ACHIEVING THE RIGHT BALANCE

Six factors to consider when designing the optimal asset mix

It is widely accepted among investors that there is no more important decision an investor makes than the asset mix they select. More than any other decision, asset mix drives performance and impacts the overall level of risk and investment returns.

Determining asset mix, however, is typically a subjective process that requires significant judgment and consideration of a broad range of factors. Six of the most important factors are discussed below.

FACTOR 1
ESTABLISHING OBJECTIVES AND RISK TOLERANCE

The first step in the asset mix decision-making process is establishing a client's investment objectives and risk tolerance. For some, their objective is a certain return target. For others, they are focused on measures such as achieving and maintaining a certain level of funded status or contribution levels.

IMCO's clients typically have investment objectives that are closely linked with their ability to meet their future financial obligations. Estimating these obligations involves a combination of known facts and assumptions about the future. For example, a pension fund can estimate future payouts based on known facts like existing membership and pensionable earnings, as well as assumptions about future changes in that membership, earnings levels, typical lifespans, and inflation levels.

Our clients' risk tolerance typically reflects the degree to which they are willing and able to tolerate not achieving their investment objectives.

FACTOR 2

IDENTIFYING ASSET CLASSES AND ASSET MIX MODELS

The next step in the asset mix process is to identify potential asset classes that can be included in a client's asset mix, as well as the asset mix model that can be used to achieve their return and risk objectives.

There are many asset classes investors can consider. However, in general, an asset class exposure needs to represent at least 5-to-10 percent of a total portfolio, so that its inclusion has a material impact on overall portfolio returns and risk.

IMCO offers its clients access to thirteen investment strategies across nine asset classes that, in combination, enable them to build a well-diversified mix:

- Riskier and higher returning asset classes (public and private equities, credit, infrastructure, and real estate),
- Lower risk and returning asset classes (cash, government bonds, and some public market alternatives), and
- Inflation-linked asset classes (inflation-linked government bonds, some real estate, and infrastructure).

IMCO also provides its clients with access to total portfolio leverage, which can be used to enhance the overall risk and return potential of a portfolio. But, this comes with exposure to increases in short-term interest rates and more liquidity risk.

Investors tend to pursue long-term investment strategies that combine asset classes in one of the following ways:

1. **GROWTH ORIENTED:** The 60/40 asset mix, as well as other asset mixes dominated by growth-oriented asset classes subject to significant short-term volatility, fall into this category. The main idea underlying these asset mixes is that over the long-term, investors are rewarded for owning growth assets like equity, credit, infrastructure, and real estate notwithstanding the expected volatility of their returns in the short-term.

2. **LIABILITY DRIVEN INVESTING (LDI):** LDI investors select assets that are closely tied to their liabilities. Often, this includes large allocations to inflation linked and long-term bonds because these asset classes most closely resemble pension obligations. Because the return on these assets is low, LDI investors often use leverage to obtain or maintain exposure to other (growth) assets to increase their total portfolio returns.

3. **RISK PARITY:** The primary objective of a risk parity approach is to invest in a range of asset classes (including growth-oriented assets like equities and credit as well as bonds, and commodities) so that the total portfolio performs well in a range of macro-economic environments (e.g., growth with high/low inflation and economic contraction with high/low inflation). If the returns of this asset mix are too low to meet an investor's return objectives, because of large allocation to bonds and commodities, short-term borrowing is used to increase returns.

4. **RESERVE FUND:** Generally, this category of asset mix invests in assets that are readily available to meet unforeseen needs. Such funds tend to be invested in shorter-term, lower risk assets to avoid having to force sell volatile assets at the wrong time.

Our current clients tend to have long-term financial obligations that require a rate of return well above the risk-free rate. Therefore, we tend to recommend growth-oriented portfolios.

FACTOR 3

DEVELOPING ASSUMPTIONS FOR EXPECTED RETURNS, VOLATILITY, AND ASSET CLASS CORRELATIONS

The next stage in the asset mix process is developing a set of assumptions such as expected future returns, volatility, and correlations for asset classes.

For this purpose, we use a neutral forecast which assumes no major changes in prevailing market factors such as yields for credit and bonds and valuations, earnings levels, and dividend payouts for equities. We believe this is a sensible approach, with the caveat that investment returns can (and often do) surprise, and volatility and correlations have varied significantly over the years.

We also focus less on the forecast returns, which may not be accurate and instead focus more on the biggest asset mix decisions, namely:

- How much to allocate to all higher returning asset classes together, given they are expected to generate higher returns over the long term, but will also likely be the biggest driver of performance volatility;

- How much to allocate to asset classes that should provide protection from unanticipated bouts of inflation or deflation that would negatively impact the value of higher returning asset classes;
- How much to allocate to asset classes that may act as a draw on liquidity in times of market stress (e.g., asset classes that require currency hedging, private assets with commitments / capital calls); and
- Total portfolio leverage.

FACTOR 4

CONSIDERING LIQUIDITY OBLIGATIONS

Investors need to carefully consider their liquidity needs, namely the periodic need for cash to meet obligations. Ensuring adequate liquidity requires a fulsome consideration of all potential draws on cash, including payments to beneficiaries, meeting collateral requirements, funding capital calls for investment commitments, and rebalancing requirements. Insufficient liquidity can undermine long-term investment strategies, by forcing investors to 'sell low', thereby reducing long-term returns.

At IMCO, our view is that the most reliable sources of liquidity are cash and government bonds. A material allocation to cash as an asset class is inadvisable because its return profile is too low. While owning government bonds in an asset mix (as opposed to equities or other riskier/higher returning assets) will lower overall portfolio returns, in times of extreme market stress, bonds can generally be relied upon to provide liquidity, as central banks typically move quickly to prioritize resolving government bond market issues.

FACTOR 5

ESTABLISHING AN INVESTOR 'WORLD VIEW'

Investors should not spend a lot of time trying to predict what is hard to predict: Very near-term developments, or very long-term changes to society, technology, economies, or the markets. But they do need to adapt their portfolios to the current investing environment.

IMCO releases an annual World View, which sets out our analysis on the current investing environment and the strategies investors should consider as they navigate prevailing trends, opportunities, and risks.

FACTOR 6

CONSIDERING OTHER PRAGMATIC CONSIDERATIONS

In addition to the above factors, there is often a set of pragmatic considerations that an investor must consider in setting their asset mix. One of the most important is clearly identifying the areas where they believe they have real investment advantages. Real advantages include a longer investment time horizon, a greater tolerance for illiquidity, the ability to access asset classes at a lower cost, operational expertise to create value, and strong relationships with other investors with origination advantages or operational expertise. We believe that where an investor has real advantages in an asset class, they should allocate more to that asset class.

At IMCO, our advantages include our scale, ability to internalize investment activities and partner with other large investors, and our clients' long investment horizons. These advantages allow us to effectively invest in many private assets, including equity, credit, infrastructure, and real estate. As a result, we generally recommend significant allocations to private assets.

Additionally, we view our clients' strategic approach to navigating the energy transition as an advantage. Their commitment to pursuing a pragmatic (versus a dogmatic) approach to reducing emissions associated with our holdings has enabled us to pursue a measured and realistic timeframe, in which to build dedicated internal expertise in this area. Their approach also enables us to play an active role in the transition, versus trying to achieve unrealistic near-term objectives.

NEXT STEPS

TRANSITIONING TO THE DESIRED ASSET MIX

There are three principles to consider when developing a plan to transition from their existing asset mix to their target asset mix:

1. Investors should seek to reach their desired long-term asset mix as quickly as possible (12 months or less), because it best reflects their view of the optimal asset mix for them.
2. Investors should spread asset mix changes over a period of time that avoids mis-timing volatility, or "buying high and selling low".
3. Investors should acknowledge the practical limitations on their ability to add to or reduce exposures to certain asset classes (e.g. the opportunity to buy or sell private market investments is more limited, so adding to, or reducing, private market exposures will generally happen at a slower pace than adding to, or reducing, public market exposures).

Clearly, the first two principles are sometimes in conflict: The first suggests that asset mix changes should be done as quickly as possible, and the second is driven by the goal of avoiding the regret that can come from exiting or entering an asset class "at the wrong time".

IMCO believes that the first principle should generally be prioritized, unless the transition being contemplated is significant, in which case investors may want to transition more slowly to avoid the legitimate goals of avoiding the potential for regret.

CONCLUSION

The factors that drive asset mix are not static. Therefore, we review asset mix at least annually with our clients, and more often if there are very material changes in any of the factors discussed above. Ultimately, we believe that providing our clients with consistent and well-considered asset mix advice is one of the most significant ways we can help them succeed.