

**CIO
Viewpoint**

**Managing
a late-cycle
multi-asset
portfolio**

Investment Solutions

26 September 2018

Central bank policies since the 2008 financial crisis have fuelled the longest bull run in history and created the conditions for an era of stable economic growth. Interest rates were kept low and quantitative easing (QE) ensured a flow of money into the system. That gave us reassuringly steady investment returns, while debt-to-GDP ratios rose across the world.

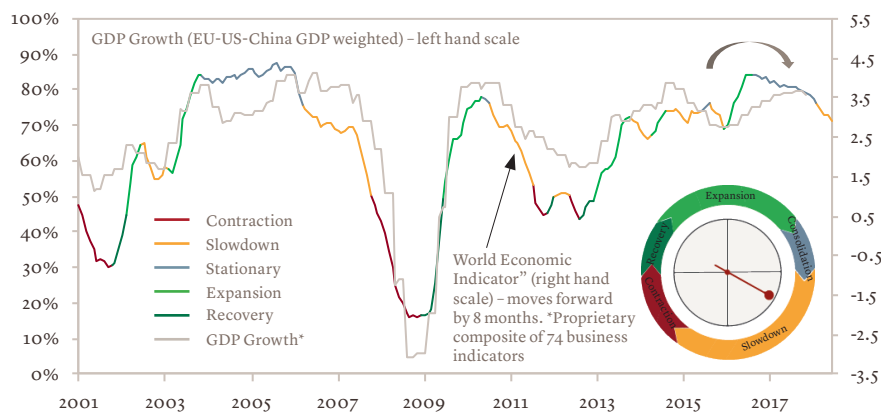
We have known for some time that the era of easy liquidity was coming to an end, but there is now clear evidence that the challenges of late-cycle dynamics are upon us. Of course, the end of the economic cycle can offer months and even years of robust returns, but it demands careful management of risk, and in particular, liquidity risk. Wealth managers now need to protect their clients' assets by deploying consistent, prudent and reinforced management of portfolio risks.

We have developed the LO World Economic Index, a proprietary model which helps assess the state of the global economy and detect shifts in conditions. This quantitative tool incorporates 74 major economic metrics for the US, European and Chinese economy, including data on housing, consumption, production, employment, investment, credit conditions and external demand, among others. It currently signals a slowdown in early 2019, which corresponds to late-cycle conditions, as illustrated in chart 1.



Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Chart 1. Our LO World Economic Index is currently signalling a slowdown regime



Source: Bloomberg, DataStream, Lombard Odier calculations

Important information: Please read the important information at the end of the document.

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‘Non, rien de rien, je ne regrette rien’

Let’s turn now to managing portfolio risk. Many investors want the very-nearly impossible: perfect market timing, perfectly executed in all environments. In reality, what they often need is to limit disappointments in a falling market, while maximising returns as markets pick up. That means the investor has to balance risk in the portfolio by moving in, and out, of cash.

A useful way of thinking about risk is the concept of regret. The Nobel-prize-winning economist Harry Markowitz (rather than Edith Piaf) can help here. Markowitz defined two types of investment regret in the 1950s when he was working on portfolio theory. “I visualised my grief if the stock market went way up and I wasn’t in it or if it went way down and I was completely in it,” Markowitz said. “My intention was to minimise my future regret.” The first type of grief describes relative regret, or the disappointment of missing a rising market, while absolute regret describes the pain of being fully invested in a bear market.

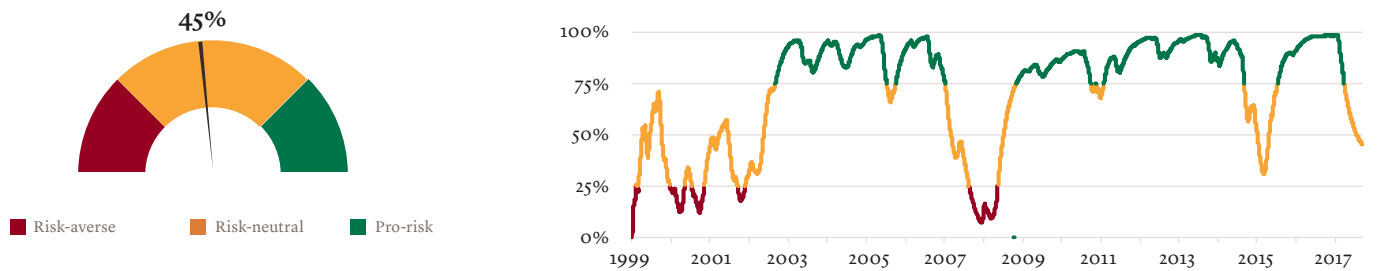
Incidentally, Markowitz’s solution for minimising his regret - simply splitting his portfolio 50:50 between stocks and bonds - is not one we are advocating at this stage of the market cycle.

Our risk management tool does, however, contain echoes of Markowitz’s regret theory and aims to provide reduction signals for our portfolios. The model uses quantitative strategies to build a picture of how much should be held in an asset allocation strategy, with the rest being invested in cash. This model is particularly useful during broad-based crises such as the technology downturn of 2001/02 or the 2008 global financial crisis.

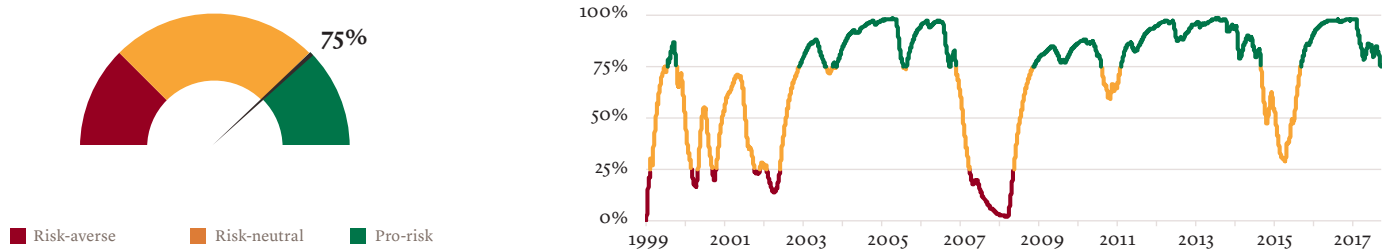
Over the year to date, markets have been volatile and performance muted in our balanced profiles. Overall, despite the wide range of signals, our ‘regret’ model advocates a reduction in risk. In particular, the model strongly suggests reducing risk in the US where short-term rates are positive, while remaining invested in markets with negative short-term rates – the Swiss franc (CHF) and euro (EUR) for example. In the US dollar (USD), cash is an alternative for investors looking to see a reward for safety. This isn’t the case for the CHF and EUR and it will probably not be the case in the near future.

Chart 2. Quantitative metrics help to steer portfolio exposure: invested assets vs cash

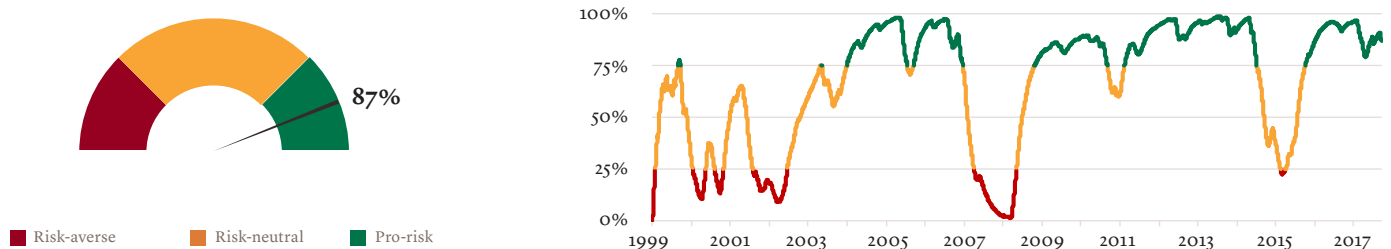
Recommended level of invested assets vs cash, USD balanced portfolio



Recommended level of invested assets vs cash, CHF balanced portfolio



Recommended level of invested assets vs cash, EUR balanced portfolio



Source: Bloomberg, DataStream, Lombard Odier calculations, as of 18 September 2018

Managing liquidity in late-cycle conditions

Once we have allowed our ‘regret’ model to inform our thinking, we then use analysis from our cross-asset strategists and investment specialists to draw in other key elements such as specific market dislocations or liquidity risks. The global financial crisis offered many lessons, but crucial for wealth managers was the need to hold assets which could easily be sold at times of stress. Last year, we adapted our strategic asset allocation and reviewed our process based on the most advanced academic work on the topic: factor-based investing. Within this framework, liquidity represents one of the five main risk premia that drive returns in a multi-asset portfolio.

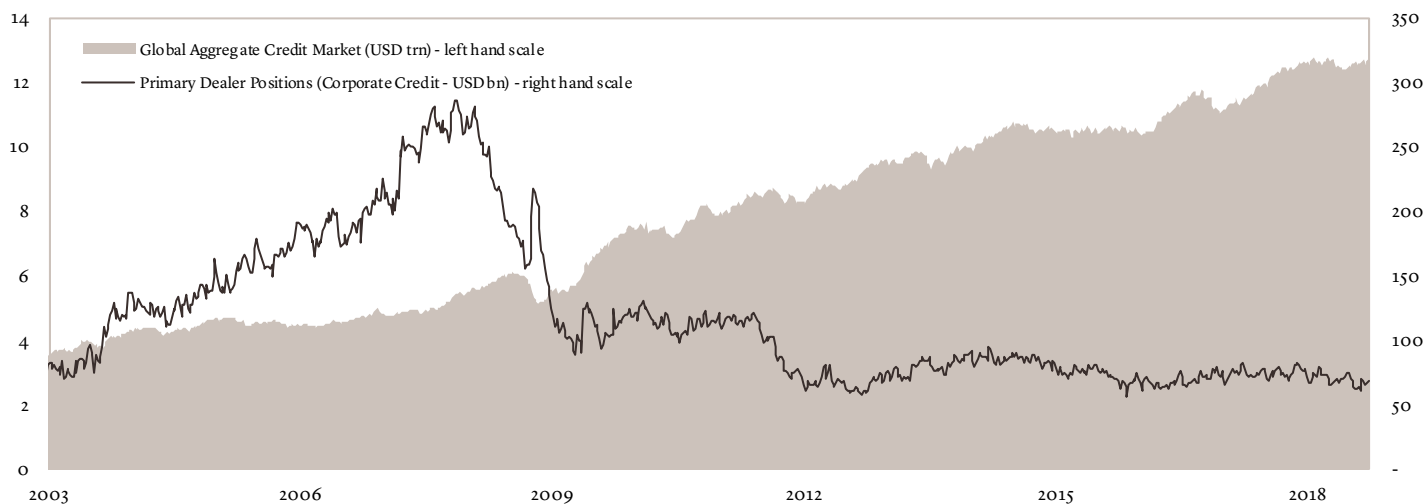
The “liquidity premium” is generally a payment for holding an asset that might be difficult to sell, among other considerations. As part of an investment strategy, it is most suited to investors who are able to commit to a long-term investment horizon – and be rewarded accordingly. This premium is reflected in the price of assets which are locked contractually (private equity, real estate, etc.) and assets that experience liquidity squeezes during periods of market stress (typically, high-yield bonds). Our estimate of the average liquidity premium on such assets over the last 30 years is around 4.7%, but we expect this to fall towards 3% over the next decade¹. That will be a function of more investors seeking exposure to liquidity premia as they hunt for returns in an era of more limited opportunity.

So, you might well be paid for taking on the additional risk, but in the latter stages of the economic cycle, the dangers of illiquidity should not be underestimated. No one wants to end up a forced seller and realise losses when an eventual contraction comes. It’s helpful to think of liquidity as a function of quality. When a portfolio holds quality positions, investors hold the key to escaping the trap because they are able to sell them under any market conditions.

Liquidity has notably affected fixed income markets. Chart 3 below shows that bank inventories of corporate bonds have been declining and that the net dealer positions (long minus short positions) collapsed over the last decade while the size of the global credit market has increased. The global financial crisis of 2008 has fundamentally changed the nature and liquidity of fixed income with large banks holding less corporate bonds on their balance sheets. In addition, regulatory evolutions, such as the adoption of the Dodd-Frank Act in 2010 in the US, and increased capital requirements have raised the costs of market-making.

Some argue that bond liquidity is solid because volumes are up and bid-ask spreads generally tight, but dealers are undoubtedly buying fewer corporate bonds for their own accounts and in so doing, they are providing less liquidity today. Even if credit market liquidity has probably moved from the dealer to the non-dealer sector since the global financial crisis, investors should not underestimate the role of dealers in the financial system. As a result, we believe that the appropriate investment strategy is to reduce exposure to the least liquid public assets to avoid late-cycle transaction frictions. Asset classes such as emerging market or high-yield debt can suffer from factors such as wide bid-ask spreads and limited market volumes in times of market stress.

Chart 3. Primary dealer positions versus credit market size



Source: Bloomberg (Barclays indices), Federal Reserve Bank of New York, Lombard Odier calculations. Primary dealer positions data adjusted for the period between 2013 and 21 September 2018 due to changes in methodology (Lombard Odier calculations).

Finally, although they harbour risks, private assets such as private equity or real estate can offer a way of investing in a late-cycle economy if they are in line with investors’ investment horizon and long-term liquidity requirements. The key here is to select appropriate investments and diversification because the range of returns is so wide. One advantage of private equity is that managers should be able to deploy capital to take advantage of attractively-priced assets during the anticipated downturn (including the liquidity premium discussed above). At Lombard Odier, we have a dedicated team with a proven track record that selects the best managers in this sphere to deliver optimal allocation for our private clients.

¹ Measured in USD

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