HEALTH WEALTH CAREER

MAKING SENSE OF MULTI-ASSET

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EXECUTIVE SUMMARY

Multi-Asset strategies continue to be popular components within many investor portfolios. However, with numerous product launches and plentiful options in the market blurring the lines between categories, understanding the sources of risk and return between these strategies, and the potential role that they could play in an investor's portfolio, is more important than ever. This paper provides some clarity around the range of options within the space, including a discussion of how different offerings rely on different return drivers, such as access to traditional beta, use of underlying active management, the degree to which dynamic asset allocation is exploited, and/or the reliance on market directional and non-directional return drivers. We also look at fees and, in particular, their relationship with equity market correlation and manager skill, respectively, concluding that in most cases it is easier to justify higher fees for those strategies that are low correlation and require high manager skill.

THE MULTI-ASSET STRATEGY SPECTRUM

Multi-Asset strategies have reinforced their ascendancy in the past few years, with the growth in assets under management (AuM) matched by abundant product launches. Liquidity, transparency and fees lower than many other liquid alternatives have made Multi-Asset strategies attractive options for constrained investors (e.g., defined contribution pension schemes with liquidity and fee constraints, or small institutional investors with governance constraints). Meanwhile, larger, less constrained investors have also found a place for these strategies within their portfolios, particularly where they can demonstrate diversification benefits within the broader asset mix.

Mercer separates Multi-Asset strategies into four main universes: Core Multi-Asset, Idiosyncratic Multi-Asset, Risk Parity and Diversified Inflation. The remainder of this paper focuses on the first two categories (which in some regions have been labeled as Diversified Growth Funds) as we examine the range of options available, the different sources of risk and return, and the potential role that these products could play in an investor's portfolio.

As the popularity of, and assets under management in, Multi-Asset strategies have increased, the range of strategies available to investors has also been expanding. We currently have more than 500 strategies listed in our Global Investment Manager Database (GIMD) within the Core and Idiosyncratic Multi-Asset categories. In 2014, Mercer created these two subcategories in order to delineate some key differences in the sources of risk and return between various Multi-Asset strategies, as well as to highlight the different roles that they can play in portfolios. We summarize the key points in Table 1.

As the market has evolved, providers have continued to innovate and push the boundaries of these two categories, and we believe that the Multi-Asset space should be seen as a spectrum of strategies. The extent to which a strategy utilizes underlying active management, exploits dynamic asset allocation, and/or relies on market directional and non-directional return drivers all contribute to this breadth of options. To help understand the key characteristics of the diverse range of strategies within this spectrum, we informally separate them into a number of subcategories. We summarize these in Table 2.

TABLE 1: HIGH-LEVEL OVERVIEW OF MULTI-ASSET UNIVERSE

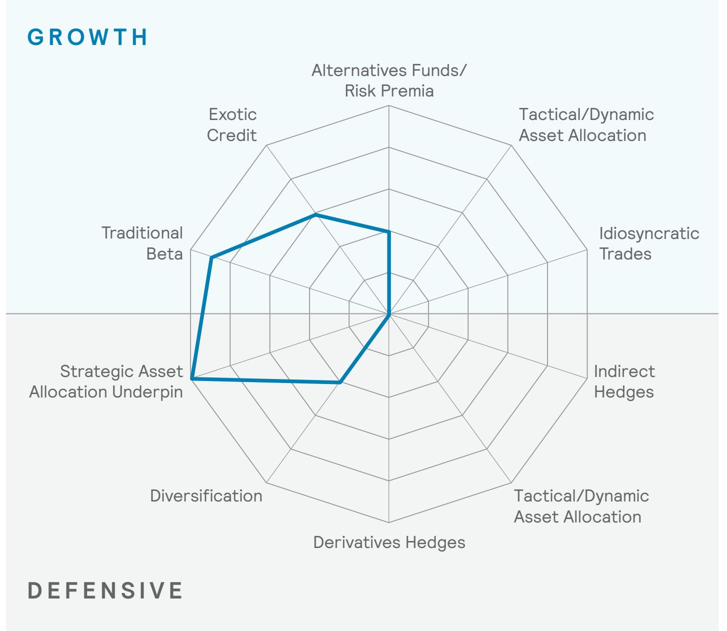
	IN A NUTSHELL	KEY SOURCES OF ABSOLUTE GROWTH	KEY SOURCES OF DEFENSE	POSSIBLE PORTFOLIO ROLES
CORE MULTI-ASSET STRATEGIES	The performance profile is typically dominated by long exposure to traditional market exposures ("betas"); higher correlations with equity market movements than Idiosyncratic Multi-Asset strategies Will typically hold a core of direct stock and bond exposures rather than derivatives-based exposures	Traditional beta (equity and fixed income) Exotic beta (such as emerging market debt and high-yield bonds) Some dynamic asset allocation (DAA), although this will only be a small component of total returns	Underpinned by a long-term/strategic asset allocation Diversification across asset classes Some DAA, although this will be a smaller component of total returns than for Idiosyncratic strategies	Core defined contribution fund holding Low governance all-in-one growth portfolio
IDIOSYNCRATIC MULTI-ASSET STRATEGIES	Typically net long exposure to traditional betas, but asset allocation can be more dynamic and non-directional exposures are significant Returns are expected to be more "Absolute Return" in nature Lower correlations with equity market movements than Core Multi-Asset strategies Derivatives are often used to implement ideas	DAA across broad markets Idiosyncratic exposures (e.g., single stock trade ideas, relative value opportunities)	DAA across broad markets Indirect hedges to balance out the portfolio and enhance downside mitigation	Satellite to a Core Multi-Asset strategy Liquid alternatives diversifier within broader investment portfolios

TABLE 2: THE MULTI-ASSET SPECTRUM

CORE			IDIOSYNCRATIC
PASSIVE CORE	ACTIVE CORE	ASSET ALLOCATOR	ABSOLUTE RETURN

Starting with the furthest left, a **Passive Core** strategy is one that attempts to provide access to a range of market betas in a cost-efficient manner through the use of passive instruments. The portfolio has a clearly defined strategic asset allocation, and rebalancing ranges are based on long-term risk and return expectations, with periodic reviews. Equity market risk remains the primary driver of returns, but with total returns expected to exhibit lower volatility than equity markets through the introduction of allocations to fixed income and possibly some listed alternatives, such as real estate and infrastructure. The accompanying radar chart[1] shows the biases (qualitatively assessed by Mercer) for a typical Passive Core strategy.

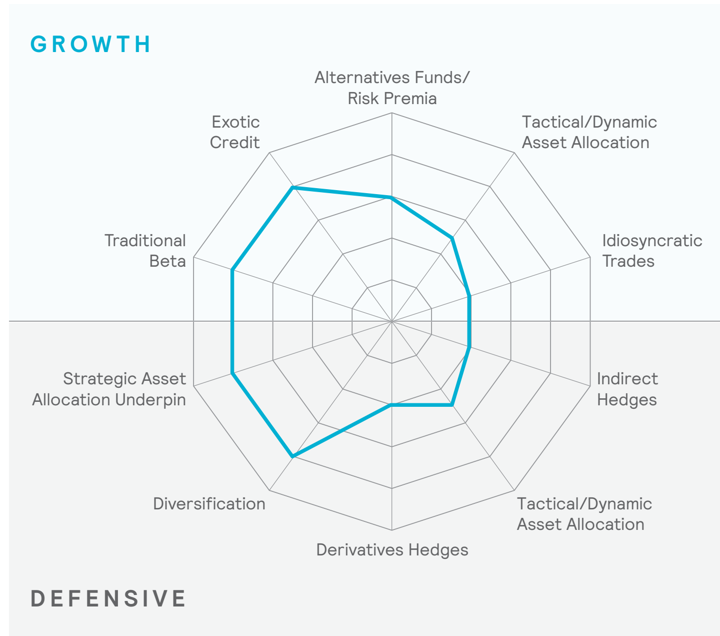
CHART 1: EXAMPLE RADAR CHART FOR A PASSIVE CORE MULTI-ASSET STRATEGY



Source: Mercer

The second subcategory, **Active Core,** builds on the Passive Core universe by introducing some, or all, of the following additional return drivers: security selection through allocations to actively managed underlying strategies; a degree of dynamic asset allocation; and limited use of non-directional trades either directly or through allocations to Absolute Return strategies. Despite the addition of these return drivers, equity market beta remains the primary return driver for most strategies in this space, resulting in a high correlation with equity markets. The few exceptions to this generalization are those strategies that have a higher-than-average allocation to alternatives within their strategic allocation.

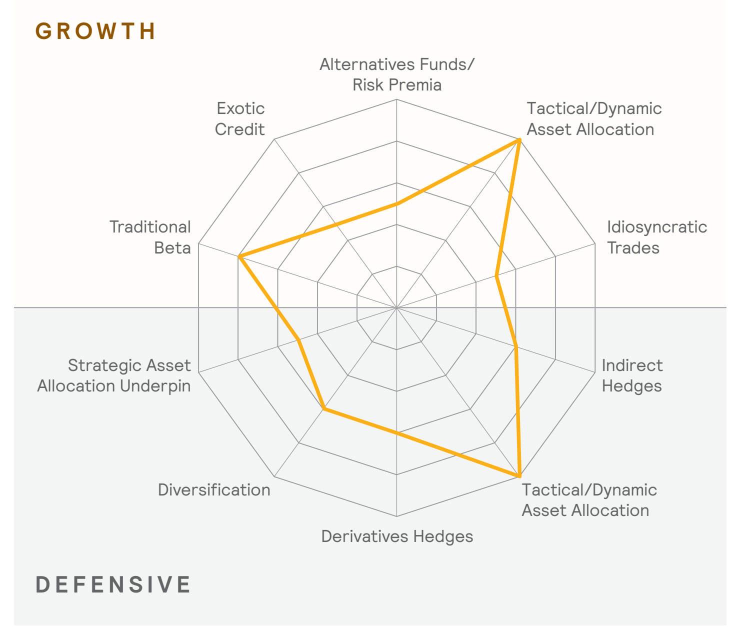
CHART 2: EXAMPLE RADAR CHART FOR AN ACTIVE CORE MULTI-ASSET STRATEGY



Source: Mercer

The third group falls within the Idiosyncratic Multi-Asset universe and comprises **Asset Allocator** strategies. These strategies also typically invest the majority of their portfolios in traditional asset classes; however, they utilize dynamic asset allocation to a much greater degree, such that it becomes a significant driver of returns. The dynamic asset allocation process is predominantly driven by the manager's top-down macroeconomic views, with some providers relying more on systematic inputs to drive decision-making, while others are more discretionary in nature. These strategies have a moderate to high correlation with equity markets, but this correlation can vary meaningfully over time.

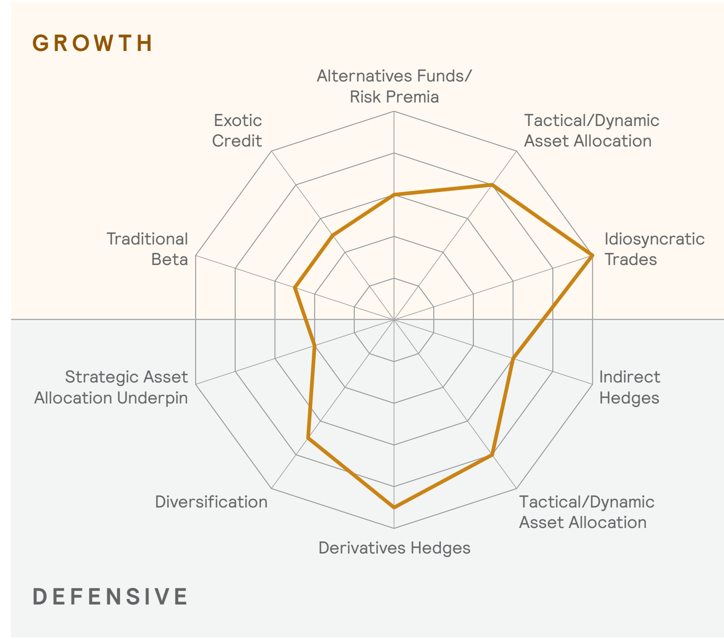
CHART 3: EXAMPLE RADAR CHART FOR AN IDIOSYNCRATIC ASSET ALLOCATOR MULTI-ASSET STRATEGY



Source: Mercer

The final group is **Absolute Return** strategies. These are products that rely far more heavily on non-market directional trades to drive portfolio returns. Typically, these strategies utilize hedge fund-like techniques, such as taking relative value positions (going long and short on markets/securities), using leverage (borrowing money to increase the potential return of an investment), and implementing trades through derivatives (financial instruments with a price that is dependent upon an underlying asset or security). The aim is to make the portfolio less reliant on traditional market exposures so that it has a greater chance of generating positive returns regardless of the general direction of markets. Portfolios do still typically also include directional strategies, which are dynamically managed allocations to traditional asset classes. The degree to which strategies rely on directional and non-directional allocations varies across this space; however, non-directional drivers typically represent more than half of the risk allocation.

CHART 4: EXAMPLE RADAR CHART FOR AN IDIOSYNCRATIC ABSOLUTE RETURN MULTI-ASSET STRATEGY



Source: Mercer

CONSIDERING COSTS

As with all investments, it is important to understand the associated costs of each option when allocating to Multi-Asset strategies. To help assess value for money, we have looked at the relationship between the sources of return within a strategy and the total cost of investing in that strategy. As things stand, our high-level qualitative assessment of this in relation to each Multi-Asset subgroup is included in the graphic below.

TABLE 3: MULTI-ASSET CHARACTERISTICS

PASSIVE CORE	ACTIVE CORE	IDIOSYNCRATIC: ASSET ALLOCATOR	IDIOSYNCRATIC: ABSOLUTE RETURN
• High equity correlation • Low reliance on manager skill • Low fees	• High/moderate equity correlation • Low/moderate reliance on manager skill • Moderate/ high fees	• Moderate/high but variable equity correlation • Moderate reliance on manager skill • Moderate/ high fees	• Low/moderate equity correlation • Moderate/high reliance on manager skill • Moderate/ high fees

Overall, we believe that the justification for a higher fee can be more easily made for strategies that rely more heavily on manager skill as compared to those strategies that are driven by traditional market beta (primarily equity markets).

Equity markets are typically the primary driver of returns within low-cost Passive Core strategies, so they tend to have the highest correlation to equity markets (≈0.8–0.9) and the lowest reliance on manager skill. As strategies introduce different drivers of returns — for example, through increased allocations to alternatives, underlying active management, dynamic asset allocation and idiosyncratic trades — the correlation to equities typically falls, the contribution from manager skill increases and the cost increases. Active Core strategies stand out the most as they tend to have only a marginally lower correlation to equity markets (≈0.7–0.8) when compared to Passive Core strategies, but often with fees that are more in line with some Idiosyncratic strategies.

Asset Allocator strategies tend to have a relatively high correlation with equity markets (≈0.6–0.7), given their long-biased approach and the fact that equities trend up over the long term. However, this correlation can vary materially over select periods, given the degree to which managers can alter their asset allocation. This dynamic asset allocation skill should lead to Asset Allocator strategies having the potential for a higher risk adjusted return compared to Active Core strategies over time.

CORE MULTI-ASSET STRATEGIES

The most common primary objective of investing in a Core Multi-Asset strategy is to achieve a "smoother ride" relative to a pure equity portfolio by introducing exposure to a range of other traditional market betas. Many funds aim to provide a return not too dissimilar to that of equities over the long term, but with lower volatility along the way. This type of allocation will often have a high correlation with equity markets and is usually achieved through the use of a Core Multi-Asset strategy.

Core Multi-Asset strategies have traditionally been popular with two types of investors: those that are searching for a low-governance, all-in-one type solution, and those with a long-term investment horizon that want equities to remain the main driver of returns within the strategy. For the first group that is looking for an all-in-one solution, we believe our highly rated Active Core strategies remain appropriate options. However, in practice, with the exception of some of the smallest defined benefit (DB) and defined contribution (DC) schemes, there are few situations in which investors allocate the majority of their portfolio to a single strategy.

For long-term, fee- and governance-constrained investors that want equities to remain the main driver of returns (for example, within a low governance DC scheme), we think these investors should gain core beta exposures in the most cost-efficient way possible. Therefore, our preference is for these investors to use Passive Core strategies (or direct passive market exposures) for this allocation because we believe that these low-cost offerings provide an effective way of achieving this objective. Governance-constrained investors with higher fee budgets/tolerance that are looking for Core Multi-Asset exposure may wish to consider diversified Active Core strategies that compensate for higher fees with greater allocations to alternatives and a wider set of return drivers. Ideally, those investors with a higher governance budget should not need to use off-the-shelf Core Multi-Asset pooled funds at all because they can build their own strategic asset allocation tailored to meet their objectives — this can also be a lower-cost approach.

IDIOSYNCRATIC MULTI-ASSET STRATEGIES

The other key objective of a Multi-Asset allocation is to diversify an investor's growth assets away from traditional market exposures — in particular, equity market beta. To achieve this, investors generally have to rely heavily on strategies driven by manager skill and/or multiple alternative betas. The use of an Idiosyncratic Multi-Asset strategy is one way in which investors can try to achieve this objective.

Idiosyncratic strategies have been a popular tool used by investors to represent their liquid alternatives allocation. Although we see idiosyncratic strategies as a useful option, we also believe that they do not fully capture the available opportunity set. In our view, the purest and arguably best method of achieving this objective is to allocate to a diverse pool of hedge funds. This is particularly true for those investors who do not have any governance, fee or liquidity constraints. The emergence of more liquid and fee-conscious alternatives strategies, such as alternative risk premia and UCITS hedge funds, are blurring the boundaries in terms of the opportunity set offered by traditional Multi-Asset strategies and hedge funds. This means that all investors, including those that have relied on Multi-Asset strategies because of liquidity and fee constraints, now have a much wider range of strategies to choose from to ensure that they can access the broadest range of return sources. Therefore, we see Idiosyncratic Multi-Asset strategies as only one part of the range of options investors should consider when building their liquid-alternatives allocation.

The use of idiosyncratic strategies also introduces a greater reliance on manager skill (relative to more beta-driven mandates). This reliance on manager skill introduces a degree of manager-specific risk — in particular, when large allocations are made to a single manager. It is not uncommon to see allocations of more than 25% of a portfolio to a single idiosyncratic strategy. If a manager was to have a period of weak performance, it would have a significant and material impact on returns experienced by the investor. Therefore, we recommend investors spread their allocation across more than one Idiosyncratic Multi-Asset strategy to help mitigate these risks, with no one single manager accounting for more than 10% of a portfolio.

MULTI-ASSET STRATEGIES IN PRACTICE

To bring to life some of the ways in which investors can use Multi-Asset strategies, we offer the following case studies. It is important to note that we are not trying to create a one-size-fits-all solution that can be applied to any situation. Every investor will have specific objectives and constraints, and the reality of operating across different geographies means that, for very good reasons, investor portfolios will differ from one another.

CASE STUDY 1

A DC pension scheme that requires a low governance portfolio for the growth phase of its default lifestyle option

This is a long-term investor, but also one that has both liquidity and fee constraints in addition to a governance constraint. A potentially suitable way of utilizing Multi-Asset strategies in this portfolio is to introduce a large allocation to a Passive Core strategy alongside its global equity allocation, with smaller satellite allocations to Idiosyncratic Multi-Asset strategies as follows:

45%–60%: Global Equities
20%–35%: Passive Core Multi-Asset
0%–10%: Idiosyncratic Asset Allocator
0%–10%: Idiosyncratic Absolute Return

For a long-term investor that is looking for equities to remain the predominant driver of returns, this portfolio meets this objective through the combination of the standalone allocation to global equities and the c. 50% allocation to equities typically found within the Passive Core Multi-Asset fund. The large allocation to the Passive Core fund would also introduce additional return drivers through meaningful allocations to government bonds, investment grade credit, alternative credit and listed alternatives. The portfolio is completed with relatively small allocations to idiosyncratic strategies, split by style. These allocations should in theory introduce some uncorrelated return drivers to provide diversification from traditional markets, while also being small enough so as not to introduce significant manager-specific risk.

CASE STUDY 2

A DB pension scheme with a low to moderate governance budget, but one that is also fee- and liquidity-constrained

This scheme allocates 20% of its overall growth portfolio to liquid alternatives, of which we think Multi-Asset strategies could represent up to half of the allocation. The other half could consist of allocations to other liquid alternative strategies such as hedge funds, including alternative risk premia strategies or UCITS hedge funds as follows:

5%: Idiosyncratic Asset Allocator
5%: Idiosyncratic Absolute Return
10%: Liquid Alternatives

For a DB scheme with a higher governance budget, there is no need for an allocation to a Core Multi-Asset strategy since it should be able to gain these exposures elsewhere within its portfolio at lower cost. Therefore, the entire Multi-Asset allocation can be made to idiosyncratic strategies to achieve the objective of diversifying the portfolio by introducing different return drivers. As always, we would recommend the allocation is split across a number of strategies to mitigate manager- and style-specific risks.

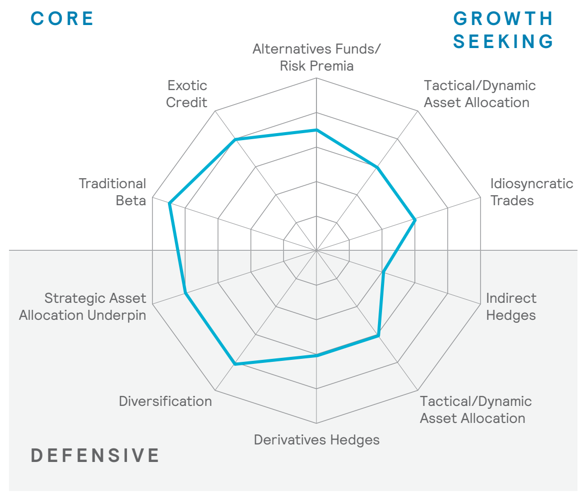
CONCLUSION

Multi-Asset strategies come in many different shapes and forms. Understanding the different characteristics of each strategy, knowing how each strategy can fit within an investor's overall portfolio and being aware of the associated costs are therefore key. We believe that pooled Core Multi-Asset strategies are only appropriate for investors with a low governance budget. For these investors, it often makes the most sense to capture traditional market beta exposures in the most cost-efficient manner through the use of Passive Core Multi-Asset strategies and direct passive market exposures. Idiosyncratic Multi-Asset strategies are only one part of the spectrum of liquid alternatives available to investors today. In scenarios in which it is appropriate to allocate to idiosyncratic strategies, investors should diversify their liquid alternatives holdings by manager and style to broaden the number of return drivers in the portfolio and to contain manager-specific risks.

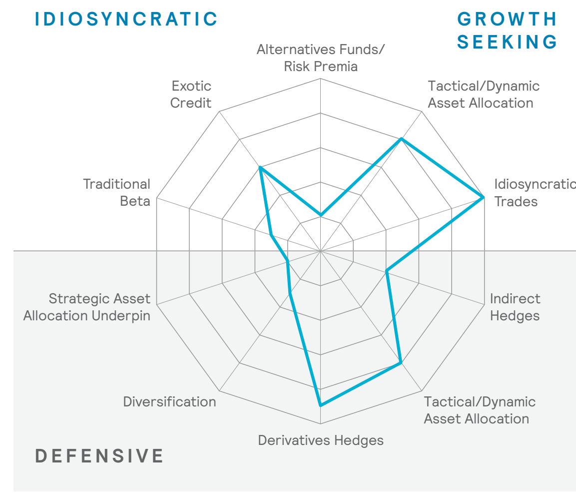
APPENDIX

FACTORS SHOWN IN THE RADAR CHARTS

We can illustrate the differences between managers by plotting the strength of bias toward different factors. The radar charts provide examples of two multi-asset managers — one we regard as being core; the other more idiosyncratic. The further a marker is toward the outside of the chart, the more significant the bias.[1] The factors above the horizontal line represent how the manager seeks to generate growth; the factors below the line illustrate how the manager looks to incorporate defensive characteristics into the portfolio.



Typical biases in a core product are to traditional (equity and credit) beta and a reliance on a strategic asset allocation mix. Idiosyncratic strategies, in contrast, seek material return contributions from specific (idiosyncratic) trades — such as active currency positions, bottom-up security selection or particular macro trades — as well as from tactical or dynamic asset allocation.



Growth-seeking approaches can be defined as: **Traditional Beta** (to what extent the long-term exposure to equity or investment grade credit, for example, is seen as a core component of long-term returns); similarly for **Exotic Credit**, including the use of EMD, High Yield and Convertibles, for example. **Alternative Funds/Risk Premia** include fund investments (or similar) to hedge funds, real assets (commodities, property, infrastructure, etc.) and other alternative asset classes. **Idiosyncratic Trades** include, for example, specific active currency positions, bottom-up security selection or specific macro trades. **Tactical/ Dynamic Asset Allocation** refers to the use of tactical/ dynamic changes in the broad asset allocation to drive the portfolio performance.

Defensive approaches reflect the manager's bias to different techniques to help manage the "risk" in the strategy — what managers fall back on in periods of challenge. For many, the underpin to their investments (and what they might seek solace in during shorter-term periods of absolute loss) is a strategic asset allocation (an **SAA underpin**) — either an explicit beta benchmark or a long-term strategic asset mix (formal or informal).

In addition, the charts highlight the manager's focus on **Diversification** across asset classes or specific trades and the use of **Derivative Hedges** (for example, option overlays to protect the portfolio). The use of **Indirect Hedges** in portfolio construction includes (typically) long positions to balance the portfolio (for example, the use of gold in portfolios post 2008). Finally, **Tactical/Dynamic Asset Allocation** is considered for its potential to protect the portfolio, as well as to seek out growth opportunities.

[1] The strength of bias is qualitatively assessed by Mercer as part of our manager research activities. The instruments and drivers of return will vary over time — these charts are no more than an illustration of Mercer's own view of these strategies, all else equal.

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