2011 03/2012 06/2012 09/2012 12/2012 03/2013 06/2013 09/2013 12/2013 03/2014 06/2014 09/2014 12/2014 03/2015 06/2015 09/2015 12/2015 03/2016 06/2016 09/2016 12/2016 03/2017 06/2017 09/2017 12/2017 03/2018

Trend Macro

Source: Bloomberg, SG Trend Index, SG Macro Trading Index, Pendal

Yes, but it works better with a light fee load!



Source: Bloomberg, SG Trend Index, SG Macro Trading Index, Pendal. Assumed fees of 1.5% base & 15% performance added back to net returns

Portfolio construction vs traditional model

Active asset allocation		Uncorrelated alpha		Risk control		
Dynamic asset allocation *Taking non-consensus views*	+	**Macro alpha** *Sizing positions*	+	**Risk hedges** *Opportunistic vs permanent leakage*	=	**Outcome** (target CPI+5)
Tactical asset allocation *Speed to market*		**Stock selection alpha** *Capital vs Risk Allocation*				

Using multi-asset / target return funds

<table>
<tr><th>Portfolio 1</th><th>Portfolio 2</th><th colspan="2">Portfolio 3</th></tr>
<tr><td>Equities</td><td>Target return 1</td><td>Equities</td><td rowspan="3">Target return slice</td></tr>
<tr><td>Bonds & cash</td><td>Target return 2</td><td>Bonds & cash</td></tr>
<tr><td>Target return (5-25%)</td><td>Target return 3</td><td rowspan="2">Illiquids & other alts</td></tr>
<tr><td>Illiquids and/or other alts</td><td>Illiquids and/or other alts</td></tr>
</table>

Portfolio 1 is the most common so far. Insurance / Post Retirement could consider Portfolio 2 + “matching assets”

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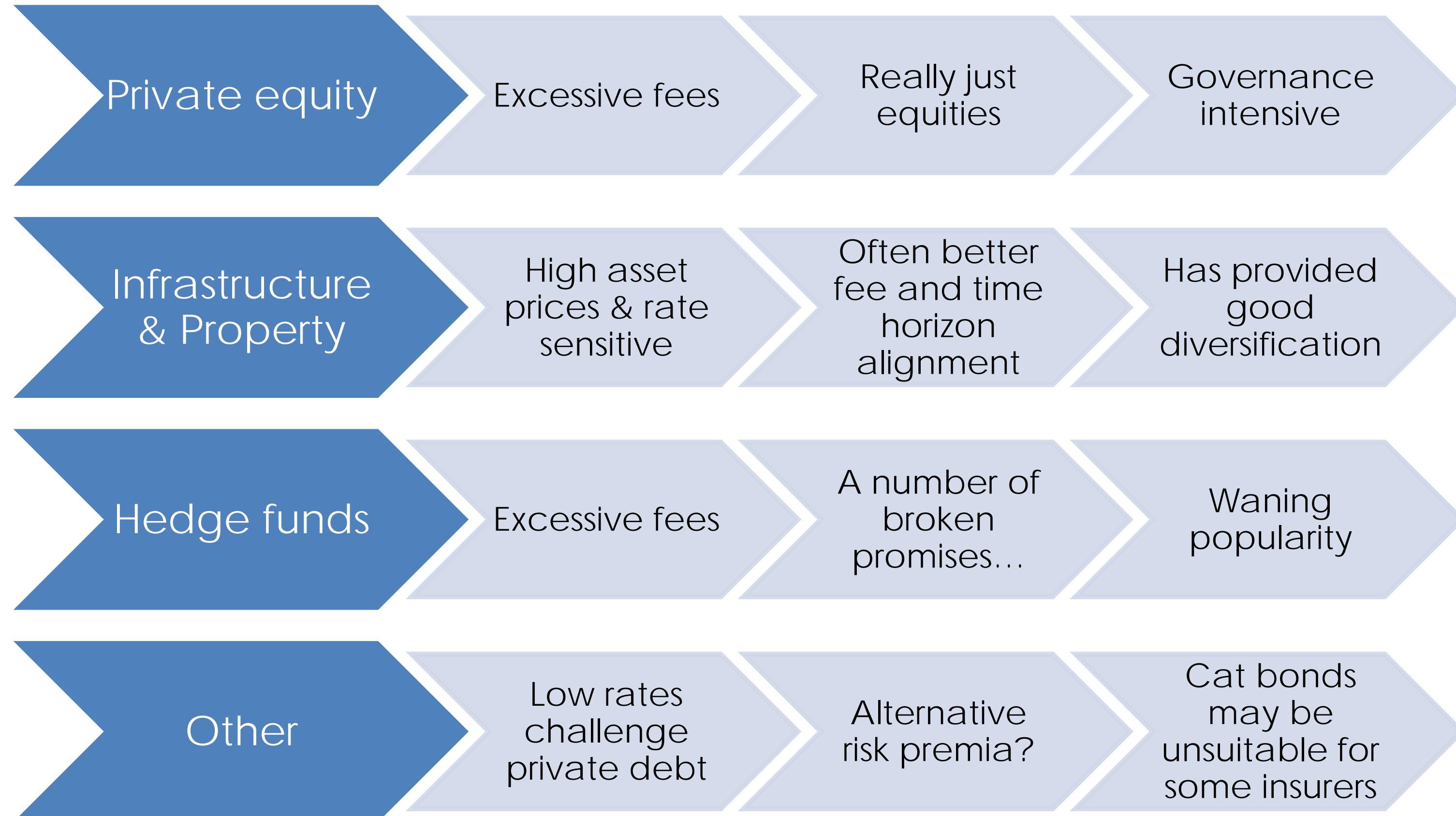
Vs Other Alternatives

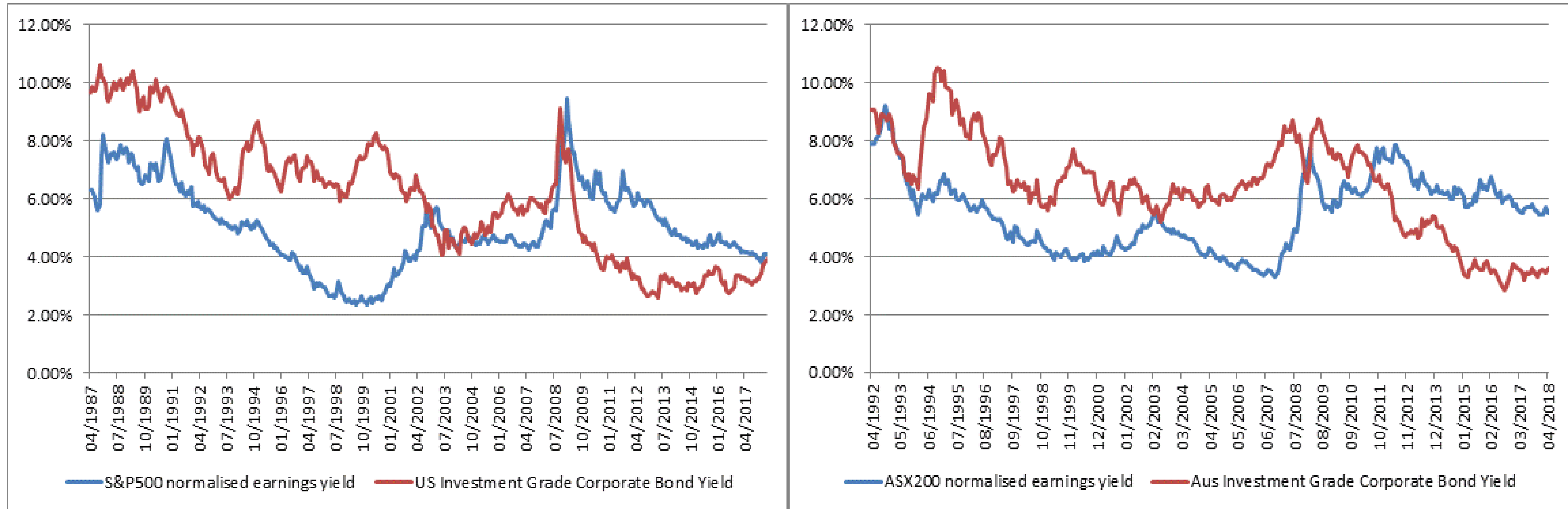


Is CPI+5 achievable going forward?

- No, if you "sum product" most current long term asset class forecasts and a fixed SAA
- But active management has the potential to improve this a lot
  - Requires a willingness to buy at some point in the future when consensus turns sour
- Regardless, for many investors there is value in reducing downside risk

Source: Pendal risk model. Pro-forma allocation used

Some challenges



Source: Bloomberg, Datastream, Pendal

But it's not all bad

z-scores: equity markets - blended valuation metrics

1.00
0.50
0.00
-0.50
-1.00
-1.50

Australia, USA, EU, JN, UK, SWISS, HK, Canada, Korea, Taiwan, Brazil, India, China - HSCEI, China - MSCI, China A

Source: Pendal, numbers derived using data from Bloomberg, Datastream, MSCI, S&P. As at 30/4/18

Practical impediments

- Organisational structures focus on single asset classes
  - Agency issues favour incumbency
- Traditional asset planning cycle leads to insufficient diversification of strategy relative to active risk
  - Index like asset class returns, with excessive asset class risk concentrations
- Super fund focus on peer relative outcomes
- Most post retirement products are small and surveys are less prevalent – opportunity to tear up the asset planning cycle and start again?

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