Think strategic, act tactical: Allocating capital in the new reality

As investment strategies become increasingly complex, traditional asset allocation frameworks need to evolve with the global markets. We believe that an actively managed asset allocation program with a robust approach to managing intermediate-term tactical insights can deliver portfolios that generate greater returns with better risk profiles.

Over the last several years, J.P. Morgan Asset Management’s Global Multi-Asset Group (GMAG) has been developing new tools that combine quantitative models with qualitative insights to deliver innovative asset allocation strategies. We believe this approach allows managers to be more flexible and opportunistic and addresses some of the shortcomings of traditional asset allocation which can add unexpected risks to portfolios or result in lower-than-expected returns.
The post-war evolution of asset allocation

Investors have worried about asset allocation since the dawn of investing. In the fourth century, for example, people were advised to divide their wealth equally into land, merchandise and “ready to hand” — the equivalent of real estate, equities and cash today. Fast forward to modern times when financier and Nobel laureate William Sharpe — when asked how he approached asset allocation — said he initially decided on a 50/50 stock and bond allocation and kept that allocation in place for many years.

Most investors, like Mr. Sharpe, make an initial decision about their asset allocation and never change it. Their strategic asset allocations, which are based on long-term capital market assumptions, form the basis for their final portfolios.

But is that the optimal portfolio construction? Not necessarily.

In a typical balanced portfolio, over 90% of the portfolio’s risk stems from the systematic, or the beta, of equities. In other words, the concentration of risk stems largely from equities.

To be sure, equities have outperformed bonds over the long term. Investing a dollar in U.S. large-cap stocks over 90 years ago would have netted over 40 times the returns of bonds, according to data from Ibboston Associates (in small-cap stocks, the returns would have been more than 200 times greater). To put it another way, if those returns are divided into 20-year cycles, stocks outperformed bonds and cash in nearly every 20-year period except for the 1920s and 1930s.

But investors usually have shorter investment horizons and equity returns are rarely “average.” For example, U.S. large cap equities posted inflation-adjusted annualized returns of about 15% between 1950 and 1965 and also between 1983 and 1999, according to Ibbotson. Between 1966 and 1982, however, the real return to equities was zero and appears to be headed in that direction for the 2000 to 2016 period. The upshot: For any given 15-year period, investors could be holding risky assets in their portfolio that could result in very little real returns.
Just fifteen years ago, portfolios were structured in much the same way, where investors ranging from endowments to pension plans opted for asset allocations that were roughly 60% stocks, 30% bonds and 10% alternatives. It was only in the past decade that asset allocation strategies started to shift as investors allocated a larger portion of their portfolios to alternatives, real assets and hedge funds — assets that began to address the differing needs for their asset allocations.

**Today’s markets require a flexible asset allocation framework**

In recent years, however, the “protections” that hedge funds had successfully provided in the aftermath of the dot-com bubble didn’t work as well during the financial crisis of 2008, mainly because the risks themselves had changed.

Today, investors are asking themselves how they can better manage unexpected risks and capture potential rewards across the various investment cycles. At J.P. Morgan Asset Management, we believe we have developed an approach to addressing these challenges.

Historically, investors built portfolios by starting with a strategic asset allocation, selecting the best managers in each asset class, and making relatively few tactical moves to add returns and hedge risks. The problem is that strategic allocations typically don’t change much over time and assume a long-term neutral economic cycle.

In order to achieve higher risk-adjusted returns, we have integrated three additional tools to the asset allocation process. After the strategic asset allocation framework, we introduce an intermediate term (or “cycle aware”) asset allocation which adjusts the portfolio’s risk to the economic cycle. After the manager selection process — where we select managers based in part on the diversity of their investment styles — we incorporate a global tactical asset allocation (GTAA) framework where we make tactical moves based on a combination of quantitative and qualitative analyses. The final step in the portfolio construction utilizes a risk-management process that analyzes how all the assets fit together in the portfolio. (See Exhibit 1.)

**Asset classes perform differently at different stages of the economic cycle**

Since different assets perform their best at different stages of an economic cycle, one of the tools J.P. Morgan has developed to achieve higher risk-adjusted returns is an “investment clock” to assess where we believe we are in the global economic cycle and where we think we’re going on a fundamental basis.

The “clock” itself is based on two primary data points—whether growth, as represented by global industrial production, and inflation are rising or falling. At the top of the clock, growth is declining; at the bottom, it is accelerating. Inflation, meanwhile, is rising at the left side of the clock and is falling on the right side. Depending on the combination of those factors, we end up with four different economic environments. (See Exhibit 2.)
Historically, as you would expect, there have been significant differences in returns in each of those environments. A reflational environment — where growth is rising, but inflation is still low — is generally good for all assets with relatively small differences in returns among them. In a deflationary environment, where growth and prices are both falling, you want to emphasize equities over real assets, although bonds and credit still do reasonably well. Returns are more mixed in a stagflationary environment — where the inflation rate is rising and the economic growth is falling — and investors may do well to emphasize real assets, though equity and credit have still done reasonably well in past periods. Generally, the worst environment for investors is an inflationary one, where growth and inflation are both rising, so investors may do well to avoid equities, credit or bonds, especially relative to real assets.

As Exhibit 3 illustrates, from Oct. 2005 through April 2007, investors moved from a reflational environment into an inflationary one. From May 2007 to September 2008, the economy stayed in an inflation/stagflation period, then — prompted by Lehman’s collapse — shifted into deflation starting in October 2008 and continuing through May 2009. June 2009 through 2010 was mostly characterized by reflational trends, and today the economy appears to be moving further into stagflation.

So how can this tool help you? For one, an investment “clock” can help stress-test the portfolios you have while also questioning whether the assets you currently own (or want to emphasize in a portfolio) are cheap or expensive based on the environment you’re in or think you’re likely to be in. In 2009 — when investors were debating whether the economy would sink into a depression or embark on a global recovery — the “clock” questioned the bearish view given that we were in a period of growth acceleration with low inflation — an environment that signaled it was a good time to own riskier assets. In fact, if you look at where we positioned portfolios in 2009, we were emphasizing credit in part because of this model but also because the relative valuations were extremely attractive.

Tactical allocation has evolved to a multi-factor model

Aside from macro factors such as growth, inflation and monetary policies that affect markets, investors can capture short-term betas through global tactical asset allocation, or GTAA.

GTAA’s reputation took a hit in the 1990s largely because the models were typically single-factor, valuation-driven. For most investors, their asset allocation decisions boiled down to whether they should overweight stocks relative to bonds and cash. In the run-up to the dot-com bubble that started in the mid-1990s, for example, most valuation models signaled that equities were expensive relative to bonds, which led many GTAA managers to underweight stocks — and subsequently lose out on returns.
Today, GTAA considers a broader opportunity set across asset classes and geographies and looks at many more relative-value decisions within — rather than across — asset classes. At J.P. Morgan, our GTAA process starts with a series of quantitative models which are able to filter through vast reams of data consistently and rigorously. To that, we add qualitative analysis — which addresses fewer factors but goes into greater depth — to analyze factors that the quantitative models are not capturing, such as quantitative easing for which there is no history. The breadth of quantitative analysis, combined with the depth of qualitative analysis results in a more optimal portfolio. (See Exhibit 4.)

As a result, we believe GTAA adds an independent source of alpha that captures short-term mispricings and momentum-driven and behavioral inefficiencies.

Keep in mind that your final portfolio isn’t just a collection of your best ideas. For an optimal portfolio, investors should take into account how the assets fit together in the portfolio and how best to allocate risk across those assets. For example, a few years ago, our system ranked U.K. equities No. 1, European equities No. 2, U.S. equities No. 3 and Japan No. 4. But in constructing the final portfolio, we went underweight U.K. equities and overweight European equities mainly because Continental European stocks were highly correlated with U.K. stocks. We believe that doing so resulted in a more optimal portfolio because it was a more efficient allocation of risk.

To summarize, we believe static buy-and-hold decisions have proven over the long-term to be rarely optimal. Asset allocation programs must systematically evaluate market environments, assess opportunities, and reposition the portfolio accordingly.

EXHIBIT 4
GTAA captures for quantitative and qualitative insights

- Market inefficiencies in global macro markets
- Relative value and market directional strategies
- Systematic and irregular market opportunities
- Insights from economists and the investor network
- Optimized quantitative portfolio construction
- Proprietary risk forecasts for each asset class
- Efficient allocation of risk across the final portfolio
- Positions incorporate qualitative judgments

Source: J.P. Morgan Asset Management.
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