Canada Life

How can risks be managed within multi-asset solutions?

Following on from our recent focus on risk profiled and managed funds, we look closely at risks in multi-asset funds. In particular, what are the risks inherent within investing and how can these be managed within a multi-asset portfolio?

First of all, how do we define risk?

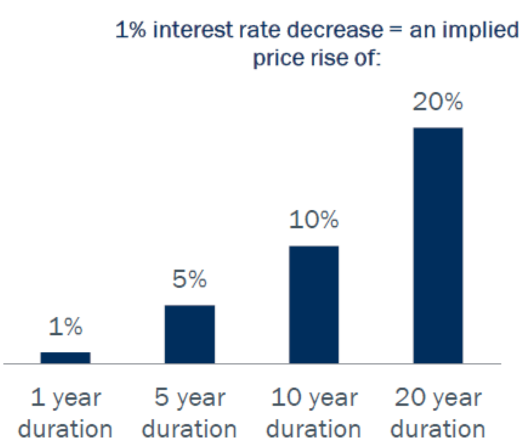
We look at four different pillars when analysing the various risks inherent within multi-asset portfolios:

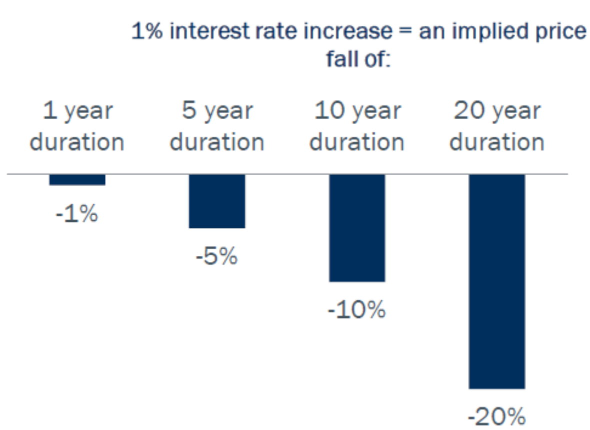
1. Interest rate risk
2. Market risk
3. Currency, or exchange rate risk
4. Brand risk.

Generally, when 'risk' is discussed, often it involves only one of these pillars as they can have very separate impacts on your portfolio. Now, let us take a look at each one.

Interest rate risk

It is common knowledge that fixed income investments have an inverse relationship with interest rate movements. That is to say that, if interest rates rise by c. 1%, a bond's price will fall by c. 1% for every year of its duration. Conversely, if interest rates fall, the bond's price will rise. But why is that so important now?



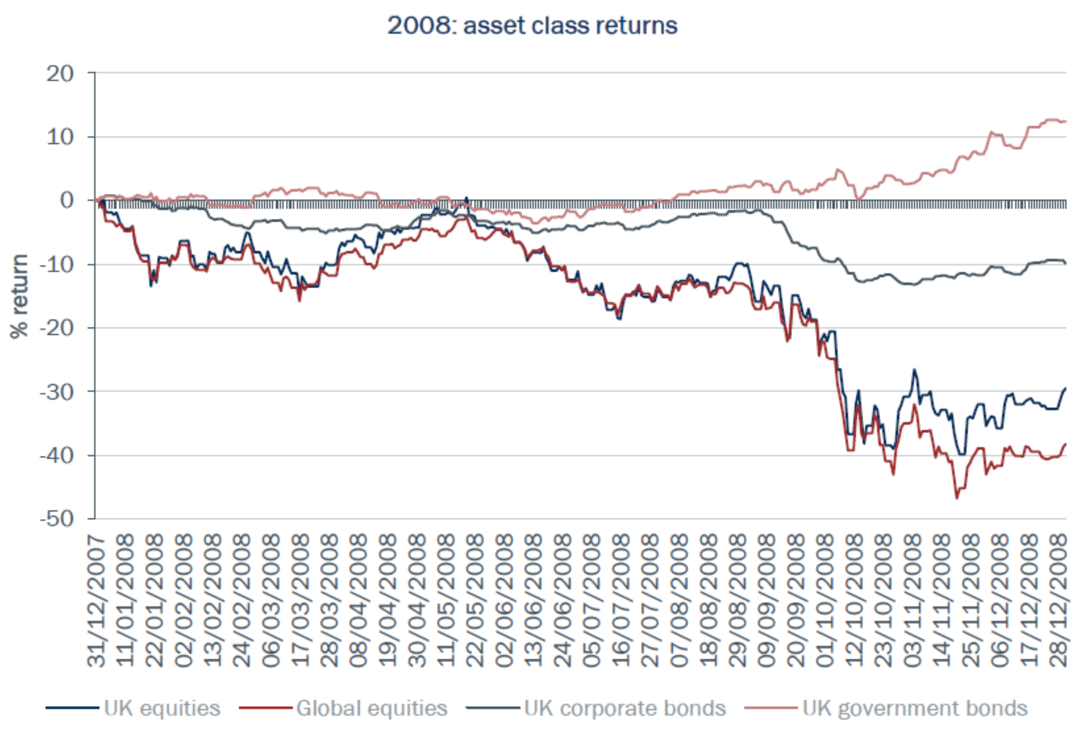


Source: Canada Life Investments, for illustrative purposes only. January 2018.

This has become increasingly important as a decade of extraordinarily loose monetary policy is coming to end. This period has been witness to historically low interest rates, which have supported bond prices. Interest rates are now rising globally, meaning that duration exposure and credit selection will be more important than ever. For example, shorter-dated bonds – with less duration – will protect portfolios from interest rate rises. However, they will also dampen the volatility, as longer-dated assets are inherently more volatile. This is because they have greater market risk, which is discussed next.

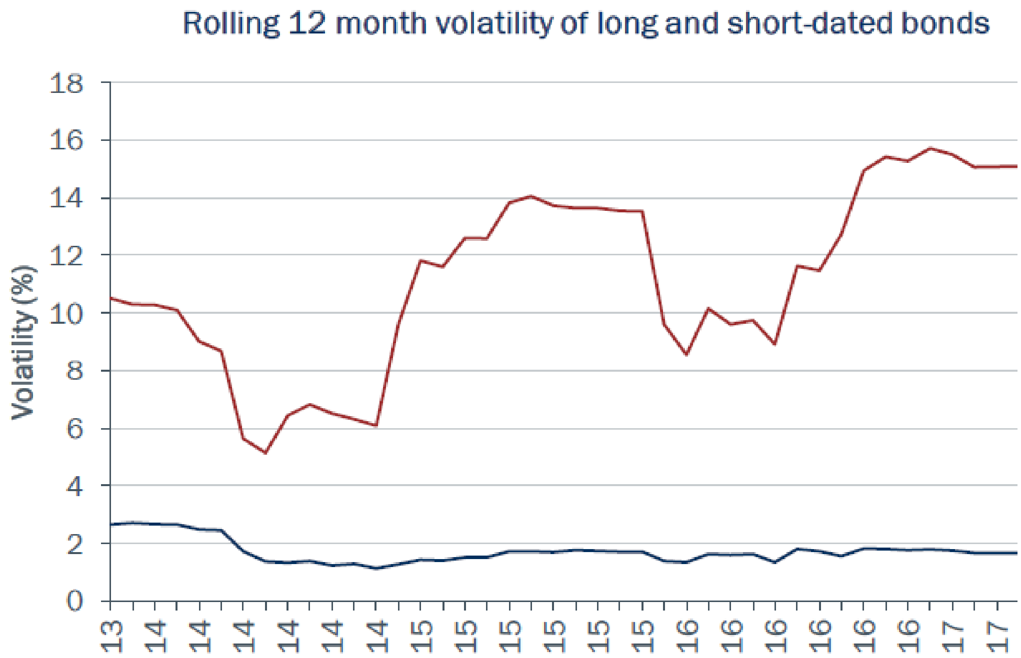
Market risk

Put simply, market risk is the risk that an investor takes when putting money into a particular asset class. In any one year, there is a significant divergence of performance between equities, bonds and property for example as each asset class possess idiosyncratic market risks. Equities are more sensitive to global economic growth – any sharp fall and they could follow – property is correlated to the amount of finance available in the market in many instances and bonds are susceptible to changes to creditworthiness. In the worse case scenario, this leaves investors at the peril of losing money. This can be highlighted by the performance of different asset classes in 2008.



Source: Morningstar Direct, from 01/01/08 to 31/12/08. UK equities = MSCI UK IMI Index, global equities = MSCI World Index, UK corporate bonds = iBoxx £ Corporate All Maturities Index, UK gilts = iBoxx £ Gilts Index.

This graph also shows how investment decisions within asset classes can make an impact. For example, UK investors in 2008 would have been better off in UK equities compared to those listed overseas and in government bonds over their corporate counterparts. Intra-asset class risk is also important from a volatility perspective. We have mentioned that longer-dated assets are riskier as they have greater exposure to the market. This can be demonstrated in the rolling volatility of long-dated bonds compared to short-dated bonds, shown in the following chart.



Source: Morningstar Direct, as at 31/12/17. Short-dated = iBoxx £ Corporate 1-5 Year Index, long-dated = iBoxx £ Corporate 15+ Year Index.

Therefore, when dealing with market risk, investors have a huge number of issues to grapple with, all of which need to be managed within a multi-asset portfolio.

Currency, or exchange rate risk

We have said before that when picking up the KIID of any fund with overseas exposure you will see the risk of 'currency movements in the value of overseas assets may impact the value of the fund' often cited. This is because the value of any overseas asset is also impacted by how sterling is performing against the particular currency in question. Weak sterling would inflate the value of an overseas asset, where as strong sterling would diminish it.

At the most extreme, one just has to look at the example of Russia in 2014. Following the military incursion into Ukrainian territory and the ensuing sanctions, it would be easy to assume that the value of Russian companies duly plummeted and left the domestic stockmarket in dire straits. However, although the equity market performed poorly – losing 12.5% in rouble terms – it was the currency impact that harmed overseas investors. UK holders of an MSCI Russia Index tracker would have lost 42.9%, simply because the rouble depreciated so much against sterling.

However, it also works the other way. In the aftermath of the Brexit vote, sterling weakened significantly across global foreign exchange markets. This actually benefited fund managers with international mandates, as the value of their assets rose by nearly 20% overnight. Therefore, there are risks to both the upside and downside when deciding to invest overseas and 'take on' currency risk.

However, there will be some clients for whom any overseas currency exposure would be deemed too risky. In this instance, it is important to remember that much of the revenue generated by UK companies, in fact comes from overseas. For example over 70% of the revenues generated by listed UK businesses comes from overseas. Therefore, UK equity exposure within a managed fund could go some way to maintain exposure to favourable currency themes, without taking direct exposure. This is because the revenues and profits of these internationally-exposed companies benefit from a weak sterling in the same way as a direct asset does.

Brand risk

An area that is commonly ignored when talking about constructing a portfolio, is brand risk. This can be broadly defined as to how your track record, experience and transparency stacks up with clients and the wider industry. For example, at Canada Life Investments, we use an in-house fund of funds approach in our multi-asset business due to brand risk. This is because using internal products allow:

- Direct manager relationships per asset class
- Access to low cost active funds
- Readily available information on all funds, which can be shared with clients
- Ability to leverage on long-term track records and expertise.

How does this come together?

In short, we believe multi-asset fund managers need to be capable of analysing and managing the above risks when putting together their portfolios. Using our Managed 0%-35% Fund as an example, we aim to construct a diversified portfolio that exhibits low volatility. By controlling the above risks as much as possible, we seek to dampen down fluctuations for investors and deliver reasonably steady growth and income over a cycle.

For example, the fixed income weighting within our multi-asset portfolios is positioned short of the market from a duration perspective. This is designed to protect capital against rising rates, whilst also allowing us to reinvest the proceeds of maturing bonds in higher yielding securities as and when rates do rise. From a market risk perspective, we currently prefer corporate credit to government bonds, as we believe they are more attractive from a risk/reward perspective. These asset allocation decisions have helped our multi-asset fund range dampen down volatility.

When looking at equities, it very much comes down to the risk level of the particular multi-asset portfolio. For defensive products for example, we look to invest in high quality, income-generating UK stocks. For higher risk portfolios we like European equities in particular, given the combination of attractive valuations and earnings growth. The same is true of currency, higher risk portfolios invest substantially in overseas assets, but currency exposure in the more defensive portfolios is gained via internationally focused UK assets, thereby removing direct currency risk.
Andrew Morris, Sales Manager, Canada Life Investments

Important information

About Canada Life:

Canada Life is part of a group of companies controlled by Great-West Lifeco Inc., a diversified financial services holding company headquartered in Winnipeg, Canada. Through its subsidiary companies, Lifeco has operations in Canada, the United States, and Europe. Great-West Lifeco and its insurance subsidiaries have received strong ratings from major rating agencies.

Canada Life Limited, a wholly owned subsidiary of Great-West Lifeco, began operations in the United Kingdom in 1903 and looks after the retirement, investment and protection needs of individuals and companies alike. As well as providing stability and security through its individual contracts, Canada Life Limited has grown to become the leading provider of competitively priced group insurance solutions. www.canadalife.co.uk.

Canada Life

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