Challenges and Changes in Asset Management

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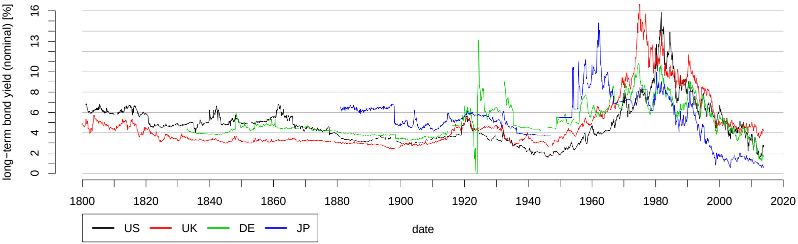
THE Challenge in Asset Management:
Low Bond Yields Likely for Years to Come



Source: GlobalFinancialData

- **Institutional Investors:** Big challenge to **earn required returns** at reasonable levels of risk.
- Must **rethink asset allocation**; new asset classes and new allocation strategies

THE Trend: Pure **Risk-Balancing** Strategies

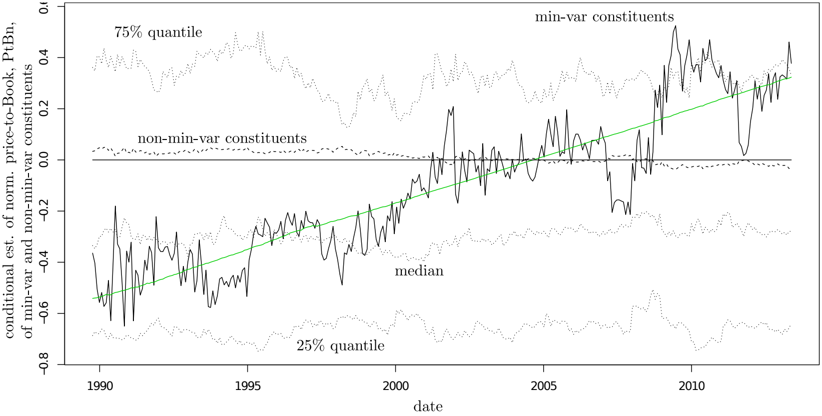
- **"Risk Parity"**, **"Minimum Variance"**, **"Low Volatility"** – strategies that focus entirely on **balancing risk contributions** attracted **enormous attention** / from practitioners as well as from academics
  - **Forecast-free**
  - Works **within** and **across asset classes**
  - Delivered **superior** (risk adjusted) **returns**
  - In **recent years: Outperformed** even **non-risk-adjusted**
  - We saw **huge inflows** in **strategies and ETFs** etc.
- A lot of **academic input** dedicated to practitioners
  - E.g., **Journal of Portfolio Management**: In 2013, **10 out of 44 articles** published deal with pure risk-balancing portfolio approaches

Is Pure **Risk-Balancing** the **Answer to** the Challenges in a **Low-Interest Rate World?**

- **Yes**, to some extent:
  - **Robustness:**
    - Forecast-free: Better to use no return forecasts than bad forecasts!
    - Balancing risk contributions allows inclusion of riskier asset classes – makes portfolios robust against adverse scenarios
  - **Low-Beta effect, Low-Vola effect:** Attractive returns on top of all diversification benefits
- But there are **reasons to be cautious:**
  - Over the years, **low-vola assets** became **rather expensive?!**
  - Some of these concepts **lack a sound foundation in economic theory**
    - *You never start with a proposition like that–equalizing risk of assets in a portfolio–as the way to solve the portfolio problem. . . . A risk parity portfolio almost surely represents a* **suboptimal solution to the portfolio optimization problem**. (Eugene Fama, when asked about his opinion on risk parity in 2012)

Are **Low-Vola Assets Expensive?**

- **Valuation levels increased** over the years for stocks typically selected by min-var approaches (normalized price-to-book of S&P 500 min-var consituents)



Source: Dangl, Kashofer (2013)

How Can We Get **Return Expectations Back into the Equation?**

- Use **long-term historical averages?** Good starting point, but ...
- **Characteristics-based** asset allocation: **Value** and **Sentiment** as return predictors
- **Scenario-based optimization**. Find the right **balance** between **broad coverage** and **detailed modeling** of risk factors