Momentum Investments

Changes to the strategic asset allocations of the Momentum Investments Factor Series portfolios

Highlights

- The review of the strategic asset allocations is to ensure robust outcomes for clients
- Regulation 28 changes and amendments to the Pension Funds Act regarding global allowance
- Change in forward-looking expected risk premia
- Ensure maximum probability of delivering on client outcomes – risk and return

Introduction

Before an asset class can be considered for possible inclusion in an exercise of asset modelling when designing a portfolio with certain goals or objectives in mind, there are certain characteristics it needs to adhere to. There needs to be a clearly defined framework and methodology to help identify and motivate the use of certain asset classes to be used in formulating the strategic asset allocations.
These principles apply equally to institutional and retail investments.

Momentum Investments' framework for combining asset classes within the clients' portfolios is designed to target specific goals in terms of inflationary targets over certain predetermined periods.

The asset classes considered in determining a suitable framework for strategic asset allocations are as follows:

- Local equities
- Local listed property
- Local bonds
- Local inflation-linked bonds
- Local cash
- Global equities
- Global listed property
- Global bonds

There are certain predetermined characteristics an asset class should adhere to for it to be defined as a distinct asset class and for it to be relevant and suitable for the framework for strategic asset allocations.

These characteristics are as follows:

- Appropriate
- Diversified
- Investable
- Liquid
- Measurable
- Unambiguous

Momentum Investments attempts to measure and define each asset class in a way that helps the company identify whether it adheres to some or all the characteristics described above. It is important to note that not all characteristics have to be true to the same extent for each asset class, but rather conform to the principle thereof to be considered a suitable asset class for investing.

Momentum Investments starts its quest for diversification by investigating the best combination of asset classes to likely achieve inflation-outperforming abilities over various time frames, using asset classes adhering to the core principles set out above. The process followed is in line with the company's outcome-based investing philosophy and applies the mindset of getting to the highest probable solution of outperforming the inflation objective, while being aware of the risk implications of each possible combination.
Three core components are critical in determining the optimal strategic asset allocation.
These components together formulate the client objective. They are the return objective, risk budget and investment horizon.

In designing the client risk budget, a couple of risk factors are taken into account. These typically consist of combinations of the following:

- Maximising the probability of achieving a return of inflation plus a certain outperformance a year over any specific investment horizon
- Minimising the drawdown compared to this target over the same investment horizon (shortfall loss)
- Considering shorter-term risks of capital loss

Two key elements warrant a relook at strategic asset allocations for clients.

- Structural changes in the expectations of longer-term, forward-looking returns of asset classes
- Regulatory changes

Both of these have been amended more recently and, therefore, Momentum Investments reviewed the implications of these changes on client portfolios.

Change in expected returns of asset class

Momentum Investments has longer-term expected real returns for each asset class that feeds directly into the process of asset modelling. Some of the asset classes have historically generated returns that are different to the forward-looking expected real returns for the period of analysis. However, the company has the view that the expected real return numbers are realistic estimates on a longer-term forward-looking basis and are important to take into account.

It is important to note that the process of asset modelling to determine the optimal asset allocations for a client risk profile is calculated on the basis of the expected real returns.

This ensures extreme outliers do not skew the analysis and the results do not have an embedded bias to the better-performing and, perhaps, unsustainable returns certain asset classes have delivered historically.
These expected real premia on asset classes do change over time and do result in a need to review the forward-looking strategic asset allocation as and when there are large adjustments to the expected returns.
The table below indicates the change in the risk premias from 2017 to 2018.

Asset class	2017	2018
Local equities	6.50%	5.75%
Local listed property	6.00%	7.00%
Local bonds	2.50%	3.25%
Local inflation-linked bonds	1.75%	2.75%
Local cash	1.50%	1.25%
Global equity	5.50%	6.50%
Global property	4.00%	4.00%
Global bonds	0.00%	-0.25%

Regulatory changes

Regulation 28 limitations are integrated in the asset model itself where applicable and the optimisation is run on the full set of asset classes from 1964. With the amendment of the Pensions Fund Act and the resultant increase in the global allowance from 25% to 30%, a review of the asset allocations was a definite requirement. For portfolios with a long-term investment horizon, the methodology for constructing outcome-based portfolios suggests a global allocation of 30% to 40% results in more efficient outcomes.

This, however, is very much dependent on the risk budget, but the shift from 25% to 30% global allowance does allow a bit more freedom to create more efficient and robust solutions for clients.

Following the methodology for constructing strategic asset allocation outcome-based portfolios, the table below indicates the newly constructed allocations for the different inflation-targeting portfolios.

New benchmark allocations	Local equities	Local listed property	Local bonds	Local cash	Local inflation-linked bonds	Global equity	Global property	Global bonds	Total growth exposure	Total global exposure	Implied real return
Inflation plus 3% portfolio	15.00%	8.00%	15.00%	25.00%	20.00%	10.00%	2.00%	5.00%	35.00%	17.00%	3.49%
Inflation plus 4% portfolio	28.00%	8.00%	15.00%	10.00%	20.00%	11.50%	2.50%	5.00%	50.00%	19.00%	4.17%
Inflation plus 5% portfolio	40.00%	12.00%	10.00%	7.50%	10.00%	15.00%	3.00%	2.50%	70.00%	20.50%	4.92%
Inflation plus 6% portfolio	45.00%	13.50%	7.00%	2.50%	3.50%	23.50%	3.00%	2.00%	85.00%	28.50%	5.53%
Inflation plus 7% portfolio	46.50%	15.00%	4.00%	1.50%	3.00%	25.00%	3.50%	1.50%	90.00%	30.00%	5.72%

The strategic asset allocations are driven from the basis of maximising probabilities of delivering on the predefined outcomes, while minimising absolute drawdowns and shortfall risk. The resultant probabilities of the asset allocations are shown below for their respective relevant investment horizons.

Probabilities	Inflation plus 3% portfolio	Inflation plus 4% portfolio	Inflation plus 5% portfolio	Inflation plus 6% portfolio	Inflation plus 7% portfolio
Forward-looking probabilities – new asset allocations	62.55%	65.47%	69.31%	66.80%	56.48%
Forward-looking probabilities – old asset allocations	61.44%	64.53%	67.76%	64.23%	51.82%

These probabilities are calculated on the level of the asset class only and it shows the new strategic asset allocations will deliver on client outcomes with a higher level of certainty than the previous strategic asset allocations. These are, however, still fairly low in absolute nature and, therefore, there is a need for additional added value from the perspective of strategy selection and alpha delivery to assist with delivering on robust outcomes for clients. It is important to understand what the implications are for clients from a risk perspective. Given shortfalls and absolute losses are the more important risks to consider from a client perspective, these are taken into account in the process of portfolio construction. These resultant risks are shown below. These are the core risks that are addressed and managed throughout the journey to delivery on a client outcome.

Portfolio	Average shortfall (relevant investment horizon and return objective)	Absolute drawdown	Minimum one-year return
Inflation plus 3% portfolio	-3.83%	-12.82%	-7.84%
Inflation plus 4% portfolio	-4.10%	-18.28%	-11.69%
Inflation plus 5% portfolio	-4.79%	-21.98%	-19.05%
Inflation plus 6% portfolio	-4.56%	-26.60%	-24.93%
Inflation plus 7% portfolio	-3.61%	-28.55%	-26.66%

Conclusion

The portfolios were rebalanced during the fourth quarter of 2018 to reflect the strategic asset allocations required to achieve the inflation objectives of the respective portfolios over time. The revised asset allocations are derived by the optimal combination of asset classes that will deliver on the client return objective with the highest possible probability, but, at the same time, minimising the probability or extent of capital loss.

In conclusion, it is extremely important to choose asset classes for investments very carefully on various criteria. The combination of asset classes should be combined in an appropriate and relevant way to deliver on certain predetermined objectives. Not only should probabilities be taken into account, but risk, in various shapes and forms, is a very important element often overlooked in the decision of the ideal asset allocation for a specific client objective. Given the adjustment in forward-looking expected returns as well as the amendments in the Pension Funds Act, the change to the strategic asset allocations for the different portfolios was a requirement to create more certainty in delivery on the outcomes.

Eugene Botha
Deputy Chief Investments Officer