

Alternative thinking: asset allocation for the next phase

Financial markets can often be the best leading indicators of economic cycles. Right now they seem to be pointing to a sluggish global growth picture, except in the US where the engine motors on. Growth expectations are subdued across most of the world, a reaction to the anti-trade rhetoric from the White House and monetary tightening efforts from the Federal Reserve. This combination has put downward pressure on emerging market assets while boosting the US dollar. Hence, risk appetite, outside of US equities, has been somewhat hamstrung for most of this year and a large swathe of the traditional return drivers have either been treading water or been outright weak.

Episodes like this illustrate the importance of finding alternative sources of return within multi-asset portfolios. This has been a focus of attention for us over recent years. After all, if traditional equity market volatility starts to rise as the cycle evolves, then traditional asset classes may struggle.

Finding alternative sources of return . . .

One example of this is our position in **energy and industrial metals**, which can be driven by market-specific supply/demand factors and help to provide an inflation hedge (although lately metals have behaved similarly to emerging markets). **Commercial property** would also fit into this category of alternative return drivers, yet our enthusiasm is capped by valuations and exposure to rising yields.

However, we have been investing in other real assets such as **infrastructure and social housing**, where the drivers are a lot more idiosyncratic and uncorrelated to the broader business cycle. We have also added what we describe as 'volatility winners', in the form of **hedge funds** designed to swiftly change positioning as market trends change direction and potentially benefit as market volatility rises. These types of systematic trading strategies can offer something different to the path of public asset markets and so are playing an important role in our portfolios.

. . .and different protection strategies

As is the case with return drivers, we also believe it is important to have a mix of different protection strategies in portfolios – no two market cycles are ever the same and assets that may have offered diversification during stress periods in the past may not do so in the future. Government bonds have traditionally been the 'diversifiers-in-chief' but today they have a major issue – valuations are expensive. With many major bond yields already very low – partly as a result of years of global central bank easing – how much real protection can bonds provide during the next crisis? Cash is another traditional way in which we protect portfolios. It's not an all-weather diversifier as it won't help when inflation is rising, but cash is king when investors are in de-risking mode and liquidity is drying up. Holding cash is also an important source of dry powder when things improve and opportunities present themselves.

Gold is another useful alternative asset and our gold holdings should prove beneficial if another financial crisis develops or geopolitical shock occurs. We are, however, always seeking other ways we can mitigate against recession risk or 'black swan' events. Lately, we have been investigating and have now introduced, some '**left-tail**' protection strategies to help offset the potential sharp falls in riskier asset classes. Though no return is truly guaranteed, these strategies (built via options and other derivatives) offer payoffs in the event of extreme market moves but come at a cost to portfolios during benign periods – much like insurance policies. We have thought carefully about balancing their cost during those benign periods with their potential payoff during extreme downturns. On the basis that these left-tail protection strategies improve convexity in portfolios (i.e. their return expectations accelerate as the size of the market move increases), we believe they have a role to play across our strategies.



Contact

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To summarise, we constantly try to find the right mix of return drivers and diversifiers for whatever set of macroeconomic and market conditions are prevalent at the time. Given the bull run in most equities over the past seven years, plus low levels of bond yields, we have been working hard to find alternative return drivers and diversifiers.

Commodities, infrastructure, volatility winners and tail risk protection strategies are all now being deployed to improve the investment journey for our clients and to maximise the probability of hitting our return objectives.

Graham Bishop
Investment Director

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Registered Head Office: No.1 Kingsway, London, WC2B 6AN | Registered in England Number: 4132340
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