



Viewpoint

Back to basics: why the time is right for a return to multi-asset



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- The flexibility offered by multi-asset strategies meant that for many years they were the perfect vehicle to navigate market crises
- As yields ratcheted lower during successive financial pinch points, bonds were no longer able to offer downside protection
- But the great reset in bond yields and the prospect of inflation falling further means multi-asset is once again an attractive option for investors seeking a smoother return profile

Diversification Don't have all your eggs in one basket

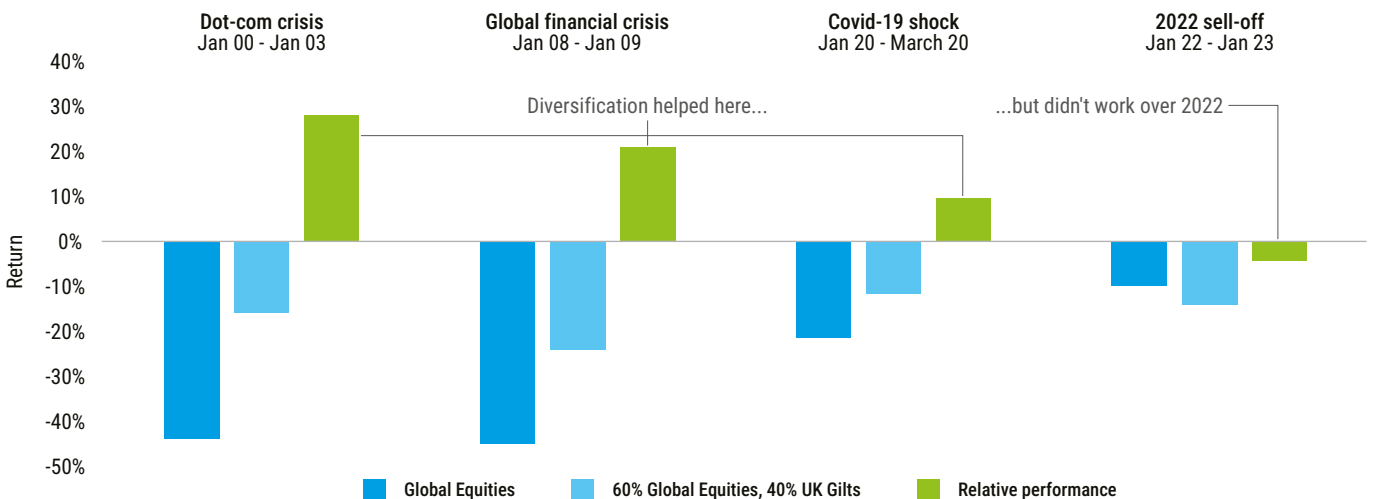
The key characteristic that draws investors to a multi-asset portfolio is diversification. Diversification – sometimes referred to as the only free lunch in finance – embeds the idea that if a portfolio holds various asset classes, each with their own return drivers, the outcome is a smoother return profile. In other words, protection on the downside while still participating in the upside market moves.

This was the thinking behind mixed asset funds including traditional balanced funds. But multi-asset funds were designed to go further than balanced funds in one key regard: flexibility.

This simple idea of diversification proved reliable in each of the major crises from the start of the century: the dot-com crisis; the global financial crisis (GFC); and the initial Covid-19 market shock. However, the 2022 sell-off told a different story.

- **Dot-com crisis:** Global equity market fell 43%, while a multi-asset approach fell 15%
- **Global financial crisis:** Global equity market fell 44%, while a multi-asset approach fell 23%
- **Covid-19:** Global equity market fell 21%, while a multi-asset approach fell 11%
- **2022 sell-off :** Global equity market fell 10%, while a multi-asset approach fell 14%

Figure 1: Multi-asset diversification benefit over various crises



Source: Bloomberg, as at May 2024

Beyond the balanced fund

Multi-asset funds in their current “diversified growth” configuration were first popularised as a strategy in the early 2000s, and saw demand grow during the GFC and eurozone crisis. Perhaps the main difference was this ability to make greater changes in asset allocation than a traditional balanced fund would find comfortable. This was a key requirement during the 2000-2003 bear market. During that period, balanced funds with their traditional 60% weight to equities saw poor absolute returns as equities almost halved in value. Clients desired an approach that both included more asset classes and a willingness to change allocations more meaningfully – enter multi-asset.

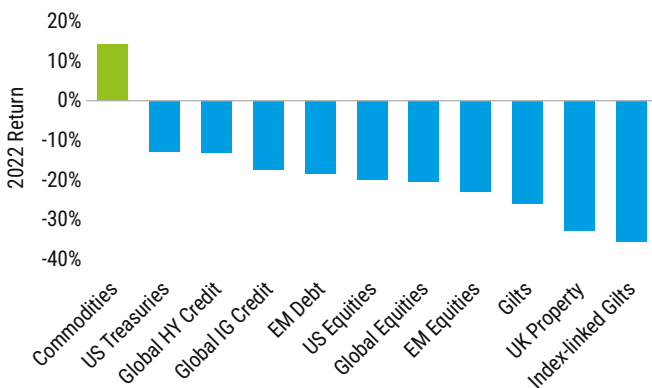
Success set the stage for weakness

All this proved useful. In the GFC, the eurozone crisis and to a lesser extent during Covid, the diversification of multi-asset funds proved helpful. However, the strategy embedded a weakness: with each crisis bond yields ratcheted lower, weakening the ability for those same bonds to offer protection. By the end of the Covid-19 shock, bond yields had been driven to a low of 0.17%, when at the turn of the century they were 5.5%¹.

The stage was set for diversification disappointment. Bond yields marched sharply higher over 2022 as central banks began to combat inflation. In the UK, with the Liz Truss premiership fiasco adding fuel to the fire, bond yields reached 4.5%, and even in the US they reached 4%. And so, the usual diversification benefit of a 60:40 portfolio wasn't just absent, it had gone into reverse.

This hiking of interest rates caused a coordinated sell-off across markets and asset classes. Yields on bonds rose (and prices fell) across the spectrum of government bond and credit markets, and equity market price-to-earnings ratios fell to reflect the higher discount rate. Even the greater diversity of a diversified growth multi-asset fund didn't work with nine out of 10 major asset classes falling hard (Figure 2).

Figure 2: 2022 asset returns



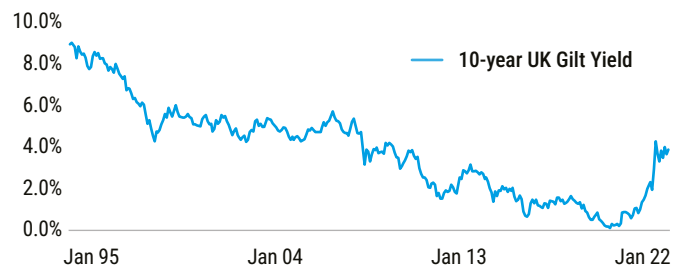
Source: Bloomberg, May 2024

As the major asset classes fell, only small pockets of protection could be found. Our Dynamic Real Return strategy kept portfolio duration (return sensitivity to yield movements) low to insulate returns and essentially shift fixed income holdings more towards cash. Good use was also made of commodities, but even these joined the sell-off from mid-2022. Even with our dynamic approach, the portfolio couldn't fully immunise against the headwinds in financial markets.

The great reset

However, following a period of pain, today the tables have turned. Government bond yields are attractive and back at the levels of 2000 (Figure 3) when the classic multi-asset diversification strategy was born.

Figure 3: core government bond yields back to early 00s levels



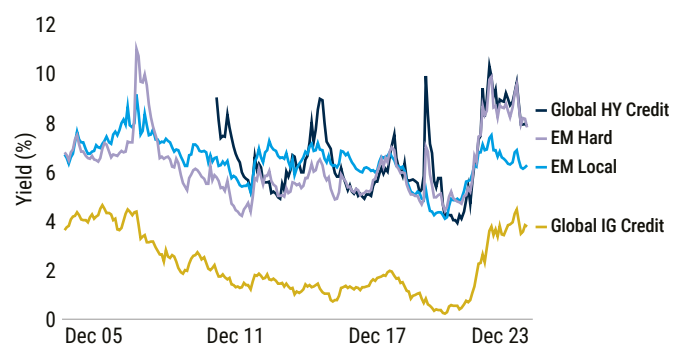
Source: Bloomberg, May 2024

Inflation concerns lingering

However, the switch towards bonds again being able to offer protection in a multi-asset portfolio is not instant. Lingering inflation concerns continue to drive both equity and bond markets up and down together. But our view is that this is a temporary phenomenon. Evidence continues to build that by December this year the lingering sticky inflation concerns will have dissipated, and bonds can once again offer reliable protection.

In the meantime, the high running yields on fixed income mean investors are paid to wait (Figure 4).

Figure 4: yields across fixed income markets have increased to attractive levels



Source: Bloomberg, May 2024

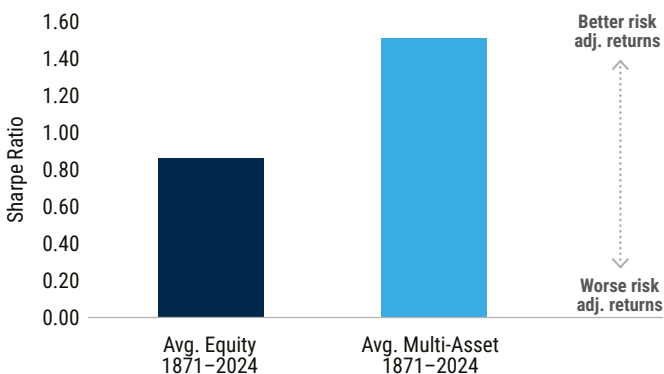
¹ 10-year UK Gilt yield as at 30 June 2020 and 31 December 1999, respectively



Back to basics How multi-asset can help your portfolio

Multi-asset is aimed at investors who cannot afford the risk that comes with equities and pure growth assets in general. The good news is that it can indeed help smooth returns. As we have seen from the past 25 years, it is far more effective when starting yield levels are higher – fortunately, this is the state we find ourselves in today. The balance between risk and return is far better.

Figure 5: multi-asset portfolios generally have better risk-adjusted returns than equities



Financial consultants often use the Sharpe ratio as a measure that accounts for both risk and return, calculated as return per unit of risk. The higher the Sharpe ratio the better. We note that:

- Since 1871, a holder of equities over a five-year time horizon has typically seen a Sharpe ratio of 0.84
- Since 1871, a multi-asset holder of both equities and bonds over a five-year time horizon has typically seen a Sharpe ratio of 1.47

This does mask huge variations of good periods and bad periods for the multi-asset strategy. As you would imagine, higher starting yield levels produce far better multi-asset outcomes, while the strategy can flounder in low starting yield environments.

With yields in the US 10-year Treasury and UK Gilts currently back up at 4.6% and 4.4% respectively, and with inflation set to come off by the end of the year, we believe this is an opportune time to reassess the long-term merits of a multi-asset portfolio and take advantage of the smoother return profile on offer.

To find out more visit columbiathreadneedle.com



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