for financial advisers only

from darkness, into light

John Ventre
Portfolio Manager, Skandia Investment Group

May 2009

“Where truth and reality shine resplendent it ... appears to possess reason, but when it inclines to that region which is mingled with darkness... it opines only and its edge is blunted... and again seems as if it lacked reason.”

Plato, The Republic

John Ventre provides an update on managing risk within the Spectrum funds through unprecedented and remarkable economic conditions and explains why the funds will continue to serve investors well in brighter times.

Investors have certainly needed to be philosophical about financial markets over the last year. Events have been extraordinary, with much of the year spent in ‘that region mingled with darkness’.

On a total return basis, UK Gilts have now outperformed UK equities over both a 10 and 20 year period. Yet it is a well established investment theory that investors should be rewarded for taking the extra risk of investing in equities, ie that there should be an equity risk premium. To the uninformed observer, the absence of reward over these time periods defies ‘reason’. In the last year, we have seen investors take flight from their investments in ‘risky’ assets, seeking instead quality and safety. At one point, this culminated in the yield on US Treasury bills turning negative - investors were actually paying a counterparty (the US Treasury) to look after their money. This also displays a lack of reason.

a bespoke investment solution

Spectrum was built as a bespoke solution to match the risk profiling tools which Skandia provides to financial advisers and their clients. It is unique and innovative in this respect, turning the risk profiler and tools into an end-to-end solution which encompasses tax efficiency, regular rebalancing, fund blending and selection. It is not the techniques which are innovative, but rather their application.

whether and how to adapt?

With years of excess returns for equities disappearing in months, what conclusions can we draw and what can we learn about how assets are likely to perform in the future? This is a very complex question because financial markets are a game of imperfect information. Responding to that in planning is key and in the case of the Spectrum Funds, the advice provided by Watson Wyatt is crucial in this respect.

Prior to 2008, the assumptions used by Watson Wyatt in its asset model were quite stable, with only small changes to asset allocation required on a quarterly basis. We have, however, seen much larger changes in the last year as these assumptions have had to be adapted to the very different environment we now live in.

While 2008 was an unprecedented year for financial markets in many respects, Watson Wyatt considers some of the recent trends sufficiently persistent to incorporate into their model. For example, Watson Wyatt has decreased the fixed income correlation assumptions to reflect the ‘flight to quality’ behaviour and increased the assumed volatility of equities, as might be expected. However, they have also increased the expected future returns from equities, on the basis that the higher risk of equities implies that investors should be paid a higher risk premium.

assumptions, not guarantees

Watson Wyatt provides the Spectrum Funds with ten year assumptions for return, risk and correlation. A decade ago, it would not have been responsible to assume that the total return on equity investments would have been negative over a ten year horizon, but this has been the result. Clearly these assumptions cannot come with guarantees. Instead, we need to focus on whether the framework for building the assumptions is robust, and whether it is likely to deliver to the expected risk level over time. Against a backdrop of the most volatile period in stock market history, the Spectrum Funds have experienced slightly higher volatility than targeted in their first year. These targets are for ten years and there are times when volatility is likely to be lower than our expectations as well.

different routes, same destination

We are often asked why the asset allocation of the Spectrum funds does not mirror the asset allocations that are provided on Skandia’s investment platform. Each wrapper on the platform has a different asset allocation for the same risk level reflecting different charging structures, tax implications or acceptable asset types. The asset allocations for the Spectrum funds also take all of these elements into account, but with important differences. For example, the Spectrum funds are rebalanced daily within predefined tolerances. This is different to the way money is generally run through the platform and can be allowed for in the optimisation. In addition, with significant changes to asset allocation happening every quarter, a cost benefit analysis of these changes has also been important. Investors have benefitted from the strong inflows into the Spectrum range, which have allowed a number of changes to be implemented more cheaply and efficiently.

As an institutional buyer of managers, Skandia Investment Group (SIG) has access to an even wider range of funds than is available on the platform, and this too is factored into the assumptions. One example of where SIG has exploited this broader opportunity set is the Spectrum funds’ investment in the Fulcrum Alternative Beta Plus Fund. Although this fund has recently been made available on Skandia’s platform on an exclusive basis, the Spectrum funds have been invested with Fulcrum since launch. The Fund provides valuable diversification benefits for the Spectrum range and has significantly outperformed equities over the past year.

into the light

As John Kenneth Galbraith put it: ‘there are two kinds of forecasters: those who don’t know, and those who don’t know they don’t know’. However even the period of darkness we have seen is illuminating in certain respects. We now have a new ‘stress test’ and a new perception of how bad things can really get, or at least we understand better how little we know, or perhaps how little we can rely on it.

In that context, both managing portfolios and investing in portfolios using a sound and robust framework for risk are essential. When the Spectrum range was launched, we talked about a ‘dynamic strategic’ asset allocation approach which had some flexibility to adapt to the changing nature and changing risks of assets. This framework can provide comfort that risk is being appropriately managed in the bad times while being adaptable enough to cope with more than one market environment, allowing investors to remain invested for the good times when they return.