Multi-Asset Fund Suites - *Apples & Oranges?*

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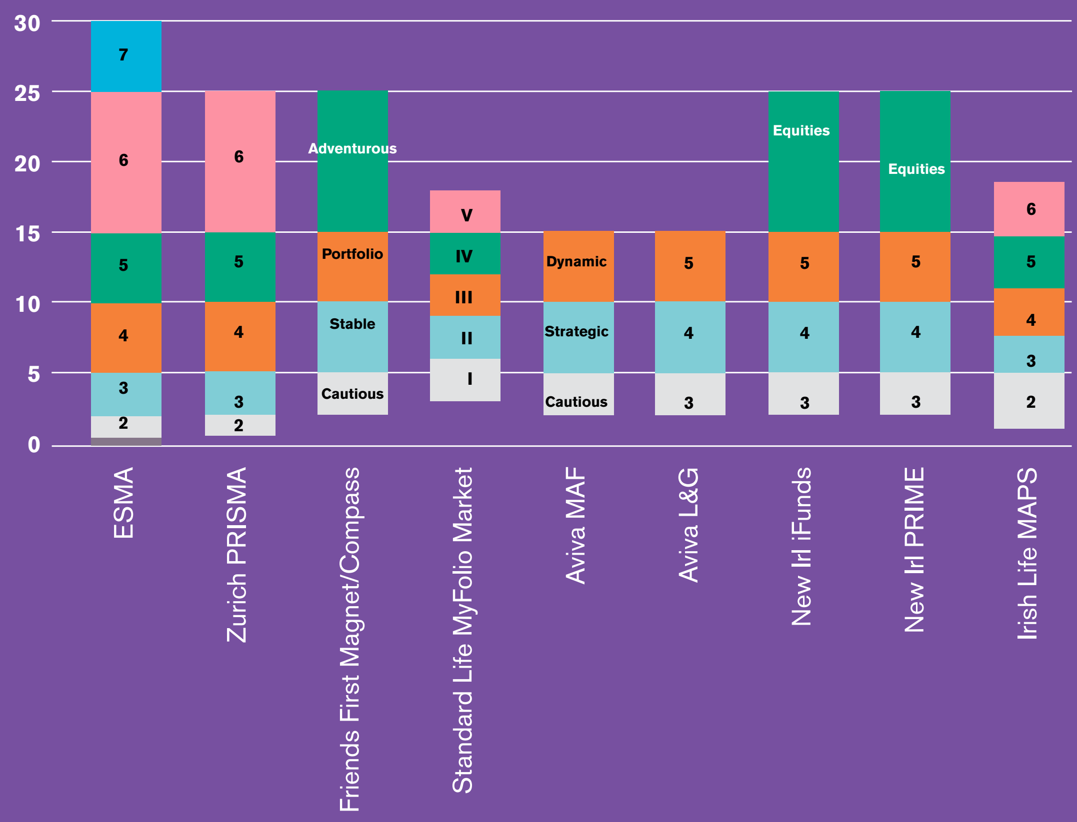
The flagship investment product of each of the life companies are now their multi-asset, volatility-targeted fund suites. With us for a relatively short time – the first was launched in May 2011 – they now represent a very significant part of the savings market with combined assets of €10 bn.

Each suite constituent is designated by a number, Roman or otherwise, and at first glance they look pretty comparable. But is the comparison one of apples and oranges? We recently undertook a very detailed review of the multi-asset universe and concluded that it is closer to a fruit salad!

Risk Measure

A majority of the providers use the ESMA risk measure and the associated banding regime. Another uses ESMA but a different banding regime. Yet another uses its own banding regime and a risk measure very different to ESMA. As a result, funds labelled 4 or IV may not sit in the same area of the risk spectrum. Below is our best effort at putting the regimes 'cheek by jowl':

Multi-Asset Fund Suites Volatility Ranges



We believe that ESMA is a fundamentally unsuitable measure as five years is not long enough to be stable and it can easily misrepresent risk. Its relative instability presents particular challenges to the providers with obvious potential to impact on returns. From 1st September 2017, Canadian funds are using ten years of data to represent risk: the *Canadian Securities Administrators* considered using shorter time horizons and were aware of ESMA, but took the view that ten years was needed to encompass at least one full market cycle.

Emphasis on Volatility Control

It is perfectly understandable that providers are keen that funds stay in the relevant risk band as this is part of the expectation created by the product design and literature. A number confirmed that *this is either the primary or sole formalised objective*. Others refer to generating returns while staying within the relevant volatility band. Within this group there is an important distinction – some look backwards and will intervene if the desired outcomes are off course. Others say that they are looking at future volatility outcomes and are more relaxed about realised volatility. One provider stands apart in terms of being much less exercised about volatility outcomes.

These may sound like somewhat arcane differences but we believe they will cause major deviations in returns over time.

Experience and Expertise

Some providers are doing this for longer than others and others can tap into experience gained in the UK. (It is worth pointing out that even the latter have no experience of running funds on this basis through a proper bear market.) The profile of the key decision-makers is also interesting – in some houses the process is dominated by actuaries, while others give primacy to investment personnel. Perhaps not surprisingly, we believe that the latter should have a major role!

We have had a relatively short period in which to observe how these funds are managed and in which markets have been benign; the decision-making processes have yet to be put under pressure. Notwithstanding, we have seen one provider make a very strange asset allocation where (in our view) the volatility 'tail' wagged the investment 'dog' – it made no sense to us.

Investment Palette

Another key area of differentiation is the breadth of palette from which the managers can select. Most particularly, some do not use absolute return – their lower-risk funds have little choice but to have large holdings in bonds and cash. The highest we have seen is a 77% weighting in cash and short-dated bonds, an asset mix which has little or no chance of covering its AMC over the next few years.

Property is another significant point of differentiation with some of the funds maintaining weightings of up to 10%. That has been and may continue to be beneficial to returns but given the scale of the multi-asset funds it could be an interesting challenge in the next downturn.

Change Coming

A new EU Directive (PRIIPs) is due to come into force on 1st January 2018 – it deals with Packaged Retail and Insurance-based Investment Products **and will cover unit-linked funds**. It specifies a very different disclosure regime including a risk measure other than ESMA and a different banding regime.

Regrettably, the new risk measure is still based on volatility over a five-year period. It is not clear at this stage what effect, if any, the adoption of PRIIPs will have on how the multi-asset fund suites are managed. Considering the short term to implementation, it is surprising that none of the responses we received from providers during our review adverted to PRIIPs.

Volatility Control in Practice

The key question in our minds is not if, but how much return will be sacrificed; if returns are a bit lower, but volatility has been suppressed **this may be perfectly satisfactory**. Providers focused on realised volatility have the greatest propensity to leave return behind as they find themselves selling risk assets after volatility has spiked and prices have fallen. The subsequent fall in volatility is likely to see funds re-risking but after prices have recovered.

In our view, achieving similar returns while limiting volatility (a free lunch!) will only ever be attainable where the portfolio adjustment is done very dynamically – every day, or even more frequently. We are aware of only one Irish multi-asset offering which incorporates a highly dynamic volatility control process. The others adopt more slow-moving approaches, where the price of controlling volatility is very likely to be a reduced return.

Volatility 1.01

Volatility systematically erodes returns for investors in drawdown mode – it is the reverse of 'euro cost averaging'. It benefits investors who are adding money, with in both cases the time horizon mattering greatly. Once that is accepted, the attitude of such investors to volatility (and their desire to have it managed) could/should be quite different. Logically, investors with a long-time horizon and many future contributions should not fear volatility and should not be willing to risk sacrificing any return to have volatility managed over five-year periods of a journey measured in decades.

Other Risk Mitigation

The objectives of one suite include a specific focus on down-side risk and managing the probability of losses, and features have been incorporated with this in mind. If they work, such funds/features might be especially well-suited for investors who are in drawdown mode for whom the sequence of returns can be particularly damaging. (Their particular suitability for investors in drawdown is mirrored by their being less suitable for investors who are not.)

The Intersection with Risk Profiling

With a significant skew towards risk aversion being confirmed by all of the research in both Ireland and the UK, and most risk profiling tools having seven graduations, the most common outcome can be expected to be (and is) a 3. We understand that it is common practice for such investments to be directed towards funds rated 3/III and this is where over 40% of all the money in these fund suites sits. **This person who is middle of the road in a risk profiling context is actually in the bicycle lane in risk/reward terms!** This is because the ESMA banding regime is heavily skewed towards the lower end of the risk spectrum - funds rated 3/III are actually quite low risk and in very many cases will not deliver the returns needed to meet the investor's financial objectives.

Risk Class	Volatility Intervals	
	equal or above	less than
1	0%	0.5%
2	0.5%	2%
3	2%	5%
4	5%	10%
5	10%	15%
6	15%	25%
7	25%	

Conclusion

We understand why people want an indication of where a fund sits on the risk spectrum but it is unfortunate that a measure like ESMA is used so widely. The use of a more stable measure would reduce the likelihood of return being sacrificed by the volatility management process. It is not obvious to us that an investor with a long-time horizon and many future contributions to make should want to stay in a particular volatility band over a given five-year period. Whatever our misgivings, these fund suites will dominate the market for the foreseeable future. Some are managed with much greater sophistication than others; this, together with the expertise being applied and the breadth of the investment palette, is likely to have the greatest bearing on outcomes.