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Flexible asset allocation – a curse or a blessing?

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Global Macro Allocation is a flexible multi-asset strategy that aims to compound high total returns through time. Sometimes prospective investors query our strategy's degree of flexibility relative to more static multi-asset strategies. This is a legitimate observation, because truly active and material asset allocation will either add value through time or detract from it, much like a very high active share in stock picking. Understanding how flexibility is used matters a lot.

The key is repeatability. This brief note explains the philosophical beliefs that underpin our approach in the context of the Global Macro Allocation strategy, and which guide our flexible approach. We believe this has a higher likelihood of being repeatable and will deliver strong outcomes for our investors over the longer-term.

But first, let's explore why flexible asset allocation can be dangerous. The key reason is behavioural because the average human decision-maker tends to swing between the emotions of greed and fear. This is evidenced in asset class bubbles and crashes. It is safe to say that humans want to buy and own assets that are doing well and sell those that are doing badly. Such behavioural biases can cause financial market booms and busts, as well as short-term gyrations in asset prices. The combination of such biases with a high degree of investment flexibility can be dangerous, particularly when combined with a short-term investment horizon as investors try to time every twist and turn in markets with material asset allocation moves. Indeed, this is the surest route to considerable value destruction over time.

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So how do we seek to avoid these biases and use flexible, or dynamic, asset allocation to add value?

Three core philosophical beliefs underpin our approach:

1 A longer-term structural timeframe

We believe investors place too much emphasis on the short-term and market 'noise', and not enough attention on the impact of the more profound structural macro forces on the global economy and asset markets. Debt build-ups, demographic changes, and decarbonisation are examples of structural forces that have a degree of predictability and that drive tailwinds and headwinds across asset markets. Focusing on these trends provides us with a longer-term (five to ten plus years) investment 'roadmap' and allows us to cut through the noise. This provides us with an information advantage, while narrowing our areas of focus for bottom-up security selection within a global unconstrained opportunity set.

2 Focusing on what's important cyclically

Economies tend to advance at a relatively stable rate over time, in line with their productivity gains. However, there can be short-term cycles within this longer-term trend that are driven by sentiment, or 'animal spirits' as we like to say. This sentiment is influenced by central bank actions and policy makers in general. For instance, when policy is 'loose', future growth and inflation will accelerate and the economy will grow above its longer-term trend rate. Once excess capacity is deployed and inflation becomes present, central banks will ultimately move policy to a 'tight' setting, slowing inflation and growth and possibly inducing a recession.

We analyse major and minor economies to determine whether policy is 'loose' or 'tight' in different regions. Put simply when policy is beginning to move to a 'tight' setting, we will typically reduce the amount of risk that the strategy is exposed to as we focus on protecting capital. When policy is moving to a 'loose' setting, we will typically be willing to take more risk in pursuit of higher returns. Everything else is noise, and we don't let it influence our investment decisions.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

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3 Allocating capital countercyclically

We seek to exploit the pro-cyclical behavioural bias described above by allocating capital counter-cyclically. We believe there are better times to expose investor capital to risk and, conversely, to less risk. Thus, we will take on risk to generate returns when valuations are attractive, investors are generally pessimistic, and policy is set to become 'loose'—as in March 2020. We will de-risk the strategy when valuations are extended, investors are generally enthusiastic or euphoric, and policy is set to tighten—as in Autumn 2021.

In summary

Our longer-term investment roadmap drives investment idea generation, while our cyclical view, with a strong focus on policy evolution and an assessment of valuation helps us determine how much capital we should be allocating to any one of our longer-term investment ideas at any point in time. It's this that determines the overall asset allocation of the strategy.

Importantly, being unconstrained by benchmarks frees us to take advantage of the behavioural biases discussed here and to deliver a different risk and return profile. This is contrary to more static multi-asset and shorter term flexible multi-asset approaches. The benefit lies in the flexibility: we can be patient and protect capital during times of excess when future returns are low, while we have the freedom to allocate capital during times of panic, when the expected returns on our long-term investment ideas increase significantly.

It is these beliefs and this approach that underpins all our decisions. We are not trying to time every twist and turn in financial markets—that has proved to be the road to considerable value destruction. Instead, we believe that this approach increases the likelihood of a repeatable outcome through time.

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