Omba Advisory & Investments Limited

Multi-Asset Portfolios

10 Questions you should be asking

Many people around the world have multi-asset class portfolios. We think too many investors fail to ask the right questions to understand design, exposures, risks and fees. In this document we ask some of these questions and answer them too.

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Overview

Most investors know of, have heard of, or use multi-asset class portfolios which may be made up of bonds, equities, commodities and alternative assets (e.g. hedge funds, private equity, venture capital).

Coming up with the right ingredients for these asset classes and appropriate and suitable asset allocations is a debatable topic and from one firm to the next the soup might look and taste different.

The academic frameworks to design these portfolios tend to result in similar portfolios – increasing equity weight increases risk and potential return and increasing "safe-haven" government bonds reduces risk and potential return. Those in academia may argue the merits of home bias or against home bias. Both arguments are sound.

In this document we ask some important questions (the ones that investors should be asking their wealth and asset managers), we provide our thoughts about and answers to these questions.

Multi-Asset Portfolios – Key Questions

1. How much equity should your multi-asset portfolio have?

This depends on your investment objectives and risk profile, but within your relevant investment profile, our view is that there is no right or wrong answer to this. Knowing which multi-asset mix to choose - Conservative, Moderate or Aggressive is a function of many inputs and considerations.

We list some of these considerations below and suggest whether you should have more or less equity as a result. Again, this is not prescriptive but subjective. You can see the challenge in answering these definitively as right or wrong.

Attribute	Weight of Equity	Example of further consideration
Young	More	Risk averse, low earnings power.
Old	Less	Large balance sheet, risk seeking.
Significant concentration to one country	Less	Size of balance sheet, earnings power, risk propensity.
Significant concentration to one stock	Less	Size of balance sheet, earnings power.
Significant private equity or real estate assets (illiquidity)	Less	Size of balance sheet, earnings power.
High level of wealth and large balance sheet	More	Depends on risk propensity.
Complex family situation where cash may be required	Less	Depends on whether or not principal wishes to help family.
High earnings potential (for example good education)	More	Depends on risk propensity.
Significant concentration to one currency	Less	Size of balance sheet, earnings power, risk propensity.
Reside in a risky jurisdication	Less	Depends where the assets are held, size of balance sheet.
Imminent liquidity need	Less	Other cash balances.
Risk seeking personality	More	Size of balance sheet, earnings power, liquidity needs.
Good ability to tolerate loss and drawdown	More	Liquidity needs.
Easily panicked during market corrections	Less	Long term return requirements.
High level of uncorrelated assets	More	Asset correlation changes over time and current regime

Generally speaking, it does not make sense, particularly in a world with low (or negative) interest rates, to be paying investment managers fees to hold more cash or high quality government bonds for you (on a long term basis) and thus we don't recommend paying the same fees for conservative portfolios as you would for aggressive risk portfolios - unless the manager is significantly active enough during volatile market conditions to take more risk with cash or safe-haven bonds. Or, following a strong period of market returns, reducing your equity and overall risk appropriately.

At Omba we don't manage Conservative risk portfolios for this exact reason. We think it is wrong to charge clients the same fees for Conservative portfolios. We would rather our clients control their own cash and rather invest into our moderate or higher risk portfolios which provide much better value for money.

These portfolios have wide tolerance bands for equity (30% to 70%) such that we can be active when market opportunities present themselves. This gives investors a solution for their cash to invest into our moderate solution which considers the economic environment, valuation levels and opportunities resulting in an increase or decrease to equity for their portfolio compared to a static bond vs equity allocation like many traditional portfolios. If a portfolio is static (or within strict tolerance bands) we don't think the manager fees charged by many in the industry are justified. If the portfolio is static or within a tight band we think investors should consider some of single house multi-asset solutions like the Vanguard Lifestyle Strategies.

2. What is a home-bias and do I need one?

A home bias is when a portfolio's construct is primarily weighted to towards their home country. Although it is well-known in academia that optimal portfolios are constructed using international exposure in practice firms and investors often have a home bias. The reasons for this are extensive and include: (i) hedging domestic risk, (ii) implicit and explicit costs of foreign investments, (iii) information asymmetries, (iv) corporate governance and transparency, and (v) behavioural biases[1].

The benefits to global diversification are intuitive but also well founded in modern portfolio theory. As the world has become more integrated and globalised it has made the investible universe bigger and more complex. Exports as a percentage of global GDP has grown, foreign direct investment into emerging and frontier countries has grown and foreign sales as a percentage of total sales of major corporations have also grown. Accounting standards have improved and been adopted in many countries and central banks have begun targeting inflation and improving bond and currency stability. All this has created an ever-increasing opportunity set for investors. As discussed by the well-known index provider MSCI in a 2009 paper the global GDP weights of each country in their index had changed substantially at that point and was expected to change substantially[2]. A good example of this is China. Every year China becomes an increasingly more meaningful contributor to global GDP and its subsequently growing importance as a constituent of both equity and bond indices. See our publication here on this topic.

At Omba we build global equity portfolios that have no home bias. Our clients are global citizens and thus their equity allocation should be constructed from the world universe of investible options. Furthermore, given globalisation, from which perspective does one establish the "home" of the equity allocation when in fact their heirs might live and spend elsewhere.

We believe as pertains to equities a home bias does not make sense and investors should have global equity portfolios. We look at fixed income allocations differently, as matching base currency and home bias are *often best for Asset - Liability Matching or future expense matching. At times of market stress, Investment Grade fixed income needs to be liquid and more likely to be held shorter term (and potentially used for funding) and thus should match the "home" or "base" currency in the main.*

3. My portfolio is global – what global indices are being used to benchmark my performance?

You may have noticed that your bank or wealth manager is already using a blended benchmark to compare performance (sometimes a 50/50 or 70/30 mix of bonds and equity). Have you ever wondered why they chose those specific benchmarks? You may have already noticed the major index providers like MSCI and FTSE Russell have well-established benchmarks for assessing equities. There are well-known bond indices like the JPMorgan Global Aggregate Bond Index or the Bloomberg Barclays Global Aggregate Bond Index. In fact, there are 1000's of indices. See below for a short list of some of the ones we watch and which we have seen used by competitors.

USD - Equity benchmarks	CCY
FTSE Intl All-World Regional Indices - All World Local Currency Index	Local
FTSE Intl All-World Regional Indices - All World USD Index	USD
MSCI All Country World Net Index Local End of Day	Local
FTSE All-World Index	Local
MSCI ACWI 100% Hedged to USD	USD
MSCI All Country World Gross Index Local End of Day	Local
iShares MSCI ACWI UCITS ETF USD (Acc)	USD
MSCI All Country World Net Index USD End of Day	USD
MSCI World Net Index USD End of Day	USD
FTSE All World USD Index	USD
MSCI All Country World Gross Index USD End of Day	USD
MSCI World Gross Index USD End of Day	USD
MSCI World Gross Index USD End of Day	USD

GBP - Equity benchmarks	CCY
MSCI All Country World Net Index Local End of Day	Local
MSCI All Country World Gross Index Local End of Day	Local
MSCI World Net Index GBP End of Day	GBP
MSCI World Gross Index GBP End of Day	GBP
FTSE All-World Index GBP TR	GBP
FTSE All-World Index GBP PR	GBP
FTSE Intl All-World Regional Indices - All World Local Currency Index	Local

Note how many different benchmarks there are for Equities and Bonds provided by the same benchmark providers - how is your benchmark being chosen?

USD - Bond benchmarks	CCY
BBgBarc Global Aggregate TR USD	USD
BBgBarc US Agg Bond TR USD	USD
JPM GBI Global TR Hdg USD	USD
JPM GBI Global TR LCL	Local
JPM GBI Global TR USD	USD
JPM GBI Global Traded TR LCL	Local
JPM GBI Global Traded TR USD	USD
JPM GBI US Traded TR USD	USD
BBgBarc Global Aggregate TR USD	USD

GBP - Bond benchmarks	CCY
BBgBarc Sterling Agg TR GBP	GBP
JPM GBI Global TR Hdg GBP	GBP
JPM GBI Global TR LCL	Local
JPM GBI Global Traded TR GBP	GBP
JPM GBI Global Traded TR LCL	Local

4. What benchmark should be used?

Well that depends on the asset mix. If your manager has a significant home bias, or only used a home equity universe, then perhaps their benchmark for equity should reflect that. If they invest globally perhaps one of the above might meet good benchmark criteria. Depending on the bias or centricity of the firm you might see the equities or bonds being quite concentrated or overweight a particular country or currency. For example, a US firm might favour US equities, a Swiss firm might have more Swiss and (or) European exposure (e.g. Swiss banks) and a UK firm might have more FTSE 100 or FTSE 250 exposure and perhaps they should be using the FTSE All Share Index or FTSE 350 both of which would better represent UK shares.

In practice multi-asset managers often show vastly different benchmarks or blended benchmarks which might make their portfolio performance appear better. One should look out for change in benchmark use over the years.

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As discussed in CFA Institute material[3] a benchmark should have certain important characteristics:

- unambiguous,
- investable,
- measurable,
- appropriate,
- specified in advance

"We would, however, suggest over the long term (greater than 7 years) the most appropriate benchmark is inflation + a spread."

If the portfolio includes global equities and there is no mandated cap on deviation from the home bias, then a global benchmark is most appropriate.

We would, however, suggest over the long term (greater than 7 years) the most appropriate benchmark is inflation + a spread. The spread should take into account the level of risk inherent in your portfolio. Are you growing your assets above inflation over a market cycle? That is the ultimate goal. We want to ensure that our clients' assets are worth more in real terms in the future. Historically the best asset class to achieve above inflation returns is equity but often investors find the volatility hard to stomach. The addition of bonds to a portfolio can reduce this volatility and provide an important ballast which makes it more likely that the investor achieves their long-term goals. For our moderate portfolios we use inflation + 2% as the long-term benchmark.

The problem for both the client and the investment manager with inflation benchmarks is that inflation is often well-contained by central banks within a certain band (as per their mandate) and the "+ spread" amount is fixed thus the returns of an inflation benchmark are quite linear compared to a blended benchmark of equities and bonds (using some of the above benchmarks for example). The portfolio performance can differ wildly from the inflation benchmark depending on the period under consideration.

Thus, investors tend to then gravitate towards other shorter-term benchmarks too such as:

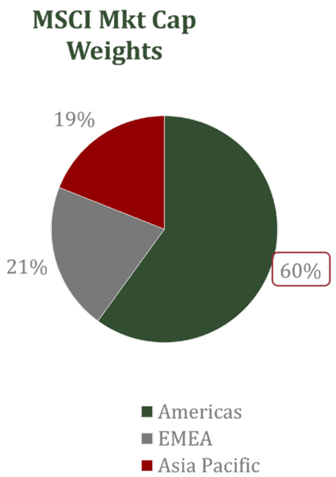
- a **blended benchmark** (like 50% bond and 50% equity) as discussed above; or
- a **peer group benchmark** like:
  - Morningstar Peer Group Benchmark
    https://www.morningstar.co.uk/uk/tools/categoryoverview.aspx?filterId=2&lang=en-GB
  - ARC Private Client Indices (PCI)
    https://www.assetrisk.com/research/performance-indices/private-client-indices/
  - STEP Managed Portfolio Indices (MPI)
    https://www.step.org/member-tools/managed-portfolio-indices-mpi

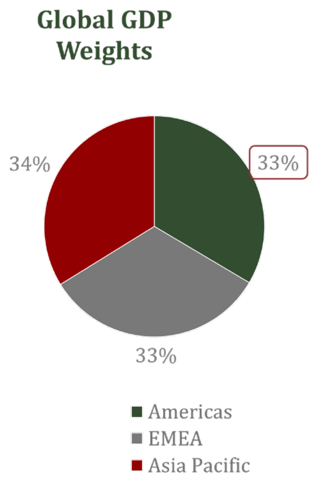
One problem to consider with peer group benchmarks is survivorship bias as firms which start to perform poorly, or which no longer exist, don't submit data thus the benchmark performance could appear better than would otherwise be the case.

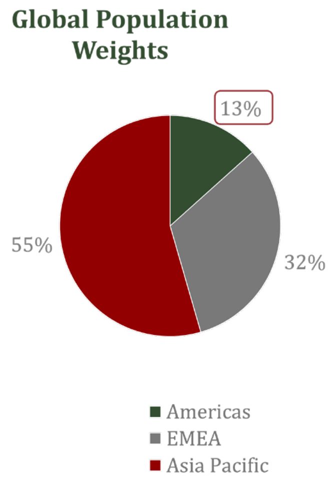
5. Are the most widely used global equity indices the right ones to use?

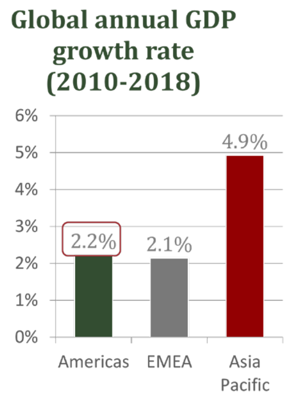
The MSCI and the FTSE Russell global indices (some of which are listed above) tend to be the main ones used for global equity portfolios. The reason for this is that they meet a lot of the criteria discussed above to make them good benchmarks. MSCI which is perhaps the most widely used index provider has over 150,000 different indices and at the end of October 2020 nearly $890 billion worth of ETFs tracked their indices[4]. Per their 2019 annual report which speaks to the pervasive nature of their indices, we quote, *“As of December 31, 2019, we served over 7,500 clients in more than 85 countries. For the year ended December 31, 2019, our largest client organization by revenue, BlackRock, accounted for 11.5% of our total revenues, with 94.5% of the revenue from BlackRock coming from fees based on the assets in BlackRock’s ETFs that are based on our indexes”[5].*

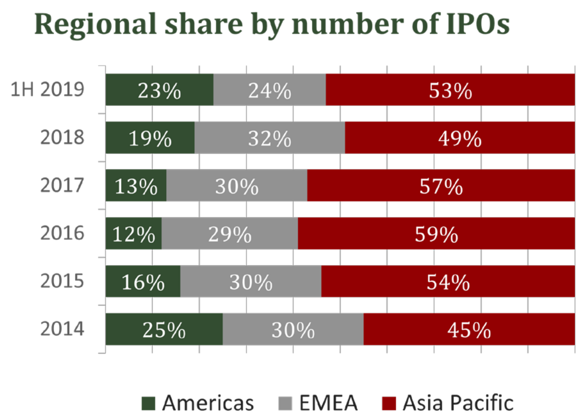
At Omba we like to be forward thinking and since the inception of our firm and the development of our strategies and portfolios we have questioned the US centric nature of these indices. Typically for both MSCI and FTSE world indices the weight to the Unites States is somewhere between 50% and 60%. We don’t feel this accurately reflects the world and the shift towards Asia and in particular China. For this reason, we designed our global equity allocations based on different inputs. Our allocation inherently underweights the US and over-weights China and Asia Pacific relative to the MSCI and FTSE world indices. In recent years these index providers have been increasing the weighting of China in their indices. Our clients value our forward thinking on this portfolio construction. We’re not saying one should not use these indices as benchmarks for our process to see if we’re right long term in our thinking but what we are asking you to think about is – does your investment and wealth manager use a major MSCI or FTSE global equity benchmark and if so which one, and how do they fare vs that index or do they mostly track it with little differentiation in their thinking. If their annualised performance over time is closely in line with the benchmark would it not perhaps be better to 1) invest in a passive process which is at least very likely to track the index closely and save you fees; or 2) consider a differentiated manager like Omba which uses the low cost building blocks of ETFs but designs the global asset allocation with long term forward thinking and a differentiated approach with high tracking error to these indices. Sources:[6], [7],[8]

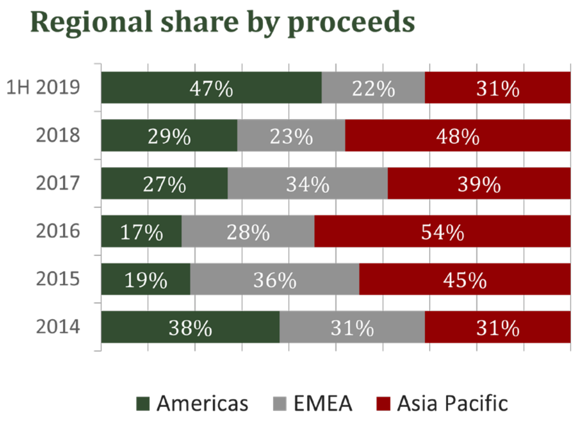












6. What level of under-performance by a manager constitutes a reasonable margin of error?

This really depends on the reasons for underperformance:

- Is it due to manager failings and selection of positions which completely "blow up" - poor risk management or concentration risk? Consider firing the manager.
- Is it due to a dislocation in a particular area of the market which is exogenous (like a geo-political event or natural disaster) and the dislocation is likely to abate and the underperformance likely to reverse? Put the manager on watch.
- Is the dislocation due to high fees and expensive product included in the portfolio which may be a continuous performance drag? Consider firing the manager.
- Is the performance due to currency weakness which has been unhedged? Depending on your currency decisions upfront this could be cause to fire a manager too. Our view on currency hedging can be found at this link: https://www.ombainvestments.com/faqs/#currencyHedging

7. Why do you even bother to include bonds in portfolios when yields are so low?

The debate about the inclusion of high-quality sovereign bonds in traditional multi-asset portfolios has come under scrutiny in recent months and years as bond yields have moved into the zone of zero, and in some instances, negative returns. How can one honestly justify holding a negative yielding asset in a portfolio?

Investors tend to forget the important role that these bonds perform. Of primary importance is that these bonds, which these days offer similar returns to cash, provide optionality to investors i.e. when markets do crash if investors are 100% invested in equity with no bonds or cash they provide the necessary liquidity to take more risk.

Furthermore, when equity markets fall sharply, they have historically provided uncorrelated or inversely correlated returns as investors move risky assets into the safer government bonds.

The final important role in our opinion is that if deflation were ever to rear its head, bonds provide strong protection against deflation as they retain their value.

At Omba our view is that given the above one should, if the mandate is long term enough (e.g.>10years), hold primarily equities. However, each investor's other exposures away from their investable portfolio differ and we find that if they primarily hold large concentrations to private companies (i.e. private equity) or large single listed stocks which can't be easily sold, and which may also be in a riskier currency, they tend to prefer moderate risk portfolios which invest in more bonds and cash. Our range of bonds and cash in such moderate portfolios is a high as 70% and as low as 30%. The next important point is that we believe global portfolios should have global currency exposure and as such holding high quality bonds in other currencies outside of your base currency can also have merit, for example, Chinese Government Bonds. Furthermore, given the strong demonstration of the Federal Reserve and ECB to support US and European corporate bond markets we have an inclination to also revisit strategic holdings of corporate bonds in portfolios.

"*The next important point is that we believe global portfolios should have global currency exposure and as such holding high quality bonds in other currencies outside of your base currency can also have merit, for example, Chinese Government Bonds.*"

8. Is the investment process you run active or passive or a combination and why?

Most wealth management firms we've seen across the UK and Europe tend to populate their multi-asset portfolios with a mixture of traditional long only funds (active managers), ETFs (passive) and sometimes also direct securities (active). The funds they use often include a mix of their own product and third-party product. The key thing that investors should look out for when their wealth manager has chosen to use active managers to build the portfolio is whether or not those active managers are beating their underlying benchmark. e.g. a European manager investing in European large capitalisation equity might be benchmarked against the Stoxx 600 index. Did they beat that index? If not, why is the multi-asset manager using that manager? Of particular importance in this regard is to look at multi-asset firms that use their own funds. Do their own funds beat the respective benchmark? If not, one should question their use.

When firms use a hodgepodge of their own fund, third party funds, ETFs, direct securities and also structured products (see below) one really should challenge the manager on process.

Furthermore, how active is the wealth manager – are they changing your portfolio often by switching into and out of stocks or bonds quite often (earning commissions in the process) – if so and they add extra return compared to being less active, no problem – if not then ask why.

One should also try to understand if all clients in the same risk profile across their business have the same portfolio. Often the portfolio construct is a function of the team with which the investor deals.

At Omba we know what we know, and we know that we don't know everything. We know that ETFs are lower cost. We know that ETFs are a great building block to express an asset allocation view. We know the universe is large enough to express a nuanced view on a country, sector, theme or factor. We know that by *using an ETF to gain an exposure compared to an active manager in that area of the market we won't have any underperformance as we'll have something tracking the index.*

> ***"Our process is "Pactive"- a term we once read elsewhere. We're active tactically by choosing country, sector, theme or factor and by expressing a credit or duration view, but we're passive in that we only use ETFs to express that view thus keeping costs to clients down."***

We know that stock picking is difficult and single stock concentrations can blow up portfolios. We know that using ETFs provides great single stock diversification. We also know that by not being tied to a large firm we can use the entire universe of ETF products. We also know that we don't have to worry about trying to find the top 10% or 20% of active managers that beat their benchmarks (which is an arduous task) we can effectively just own the benchmark by using ETFs. Our process is "Pactive"- a term we once read elsewhere. We're active tactically by choosing country, sector, theme or factor and by expressing a credit or duration view but we're passive in that we only use ETFs to express that view thus keeping costs to clients down.

9. Do you use structured products in the portfolio and if so why?

Many firms still build multi-asset portfolios using structured products which we think remains one of the last areas where banks and wealth managers can continue to earn a healthy margin. By using structured products with embedded derivatives which are often too complex for the investor to understand they are able to hide their high fees. Many structured products also provide a capped upside so in strong markets investors often lose upside, many utilise dividends to pay for the options so investors lose this income and lastly, although many provide initial downside protection when one really needs protection in a large sell-off the barrier is often breached and there is no protection. Make sure you get a very good and clear explanation why an expression of a view to have a regional or index exposure is done through a structured product compared to owning an ETF which tracks the index and also ask what the embedded fees of that product are compared to an ETF.

At Omba we do NOT use structured products in our portfolios. Structured products have a set maturity date and closing the position prior to this date often comes at a cost (wide bid-offer spread). During the life of the product one is also subject to the credit risk of the counterparty, which means should the counterparty default, in a worst-case scenario, the entire value may be lost. Finally, the defined nature of the set maturity date of the structured product negates some of its usefulness, unless the proceeds are specifically needed on a particular date. What this means is that having downside protection, for example, is great, but when the market is down 30% then perhaps some of this downside protection should be sold and more risk be taken (exactly as cash or bonds would be used in such a scenario) but exiting the structured product at this time is often expense due to increased volatility.

10. Do you use your own firm's products and if so why?

There is nothing wrong with a firm using only its own products but as long as they have products which outperform the underlying indices that they are designed to beat. Very few firms (and we don't know of any ourselves) have enough products where a sufficient number of these funds beat their benchmark. Furthermore, survivorship bias results in many firms shutting funds which underperform and which have had significant withdrawals so you wouldn't even notice them as having existed when viewing a list of products. If you choose a firm which only uses its own product we think it should be an ETF firm (like a Vanguard or an iShares) where at least the product being used to build the portfolio is likely to match the index closely.

At Omba we only use ETFs but uniquely we consider the entire global universe of over 7000 ETFs to build portfolios and we are not tied to any firm or product provider.

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