special report Q2/3 2016

Multi-asset

BNY MELLON

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special report

Classes of multi-asset

Rapid growth in the multi-asset fund sector over the past decade has given investors access to an ever widening range of individual assets, each capable of delivering specific return and risk qualities.

While equities and bonds were once the mainstay of mixed investment portfolios, multi-asset investing now encompasses assets as diverse as gold, emerging markets, renewable energy, infrastructure investment and can even employ absolute return and 'liquid alternative' strategies.

The multi-asset approach can bring valuable diversification to portfolios, helping investors to balance out returns and smooth some risks and, as such, demand for mixed asset funds remains strong.

According to figures from data provider Lipper, the large Mixed Asset € Balanced Global sector had combined assets of around €64bn across 372 funds as of 31 March 2016, an increase of some €10bn in assets over 2015's figures, including some €4.6bn in inflows.

One of Lipper's largest euro-denominated Mixed Asset categories is the € Flexible Global sector, which has more than 900 funds with combined assets under management of almost €125bn. Over the past year to the end of Q1 2016 the sector has seen inflows of €7.8bn, according to Lipper figures.

A recent survey conducted by BNY Mellon and research provider FT Remark[1] also gives evidence of how great the interest is for investments beyond traditional asset classes. In a poll of 400 large institutional investment firms, more than half said they would increase allocations to private equity over the next 12 months, with 36% of respondents planning to raise their exposure to real estate; 40% said they would invest more in infrastructure. All these assets can form the components of diverse multi-asset portfolios.

In our second annual multi-asset report, portfolio managers from across BNY Mellon Investment Management and its affiliates identify and explain the many facets of this rapidly evolving class of strategies, outlining the types of approaches and instruments used in multi-asset portfolios today. Here we feature the expertise and opinions from managers across our range of investment boutiques, including Newton Investment Management, Insight Investment, Mellon Capital, Siguler Guff, the Boston Company Asset Management (TBCAM) and CenterSquare.

1 BNY Mellon/Prequin. Building for the future: How alternative investment managers are rising to the demographic challenge. 01.04.16/Split Decisions: Institutional Investment in Alternative Assets, BNY Mellon and FT Remark, Research from the Financial Times Group, 2016.

Across the spectrum

Multi-asset investment embraces a growing range of investment styles and assets and growth in the sector is encouraging the use of increasingly diverse allocation strategies. Here, managers across BNY Mellon Investment Management boutiques assess the development of the market and consider its future prospects.

These are turbulent times for global investors. Against the recent backdrop of market uncertainty, global regulatory change and unconventional monetary policies, investors have found it increasingly difficult to find reliable and sustainable sources of return.

Traditional diversification principles are also becoming challenged with increasing correlations between some asset classes encouraging asset managers to explore a broader spectrum of investment possibilities. Consequently, uncertain market conditions and a low yield, low return environment have focused new interest on multi-asset investing.

The multi-asset approach embraces a broad range of investment techniques, including passive and active management, applied across an ever widening pool of investment assets, geographies and capital structures.

The European 'mixed asset' market alone attracted €189bn in net flows in 2015 – 37% more than in 2014 . This was boosted partly by a drive by continental retail banks to encourage customers out of cash deposits and into mutual funds[1], though sales flows do vary significantly from market to market.

> **The holy grail of multi-asset investing is finding alternative assets that can deliver in times of stress when more mainstream assets are not performing well.**
>
> Paul Flood, Newton

Despite a dip in UK inflows to multi-asset funds in early 2016[2] triggering speculation about prospects for the sector, in March they were the second best-selling fund types with net retail sales reaching £190m, according to figures from the industry trade body Investment Association (IA)[3]. The sector also continues to enjoy strong support from institutional investors[4], particularly smaller institutions, across Europe.

BNY Mellon Investment Management head of international distribution, Matt Oomen says: "Demand for these products in the UK remains despite the impact of regulatory change such as the recent imposition of a fee cap on defined contribution pensions, which has prompted some funds to shift away from actively managed multi-asset based products such as diversified growth funds (DGFs) into lower cost solutions.

"In Europe the past decade has also seen massive growth in multi-asset. This has been driven, to a large extent by the evolution of distribution channels and the way in which client objectives, risk tolerance and anticipated outcomes are now assessed and addressed. Often the best way to address these varied outcome oriented needs is by promoting and providing clients with access to a range of multi-asset solutions."

Market evolution

The multi-asset approach itself derived from traditional balanced fund strategies employed which often relied on a straight 60/40 split between equities and bonds with the flexibility to adjust weightings depending on prevailing market conditions.

Over the last decade factors such as the global financial crisis, access to new investment areas, growing sophistication of investors and added liquidity fuelled by unconventional central bank policies have all increased the attractiveness of multi-asset solutions. Today, emphasis is much more on tactical asset allocation, with a growing awareness different assets can deliver specific benefits in certain market conditions, in specific geographies at specific times.

Commenting on the evolution of this investment strategy, Newton Investment Management multi-asset manager, Paul Flood, says: "Multi-asset has evolved to the extent there is now a much wider array of assets with much more differentiated characteristics than was available 10 years ago. Many investors are beginning to realise the advantages of the wider diversification and exposure they can bring.

"The holy grail of multi-asset investing is finding alternative assets that can deliver in times of stress when more mainstream assets are not performing well."

Managers at San Francisco-based Mellon Capital also note the evolving nature of the multi-asset investment market and say its own investment strategies encompass a steadily growing asset range.

Commenting, Mellon Capital managing director and head of asset allocation portfolio management Vassilis Dagioglu says: "Back in the 1990s, it was typical to see global balanced portfolios based on a straight split between bonds and equities. Today, we look at multi-asset as a much more flexible 'go anywhere' type

1 Fund Radar Asset Management Outlook. MackayWilliams. December 2015.
2 Multi-asset funds see first outflows since 2011. Portfolio Adviser. 23 February 2016.
3 End of tax year investor rush drives positive fund sales in March. Press release, Investment Association 25 April 2016.
4 Investment and Pensions Europe (IPE). Asset Management: The rise of multi-asset. September 2015.

strategy, with no set strategic asset mix. Increasingly, investors want diversification and the multi-asset approach is a natural way to address that."

At Newton, Flood believes there is value to be found in unconventional assets such as renewables, infrastructure and aviation finance. He adds instruments such as these enjoy low levels of correlation with more traditional assets and can bring useful diversification to portfolios.

"By adopting a multi-asset approach you can identify assets with some very attractive characteristics and good long-term returns. That said, it is important to recognise there may be short periods of time when those returns deviate from those of traditional asset classes - both for better and for worse," he says.

QE or not QE?

At a macroeconomic level, Flood is concerned quantitative easing (QE) policies employed by central banks have distorted sectors such as government bonds with potentially damaging long-term consequences for investors. He adds a multi-asset approach can help investors to insulate themselves against potential and ongoing QE-related problems.

> **No investment is 100% risk-free and investors in multi-asset funds should consider their risk tolerance carefully, while also targeting realistic returns.**
>
> Vassilis Dagioglu, Mellon Capital

"Never before have we seen people pay to lend money. But under QE that is exactly what is happening in a large section of global government bond markets. My view is that investors need to be as far away from the effects of QE as possible and the most affected sectors are government bonds and cash. The further away investors can be from these, the more likely they will be better protected from any fall-out if QE ultimately breaks down," he says.

No investment is 100% risk-free so investors in multi-asset funds should consider their risk tolerance carefully, while also targeting realistic returns, adds Dagioglu.

"In the first instance, investors need to identify the reasons why they would like to have a multi-asset in their portfolio – whether it is to be able to have a return or capital appreciation or to provide diversification to other asset classes," he says.

"They need to identify what is the level of risk they want to target within their portfolio, consider the correlation with other asset classes and what level of liquidity they want to maintain on their portfolio. Then they need to basically judge the different performance of different managers and strategies and see how well they have delivered on the level of risk, risk management and returns they have set out to achieve."

According to Dagioglu, a significant challenge facing the sector is the limited track record of many multi-asset funds in what is still a relatively immature market. This can make it hard for investors to gauge both likely performance and risk on some portfolios.

"A number of managers have launched multi-asset strategies in the past three to five years so consequently they only have a limited track record. It is not always easy to go back and test the performance of the assets they hold or draw meaningful conclusions about how they would perform in different market conditions," he adds.

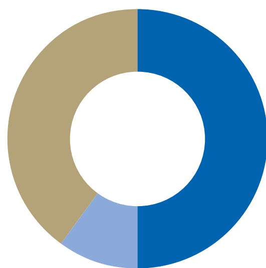
Risk management

Mellon Capital global investment strategist Jason Lejonvarn, believes the growing size of some multi-asset funds should also be viewed with some caution by investors.

"Downside risk management is very important within the multi-sector asset space and investors should be cognisant of potential risk. The growth in assets in the sector and sheer size of some multi-asset funds now probably points to some degree of underlying

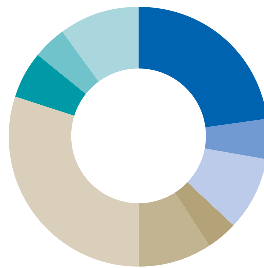
DIVERSIFICATION: POTENTIAL TO INCREASE RETURNS WHILE REDUCING RISK

LESS DIVERSIFIED PORTFOLIO



US Equities	50%
International Equities	10%
US Bonds	40%
RETURN	4.80%
STANDARD DEVIATION	9.13%

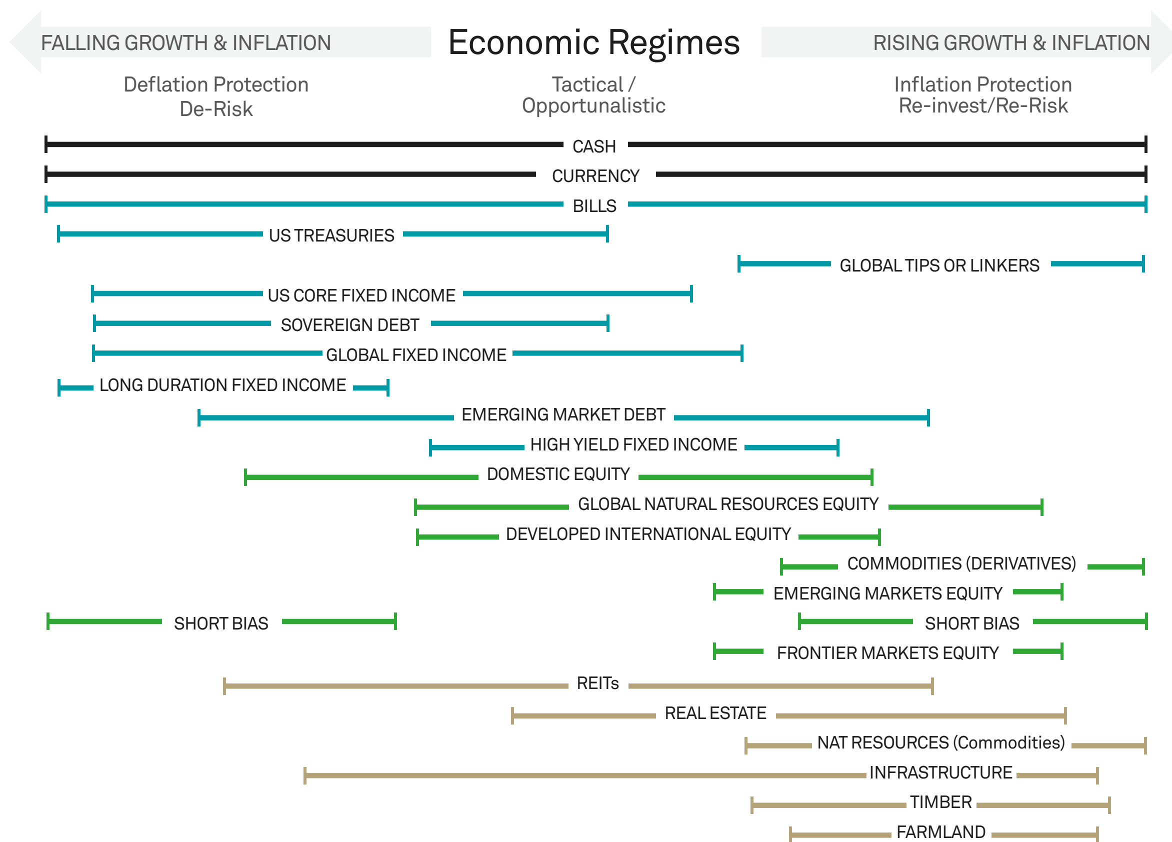
MORE DIVERSIFIED PORTFOLIO



US Equities	23%
US Small Cap Equities	5%
International Equities	9%
Emerging Markets Equities	4%
Real Estate	9%
US Bonds	30%
Global Bonds	6%
High Yield Bonds	4%
Alternatives	10%
RETURN	6.01%
STANDARD DEVIATION	8.95%

Source: Morningstar. Time period: Jan 2000 to Dec 2015. Asset classes represent the following: U.S. Equities: S&P 500 Index, Int'l Equities: MSCI EAFE Index, Emerging Market Equities: MSCI Emerging Markets, U.S. Bonds: Barclays US Aggregate Index, Global Bonds: Barclays Global Aggregate Bond Index, High Yield Bonds: BofAML US HY Master II, U.S. Small Cap Equity: Russell 2000 Index, Real Estate: FTSE All Equity NAREIT Index, Alternatives: HFRI FWC Index. Past performance is no guarantee of future results.

ASSET CLASSES MAY OFFER DIFFERENT PROTECTION IN DIFFERENT ECONOMIC REGIMES



Source: BNY Mellon. The chart depicts which economic environments (high growth & Inflation, low growth and inflation, etc.) are the most supportive for each of the major asset classes. For example, BNY Mellon would anticipate that TIPS would most likely outperform when inflation is the highest and underperform when inflation is falling. Asset classes are also ranked from those considered the most liquid on top to the least liquid at the bottom.

liquidity risk which investors should consider carefully," he says.

Despite these potential drawbacks, Oomen adds that many investors continue to target multi-asset products for their risk management qualities. "The importance of asset allocation to your overall investment returns is key. In all instances the appetite for multi-asset is driven to some extent by risk management and the question of objectives and outcomes.

"If an investor was just seeking maximum returns in isolation, I am not sure they would necessarily buy a multi-asset fund. The idea of multi-asset is that you can aim for a return objective with appropriate diversification, active asset allocation and risk management," he says.

Rising volatility

After a volatile start to 2016, investors across a wide range of assets are now bracing themselves for continued uncertainty in the months ahead.[6] Nevertheless some multi-asset managers believe market turbulence can work in their favour, particularly in sectors such as emerging markets investment.

Flood says: "We expect more volatility and therefore more opportunity to emerge in areas such as emerging markets and subordinated debt in the months ahead. We don't think it is a good idea to chase yield but there are opportunities out there to generate attractive returns if you are willing to adopt an opportunistic approach and take tactical positions," he says.

Commenting on broader market prospects for growth in the multi-asset investment sector, Dagioglu remains optimistic, predicting it will continue to expand and attract investment throughout the rest of 2016.

"It will be interesting to see what new 'flavours' of investing will develop in the multi-asset space. One area of recent growth we have seen - particularly in the recent low yield market – has been investors looking to multi-asset as a potential source of income. The multi-asset approach allows them to combine a dynamic suite of asset classes to preserve capital and manage risk while they are generating income," he says.

Oomen believes further evolution is inevitable thanks to shifting regulation and market needs. "As the multi-asset arena has matured we have begun to see many parts of both the distribution and product landscape change and evolve. There are also regulatory pressures likely to impact the future development of the market, including the advent of MiFID II and other measures which could influence the ways both advisers and investors approach the sector in future.

"Looking ahead, my view is that we will certainly see continued demand for multi-asset products but potentially we may also see some consolidation in the market going forward and we will undoubtedly see further evolution in this sector," he concludes.

6 The Guardian. What volatile markets say about the world economy. 01 February 2016.

Commodities can offer challenges but also a rich seam of diversification possibilities in multi-asset investing, says Aron Pataki, one of the portfolio managers on Newton's Real Return strategy.

Commodities can be used for both diversification purposes and as a hedge against certain outcomes and, when these two objectives align, there is a strong case for using the asset class within a portfolio, according to Pataki. A constant diversifier, gold can be used in risk management to protect against infrequent or unlikely but significant negative events that are often referred to as 'tail risks'. It has the virtue of not being significantly correlated with changes in the price of other mainstream asset classes.

Unless commodity exposure is obtained through a listed equity, such as a mining company, commodities do not necessarily produce a cash flow so the bar to investing in them for a portfolio manager can be high, says Pataki. When investing in commodities, the use of derivatives is also often necessary and this introduces counterparty risk to a portfolio. By their nature, derivatives do not fall into the category of simple and transparent instruments, he comments.

The 'commodity complex' can be subdivided into specific categories, notes Pataki, adding that these are pro-cyclical commodities (industrial and energy-related commodities, such as iron ore, copper, oil & gas), precious metals (e.g. gold) and soft (agricultural) commodities, such as wheat, corn and sugar.

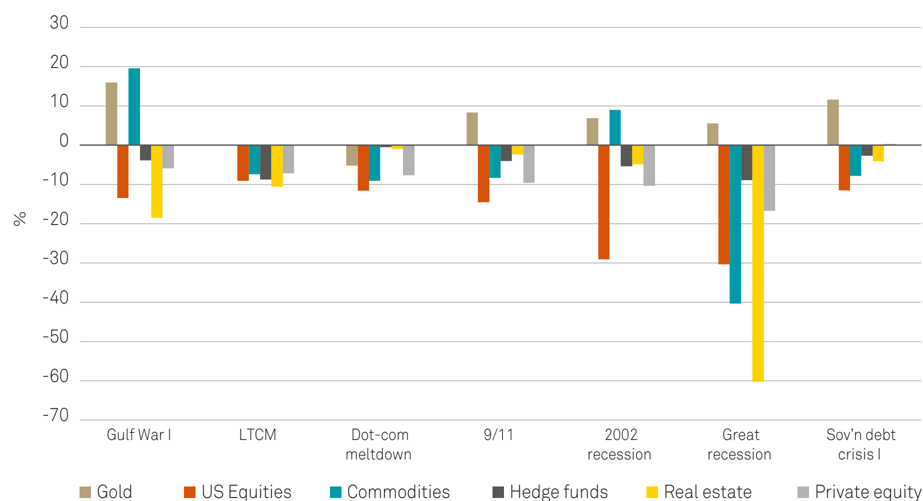
The past decade can be described as having witnessed a 'super cycle' for commodities, when China grew very rapidly and stimulated its economy through investment in infrastructure that required the extensive use of raw materials. The unprecedented stimulus encouraged a credit bubble after the global financial crisis that authorities are now trying to deflate in an orderly fashion. This process and changes in the structure of the economy have the potential to exert a continuing impact on demand for commodities. Understanding how Chinese demand for commodities will change – if and when its economy rebalances away from investment and exports towards consumption – is key in identifying the driving forces of future commodity price changes, says Pataki. Over the longer term, the relative availability and cost of supply is also very influential in driving commodity prices (not just the rate of demand growth).

'Super cycle' to 'super downturn'

Commodity producers tended to overinvest as they extrapolated the trend of China investing in infrastructure into the future, believing it would go on forever. Faced with a new reality, the management of such companies is typically doing what it is supposed to do, says Pataki. That is, harvesting cash flows rather than investing in new production. Capital expenditure has been cut back and is running below economic depreciation.

In contrast, the 'sell side' has yet to 'capitulate' and is still prone to cry 'buy, buy', says Pataki. When producer margins trough and the sell side does indeed 'capitulate', there is likely to be some buying opportunities, he comments. There is a need to see a deleveraging-driven demand pullback in China and

RETURNS DURING PERIODS OF SYSTEMIC RISK



Notes: Gulf War I: Q3 1990, LTCM: Q3 1998, Dot-com meltdown: Q1 2001, 9/11: Q3 2001, 2002 recession: Q2/Q3 2002, U.S. Credit Crisis: Q4 2008/Q1 2009, European sovereign debt crisis: Q2 2010.
Source: Barclays Capital, Bloomberg, Hedge Fund Research, J.P. Morgan, Thomson Reuters, World Gold Council.

consolidation among producers, even some defaults. So-called 'zombie companies' (that should by rights be dead) continue to stagger on as the initiatives of the central banks and governments in the wake of the financial crisis have inadvertently relocated capital to failing companies as they sought to boost economies by buying assets.

As the commodity 'super cycle' has evolved into a 'super downturn', many prices for commodities have halved from their 2011 peaks but some remain well above levels seen 15 years ago, says Pataki. This extreme range has contributed to long-term uncertainty, leaving investors unsure how best to forecast what commodity prices might do.

Shale oil and gas

After the credit crunch, central banks flooded the world with cheap US dollar liquidity that was used to build out capacity, notes Pataki. Taking the example of the US shale oil and gas industry, this cheap US dollar liquidity was used to increase production at a time when the rate of demand growth was slowing, particularly in China and the emerging markets. With a prevailing consensus that commodities provide a good hedge against inflation in the inflationary world that was thought likely, investors were encouraged to "flood the asset class", which unsurprisingly collapsed, says Pataki.

However, even with the collapse in oil prices, the shale industry has not been wiped out, he says. Just as it was possible to shut a valve quickly, it can equally be reopened quickly. If the price of oil rallies above breakeven levels (that are falling due to efficiency gains), then a lot of new oil shale production will be switched on, capping prices. Members of the Organization of the Petroleum Exporting Countries or OPEC are finding it difficult to agree on production cuts that could stabilise the price of oil. Iran, in particular, is returning to the market and anxious to regain market share after having been long shut out as a consequence of sanctions.

Store of value

Gold (see box) can be used to hedge against a very wide range of outcomes, says Pataki, as well as against the policy errors of the authorities and against currency debasement. In the event of future inflation, it can be a store of value (useful for the preservation of capital) but it can also work in a deflationary environment. With negative interest rates in Europe and Japan, the opportunity cost of owning gold has come down substantially: some 40 basis points per annum for holding cash deposits in Europe with the European Central Bank, whereas owning physical gold might cost around 10-15 basis points annually, he notes.

Rather than owning physical gold, it is possible to gain geared exposure to the broad price of gold through holding gold mining companies, notes Pataki. Generally gold miners have a cash flow stream and should pay a dividend, whereas physical gold is a non-yielding asset. There are advantages in accessing through listed equities not least as it imposes the obligation to do fundamental analysis in order to, say, avoid companies that are financially levered or have operational gearing to the price of gold.

Weather vane

Within multi-asset portfolios, soft commodities can be used as a diversification tool as they tend to be less correlated with business cycles or financial risk than industrial and energy commodities. Soft commodities are also supply constrained. Production is limited by the amount of arable land available and competition between crops, as well as continuing adverse weather conditions and water constraints affecting supplies. For instance, a heatwave in California could put pressure on the provision of wheat and grain and further have an impact on global supply, notes Pataki. A drawback is that soft commodities can only be accessed through derivatives or structured products. Such commodities always have a storage cost and this can have an effect on the yield.

Good as gold?

Gold represents a 'real' asset and there is a finite supply as there is only so much gold that can be dug out of the ground. For that reason, gold cannot be replicated so it is not subject to debasement in the way currencies can be. The authorities would seem intent on reducing the value of fiat money so that their individual economies can get a competitive advantage (fiat money is currency a government has declared to be a legal tender but is not backed by a physical commodity). Owning gold is also a way of providing distance from the financial system as it sits outside that system, being seen as less prone to manipulation by central banks than fiat money. Gold can also act as a barometer for confidence in an economy and by extension in fiat money.

When currency counts

Investing in a currency fund as part of a multi-asset approach can offer some potentially wide-ranging benefits, argues Insight Investment 's head of currency, Paul Lambert.

Investors looking for an alternative to standard fund strategies could do well to consider allocating active exposure to currencies. This is the view of Paul Lambert, manager of the Absolute Insight currency strategy, who notes how investing in money markets can help diversify portfolio returns while also offering a potential hedge against periods of volatility.

On the question of diversification, Lambert points out how Insight's currency strategy has tended to generate an income stream that does not correlate with equity returns, bond returns, or emerging market returns in either bonds or equities. The same can be said for the strategy's returns versus other macro funds or indeed the returns of most currency indices.

Significantly – and unlike other strategies that offer diversification benefits – it also manages to achieve this while not 'locking in' investors over the long-term.

According to Lambert: "Other approaches such as private equity or real estate tend to be illiquid. Generally, this isn't the case for currency. The beauty of currency – especially if you avoid the more niche areas – is how freely it's traded. Even in periods of heightened duress, we're able to rapidly open and close positions in response to events. In that sense it's fairly unique in offering both very good liquidity and a lack of correlation with other asset classes."

The lack of correlation with other markets goes further, however. In Lambert's words: "As a currency manager we don't really care which direction markets are travelling – whether equities are rallying or bonds are falling, for instance. Because currency is always a long/short strategy it tends to have very limited directional bias versus other asset classes."

The volatility response

In addition to diversification and liquidity benefits, currency investing can also offer a hedge against wider market volatility. This is potentially the case in the current economic climate where Lambert notes there has been a

"growth wobble" accompanied by spikes of volatility as some of the more positive trends – such as increased corporate profits – begin to retreat. Investors are now worried that central banks have "run out of ammunition" to boost growth. They are also concerned about deflation as oil prices and other commodities continue to slump in response to oversupply.

> **The beauty of currency – especially if you avoid the more niche areas of the market – is how freely it's traded.**
>
> Paul Lambert, Insight Investment

One of the root causes for this current lack of confidence, according to Lambert, is the lacklustre pace of the recovery, which is weaker than post-recession recoveries in 1957, 1973, 1980, 1990, 2001 and 2007 (see chart below). Taking an analogy from physics, he notes how Hooke's Law would suggest an equal and opposite reaction for any downturn: that the bigger the recession the bigger the bounce back. "But with this recovery that's not been the case," he says. "This time something's different."

While this may be a concern for equity and bond investors, the increased volatility accompanying investor uncertainty can actually be helpful for a currency fund, says Lambert. "For us," he says, "volatility is not the enemy: if anything it actually widens the range of opportunities to express views on developments in the wider world. Currency strategies can offer a simple and transparent way of gaining a broad exposure to global markets – but without the need to invest directly in the underlying assets. It's proven to work well during periods of increased volatility and as such we believe it could be highly beneficial in hedging against future market turmoil."

Investing in the real world

But how does investing in currencies work in practice? Currencies are affected by a vast array of themes taking in everything from macro-economic factors, the economic cycle, central bank policy, a broad range of commodity prices and business confidence. By investing in currency pairs a manager can take a specific view of how they expect these wider political or economic trends to play out in real life.

If one has a particular view on oil, for example, a potential strategy may be to go long or short on the Russian rouble, the Canadian dollar, the Mexican peso or the Norwegian krone, all of which are correlated to changes in the price of crude. In metals and mining, the Australian dollar or the Chilean peso might offer a proxy for changes in supply and demand and pricing for coal and iron or copper respectively. In soft commodities, the New Zealand dollar can act as a proxy for dairy pricing, while the South African rand often mirrors changes in precious metals pricing, particularly platinum. More generally, a 'risk-off' environment can benefit 'established' currencies such as the US dollar, the euro and the Japanese yen versus other currencies.

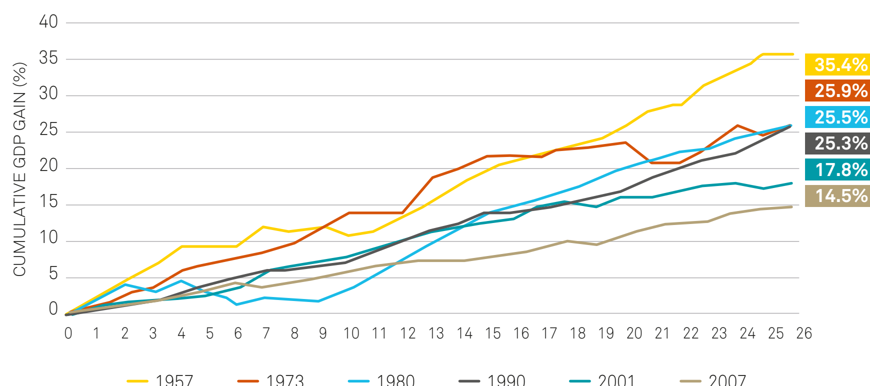
Says Lambert: "In emerging markets, for example, we saw a fairly broad currency sell-off in 2015 because of the slowdown in China and the knock-on effect this had on commodity-producing countries. Elsewhere, the actions of central banks and their influence on interest rate cycles often offer huge scope to express a view through currency trades."

This was the case in the latter half of 2015, for example, when the US Federal Reserve's (Fed) decision to raise interest rates contrasted with generally looser policy in the rest of the world and in Europe in particular. Lambert says: "We believed expectations of a US rate rise would push the dollar higher versus the euro." As such he believed there was opportunity to short the European currency versus the US dollar.

Economic data from the US has recently been firmer than its main trading partners, having suffered a set-back over the first quarter. It seems policy divergence is once again back on the agenda and dollar strength is likely to prove to be an increasingly important theme over the year ahead while the rest of the world is still beset by economic headwinds. However, caution is appropriate. While the Fed is currently expected to hike rates this summer in response to stronger data, any stumble will produce strong counter trends and the narrative will change once again. Lambert believes that investors are adapting to potential changes to central bank policy dynamics "Market expectations have been reset and we are likely to see trading in ranges punctuated by breakouts," he says.

Looking forward, Lambert believes this means other currency crosses and pairs may prove far more compelling in the near-term. He concludes: "The recent bounce in commodity markets and an improvement in sentiment towards emerging market assets puts commodity-linked and EM currencies back in the spotlight."

THE WEAKEST POST-RECESSION RECOVERY IN 50 YEARS?



Source: Federal Reserve Bank of Minneapolis. As at 31 January 2016.

Volatile markets present challenges to a wide range of global investors making it difficult for managers to identify areas where they can generate returns and avoid losses. In the current low yield, low interest rate environment intelligent tactical asset allocation is increasingly important as the hunt for return intensifies.

Here, we ask investments specialist at Newton Investment, Mellon Capital, Insight Investment and BNY Mellon Investment Strategy & Solutions Group (ISSG) their views on the market and the strengths of the various asset classes and investment opportunities in the market.

Paul Flood, multi-asset income manager, Newton

Suzanne Hutchins, Real Return strategy portfolio manager, Newton

Peter Hensman, global strategist, Newton

Vassilis Dagioglu, managing director and head of asset allocation portfolio management, Mellon Capital

Stephen Kolano, head, multi-asset solutions, Investment Strategy & Solutions Group, BNY Mellon Investment Management

Steve Waddington, multi-asset manager, Insight Investment

Which asset class do you favour most in the year ahead and why?

Paul Flood: In the current market, UK renewable energy is an area we really like. The returns available from this sector look relatively attractive compared to government bonds and equities and are not dependent on the economic cycle. The renewables market in the UK could also be worth about £20-30bn in the next five years and there is huge scope for development of these assets and related listed structures. Exposure to this sector means you are invested in an asset that generates power and there will always be a need for power, irrespective of whether you are in a recessionary period or not. The majority of the revenues from this sector are actually based on government subsidies, which are fixed and linked to inflation, allowing investors to take some fairly aggressive assumptions before incurring losses.

Stephen Kolano: As the US economy moves into its economic cycle, oil prices stabilise and the labour market continues to improve we are starting to see upward pressure on expectations for inflation. These indicators, combined with investor sentiment that increasing inflation is a very minor threat, makes inflation-sensitive assets, such as commodities and global natural resources equities, attractive to us in the year ahead as part of a barbell strategy of inflationary and deflationary assets.

Peter Hensman & Suzanne Hutchins: We believe US Treasuries (in sterling terms) have the greatest return potential in the next 12 months. While the market remains focused on the likelihood of interest rate 'normalisation' and higher yields along the length of the yield curve, we view the repeated failure of central banks' forecasts as indicative of the inaccuracy of their demand-driven models. Instead cheap finance has spawned an extraordinary level of competition, distorted perceptions of risk and encouraged even greater levels of indebtedness, which in turn increases financial and economic fragility. As profitability and market liquidity face ever greater pressures, and the prospect of US policy tightening melts away, the certainty of (low but positive) returns available on Treasuries will likely push yields down, not up.

Vassilis Dagioglu: We believe major developed market large capitalisation equity indices such as in the US, Eurozone and Japan offer more potential value than the UK or emerging markets. Given there is still a little uncertainty about economic and earnings growth, we are taking something of a more moderate world position compared to the past, but we still believe the global economy is not falling into recession and that we remain in a moderate growth environment. US TIPs and high yield bonds have had a very good run of late and we would favour that asset at this time.

Steve Waddington: We expect moderate growth in the key developed markets as domestic conditions improve and the slowdown in China stabilises but the risks appear skewed to the downside. We also expect a pick-up in volatility, driven by higher levels of economic uncertainty and market-specific factors. Given this uncertainty we are focused on areas of value. While we do not have a single favourite asset class, we believe emerging market debt is starting to look attractive. We also consider dividend futures to be attractive, particularly in Europe - where fair value discounts are largest in some tenors.

Which asset class do you think will be the most effective in smoothing returns/providing diversification over the next 12 months and why?

Paul Flood: Infrastructure is an asset we do feel will be helpful in smoothing returns in the months ahead and it continues to offer stable, cash generative returns and is a well understood asset class that holds broad appeal. Infrastructure assets have the advantage of not being dependent on the economic cycle. Ultimately we look to balance out the risks across the portfolio and find securities that can help smooth some of the risks that offset the opportunities and we are always very cognisant of what has been priced into the securities in terms of the different risks. From this perspective we think infrastructure presents a good proposition.

Stephen Kolano: Given the mixed economic signals investors are seeing in the economy today, the strategy we are employing to smooth returns going forward actually combines inflationary and deflationary assets as opposed to a single asset class. As volatility increases in the markets, we believe it is important to understand how asset classes hedge one another within the portfolio as a way to manage risk within boundaries as opposed to increasing single sources of active risk.

Peter Hensman & Suzanne Hutchins: We view US Treasuries and gold as likely to be the most effective at providing portfolio diversification. Both have a low correlation with risk assets as they have been viewed by the market as unnecessary and detrimental to generating returns since the consensus of market participants expect our financial systems are returning to 'normal'. This is unlikely to change in the period ahead.

Vassilis Dagioglu: In terms of smoothing returns within a multi-asset portfolio we would look to US Treasuries - which we believe are comparatively cheap and still negatively correlated to a range of other growth assets. In a low yield environment US Treasuries can provide a positive and attractive yield. Currently, they are also cheaper than other alternatives such as other non US government bonds like Bunds or even Japanese bonds. For diversification we also look to some other assets including some 'haven' investments, including a long exposure to the Swiss franc.

Steve Waddington: Generally speaking, our economic outlook suggests government bonds should remain a reasonable diversifier to risk assets unless rate expectations become unanchored or inflation expectations move sharply higher. We also expect curve flatteners to perform well in core markets: these should perform well in both a rate-hiking scenario, where short rates rise, and in an environment of structural weakening, which would weigh on long-term yields.

Measure for measure: fund sector comparison

A perennial challenge facing the multi-asset sector is the lack of a natural benchmark or peer group allowing for reliable comparison between individual multi-asset funds.

Organisations such as the UK trade body the Investment Association and investment research specialist Morningstar have worked to define multi-asset in recent years. Still, the investment industry offers only limited direct comparison between funds, although rapid evolution of the sector could allow for greater ease of comparison in the future.

According to Mellon Capital's Dagioglu, the sheer diversity of multi-asset investing means, for now, the industry is still some way off creating meaningful benchmarks. He adds that this places an onus on investors to take particular care when considering their objectives and risk tolerance.

"I don't think we are any closer to developing universal benchmarks across the multi-asset fund sector because it contains such a wide variety of assets. This means it is really up to the individual investor to understand how their strategy is structured, how it looks at different asset classes and how it manages the risk. Every fund will have its own different levels of risk and different ways of managing risk and so we have not come to a universal benchmark yet."

Newton's Flood believes the relative lack of benchmarks within the sector should not discourage investors. It gives fund managers the scope to move beyond the short-termism of much benchmark-investing to deliver longer term gains, he notes. He also feels it pays to take a more nimble approach in a market heavily influenced by unconventional central bank policy.

"In some ways it doesn't matter what benchmark you give people, a fund manager's job will be to outperform it. However, investors need to move beyond short-term thinking. In the current market environment it pays to adopt a more long-term view to deliver sustainable performance. The backdrop of QE creates conditions where asset prices can move based on the whims of what policymakers decide, but you cannot invest based on what you think a policy maker is going to say. You have to take a longer term view and make sensible investments."

special report

Trading places

With an emphasis on diversification and the goal of achieving uncorrelated returns, are absolute return funds a competitor to multi-asset funds or a peer? Here Insight Investment absolute return manager Sonja Uys looks at the role of absolute return strategies, especially in a volatile and uncertain investment climate.

With the ongoing uncertainty of the current investment backdrop, with markets vacillating between risk-on and risk-off, there has been increased interest in the type of uncorrelated returns absolute return funds can feature. The addition of differing absolute return strategies to a portfolio has the potential to alter its shape and dynamics; dampening volatility or offering diversification benefits through an uncorrelated return profile, Uys, explains.

Multi-asset portfolios – as well as absolute return strategies, which can be multi-asset in design - can leverage the uncorrelated aspect of their underlying holdings and also offer diversification benefits. While Uys prefers to classify absolute return portfolios as an approach, rather than an asset class, they can sit alongside more traditional holdings in a portfolio and act to improve diversification or enhance the overall portfolio's risk profile. Uys points out absolute return strategies should not feature high equity beta while many multi-asset portfolios take active, long-only views within defined volatility targets. "That's not absolute, that's relative." But this means absolute return strategies, appropriately chosen, can complement market-driven holdings within a multi-asset portfolio.

Strategic choices

So in a volatile environment, what type of absolute return strategy is sought after the most? Uys says, it depends on what investors are seeking. In a low yielding, low interest rate world many investors are seeking uncorrelated returns while others are looking for investments with low standard deviations and a bent towards capital preservation.

"You need to examine a fund to ensure it has the characteristics you are looking for; what do you want the fund to do? For example with an equity market neutral strategy with stringent stop/loss and risk controls you could expect to see lower returns but also lower volatility. On the other hand an emerging market debt long/short strategy could be higher in volatility but also in returns. There is no singular box you can put absolute return funds into."

Against the current economic backdrop managers across Insight's multi-alternative, absolute return team, have varying takes on expected volatility and opportunity in their respective areas and approaches. Uys says many managers in the team are cautious in the current environment. "The market remains focused on central bank rhetoric, low or negative interest rate policies, the search for yield and the outlook for global and Chinese growth."

Over the opening quarter of 2016 Insight's absolute return emerging market debt team increased net exposure and in April was still wary of consolidation driven by profit taking after the recent rally. According to Uys: "They also believe a more positive approach remains valid over the medium term given strong technicals: issuance has been lower than usual in both sovereigns and corporates, while amortisations are high and inflows into the asset class have picked up. They also believe valuations remain compelling, particularly in the wider context of a substantial proportion of global fixed income trading at negative

yields. While they expect volatility to remain high, they think the case for emerging markets remains intact."

At the end of the first quarter Insight's absolute return credit strategy team were cautious of adding risk indiscriminately and were holding a substantial cash allocation with modest net long exposure to credit, having been net short earlier in the quarter. Meanwhile Insight's equity long/short team remained tightly hedged with little net market exposure and lower gross exposure. With the US presidential election overhanging markets, it is difficult to imagine escaping the risk-on/risk-off cycle any time soon and this is likely to warrant a cautious approach, Uys says.

Uys notes that a combination of varying strategies such as these and the low correlation between them should be well-placed to deliver attractive returns with low volatility regardless of the future direction of markets.

However, the various approaches and outlooks from across Insight's absolute return strategies serve to highlight the variance in absolute return offerings available to investors.

Clear comparison

Whether investors are considering absolute return strategies as a standalone investment, or as a component of a multi-asset portfolio, clear analysis – ensuring a portfolio bears the characteristics that align with the investor's objectives – is key. Part of this will mean being aware that the management team and process, rather than the asset class or investment universe, may well have a more significant role in shaping the portfolio. "Absolute return strategies cannot easily be lumped together, leaving investors to rely sometimes on the strength, reputation and history of the team and process managing the fund rather than its design."

These considerations include looking for experience both in managing funds and executing complex alternative strategies as well as possessing an operational infrastructure capable of managing multiple compliance, transparency, trading and risk-management components, she adds.

Growing convergence

Concerns over central bank policy and global growth look set to trigger further volatility in markets, driving investors up the yield curve as returns become increasingly squeezed, according to Insight's Uys.

Highlighting some of the challenges facing investors in the current low yield, low interest rate environment, Uys said recent moves towards zero to negative interest rates had made it harder to generate returns, with yields from both government and corporate bonds falling, driving some investors towards higher risk, higher return assets.

According to Uys, quantitative easing (QE) programmes have also been a major driver of asset correlation, leading to a growing convergence across asset classes, making it harder for investors to find diverse sources of genuine value.

"Growing correlations across asset classes have persuaded some investors to look at more non-traditional or alternative assets such as absolute return funds as a diversifier, though it is important to select assets very carefully and recognise that alternative assets are not immune to losses," she says.

At a macroeconomic level, Uys anticipates further uncertainty and market volatility in the months ahead, with economists and governments increasingly unable to make accurate predictions about future GDP growth and inflation levels.

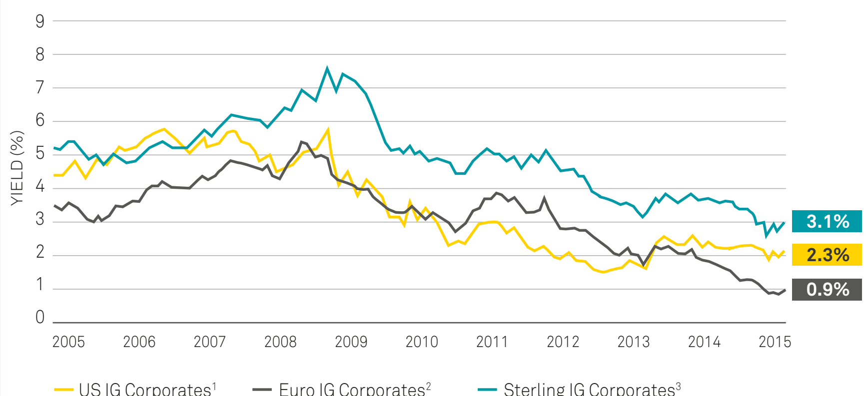
"In recent years, downward revisions of major economic indicators have become increasingly common. It is not just GDP levels that economists tend to be overly optimistic on, it is also inflation. The reality is you can't always rely on market predictions, particularly when it comes to rate hikes – for instance the US Fed fund rate has not moved in line with market forecasts.

"What we do know is that expectations and predictions are nearly always wrong. Given the current level of market sensitivity to central bank comments the one thing we would predict with confidence is that we are going to see more volatility in markets in the year ahead." she says.

Against an uncertain global economic backdrop, Uys sees a slowing Chinese economy as another potential driver of further market volatility thanks to its sheer financial scale.

Commenting, she adds: "You can't ignore China and we expect its growth to be significantly lower than it has been in the months ahead. We care about the slowdown in China because it actually makes up a large part of global spending and has been a key driver of investment. In global economic terms the country is much more important than it used to be."

CORPORATE BOND YIELDS DRIVEN LOW BY 'SEARCH FOR YIELD'



Source: Bloomberg as of 31 December 2015.
[1] The BofA Merrill Lynch US Corporate Index, [2] The BofA Merrill Lynch Euro Corporate Index,
[3] The BofA Merrill Lynch Sterling Corporate Index.

special report

In search of value

While emerging markets have experienced some turbulent conditions over the last 18 months, they can still offer significant strengths to investors, including multi-asset managers, according to US investment boutique Siguler Guff.

Investors in emerging markets have endured a torrid time of late. Both the Morgan Stanley Capital International Emerging Market (MSCI EM) and MSCI Frontier Market indexes plummeted in 2015, falling 14.92% and 17.67% respectively.[1] Worse, net capital outflows (including unrecorded flows captured by net errors and omissions) totalled US$735bn in 2015, up from US$111bn the previous year, according to the Washington-based Institute of International Finance.[2]

For Siguler Guff managing director Ralph Jaeger, however, rumours of the demise of emerging markets have been greatly exaggerated. On the question of demographics alone, he says, the arguments in favour of investing in emerging markets remain persuasive. According to United Nations forecasts, for example, the number of people on the planet is expected to rise from 7.3 billion today to 9.7 billion by 2050. Most of that growth is forecast to come from countries in the emerging world, including India, Nigeria, Pakistan, the Democratic Republic of the Congo, Ethiopia, Tanzania, Indonesia and Uganda.[3]

For all this potential, however, mainstream strategies for investing in emerging markets are not without their challenges, according to Jaeger. Take equity investing for example. Jaeger notes how emerging market indices tend to be heavily weighted towards just four sectors: energy, utilities, financial services and materials. By the same token, exposure to healthcare, consumer or tech is limited.

This is less than ideal, says Jaeger, since those high-growth sectors are exactly the ones that benefit the most from emerging market demographics. This is not to say there are no listed emerging market companies in the tech sector or consumer discretionary space – but these are comparatively few and far between, meaning they have a "scarcity" value. As a result, says Jaeger, they are often overpriced.

At the same time, companies listed on emerging market exchanges also tend to be large, often state-controlled companies. While the large-cap mining and energy companies that make up the bulk of emerging market indices are not necessarily bad companies – their predominance does limit investors' options if they do choose to access emerging markets through the traditional route of buying equities.

Alternative options

Faced with these challenges, investors do have other options. One route is to invest in emerging markets via private equity – a strategy, says Jaeger, that has a range of possible benefits.

First, emerging market private equity funds tend to have their investments spread across a far wider spectrum of sectors than public indices. Crucially, this means areas such as healthcare and technology – among the key beneficiaries of rising prosperity in developing countries – can be well represented. It also makes for a less volatile experience for investors as portfolios tend not to be focused in a concentrated sub-set of sectors that rise and fall in lockstep with each other. The difference can be significant: data provider Cambridge Associates says volatility on its Emerging Markets Private Equity & Venture Capital Index is approximately half that of the MSCI EM Index.[4]

Second, private equity funds tend to identify and invest in opportunities early in the life cycle of companies and this equates to better entry and exit multiples. Between 2003 and 2014, for example, Siguler Guff's emerging market entry multiples for private companies were 25%-40% below those for public companies.

"By definition, a lot of private equity investing is about getting in on the ground floor," says Jaeger. "Often the aim is to transform the company with a view to unlocking future value through either an IPO or M&A – and, in turn, that means valuations at the point of investing and at exit tend to be more attractive."

A third argument in favour of emerging market private equity investing is performance. To illustrate this point, Jaeger turns once more to research by Cambridge Associates. Returns from emerging market private equity funds have been broadly comparable to – or marginally better than – developed and emerging market equities as well as US private equity and venture capital funds, depending on the time period.

On closer examination, though, a far more compelling picture emerges. Says Jaeger: "If we consider returns from funds in just the first- and second-quartile you can see outperformance against equities."

Over a 10-year period, for example, returns for top quartile EM private equity funds outpace those of US private equity & venture capital funds, the Russell 3000 Index and the MSCI EM Index by 875 bps, 1338 bps, and 1308 bps, respectively.[5]

He concludes: "To us, the message seems clear. If investors are looking to tap into the potential of emerging markets, private equity investing is a potentially attractive route."

1 Morgan Stanley, 31 December 2015.
2 Citywire: *'Rush to exit: capital outflows from EMs soared in 2015'*, 21 January 2016.
3 *World Population Prospects*. United Nations, July 2015.
4 Source: *Cambridge Associates*, 30 June 2015.
5 Sources: *Cambridge Associates, Russell Investments and Capital IQ. Data as of 30 September 2015. * Russell 3000 Index. **MSCI Emerging Markets Index.*

Building bridges

Infrastructure assets can add diversification and potential returns to multi-asset portfolios in the current volatile, low-yield environment. Here, James Lydotes, managing director of the Boston Company Asset Management, outlines the current trends driving change in the sector.

Even while global economic growth remains muted, population growth and the demand for the basic needs of civilisation such as reliable supplies of water, energy, healthcare and transportation continue to increase. The United Nations population division forecasts global population will rise from 7.3 billion in 2015 to 9.7 billion in 2050.[1]

While the increase in population helps fuel the growth of demand for public services and their accompanying infrastructure, the changing characteristics of that population is also creating demand for new varieties of infrastructure to be built and operated. While the addition of 2.4 billion people over 35 years is not insignificant, the rate of increase actually represents a slowing of population growth in much of the world.

The inevitable result of slower population growth is an overall rise in the age of the population, a phenomenon that's already taking place in much of the developed world. According to the United Nations, the number of people aged 60 and above will more than double by 2050, while those over 80 will more than triple.

Under pressure

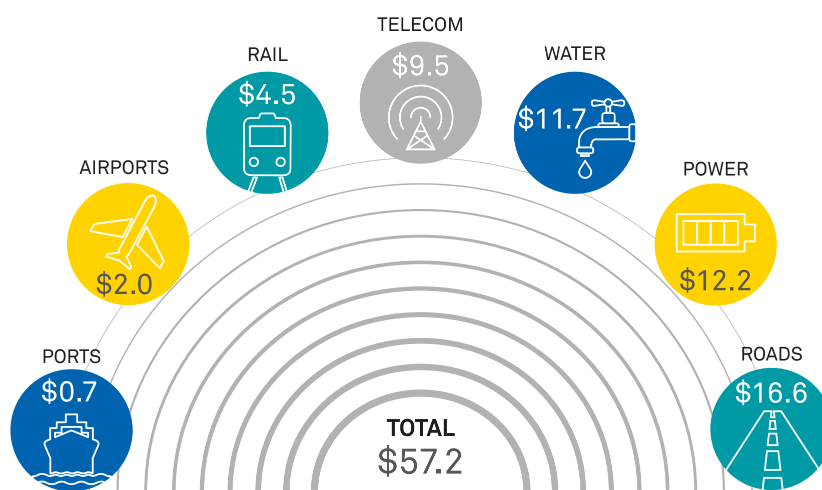
While the needs of this older and more numerous population increase, the ability of the governments that led the construction of infrastructure during the 20th century to do so in the 21st is diminishing. Public budgets in developed markets are constrained by high levels of debt, while emerging markets (EM) struggle with slowing growth. Standard & Poor's has estimated that the annual gap between worldwide infrastructure investment needs and available public funds will be at least US$500bn in each of the next 15 years.[2]

In developed markets, the need for infrastructure investment results partly from the ageing of both people and systems. Many public water and sewage systems date from the 19th century and their condition, as notable events in Flint, Michigan[3] in the US and elsewhere have shown, cannot be taken for granted. The network of roads and bridges that was built to accommodate the 20th century automobile boom also continues to age and deteriorate. Meanwhile, the existing fossil fuel-based energy production and delivery infrastructure is increasingly ill-suited to a world where limiting carbon emissions is an increasing priority.

The ageing of their populations is also creating demand for infrastructure and service provision in developed countries. As people age, their utilisation of healthcare increases significantly and governments in many countries lack the funds to build new hospitals.

Emerging markets have younger populations and stronger growth potential, but their already-insufficient infrastructure faces acute pressure from rapid urbanisation. Countries such as India need massive upgrades to their

PROJECTED NEED FOR GLOBAL INFRASTRUCTURE INVESTMENT, 2013-2030 IN $US TRILLIONS



Source: McKinsey Global Institute, January 2013

1 United Nations, Department of Economic and Social Affairs, Population Division (2015). World Population Prospects: The 2015 Revision, Key Findings and Advance Tables. ESA/P/WP.241.
2 S&P Capital IQ Global Infrastructure: How to Fill a $500 Billion Hole, January 2014.
3 The Guardian. Flint water crisis prompts schools nationwide to test water for lead. 09 April 2016.
4 Asian Development Bank Institute: Working Paper: Financing Asia's Infrastructure: Modes of Development and Integration of Asian Financial Markets', by Biswa Nath Bhattacharyay, July 2010.

transport, water and power systems. Tremendous demand for this kind of primary infrastructure exists in emerging markets and governments must find ways to build these projects if they expect to achieve their growth potential. The Asian Development Bank has warned that EM economic growth forecasts will not be achievable if a US$8trillion infrastructure funding gap for the period 2010-2020 is not closed.[4]

Market evolution

Both emerging and developed markets are also grappling with how best to build communications infrastructure to keep pace with the rapid evolution of technology and consumer behaviour. New generations of smartphones, the proliferation of tablets and other mobile devices, and the "internet of things" are rapidly making existing telecom networks obsolete. The mobile tower networks operated by specialist infrastructure operators must continue to evolve to meet the demand for data as more of the world's population conducts more of their economic and social lives using personal electronic telecommunications technologies.

In developed and emerging markets alike, the gap between the needs of populations and governments' abilities to build and maintain the systems that service those needs is creating opportunities for the private sector to partner with governments to provide necessary infrastructure. Particular opportunities exist where governments have mandated the provision of a service, but have difficulty funding it.

Renewable energy mandates are an example of this. In Europe and North America, climate change and energy security concerns have already spurred major policy initiatives to invest in renewables. Projects such as the North Sea Offshore Grid in Europe, which aims to generate 40 gigawatts of wind power by 2020, and the US Clean Power Plan 2015, mandate a shift to wind and solar investment and require new investment in power transmission systems. By requiring specific targets for renewable energy production, governments create natural opportunities for public-private partnerships or public-private agreements where the government mandates the need for a service, and the private sector steps in to meet the need.

Unique features

While infrastructure investment may not be uncorrelated to the other varieties of equity investments contained in multi-asset portfolios, it does possess unique characteristics that may benefit investors by reducing the volatility of their portfolios. Infrastructure investments' return streams are backed by real assets that require significant capital expenditure up front to build facilities but relatively little capital to operate and maintain over lifespans that may be measured in decades if not centuries. Over their lifecycles, these businesses generate cash, and return a significant amount of it back to shareholders in the form of dividend payments which are relatively insulated from economic cycles. Many infrastructure investments also have relatively high barriers to entry, which discourage disruptive competitors. These characteristics present attractive opportunities under many market conditions, but especially so in a low-interest rate environment where other opportunities for these sorts of reliable returns are limited.

Of course, where there is investment, there is also risk. Construction and operation challenges and changes to government policy can all delay and diminish investment returns. Infrastructure projects undertaken purely for profit-seeking motives, such as the Northeast Energy Direct natural gas pipeline project in the northeastern US, can encounter public opposition and changing business conditions that can raise potentially significant risks to their ability to generate expected returns. For investors, though, investment in companies engaged in the development, management, and ownership of assets related to energy, communications, water, transportation, and other essential systems may deliver consistent cash flow, inflation protection and diversification while also moderating portfolio volatility.

A different path: listed infrastructure

While many investors recognise the benefits of infrastructure investment within a multi-asset portfolio, direct investment in infrastructure projects can present risks that may deter even large institutional investors. Direct investment requires specialised expertise and the size and scale of projects may work against the goal of diversifying a multi-asset portfolio. However, it also possible to invest in public infrastructure companies listed on global exchanges as another means of gaining exposure to infrastructure.

Global listed infrastructure is a broad and diversified universe of public companies that develop, manage, and own assets related to energy, communications, water, transportation, and other essential systems. US-based real assets investment manager CenterSquare believes that in the coming years, listed companies will grow to play a much larger part in the infrastructure market, outweighing the role of governments, institutional investors, and private institutions. These companies have the experience to develop and operate infrastructure assets efficiently and profitably, as well as the capital to invest in multiple assets and projects, and the transparency and good governance necessary to secure the trust of the capital markets and obtain attractive financing.

Listed infrastructure company stocks' risk and return characteristics are determined by the quality of their underlying assets. Key factors that determine quality, according to CenterSquare, include strong cash flow visibility, low commodity risk, long duration contracts and steady long-term demand outlooks.

CenterSquare believes infrastructure securities are poised for tremendous growth and presents attractive risk and return characteristics with lower volatility. In today's economy, plagued by elusive growth and historically low yields, the group believes it is a liquid alternative investment with the potential to generate both yield and growth.

Winds of change

Ethical and environmental considerations look set to play an increasing role in multi-asset investing, according to Mellon Capital global strategist Jason Lejonvarn.

There is much debate around the exact definition of environmental and social governance (ESG) and the role it plays in asset management. By and large this is because there is no 'one-size-fits' all approach to implementing ESG practices in investing.

However, as the conversation moves on from green investing to a wider debate surrounding sustainability and the potential positive impact it can have on risk management, greater numbers are starting to take notice. It is no longer a peripheral consideration in the piecing together of a portfolio and it can often play a crucial role in investment decisions.

In the context of multi-asset investing, fund managers are likely to have to contend with a variety of governance regimes and disparate levels of disclosure and transparency, especially if they are investing globally. There are a number of ways to engage with companies in an attempt to affect change but one crucial rule of thumb should be to do so in a thoughtful fashion and not solely to pay lip service to the idea of sustainability.

> **The greenhouse gases emitted today will stay in the atmosphere for many decades to come. Almost every company emits greenhouse gases and contributes to global warming to some extent.**
>
> Jason Lejonvarn, Mellon Capital

Practical steps

This is a factor Mellon Capital's Lejonvarn feels strongly about, most specifically with regards to fossil fuel divestment. This is the practice of removing investment assets including stocks, bonds and investment funds from companies involved in extracting fossil fuels in an attempt to address the problem of climate change.

According to Lejonvarn: "The moral argument is that the majority of unused fossil fuels need to remain in the ground in order to prevent the potentially catastrophic levels of climate change that could occur if they were to continue being burned. Supporters believe if regulations were enacted to limit fossil fuel burning those assets remaining in the ground would become 'stranded'. The argument then goes that the inability to profit from these assets would increase investment in renewables and drive down the market values of those companies with large unused reserves."

At Mellon Capital the belief is more nuanced, namely that divestment on its own is not a practical solution to climate change. There are two main reasons for this: firstly, divesting of fossil fuel companies does not reduce carbon emissions because fossil fuel companies simply meet the demand from our carbon-reliant society and divestment does nothing to tackle that demand; secondly, excluding fossil fuels from a portfolio, for example, does not have an effect on the profits of the underlying companies because of that aforementioned demand dynamic. Lejonvarn believes, therefore, that divestment can lead to a false sense of accomplishment.

"While the stranded assets argument is powerful and has a number of prominent advocates, in our view it is incomplete. It requires assumptions about energy supply and demand that are driven by many complex factors such as regulations and innovation. In addition, it represents a practical challenge: The global economy is so energy dependent that we believe it is currently impossible to implement a near-term wholesale shift away from fossil fuels and the technologies that use them without a massive – some would say unacceptable – economic impact," he says.

Some countries have started down the road of materially increasing energy produced by alternative means but no viable and comprehensive alternative energy infrastructure currently exists to meet global energy needs, Lejonvarn continues.

He says at Mellon Capital the wisdom is that significant changes in energy production and usage will likely come about more gradually and in the meantime investors should find a way to have more of an immediate impact.

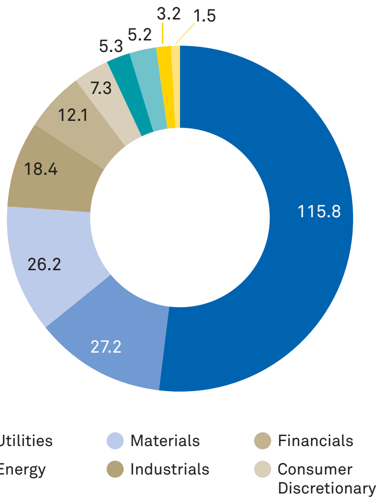
For this reason, the investment team at Mellon Capital prefers to focus on carbon emissions. "It is these that are raising temperatures, creating air pollution and damaging fragile ecosystems today," says Lejonvarn.

Cause for concern

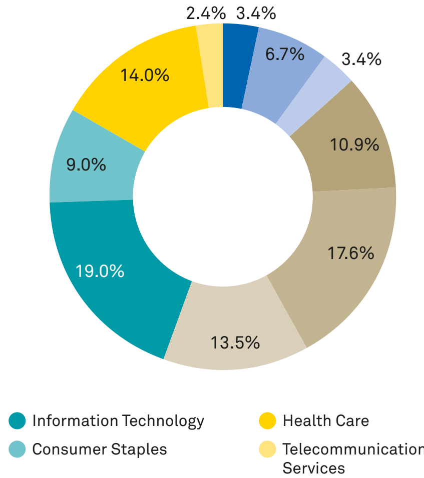
According to research by NASA's Goddard Institute for Space Studies, March 2016 set a new record temperature for that time of year: the global temperature was 1.34 °C (2.30 °F) warmer than the average month for March from 1951 to

CARBON INTENSITY[1] AND RUSSELL 3000® INDEX WEIGHT AS OF APRIL 30, 2016

EMISSIONS EXPOSURE: CARBON INTENSITY



ECONOMIC EXPOSURE: INDEX WEIGHT



Utilities
Energy
Materials
Industrials
Financials
Consumer Discretionary
Information Technology
Consumer Staples
Health Care
Telecommunication Services

1 Carbon Intensity represents the greenhouse gas emissions normalized by revenue.
Source: Mellon Capital and MSCI ESG Research

1980, which is used as a baseline. This was the sixth consecutive month the earth has seen record-setting heat.[2]

"The greenhouse gases emitted today will stay in the atmosphere for many decades to come. Almost every company emits greenhouse gases and contributes to global warming to some extent but as we invest we have a choice to make regarding the companies we invest in and how much capital we allocate to them. That choice can have an environmental impact if we support those companies that make the world greener," says Lejonvarn.

He believes divestment imposes investment risk in terms of increased volatility. To illustrate the point he uses the Russell 3000 Index and, using the energy sector as a proxy for fossil fuels, a customised Russell 3000 ex Energy Index.

The ex-post tracking error of this Russell 3000 ex Energy Index against its parent Russell 3000 Index from 1997 to 2014 is 1.59% per annum (the ex-ante tracking error is 1.20%). While the divestment approach might look smart in light of the recent plunge in oil prices, the same approach would have struggled to gain adherents during the strong energy run-up from 2004 to 2007, during which the Russell 3000 ex Energy Index would have returned 36.10%, compared to the Russell 3000 return of 44.54%.

"Considerations of investment performance aside, those divesting their holdings in fossil fuel companies lose their voice of influence over those companies. There is also risk that the holdings, and with them the voice of influence on climate change issues, pass to other investors that are less concerned with such issues.

"This motivates us to engage with companies that produce and use fossil fuels to adopt more environmentally friendly corporate policies in order to improve their carbon footprint. In addition, we think energy companies happen to be a convenient target, while many companies in the other sectors — predominantly utilities, materials, and industrials — make profits while ignoring or dismissing global warming" Lejonvarn adds.

Fighting global warming is a long journey, from reducing carbon emissions in the near term to building a more environmentally friendly energy infrastructure globally. At Mellon Capital the team believes divestment to be a missed opportunity to influence changes and prefers to pursue engagement and active underweights as a better strategy.

2 NASA: '*2016 had hottest March on record*', 20 April 2016.

Green thinking: renewable energy investment

For good or for bad, ESG is often seen as synonymous with green investing but when it comes to investing in renewables there can be greater attributes than the purely moralistic arguments commonly put forward by the pro-green community; not least an exposure to potentially attractive returns.

In an investment environment characterised by low yields, investors are casting the net wider in search of real returns. Exposure to renewable energy projects can deliver just that. In addition, investments in renewables can offer a degree of diversification from traditional asset classes particularly given the longer timelines and inflation-linked characteristics of many projects.

The renewables share of the energy market in the European Union almost doubled in the decade to 2014 – from 8.5% in 2004 to 16% in 2014, according to Eurostat. But the commitment to and proliferation of renewable energy varies widely between countries, so investors would do well to keep respective subsidies and incentives programmes in mind, as these can change with successive governments.

The Real Return team at Newton Investment Management deems UK renewables to offer a potentially attractive return profile. This is because a significant proportion of revenues are guaranteed by government subsidies and this produces a stable cash flow profile. Additionally, under the current regime, Renewable Obligation Certificates guarantee a certain level of subsidy for 20 years from the point a facility is connected to the grid.

However, the team cautions that the nature and specifics of individual investments within the sector can vary widely and can make it hard to make accurate direct comparisons across specific projects. For this reason they believe it is important for investors to be mindful of their investment horizon and risk tolerance especially when the relative youth of the market is taken into account. For the Real Return team this means assessing the liquidity of any potential renewable investment because, in fitting with its approach as a whole, the focus is on knowing what the team owns and why.

About BNY Mellon

BNY Mellon's multi-boutique model encompasses the skills of 13 specialised investment managers. Each is solely focused on investment management and each has its own unique investment philosophy and process.

The Boston Company is a global investment management firm providing a broad range of active, fundamental research driven equity strategies, including both traditional long-only portfolios and alternative investments.

Founded in 1987, CenterSquare Investment Management (formerly Urdang) is an investor in, and manager of public, private, global and US-only real estate investment strategies. It is the real estate investment subsidiary of BNY Mellon.

Insight is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.

Mellon Capital Management Corporation offers investment capabilities ranging from indexing to alternatives with the infrastructure and skill to transact in all liquid asset classes and securities.

Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies.

Siguler Guff & Company is a multi-strategy, private equity investment firm which, together with its affiliates, has over US$10bn of assets under management. Its clients include corporate and public employee benefit plans, endowments, foundations, government agencies, financial institutions, family offices and high net worth individuals.

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