

## » *The Multi-Asset Renaissance*



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A lengthy bull market for equities means multi-asset funds have garnered little attention in recent memory. After a challenging few years, the multi-asset concept is once again emerging as an appealing investment strategy, particularly where it incorporates convex asset classes.

### Liquidity and diversification

When Goethe's Sorcerer's Apprentice bids his broom to "*Swirl and churn*", it immediately begins gathering water incessantly. Central bank policy has been helping itself to extra liquidity in a similar way, with these efforts reaching their high water mark during the coronavirus crisis. Interest rates fell, central bank balance sheets expanded and "new brooms" such as helicopter money came into play. This resulted in markets' overconfidence and a steep rise in the popularity of passive investments.

By the end of 2019, there was already talk of a late-cycle expansion. Before long, however, the coronavirus crisis kick-started money creation – and with it the economic cycle. The picture painted by low interest rates helped push equity valuations back to historic highs, which investors had become accustomed to over the years.

These developments confined diversified multi-asset investments – the gold standard since Markowitz – to the sidelines. In addition, the results of combining various asset classes that would ordinarily show no correlation to each other disappointed investors in early 2022. It almost seemed as though the diversification effects of traditional asset classes, including multi-asset funds, would no longer function.

### Inflation as a consequence, not a cause

The supply and demand of goods and services has been thrown out of balance during the normalisation phase following the pandemic. Rising prices were the resulting symptom, too much liquidity chasing too few goods and services, the cause.

Geopolitical events and energy policy dependency did not help matters. Inflation surged – and the Sorcerer's Apprentice lamented:

*'Tis a chancy magic wherein I'm caught!  
The spirits whom I've careless raised,  
Are spellbound to my power not.*

Against a background of persistent uncertainty and a combination of higher interest rates and bond yields with inflation set to fall in the medium term, an environment is emerging in which diversification should once again pay off.

It has since become clear that although central banks do not want to raise interest rates, they have no choice but to do so. After years of wishing for it (albeit to a less dramatic extent), we are now facing a period of fierce inflation. While this was initially dismissed as “transitory”, with aggressive rhetoric used to buy time, interest rate hikes are now the order of the day.

### **Is diversification dead?**

When liquidity is taken out of the market, all asset classes are already, and inherently, overbought. For this reason, multi-asset investments lose their inherent diversification characteristics – at least in the short term.

What we saw in recent months was a “liquidation trade” of multi-asset portfolios, but they are now back in a strong position. Diversification is starting to work once again.

### **The multi-asset renaissance**

Higher interest rates mean higher returns and greater potential for diversifying safe-haven investments, as interest rates have the potential to fall again during times of crisis. If yields, as measured by prevailing economic growth and inflation expectations, were far too low a few months ago, they have since returned to a “fair” level.

Ultimately, the current market phase of high inflation and rising interest rates will come to an end, giving way to a period of still high, yet slowly declining, inflation. This means that the sectors that have suffered most over the last two years could be the winners of tomorrow.

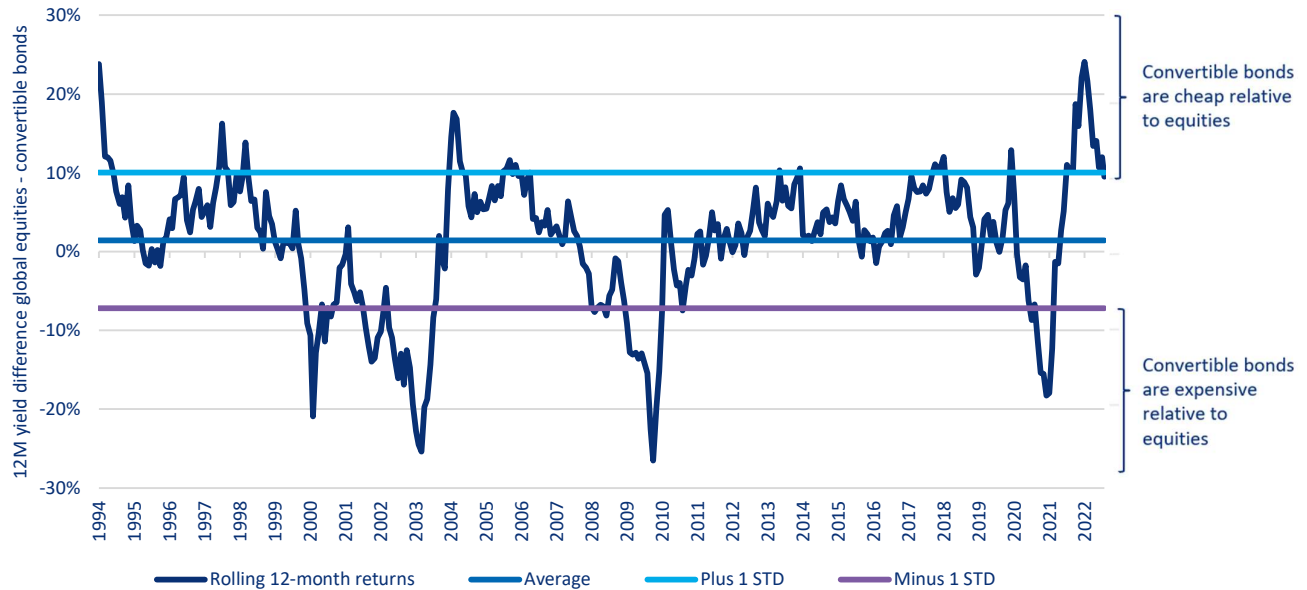
So, is it worth starting to invest in multi-asset funds? With the prospect of falling inflation that will in turn create more leeway for the economy and central banks, bonds are starting to become more attractive and compelling opportunities are beginning to materialise. At the same time, as the macroeconomic outlook is beset with uncertainty, diversification is becoming interesting once more. This is particularly the case for a multi-asset approach incorporating instruments with convexity, such as convertible bonds.

Convertible bonds offer the additional advantage of innovative small and mid-cap companies in particular which can be found in this investment universe. Valuations for such companies have fallen considerably over the last two years which means that convertible bonds not only offer absolute upside potential, but also offer the potential to generate relative upside compared to equities. This is evident from the chart below, which shows that the difference between 12-month equity returns minus 12-month convertible bond returns is around one standard deviation above the historical mean. This indicates that convertible bonds are relatively cheap compared to equities, based on past returns.

## Market commentary

7 September 2022

## Convertible bonds are looking cheap



Source: Bloomberg, Refinitiv

In our view, three components need to come together for a multi-asset approach to be successful: Firstly, a stable strategic asset allocation that guarantees the basis for harvesting risk premiums in the long term as part of a well-balanced portfolio. Secondly, active management that navigates future inflation and economic cycles successfully. Thirdly, the inclusion of convexity into the portfolio structure, as investors will have to deal with more frequent market turbulence and crises in the post-pandemic era.

Thus, a backdrop of persistent uncertainty and a combination of higher interest rates and bond yields, with inflation set to fall again in the medium term, is creating an environment in which diversification should pay off. Sectors that were heavily punished over the last two years are exhibiting particularly strong catch-up potential. Multi-asset funds have become more attractive again.

*To your corner in the hall,  
Broom, broom! A slave no more!  
Begone, ye torrents forevermore.  
Thou ghostly power, thou spirit holy,  
Thou answerest only sacred call  
Of thy old Master, first and only.*

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