Multi-Asset Investing: A Difficult Sport

Cross-Border EMEA allocation funds' performance

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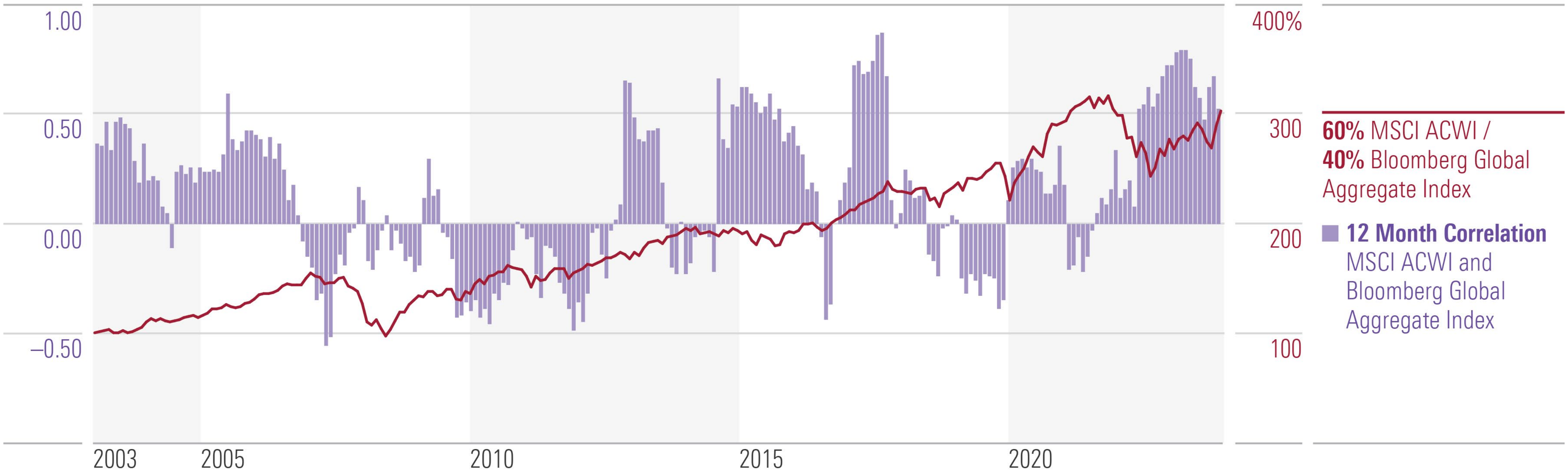
Are Basic Allocation Strategies Still Relevant?

The lure of the balanced portfolio has been its ability to limit losses in challenging stock markets through bonds' negative correlation. But in 2022, both stocks and bonds lost considerable ground. This led some pundits to suggest the 60% equities/40% bonds portfolio is past its due date. The stock/bond correlation changes through time, however. And, besides correlations, valuations matter: At the start of 2024, the bond market has been repriced and is now offering some of the highest yields in a long time.

The 60/40 Portfolio Over Time

12-Month Correlations Between the MSCI All-Country World Index and Bloomberg Global Aggregate Index



Morningstar Direct. Data as of Dec. 31, 2023.

The Importance of Holding a Diversified Portfolio

Diversification Works

Over the long haul, multi-asset portfolios have provided value to investors through their diversification benefits.

Diversifying across asset classes such as stocks and bonds has proved to be a solid strategy, as fixed income often serves as portfolio ballast during most equity selloffs. This results in superior risk-adjusted performance over the long term as measured by the Sharpe ratio, a well-known measure of portfolio efficiency.

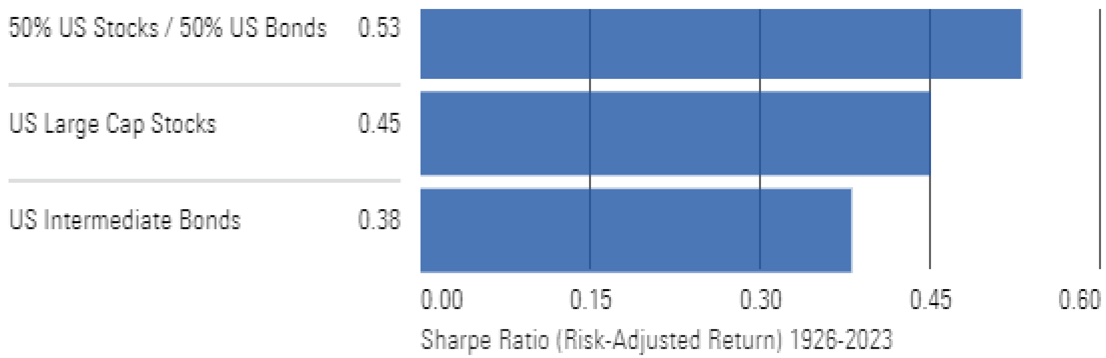
Multi-asset funds are often marketed as “one-stop shop” investment solutions that offer a readily diversified portfolio without the need to select and combine equity, bond, or money market funds. Investors merely need to choose a fund with an allocation fitting their desired risk level.

Striking Underperformance

But multi-asset funds have struggled against benchmarks. The average moderate global allocation Morningstar Category fund trailed the Morningstar Euro Moderate Global Target Allocation Index by a gaping 2.19 percentage points annualized over the past 10 years through the end of December 2023.

We discussed the effect of fees in our August 2023 study, titled [What Does It Cost to Invest in a Diversified Fund Portfolio?]() The rest of the underperformance was caused by factors such as transaction costs, strategy asset-allocation differences, security selection, and market-timing, which will be discussed here.

Diversified Portfolios Have Better Risk-Adjusted Returns



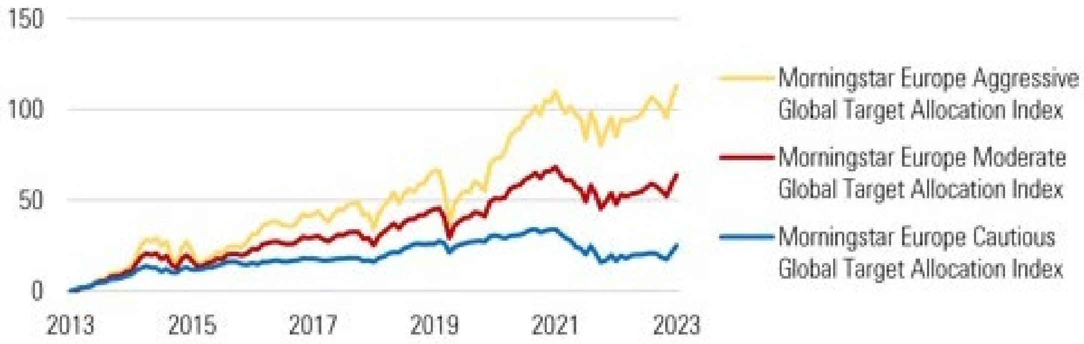
Source: Ibbotson Associates SBBI TR indexes. Annual rebalancing. Data as of Dec. 31, 2023.

Moderate Allocation Global Category Trailing Index by 26% Over 10 Years

Source: Morningstar Direct. Data as of Dec. 31, 2023.

Strategic Asset Allocation Is the Main Driver of Returns

Cumulative Return (%)



Source: Morningstar Direct. Data as of Dec. 31, 2023.

Not All Benchmarks Are Created Equal

	US Equity	Non-US Equity	US Bond	Non-US Bond	Cash
Morningstar Europe Moderate Global Target Allocation Index	23.4%	26.5%	12.5%	27.8%	9.8%
50%MSCI World 50%Bloomberg Global Aggregate	34.7%	15.3%	19.6%	29.3%	1.2%

Source: Morningstar Direct. Data as of Dec. 31, 2023.

Strategic Asset Allocation

Traditional allocation funds come in many shapes and forms. The fund manager aims to add value compared with an index-based solution through breadth of allocation, market-timing, and/or security selection.

Strategic asset allocation sets target allocations that form a baseline against which the manager may take tactical views. It is the main driver of a portfolio's return and explains a great deal of the excess performance versus the benchmark. Stocks have rewarded investors well, while European allocation funds have often been somewhat shy to take risk, as we can see on the next page. Also, allocations to alternative strategies have generally not been additive against market indexes in recent years.

Besides equity, risky bonds can also make a large difference in a fund's long-term returns. For example, Invesco Pan European High Income's overweighting to high yield and AT1s have led it to outperform its EUR cautious allocation peers by 2.5 percentage points annually over the last 10 years though December 2023.

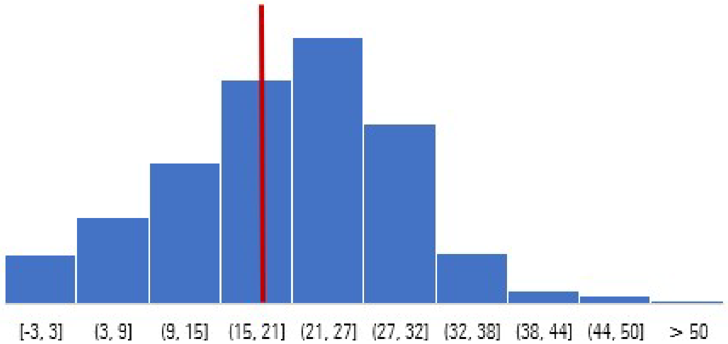
Various Definitions

Strategic asset allocation means different things to different managers, however. Some distinguish strategic from tactical asset allocation based on the time frame for which the shifts are made, with the latter anticipating shorter-term market moves.

Another challenge in performance evaluation is the diversity in benchmark-setting—while some allocation funds don't compare themselves with any bogy whatsoever. Morningstar's multi-asset indexes reflect the typical broad allocations of funds in each risk level but with a preset equity level (50% for moderate, for example).

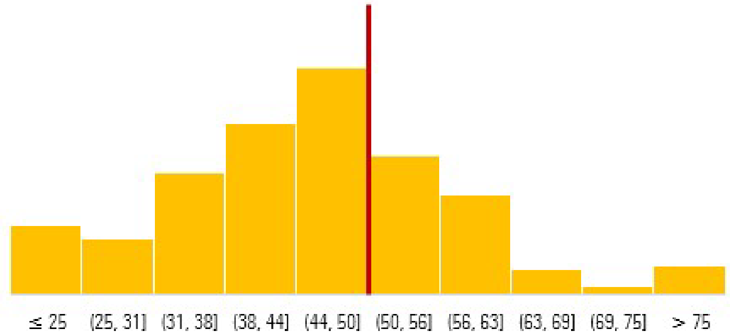
Side by Side Comparisons Are Hard

EUR Cautious Global Allocation Category – Equity



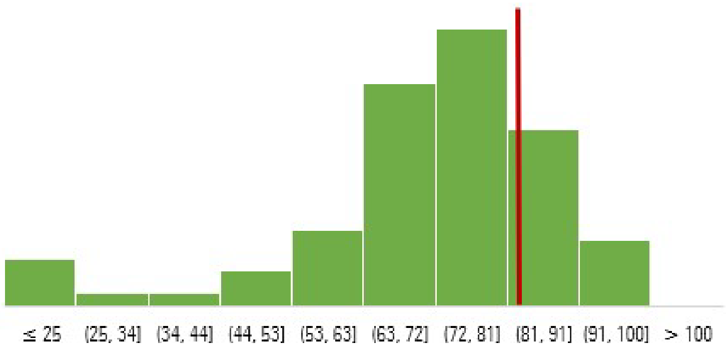
Source: Morningstar Direct. Red line is category index's equity weight.

EUR Moderate Global Allocation Category - Equity



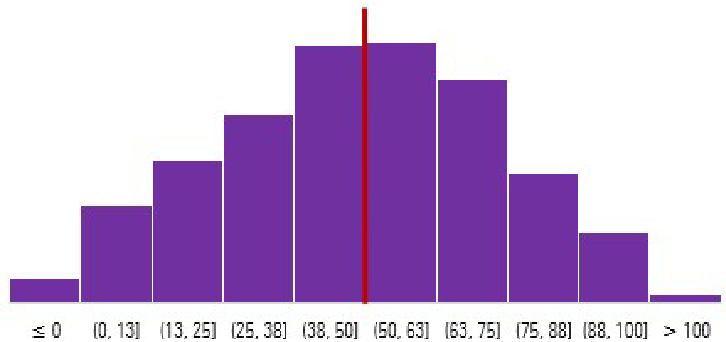
Source: Morningstar Direct. Red line is category index's equity weight.

EUR Aggressive Global Allocation Category - Equity



Source: Morningstar Direct. Red line is category index's equity weight.

EUR Flexible Global Allocation Category - Equity



Source: Morningstar Direct. Red line is category index's equity weight.

Broad Range of Allocations

Prior studies conclude that asset allocation explains more than 90% of variation between portfolios' returns.

The equity weighting is often a significant determinant of the multi-asset fund's overall performance, with a higher allocation to stocks generally implying a higher volatility and return. The Morningstar EUR global allocation indexes take their asset-allocation cues from Morningstar's multi-asset fund categories, with the equity allocation set around the category's midpoint (17.5%, 50%, and 82.5%).

Morningstar has three EUR global allocation categories, namely cautious, moderate, and aggressive, which correspond with the typical risk ranges used by asset managers in Europe. The flexible category includes portfolios that have largely unconstrained mandates or a total-return objective and typically hold from 20% to 80% in equities or fixed income. These funds tend to change their equity weights more often than those in risk-bucketed categories.

U.S. Supremacy

The U.S. Has Not Always Outperformed

36-Month Rolling Excess Return Morningstar US Market vs. Morningstar Europe

Source: Morningstar Direct. Data as of Dec. 31, 2023.

Home Bias

Many Europe-domiciled active multi-asset funds have a preference to hold assets in their home currency or lean toward domestic stocks they feel they know better. The home bias seems more prevalent in larger European countries like Germany. For example, Flossbach von Storch SICAV Multiple Opportunities had around 26% of its equity allocation in German stocks such as Adidas and Mercedes-Benz Group compared with 5.8% for its category peers at the end of November 2023.

U.S. Tech

But one of the best areas of the stock market to be over the last 10 years has been in big tech names, which are mostly listed in the United States. The sector overweighting that major U.S. equity indexes have versus their European counterparts has explained much of the annual 7.2 percentage points of outperformance.

The Start of the Century Was Different

The dominance of U.S. stocks is no permanent feature of markets, however. Between 2003 and mid-2007, the Morningstar Europe Index outperformed the Morningstar US Market Index by 11 percentage points per year. In part, this can be explained by the bursting of the dot-com bubble in the U.S. and the higher proportion of healthcare, utilities, and consumer names in the European indexes.

Interestingly, emerging markets also had their day in the sun in the early 2000s, in no small part thanks to U.S. dollar weakness and a commodities boom. The Morningstar Emerging Markets Index posted an annualized return of nearly 30% over the period.

Market-Timing Is a Fine Art With Few Masters

Timing Is Hard, and So Is Identifying Good Timers

The year 2022 provided the ideal climate for tactical-allocation funds. Unlike strategic-allocation funds, which hold on to their allocations, tactical funds try to profit during bull markets and avoid losses in bear markets. The coronavirus-pandemic-induced correction was sudden and hard to predict, but the interest-rate hikes by central banks starting in 2022 were gradual and anticipated, providing an opportunity for market-timers to shine.

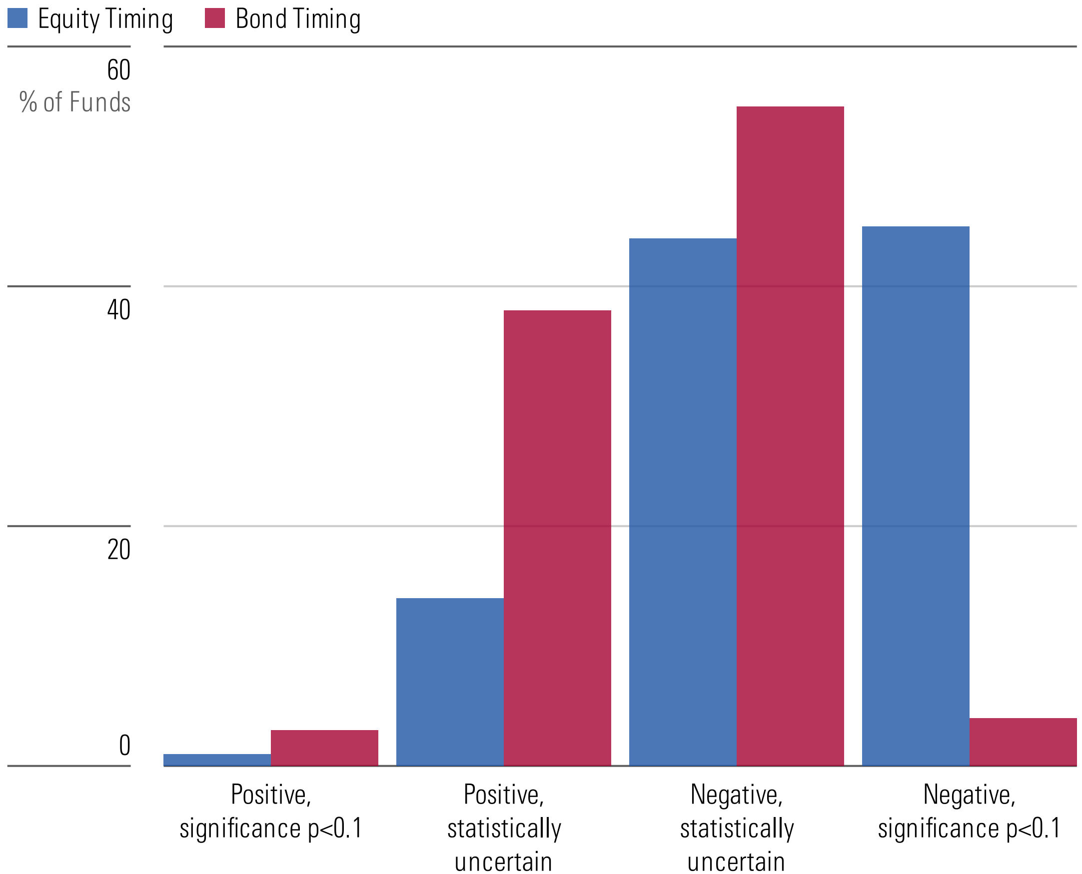
But academic research indicates that market-timing is tricky. This is not surprising considering it requires foresight to anticipate market swings. The best-known methods for identifying market-timing skill are the Treynor-Mazuy and the Henriksson-Merton models. They conceptualize market-timing as the adjustment of the portfolio's sensitivity (or "beta") to markets: The portfolio manager pushes equity market sensitivity up in anticipation of strong stock markets and pares it back when there's a high risk of equity losses, and similarly for bonds and other assets.

As expected, when analyzing globally investing allocation funds in the cross-border universe with these models, we struggle to detect multi-asset managers with a statistically significant timing success.

Using the Henriksson-Merton model with a generous 0.1 p-value hurdle (90% statistical certainty), there are only two funds out of 1,695 with a positive result on both equities and bonds. But the same is true also for negative timing: Only 0.8% of funds in the sample seem to have done damage on both sides of the portfolio. Timing is tricky, and detecting successful market-timers is hard.

Efficacy of Equity and Bond Timing Using Henriksson-Merton Timing Model

Globally investing allocation funds domiciled in Europe, returns 2013-23

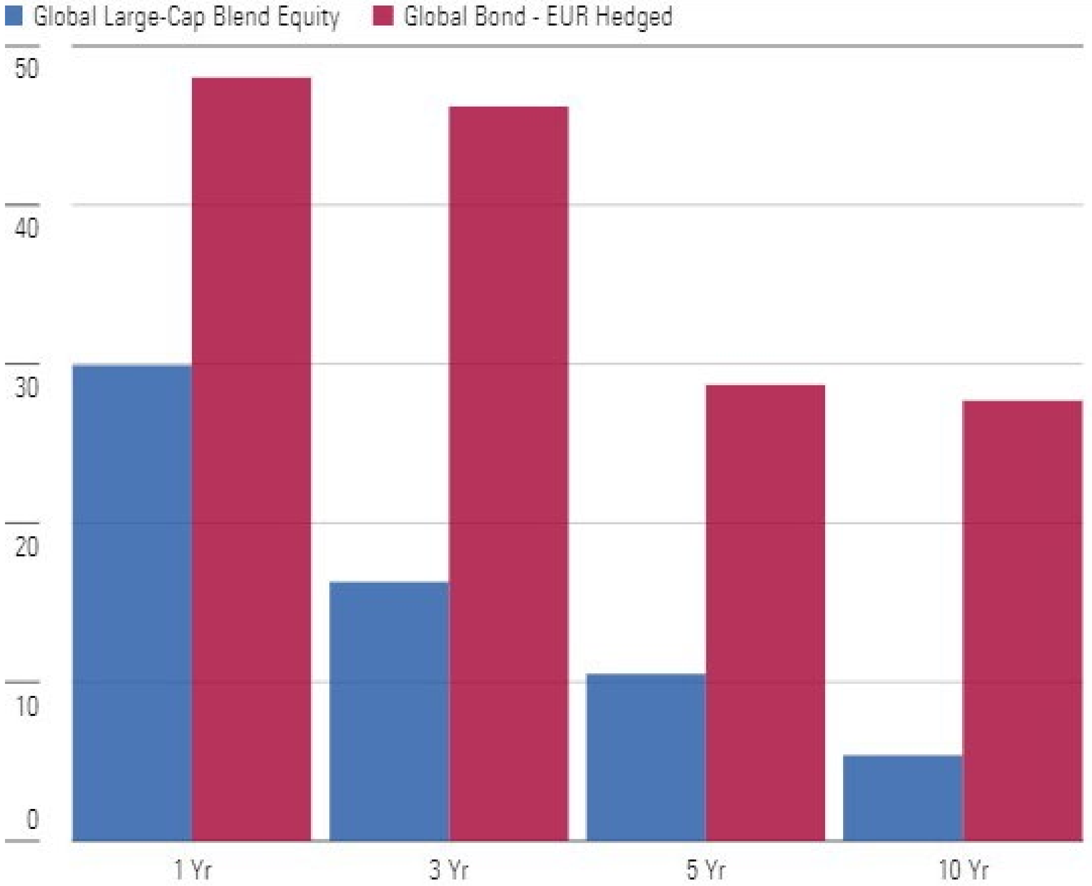


Source: Morningstar Direct. Equity: Morningstar Global, Bonds Morningstar Eurozone Treasury Bond. Currency: Euro. Monthly Returns. Total funds: 1,695.

Security Selection

Active Equity and Bond Managers' Year-End Outcomes (%)

The Odds of Outperforming Passive Solutions Are Slim



Source: Morningstar Direct. Data as of June 30, 2023.

A Source of Alpha

Some multi-asset managers are trying to create value through security selection. For example, Capital Group's Global Allocation Fund allows stock-picking to drive excess returns whereby multiple managers all strive to make good selections, while bonds serve as ballast and keep their 60/40 allocation fairly stable.

Often multi-asset managers outsource the security selection to in-house (or external) asset-class specialists that manage one of the underlying strategies. For example, the equity sleeve of JPMorgan Global Balanced is run by the firm's regional teams dedicated to U.S., Europe, Japan, and emerging-markets and Asia-Pacific equities.

But it's hard to add alpha this way, even for specialist equity and bond managers.

Morningstar's semiannual Active/Passive Barometer can help investors calibrate the odds of active funds outperforming passive peers in a specific category. Since Morningstar started this study, the success of active managers has failed to impress, particular over longer periods.

Typically, success rates for active equity managers are higher in the mid- and small-cap space, which typically is not a building block in most multi-asset funds because of liquidity constraints but can be a differentiator. On the bond side, the same holds largely true for EUR corporate and high-yield bond. Mortality is a big factor here, with survivorship rates of 54.3% and 56.3% for actively managed funds in the global large-cap blend equity and global bond–EUR hedged categories over the trailing 10 years as of June 2023.

Concentration vs. Diversification

Narrow Leadership Can Pose a Headwind for Managers

Propelled by a boom in artificial intelligence, the "Magnificent Seven" (Nvidia, Tesla, Meta Platforms, Apple, Amazon.com, Microsoft, and Alphabet) were the key drivers behind the S&P 500's 26.3% return over 2023. Investors keen on diversifying idiosyncratic equity risk had hoped to see the market's rally broaden out last year to include a wider swath of stocks, but that has largely failed to materialize.

Beware of Concentration

Active managers have good reasons to diversify, however, as concentration in the top 10 equity holdings is a double-edged sword. While it allows managers to invest in their best ideas, leading to potentially higher returns, concentrated portfolios tend to be more volatile and prone to sharper drawdowns.

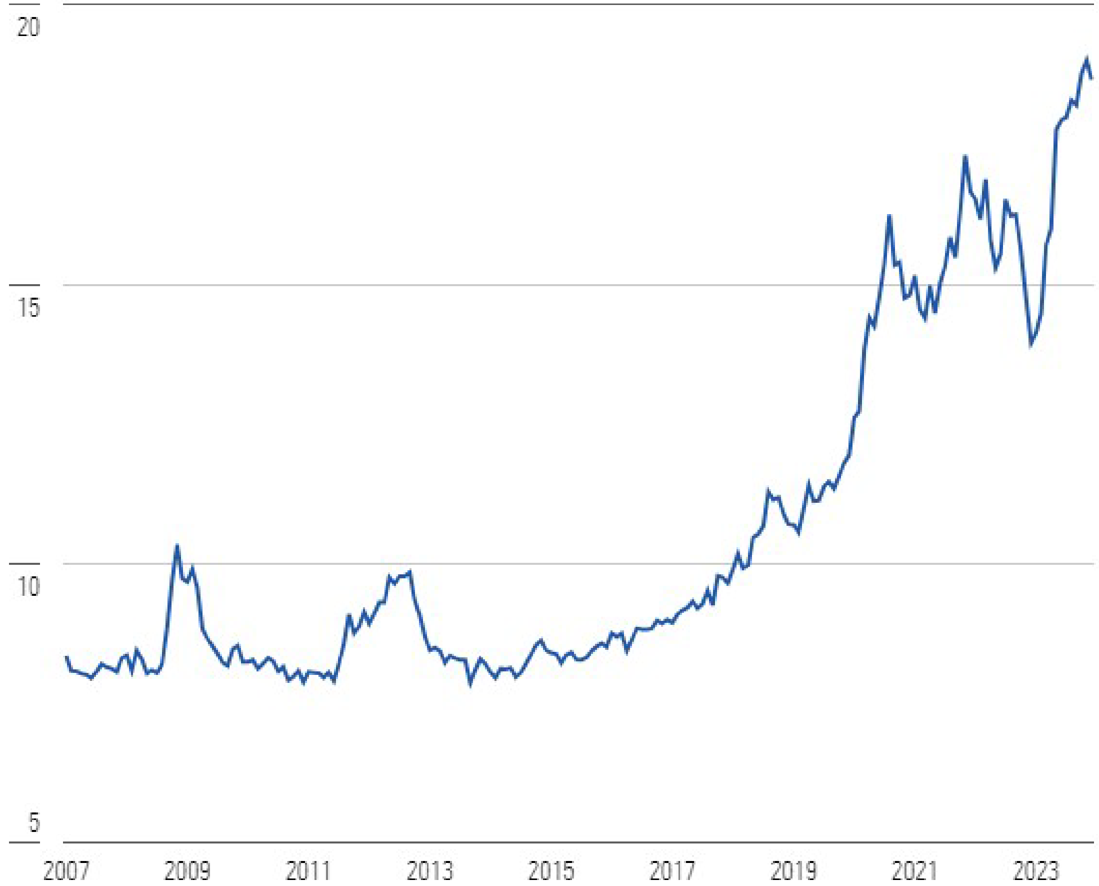
Alignment With Objectives

Stock selection should match the strategy's objectives. For example, investors would expect to see a decent allocation to dividend-paying stocks in multi-asset income funds and a blend of growth and value stocks in balanced portfolios.

The alternative, sticking to one equity style, poses risks. For example, Templeton Global Balanced invests around 65% of its assets in stocks. At such a high near-constant weight, equities dominate the outcome, but the strong value bias has tended to drive up the equity sleeve's volatility, with concentration backfiring at times. Between September 2017 and August 2020, it underperformed the category index by 5.7 percentage points annually despite the equity overweighting. Performance has since improved.

The Stock Market Is Increasingly More Concentrated

% Assets in Top 10 Holdings in Morningstar Developed Markets Index



Source: Morningstar Direct. Data as of Dec. 31, 2023.

Conclusions: Challenge From Above

Multi-Asset Funds Pose Unique Challenges

- Active multi-asset funds can use a variety of means to achieve strong risk-adjusted returns. While some are successful, many are not.
- The different types of allocation strategies can offer solutions for investors' specific needs, but evaluating relative performance is challenging.
- Benchmarking a multi-asset strategy differs substantively from a strategy focused on a single asset class as the many dimensions of multi-asset strategies complicate the analysis.
- First, there is the allocation between stocks, bonds, and other asset classes. Then, there are the kinds of stocks (size, style, geography) and bonds (sector, duration, credit quality, geography). Also, if the strategy uses actively managed underlying strategies as opposed to index funds, there's an additional layer of security selection within each sleeve.
- Second, for objectives-oriented funds, such as multi-asset income or environmental, social, and governance-focused funds, there's a specific investment outcome to consider. Other strategies are total-return-driven or promise lower drawdown risks. All the work that goes into achieving those goals is not always captured through benchmark-relative performance, nor is it always clear which benchmark to choose.
- It is essential for investors to understand the strategy, process, and promises made by the managers to see if strategic asset allocation and/or security selection is the dominant driver of performance and whether tactical allocation plays a role.

Strategic Asset Allocation

- Strategic asset allocation is a strategy whereby target allocations are set and rebalanced periodically or when the original allocations moved substantially. It is the main driver of portfolio returns.
- When going beyond risk-targeted funds, however, it is difficult to draw the boundaries and get a clear definition of strategic asset allocation.

Market-Timing Is Hard

- The call for dynamic portfolio positioning, whereby the manager frequently changes the portfolio's allocation in anticipation of price fluctuations, typically rings louder after a period of higher volatility.
- But few multi-asset funds that take a tactical approach to asset allocation outperform those that use a strategic approach, while they often have higher costs.

Stock-Pickers Wanted

- Multi-asset managers sometimes outsource the security selection to in-house (or external) asset-class specialists that manage one of the underlying strategies.
- Stock selection should match the strategy's objectives, and active managers have good reasons to diversify, as concentration is a double-edged sword.

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