Investing in a dynamic environment
Is risk profiling the answer?

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Amid the current market uncertainty, a key challenge facing investors is how to protect their existing wealth while simultaneously taking advantage of the investment opportunities available.

It is well known that risk and return go hand in hand. Without risk, good returns are not feasible. However, clever diversification can reduce the risks without sacrificing the returns.

The concept of diversification goes back to 18th century English as indicated in the phrase, *"Don't put all your eggs in one basket"*. It is possible to trace diversification even further back in time, to the Jewish Talmud, over two thousand years ago: *"Let every man divide his money into three parts; invest a third in land, a third in business and let him have a third in reserve."* According to economics Nobel-prize winner Harry Markowitz, diversification is the only free lunch available on Wall Street.

Many modern studies have shown that the correct asset allocation (i.e. investing your money into equities, bonds, real estate, commodities or cash) almost exclusively determines both the risk of your portfolio and the final return. The impact of market-timing and security selection on long-term risks and returns is negligible.

What is the correct asset allocation method?

This differs according to the investor's personal circumstances, the goals being set, the time horizon and the attitude towards risk taken. Banks and asset managers spend considerable amounts of time determining each client's personal risk profile and subsequently set certain diversification rules over the various asset classes.

However, is this enough in the current dynamic investment environment, where assets regarded as safe (for example, German 10-year bonds) are only delivering a 1.15% yield per year, and when bonds in general do not provide enough of a return to cover the current annual inflation rate of 2.2%? And what if the economic circumstances change, Europe begins to recover from its recession and inflation goes up again? Should we still invest in bonds?

There is a strong belief that if economic circumstances change, asset allocation should be changed accordingly. As the famous British economist John Maynard Keynes said, *"When facts change, I change my mind. What do you do Sir?"*

As a result, an in-house Investment Clock was developed to measure the growth and price developments on the markets, determining in which phase of the economy we stand. A typical economic cycle consists of four main phases, usually moving in a fixed consecutive order, like a clock.

They are as follows:

Recession (the phase Europe is currently experiencing): a business cycle contraction with a general slowdown in economic activity. Inflation and growth decline. Bonds benefit from the decline in interest rates and become the preferred asset class.

Recovery (the U.S. and Emerging Markets are currently in this phase): economic growth rises and productivity and corporate profits increase. Excess capacity in companies has not been eliminated; inflation remains low. Equities are the best investment.

Overheating: aggregate demand is increasing so fast that it cannot be met by the economy's productive capacity and is thus liable to fuel inflation. Commodities do well in this environment.

Slowdown: an inflationary period accompanied by rising unemployment, lack of growth in consumer demand and business activity. The best investment here is a combination of bonds and cash.

The indicators used to determine where we are in the above cycle relate to the economic activity seen over previous periods in addition to expectations for future production, new orders, inventories, employment and factory deliveries.

The Investment Clock strategy significantly improves the risk-return profile of a typical balanced portfolio, as it is possible to deliver returns under all market conditions. A further benefit is that this system is 100% rules-based and is naturally easy to understand.

Besides changes in economic circumstances, 'swings in sentiment' are important to the overall risk and return of a portfolio. History shows that assets can experience sustained periods of underperformance relative to one another, due to the 'fear and greed' drifts in markets.

Relative Rotation Graphs

Relative Rotation Graphs (RRG) constitute a unique tool for visualising the relative strength of mood swings on the market. This tool is available on Bloomberg professional terminals and will soon be released on Thomson Reuters EIKON systems. Since its release in January 2011, the functionality has been used daily by 3,000 to 5,000 users. RRGs are used to visualise the relative strength of all elements in a universe vis-à-vis a benchmark. The example below shows the RRG of the ten economic equity sectors in the U.S. Rotation generally takes place in a clockwise direction, with the top right quadrant showing the leading sectors. The technology can be applied to all asset classes but also at an asset class level. This type of visualisation gives market professionals the big picture, in one picture and enables them to keep an eye on what is going on across their universe.

Figure 1: Interest rate

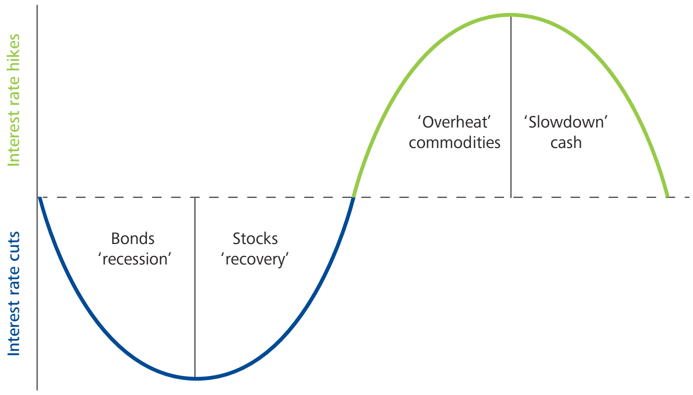
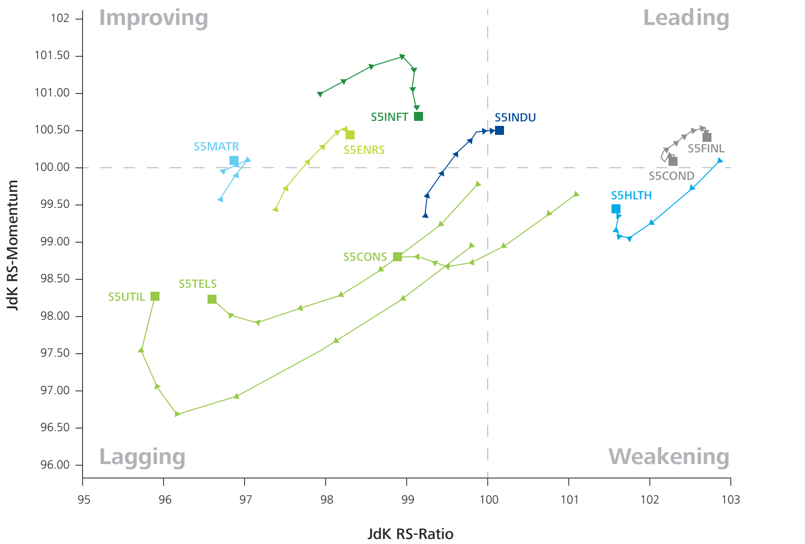


Figure 2: Example of a Relative Rotation Graph (Index SPXL1 on the 31/07/2013)



Ten group constituents

- S5FINL: S&P 500 FINANCIALS INDEX
- S5COND: S&P 500 CONS DISCRET IDX
- S5HLTH: S&P 500 HEALTH CARE IDX
- S5INDU: S&P 500 INDUSTRIALS IDX
- S5MATR: S&P 500 MATERIALS INDEX
- S5CONS: S&P 500 CONS STAPLES IDX
- S5TELS: S&P 500 TELECOM SERV IDX
- S5UTIL: S&P 500 UTILITIES INDEX
- S5INFT: S&P 500 INFO TECH INDEX
- S5ENRS: S&P 500 ENERGY INDEX

Last but not least is the Equity Risk Premium (ERP), a valuable tool for analysing the relative value between stocks and bonds. The Equity Risk Premium can be calculated by adding the real earnings growth rate of the equity market to the dividend yield, giving you the expected real return of equities. If you subtract the real interest rate (the nominal interest rate minus inflation) from this figure, you end up with the implied Equity Risk Premium, which is normally between 0 and 6%.

When the ERP reaches the upper/lower levels of its historical range, it provides a powerful signal as to which asset class (bonds or equities) do better against each other. The ERP is currently towards the upper end of its range, suggesting investors should be overweight in equities versus bonds.

The traditional static approaches of risk profiling and market implementation between asset classes are becoming increasingly outdated. The main issue with traditional approaches is that they tend to be backward-looking and as such, could potentially increase investors' exposure to potential market bubbles, e.g. historically safe assets such as sovereign bonds.

Figure 3: Today's equity premium has reached a historic high

Percentage annualised

Sources: Authors' calculations; Barclays; Deutsche Bank; Duke/CFO Business Outlook survey; Federal Reserve Board; Federal Reserve Bank of New York; Goldman Sachs; J.P. Morgan; Nomura; the Center for Research in Security Prices; Federal Reserve Economic Data; Thomson Reuters; the websites of NYU's Aswath Damodaran; Dartmouth's Kenneth French, University of Lausanne's Amit Goyal, University of California at Berkeley's Martin Lettau, Yale's Robert Shiller.

Relative Rotation Graphs (RRGs) are used to visualise the relative strength of all elements in a universe *vis-à-vis* a benchmark

We therefore advise using the three asset class tools mentioned above:

1) Investment Clock—for determining where we are in the economic cycle
2) Relative Rotation Graphs—for pinpointing market sentiment
3) Equity Risk Premium—for calculating valuations

This approach significantly outperforms an equally weighted portfolio. It also gives investors peace of mind, knowing that that the portfolio composition is changing seamlessly according to market circumstances.

To the **point**:

- Correct asset allocation is the key driver of investment risks and returns
- Historically safe assets such as government bonds could actually be risky
- It is very important to have a dynamic approach towards spreading wealth
- The winners are investors who use proven rules for protection and guidance through market movements