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Time to get more active

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For years many of us believed that a carefully constructed asset mix should be meddled with as little as possible. The long-run trend return on each asset class might be interrupted by periods of abnormal returns and occasional losses, but the trend should be powerful enough to allow the patient investor to ride them out.

This philosophy has been good in the past and may well be robust in the future; but, just as a coin tossed twice can come down heads both times, a “once in a lifetime” economic crisis can happen more than once. Equally, asset classes that we have historically relied upon to drive long-term portfolio growth can suddenly deliver only disappointment.

The classic “buy and hold” approach we grew up with was predicated on the fact that most investors had a large core holding in equities and these, as we were always told, delivered among the best long-term returns. Volatile at times, yes, but if you had an investment time horizon of seven years or more then equities were for you.

There is a temptation and eagerness on behalf of investment managers to dismiss 2008 as an aberration so impossible to predict and ugly in its scale that it can only be compared with the depression of the 1930s, but the uncomfortable truth is that a similarly disappointing period for equity returns happened as recently as 2000–2002.

There are now five periods of longer than 10 years during the past century when equities have delivered no return at all. Looking ahead, how many of us can say we expect the next decade to be much different?

Looking at 2010, our feeling is that signs will emerge that the scale of leverage and indebtedness within the global economy cannot simply be eliminated through a couple of quarters of decent growth. Conceptually, it is difficult to reconcile how problems fundamentally created by too much spending and too much debt can be satisfactorily addressed by more debt and more spending, albeit at the government rather than the private level.

This will create a much more challenging environment as it becomes apparent that the global economy is likely to settle into a protracted period of more restrained growth. Equity markets can continue to rally into this period, of course, but growth – at least in the developed world – should surely be somewhat subdued.

In this scenario “buy and hold” threatens to become “buy and hope”. Market conditions have evolved and will continue to evolve in a way that makes holding broadly the same portfolio for the long term both laughable and plainly wrong. As Lord Keynes remarked: “When the facts change I change my opinion.” Similarly, we should change our portfolios significantly as conditions dictate. We should no longer be measured against the performance of equity indices but against the realistic expectations of clients for us to deliver absolute returns.

Asset allocation must become more active, however uncomfortable that may be for practitioners unwilling to expose themselves to error.



There has always been a role for active management. By looking at the performance of various asset classes over the past 10 years, it is clear asset classes do not perform consistently.

No asset class has been the top performer for two consecutive years. Each has had a spell when it was one of the poorest performers – often hard on the back of a successful year. So, for instance, Emerging Markets equities delivered the best returns in 2007 (39.8%). The following year they delivered the poorest returns (-53.2%).

This is a clear illustration of the opportunities that dynamic asset allocation can deliver in reducing risk and enhancing returns.

Of course, when constructing a portfolio we should always pay serious attention to the clear long-term trends: the rise of China and other Emerging Markets; the supply squeeze on commodities that will drive returns in the long term; and themes like climate change, which will inevitably shape the long-term investment horizon. This is strategic asset allocation.

But the events of 2008 are a stark warning that we now need to be more dynamic with our clients'

strategic framework of assets – exploiting the short-term opportunities presented by issues like the business cycle, market-implied expectations, sentiment and fund flows.

Strategic asset allocation can be more straightforward once our clients' investment objectives are determined; however, tactical asset allocation remains extremely difficult, especially for the individual investor.

Once decisions are made to change portfolios you need the resources to act on the outcomes quickly and to move decisively if and when markets or conditions change again. (Fortunately, being more active need no longer be expensive. By using vehicles like exchange traded funds and exchange traded commodities and using institutional classes of mutual funds, it is possible to deliver market-responsive investment management cost-effectively.)

But to be consistently successful you need a huge amount of data and analytical expertise. And even then it is impossible to get every call right. "Buy and hold" may be discredited; Diversification is not. A sensible spread of assets is still key. And wealth managers must add to this the use of insurance, which can come in different guises: gold,

inflation-protected bonds, derivatives or the use of simple put options, for instance.

By building portfolios with three layers – a core of highly defensive, liquid assets, a satellite layer of investment opportunities thrown up by dislocation in markets and a final layer of investments offering insurance against unpleasant surprises – you may not always capture every upside opportunity but will have more than a hope of meeting the core requirement of most clients: to preserve capital.

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