For Professional Clients Only

SQUARE MILE
INVESTMENT CONSULTING & RESEARCH

An Overview on Multi-Asset

October 2018

Contents

1. Why multi-asset?

The multi-asset label covers a diverse and often complex range of investment funds and approaches. At their simplest, they share a common characteristic – they give investors exposure to a broad range of asset classes to deliver a return profile that reduces the risk of investing in those asset classes individually.

Diversification

A quick look at the returns from the asset classes in figure 1 highlights the benefit of diversification, or put more simply "not having all your eggs in one basket".

Multi-asset teams and fund managers aim to allocate successfully between asset classes they think can deliver good risk-adjusted returns to investors. This involves investing in those asset classes that can deliver superior returns but also balancing the portfolio to ensure that the level of risk being taken is appropriate. Including asset classes that aren't typically correlated to equities can lessen the volatility and drawdown experience for investors when equity markets sell off.

Flexibility

Multi-asset funds can help investors and advisers meet a range of needs and objectives. Returns from multi-asset funds may come in the form of income, capital growth or total return. They are designed to deliver a range of outcomes and risk expectations from a diversified asset mix. This asset mix can include developed market equities, emerging market equities, global fixed income securities (both sovereign and corporate), property, commodities, alternative assets and cash. Actively hedging currency exposure can also help investors achieve their intended outcomes. Multi-asset funds can offer an efficient one-stop solution and newer breed multi-asset funds typically have pre-defined outcomes and risk expectations making them a welcome additional to the multi-asset landscape.

The global financial crisis and regulatory changes led to a new interest in multi-asset funds

Figure 1 - Asset Class Returns

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
12.8	59.4	22.9	15.6	15.6	25.0	19.5	13.9	33.4	25.8
7.6	30.1	20.5	8.1	13.3	20.8	13.9	5.5	33.1	13.1
4.7	16.5	15.9	5.8	12.3	11.0	12.3	1.4	29.0	12.4
3.0	15.1	14.7	5.4	11.4	2.1	12.1	1.0	16.8	11.2
-9.9	5.9	14.5	4.3	5.9	1.9	7.9	0.6	11.8	5.0
-10.9	5.3	8.7	0.5	2.7	0.5	4.3	0.6	10.1	2.9
-17.4	2.9	7.2	-3.5	2.6	0.0	1.2	0.5	3.7	1.9
-22.6	1.9	4.8	-4.3	2.3	-3.9	0.5	0.2	2.6	1.8
-29.9	0.7	3.6	-12.7	0.5	-4.1	0.5	-9.7	1.6	0.3
-35.2	-1.2	0.5	-17.6	-5.4	-11.2	-11.9	-20.3	0.4	-7.1

Cash | Gilts | Property | CPI | Emerging Market Equity

Global Bonds | UK Equities | Commodity | Global Equities | Corporate Bond

Source: Financial Express (FE). Net income reinvested in GBP. Data as at 31st December 2017.

2. The evolution of multi-asset

In the 80s and 90s things appeared simpler. Investors looking for a diversified portfolio had the choice of with-profits or managed funds. With-profits funds were generally the choice for investors who wanted greater security through perceived guarantees. Managed funds were often selected by those who wanted a bit more control and transparency from their investments.

However, both these approaches ultimately disappointed investors. In the early 2000s many with-profit funds failed to deliver the returns investors expected, with many policyholders surprised to learn they were exposed to market risk and ultimately a fund can only pay out what has been earned over the medium-to-long term. This led to the closure of many but the strongest with-profits funds and ultimately the demise of flows to the sector. Managed funds on the other hand had much more equity risk in them than many investors had appreciated. So called "balanced funds" ended up with 85% exposure to equities and "cautious funds" with 60% exposure to equities as investors were focused on keeping pace with the peer group and less focused on risk. In the aftermath of the global financial crisis the Investment Association (IA) sought to clarify this misnomer by relabelling the managed fund sectors to reflect more accurately their most significant risk – the equity exposure of the fund. For example, the Balanced Managed sector was re-named the Mixed Investment 40-85% Shares sector.

3. Why has multi-asset been growing?

The global financial crisis and regulatory changes have led to a new interest in multi-asset funds in both the institutional and retail investment market. In the Institutional space, multi-asset has gained in popularity as a default defined contribution pension fund option. Institutional investors have been shifting away from specialist portfolios back to multi-asset mandates. By the end of 2017 institutional assets managed in multi-asset strategies had risen to 25%*. This is a growing part of the market.

Amongst retail financial advisers there has been growth in an outsourced investment model and the "one stop shop" attributes of multi-asset funds have been supporting their growth in this market segment. Centralised investment propositions (CIPs) have also become common. Post RDR, advisers have been focusing on their core financial planning role and less on investment management and fund selection. This has supported the use of multi-asset funds as an outsourced solution. The outsourced model gives advisers the flexibility to replace underperforming investment managers while retaining the client. This reduces the business risk associated with poor performance. Larger adviser firms have retained some in-house investment specialists to support and manage their centralised investment propositions and both larger and mid-size advisers have been turning to third party consultancy firms to support their CIPs. This includes investment consultants, risk profiling companies and ratings agencies. CIPs have been adopted across many adviser firms and they vary in their structure but at a high level allow advisers to:-

- Ensure clients with similar risk profiles and outcomes receive similar recommendations
- Reduce risk in their business from an operational and regulatory standpoint
- Provide efficiencies and economies of scale

Ranges of funds across the risk spectrum are attractive to firms with CIPs. This enables such firms to meet their differing client requirements but with a consistent approach.

*Source: Asset Management in the UK 2017-2018.

4. Multi-asset now

The demand for multi-asset funds and solutions has led to strong growth across the sector over recent years. For example, the IA Mixed Investment sectors have grown from circa £40bn in 2010 to £143bn in 2018, in excess of a 300% increase in a little over 8 years (figure 2).

The Mixed Investment sectors include the majority of retail multi-asset funds and the sectors combined include over 500 funds. In April 2017, the IA launched a new Volatility Managed sector for funds that have a primary outcome that is risk targeted. The sector already has £29.1bn**, with most of these funds having a multi-asset structure. Many of the funds in the new sector moved from other IA sectors at launch but there have also been many new fund launches. At launch there were 83 funds in the sector and now there are 124. The Targeted Absolute Return sector is home to most of the outcome orientated absolute return funds available. This sector was launched in 2007 but has seen enormous growth and today boasts assets under management of £81.1bn.

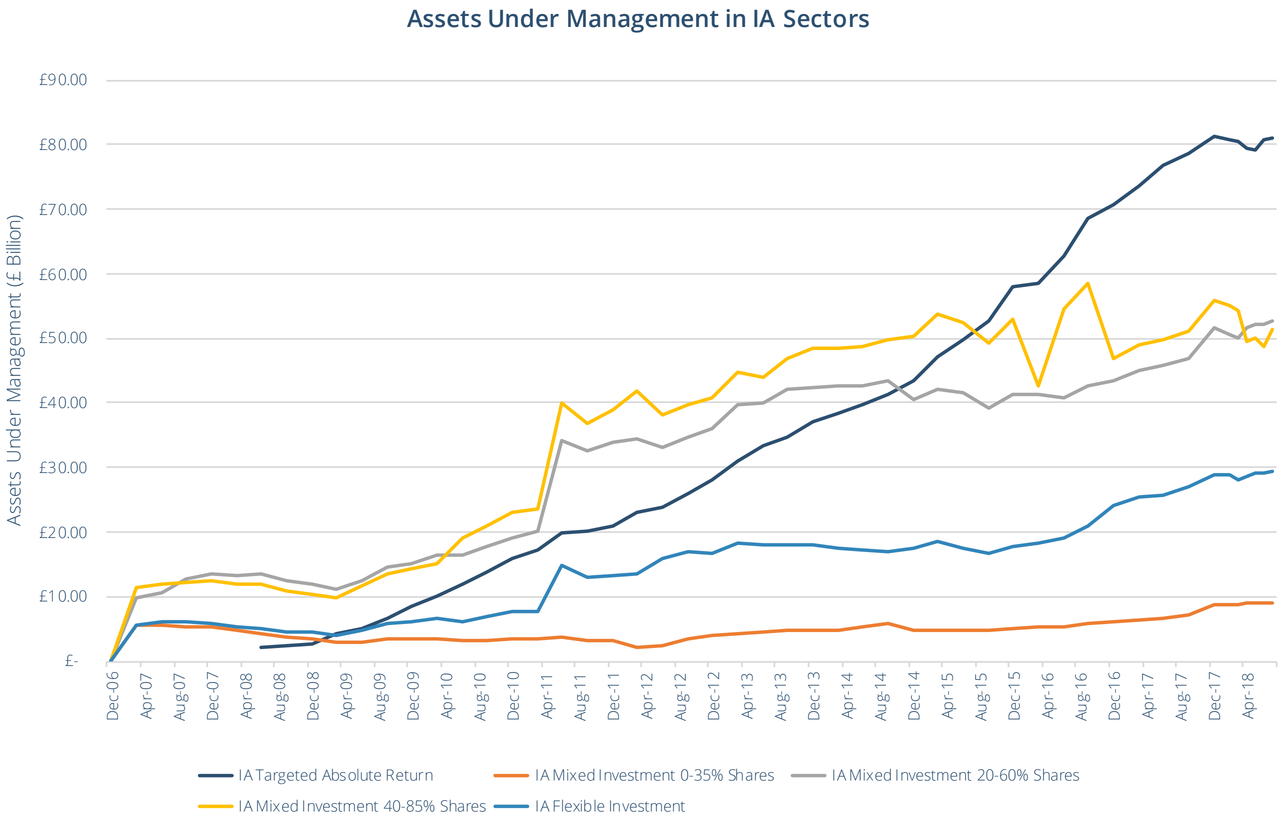
Traditional managed funds, fund of funds, risk targeted funds, outcome focused absolute return strategies, outcome orientated growth and income funds, model portfolio services and with-profits funds all make up a diverse and fluid multi-asset landscape.

Costs/Fees

There remains a wide disspertion of potential fees available in the multi-asset sector. This is illustrated in figure 3 showing the OCFs of the funds in the IA Mixed Investment 20-60% Shares and the IA Volatility Managed sectors, as at September 2018. This story is similar across all the Mixed Investment sectors, where the median OCF across the sectors ranges from 1.08% to 1.25%. Distributors have become increasingly aware of investor and regulatory sensitivity around costs and this can be illustrated by the median OCF of the newest IA sector, Volatility Managed, which stands at 0.8% - meaningfully lower than the more established Mixed Investment sectors.

** Source: IA as at August 2018.

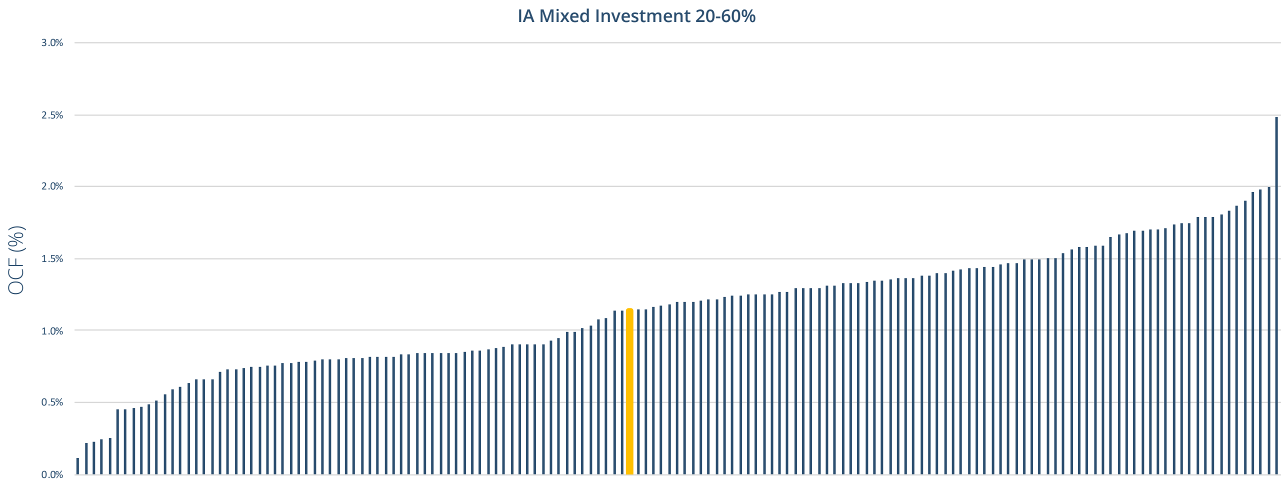
Figure 2 - Growth in IA Mixed Investment Sectors



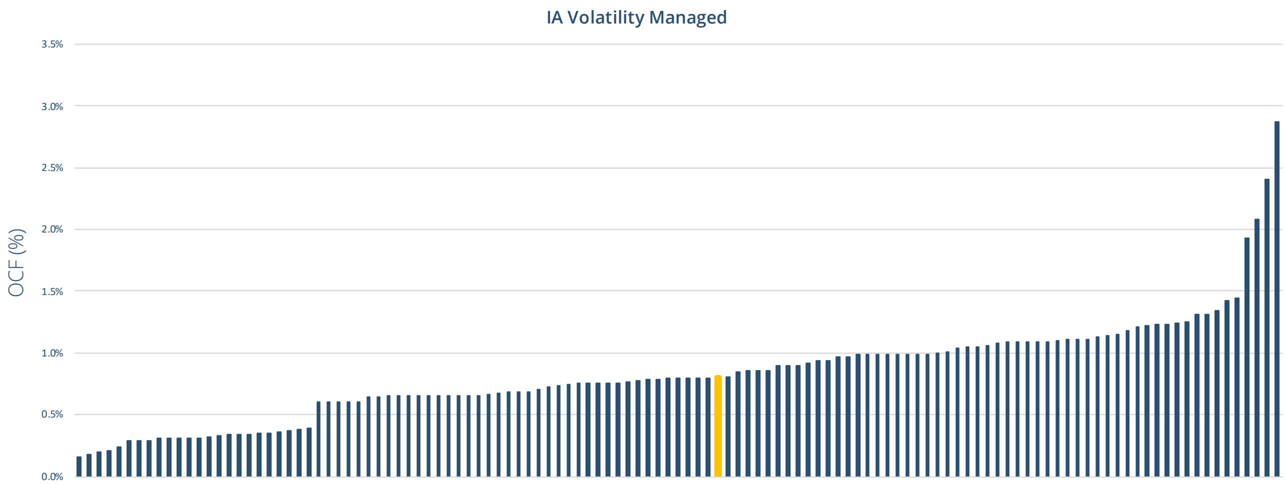
Source: Investment Association as at July 2018.

The pressure on costs is unlikely to dissipate any time soon and has led to a swathe of new fund launches using passive funds and Exchange Traded Funds (ETFs), enabling providers to offer very low-cost solutions. This increased choice has been positive. Newer entrants have placed pressure on the traditional multi-manager fund universe which now looks expensive with OCFs of around 1.5%. When adviser and platform fees are added, the total cost to the investor is heavy and puts great pressure on multi-manager funds to perform consistently above their other multi-asset peers to justify their added value. Total cost should be a focus for investors and advisers. With adviser charges typically ranging between 0.75%-1% and platform charges of typically between 0.2% and 0.4%, it is becoming harder to justify the additional fees of traditional mult-manager funds which sit well above their sector averages.

Figure 3 – Ongoing Charge Figures for Multi Asset Funds



Sector Median - 1.1%



Sector Median - 0.8%

Source: FE Analytics and Square Mile as at 30th September 2018.

5. Types of multi-asset solutions

The multi-asset market is extremely broad and non-homogenous. At Square Mile, we broadly group multi-asset funds into two main types – traditional relative return multi-asset and outcome orientated multi-asset. Multi-asset strategies can be delivered to market in a number of structures. For example, via a unit linked fund structure or via model portfolio services, either discretionary or advisory and delivered through a fund platform. Within these types there are a number of sub-groups and there are many differing approaches to structuring and managing multi-asset funds.

Traditional Balanced Funds

Many of these funds have been around for decades. They tend to be peer group focused or have a relatively static structural allocation. Vanguard's Life Strategy funds are a newish entrant to this space and have been bucking the trend by growing strongly in what is a largely static part of the market.

- These funds continue to be simplistic in their construction and the types of securities held i.e. primarily direct equities and bonds.
- This approach has not changed over time with many long-standing funds that have a mature investor base. This does mean however that fund flows for some are static or in outflow. The main exception to this has been low cost approaches.
- The level of reporting on these funds can be poor as they are often not at the forefront of a business's marketing effort and the strategy is more about maintenance and retention.
- It is rare to see funds launched into the universe now as there is a greater focus on building solutions which meet specific client outcomes rather than generating returns relative to a non-homogenous peer group.
- Despite this, it remains the largest market but its size relative to other multi-asset approaches is falling.

Multi-Manager

These funds are multi-asset but use funds or mandates to gain their asset class exposure. They can be fettered (invest in-house) or unfettered (use external third-parties). Unfettered funds are usually expensive in their peer group due to double layers of fees and many are declining in popularity. There has been a trend more recently towards the fund mandate route as a cheaper alternative to unfettered fund of funds.

- Fettered and unfettered approaches are represented fairly equally in the market.
- Old style "expensive" unfettered multi-manager funds are under pressure because of their need to consistently demonastrate value.
- Fettered funds have become more popular post RDR as cost has become a key focus. Using in-house capability for asset class implementation is cheaper as providers can avoid double charging as fund houses often don't charge for their own funds.
- Multi-manager as an implementation approach remains popular and is no barrier to sales. Many of the newer DFMs in the UK gaining good market traction are investing in funds but on a platform rather than within a fund. The declining popularity in multi-manager retail fund of funds is in our view a cost led issue and not an issue with a fund of funds investment approach. The best multi-manager fund of funds continue to thrive.

Outcome Focused Growth

Outcome orientated growth funds are a mixed universe of funds sometimes labelled as diversified growth funds (DGFs). Diversified growth funds generally have a clear capital accumulation target and often a risk target too. Performance targets are usually expressed as an absolute return over cash or inflation.

- The investable asset class universe for these strategies can be broad and includes alternative assets including infrastructure and hedge fund strategies.
- DGFs have gained particular traction in the institutional pension market as one stop shops. This started in the aftermath of the Myners Report in the 1990s which heavily criticised the institutional balanced funds market and the peer herding in that market. DGFs therefore evolved from traditional balanced funds.
- Traction in the retail market has been slower. Many that were launched pre-2008 were found lacking in falling markets.
- Additionally, they are often standalone strategies and the Adviser market has been favouring solutions across the risk spectrum. Ranges of funds which can help an adviser deliver ongoing suitability to their clients have been gaining market share.
- Advisers need to risk rate standalone solutions to make sure they are meeting suitability requirements. This is outside the expertise of many – hence the reliance on third party risk profilers such as DT, E-value and Finametrica.

Outcome Focused Income

Multi-asset income funds are typically managed to achieve an explicit income outcome. This can be expressed as a targeted income range but many funds also target a sustainable but growing level of income.

- Despite the growth of multi-asset funds and solutions, multi-asset income funds have failed to gain the traction in the UK that most commentators expected.
- Some of the factors which may have contributed to this include the fact that many advisers like to manage client cash flows themselves. Additionally, there are many outstanding managers in the UK and global equity income sector that have excellent track records and that are well established in portfolios. Multi-asset income funds do not generally form part of the output from asset allocation tools which more typically focus on growth.

Outcome Focused Absolute Return

Outcome focused absolute return strategies have a tangible return as their primary objective as well as seeking to deliver capital preservation. They have seen some of the strongest growth in assets across all the market segments in the multi-asset space.

- Outcome focused absolute return funds have been attracting net retail flows but also institutional flows.
- Growth has been driven by being in the sweet spot of demand for outcome focused strategies and a function of the current market backdrop. QE, leading to asset price inflation and historic low bond yields, have led to fears of a correlated equity/bond sell-off and demand for capital preservation strategies that have a low correlation with equities.
- These are usually complex funds using derivatives and sophisticated investment strategies.
- Our analysis indicates that approximately £69bn of assets in the IA Targeted Absolute Return sector are using a multi-strategy approach which accounts for approximately 79% of the sector assets. The sector has grown steadily in terms of number of funds since 2010.

Risk Targeted

Risk Targeted funds have a risk objective as their primary outcome and are a newer growing market segment.

- Risk Targeted funds have risen to prominence over the last few years and we estimate the market being over £55bn.

- A key reason for their success is that they are easy to plug into an adviser's centralised investment proposition, as they are focused on mapping to an attitude to risk profile.
- They come with an associated risk score which is based on an expected volatility figure. The risk and volatility figures are based on the long-term asset allocation which provides a broad framework for each fund.
- The popularity of these funds has been driven by the global financial crisis and the fact that many multi-asset funds fell short of investor expectations in terms of the level of capital loss they experienced. The impact of the FCA's Retail Distribution Review has also been a key factor.
- Around half the funds in the universe have been launched in the last five years. Some 30% of the universe are lower cost strategies which use passive implementation.
- The remainder use active funds or a mixture of active and passive investments. These funds usually come as part of a range, usually between 3-5 funds, offering a choice for investors with varying attitudes to risk.

Model Portfolios

Model Portfolio Services (MPS) typically offer investors a suite of managed portfolios. They have grown in popularity with the growth of platforms as this has given advisers the operational infrastructure to manage their client portfolios more efficiently.

- Can be offered on an advisory or discretionary basis.
- Assets in DFM are estimated to be between £22 and £25 billion according to recent data from Platforum. It is not easy to aggregate assets managed under advisory models on platforms and reliable estimates are hard to source.
- MIFID II has placed additional responsibility on discretionary firms in terms of disclosure, reporting and client communications. This has enhanced the attraction of outsourced solutions.
- Can offer a bespoke and differentiated offering to fit an adviser's central investment proposition.
- Usually structured as a suite of portfolios suitable for varying risk levels.
- Less tax efficient for "taxable" portfolios, for example outside a SIPP or ISA.
- Cost comparisons can be challenging as transparency can be an issue.
- May be limited by platform functionality, for example managing currency positions and use of derivatives.

With Profits

On the surface, with-profits funds offer investors an understandable and attractive proposition. They offer a regular level of growth through an annual bonus and the potential to enhance this at the end of the investment term with a terminal bonus.

- With-profits funds provide clarity around their objectives with a tangible level of return.
- A smoothed return profile continues to have appeal to more cautious investors.
- However, the structure of with profits is complicated. Assets that support bonuses are often not very transparent and can be poorly reported.
- Market value adjustments or pricing policies that revert to the NAV of the underlying assets at times of significant market falls mean that investors are not protected from drawdowns despite one of the key attractions of with-profits being the prospect of a smoothed return profile.

Benefits and Challenges of Multi-Asset funds by type: summary table

Multi-Asset Approaches	Benefits	Challenges
Traditional Multi-Asset	• Simple • Well Established	• Intangible Objectives • Peer Group Focused.
Multi-Manager	• Best of breed fund selection • Manager Diversification	• Higher OCFs due to underlying fund charges although fund of mandates can be cheaper than fund of funds.
Model Portfolio Services	• Fits well with adviser firms' centralised investment propositions • Can be bespoke • Suite of Portfolios	• Performance and cost comparisons are challenging • Less tax efficient outside SIPP and ISA wrappers • Platform limitations
Outcome Orientated Growth/Income Funds	• Clear outcomes in terms of return and risk expectations • Well diversified	• Long only – can be vulnerable to drawdowns when asset classes correlate • Usually stand alone funds - not part of a range of outcomes
Outcome Orientated Absolute Return	• Clear outcomes • Flexibility to deliver in all market conditions	• Complex • Many launched after the global financial crisis so sector is arguably unproven
Risk Targeted	• Clear risk objectives • Suites of funds that fit with adviser firms' centralised investment propositions	• Can be hard to predict returns • Many risk targeted funds have not been matching their long-term risk expectations • Difficult to compare performance across the sector • Can be complex to explain and analyse • Many have short track records and are arguably unproven
With Profits	• Quote an expected growth rate • Aim to deliver a smooth return profile to insulate investors from day to day price volatility	• Opaque product and charging structure. • Do not protect investors from sharp market falls – is this understood by investors?

6. Multi-asset: the future

We see little reason for the popularity of multi-asset funds and solutions to dissipate anytime soon. The structural drivers supporting their use by advisers and investors seem firmly set. We think the sector is set to continue to grow underpinned by strong structural drivers but we also think the pressure on costs is likely to persist.

Characteristics of successful strategies

Square Mile look for a number of key characteristics when analysing multi-asset funds. We have a preference for the following attributes when selecting multi-asset funds and strategies as we believe these attributes are most likely to drive success in the future.

These factors also support advisers in their job of recommending the right fund to the right client and ensuring a fund is:-

- Meeting a client's suitability requirements.
- Meeting a client's investment objectives.
- Monitored for ongoing suitability and delivery of objectives.

Helping to determine suitability

Clear outcome

At the outset, there needs to be a clear articulation of what outcome an investor can expect from their investment. This could be capital accumulation, income, inflation protection, capital protection or a combination of these.

Clear and measurable performance or risk objective

A clear, measurable performance or risk objective will give a helpful expectation of what investors can expect from a fund. This objective sets the framework for the management of the fund and the level of risk that needs to be taken to meet the objective.

Articulation of an expected risk profile

This is essential if an investor or adviser is to make a judgment on the suitability of the investment. Advisers retain responsibility for suitability even if they have "outsourced" investment management.

Risk measurement should include a range of measures including a focus on capital drawdown which aligns better than volatility with a client's understanding of risk and their capacity for loss. Funds that can provide investors with clarity around the level of risk they are likely to take are desirable to advisers in their need to demonstrate ongoing suitability.

Value for money

We accept that active management is more expensive than passively implemented strategies. However, fees are the only known in investing and their compound effect on returns should not be underestimated. "Value for money" does not preclude higher cost offerings, but they must demonstrate superior risk-adjusted returns. Cost transparency is essential to determine value for money which limits the appeal of traditional and new breed with-profits funds and of some DFM offerings.

Investment capability to meet objective

Parent company commitment to multi-asset investing

Where a parent group is committed to multi-asset investing, it is more likely they will invest in appropriate resources to support success. This will include recruiting talented investment professionals and investing in the necessary technology and infrastructure to deliver operational and trading efficiencies.

Strong team-based investment process

A strong team-based process, ideally not centred around one star manager, serves investors' interests best. Given the totality of the investable universe for multi-asset funds, breadth of knowledge and expertise is required to demonstrate the appropriate skill-set to execute these strategies successfully.

Well defined and articulated investment process

A good and well-defined investment process helps to deliver continuity of approach and supports the delivery of a fund's anticipated outcome.

Strong risk controls

The investment process should have clear risk controls to ensure that managers do not exceed the remit of their mandate and expose investors to unintended and unexpected risk. Companies with strong risk management processes are preferred.

Flexibility

Within the scope of the fund's mandate, objective and investment approach, funds with flexibility and a wide tool kit have the potential to deliver more consistent returns through time.

Does the fund remain suitable and is it meeting its objectives?

Good risk-adjusted performance

Ultimately, good risk adjusted performance needs to be delivered in line with initial investor expectations. Most risk targeted funds were launched after the financial crisis in 2008 and have arguably yet to be fully tested, often with track records of less than five years.

Transparent investor communication

Reporting portfolio activity, positioning and performance transparently helps with ongoing due diligence, helping advisers and their investors to fully understand the fund they are using. This helps investors understand performance, particularly in relation to short-term performance issues that are explainable and reasonable in the context of the fund's strategy.

Get in touch

If you have any questions regarding Square Mile or information contained in this report, drop us a line...

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Important Information