IAPF Trustee Network

# Generating stable returns in a tumultuous investment environment

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# Russell Investments

**89%**
OF EMEA FUNDS OUTPERFORMED OVER 5 YEARS*

**572**
DEDICATED INVESTMENT PROFESSIONALS

**€2.0 TRILLION**
ASSETS UNDER ADVICE

**€ 223 BILLION**
ASSETS UNDER MANAGEMENT

**€1.9 TRILLION**
ASSETS TRADED IN 2015

**45+ YEARS**
OF EXPERIENCE

**9,286**
MANAGER PRODUCTS CONTINUALLY MONITORED AND RESEARCHED

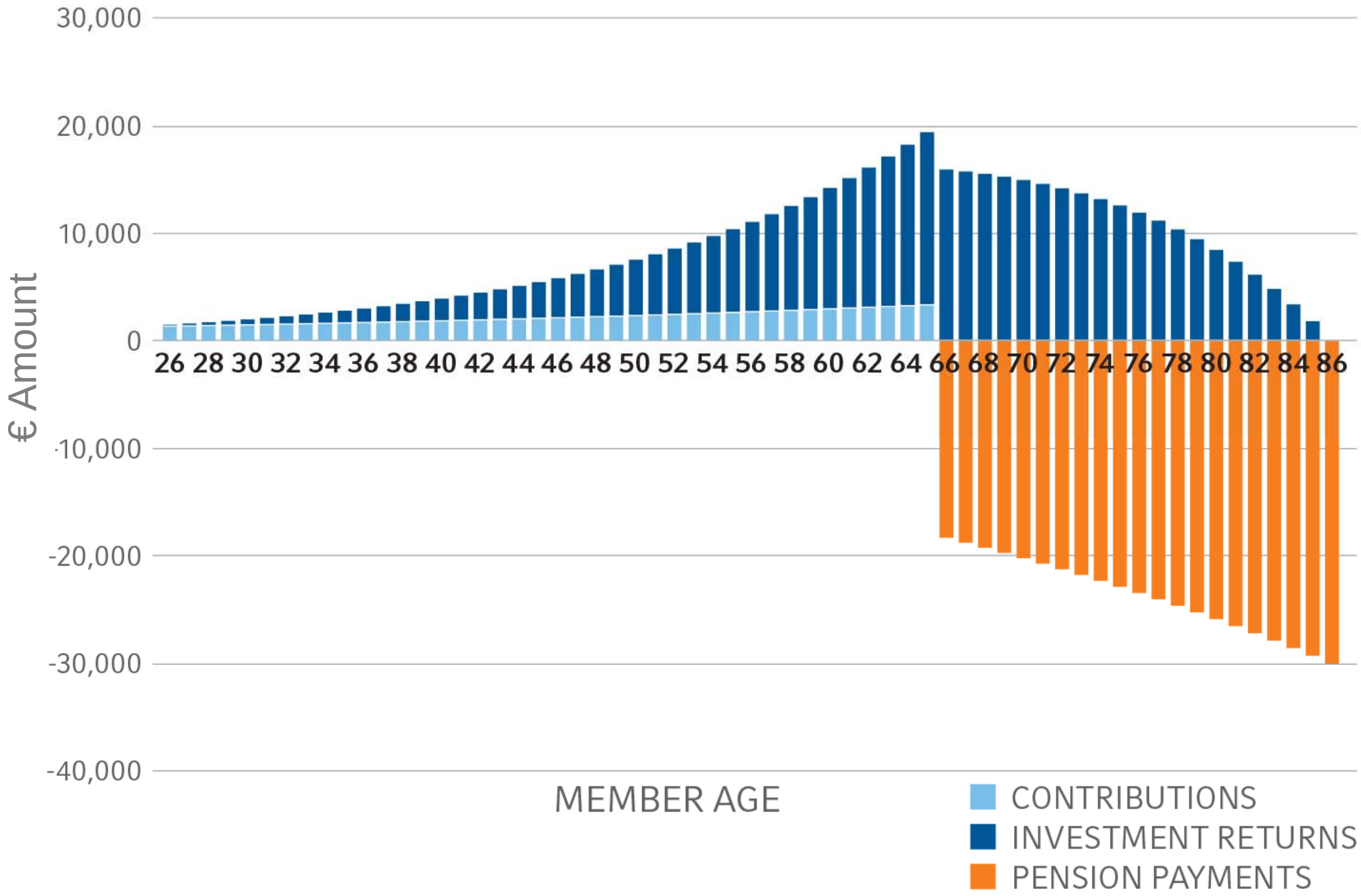
TOP DUE DILIGENCE
IN MANAGER RESEARCH
2014 FUNDFIRE SURVEY

2015 chief investment officer
TRANSITION MANAGEMENT SURVEY
#1 in Cost Performance vs. Estimate

2011-2015
Pensions&Investments
LARGEST OUTSOURCER
RANKED BY WORLDWIDE ASSETS
RUSSELL INVESTMENTS

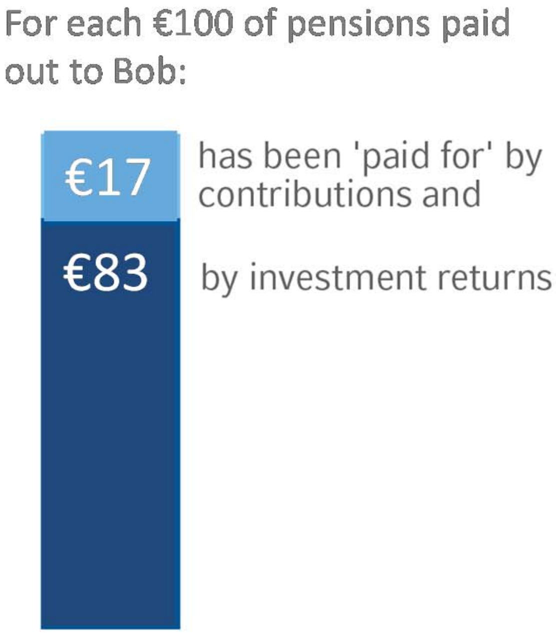
Source: Russell Investments. As of December 31, 2015 unless otherwise stated; Assets under advice as at June 30, 2015. * Calculations based on Confluence, as at 30th September 2015. Gross of fees stated in USD. Calculations do not include discretionary mandates. Non-benchmarked funds excluded; RIF MAGS EUR, RIF MAGS GBP, UK IFA Real, UK IFA Defensive, RIC LDGF, RIC 3 GBP Cash, RIC UKIL, RIC Euro Cash.

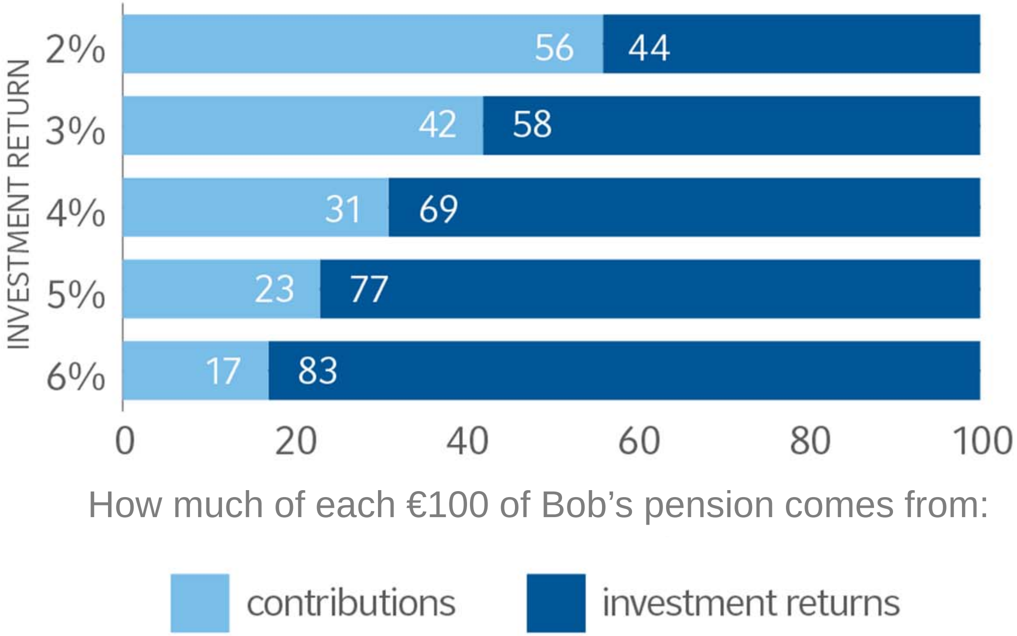
# Paying the pensions – where does the money come from?




Source: Russell Investments, for illustrative purposes only.

# Investment returns matter – a lot



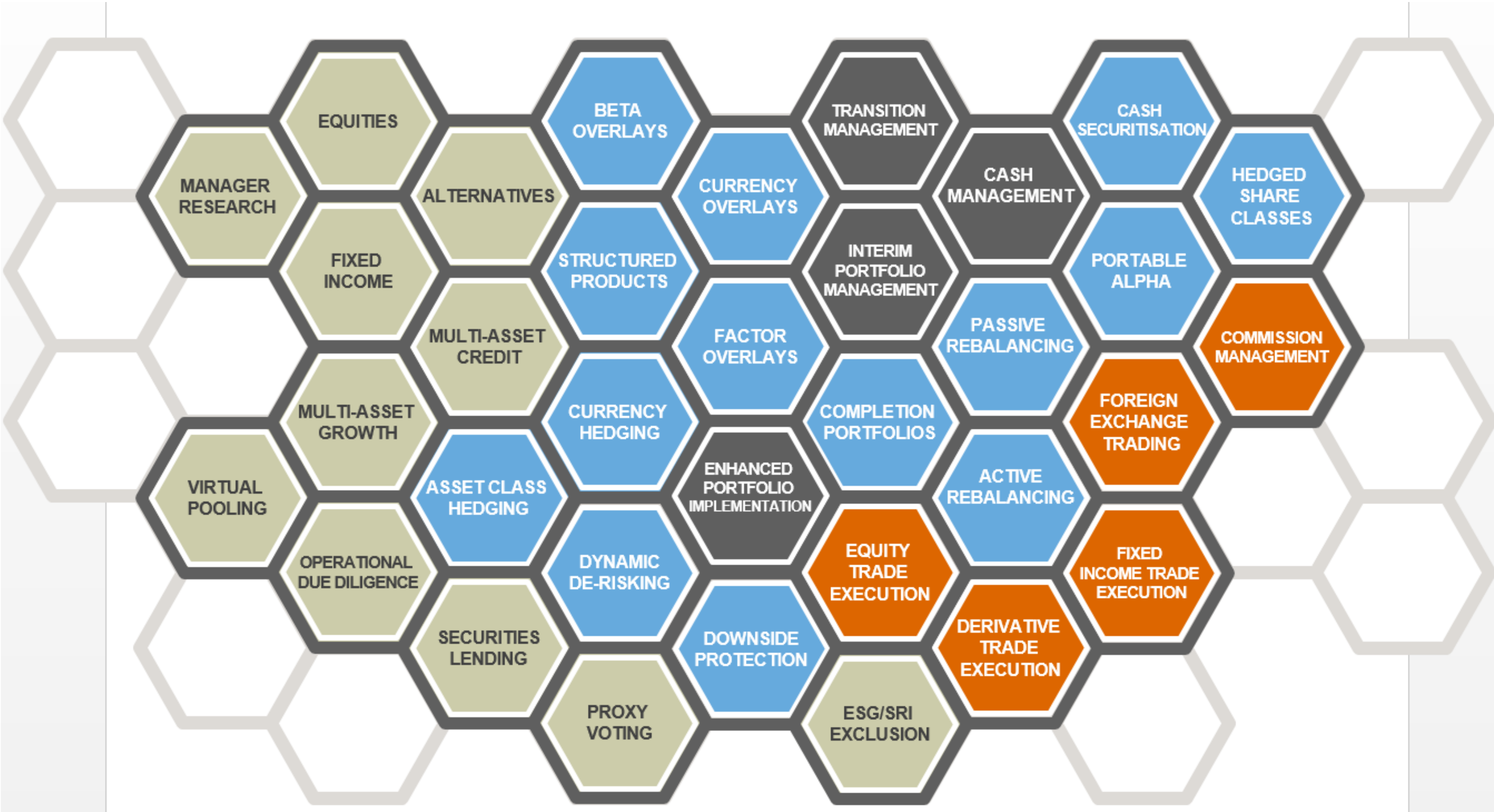

**A factor of roughly 5:1**

**Lower investment returns lead to greater required contributions**

Source: Russell Investments, for illustrative purposes only.

# Techniques which help to deliver stable returns...

# …are not in short supply!



# Let’s focus on some of the most common

- Asset allocation
  - Strategic – a quick recap
  - Dynamic – adapting to threats and opportunities
- It’s all about risk management
- Downside protection
- Alpha
- Controlling all costs (Tricks of the trade: how investment managers extract additional value from their relationship with you…and what you can do about it)

# How are you tackling the challenging investment environment?

# Three interlinked priorities integral to all decisions

Russell Investments

# Asset Allocation

The single most important determinant of success

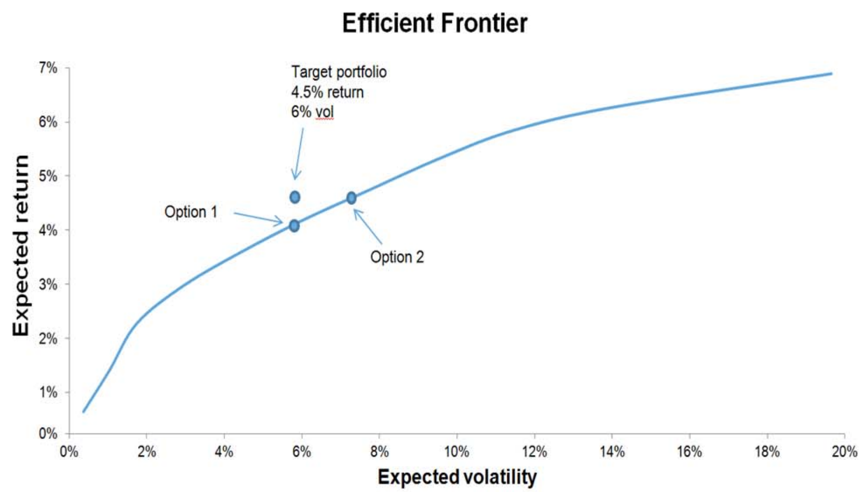
# Strategic Asset Allocation

› Establish the portfolio's objectives

› Apply capital markets forecasts

› Develop Strategic Asset Allocation

**Now what…..?**


Source: For illustrative purpose only.



Russell Investments

# Diversification – the only free lunch?

BEST PERFORMANCE

| 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|
| Emerging Markets 32.6 | Real Estate 41.8 | Emerging Markets 40.9 | Global Bond 4.8 | Emerging Markets 83.8 | US Small Cap 26.2 | Sterling Bond 12.6 | Real Estate 27.7 | US Small Cap 36.2 | Real Estate 15.0 |
| Japan 26.1 | Europe 34.5 | Asia Pacific 37.7 | Cash 2.7 | Asia Pacific 78.1 | Emerging Markets 21.7 | Global Bond 5.6 | Asia Pacific 21.7 | US Large Cap 32.3 | US Large Cap 12.6 |
| Commodities 21.4 | Emerging Markets 33.4 | Commodities 16.2 | Global Credit -7.0 | UK Equity 46.1 | Asia Pacific 20.2 | Global Credit 4.6 | Europe 19.5 | Global Equity 27.4 | Sterling Bond 7.3 |
| Asia Pacific 19.5 | UK Equity 33.1 | Europe 14.0 | Sterling Bond -24.7 | Europe 39.3 | Real Estate 19.6 | US Large Cap 0.9 | Emerging Markets 18.8 | Japan 26.7 | US Small Cap 6.6 |
| Real Estate 17.8 | Asia Pacific 32.7 | Global Bond 9.5 | Japan -26.8 | Real Estate 37.1 | Commodities 16.8 | Cash 0.2 | UK Equity 17.5 | Europe 24.6 | Global Equity 5.2 |
| Europe 10.6 | Global Equity 20.1 | Global Equity 9.2 | Commodities -35.6 | US Small Cap 33.7 | US Large Cap 15.4 | US Small Cap -2.9 | US Small Cap 17.3 | UK Equity 23.1 | Global Credit 2.9 |
| Global Equity 9.6 | US Small Cap 15.7 | Global Credit 7.3 | US Small Cap -37.1 | Global Equity 31.5 | Japan 15.9 | UK Equity -4.2 | Global Equity 16.2 | Asia Pacific 4.6 | Asia Pacific 2.8 |
| UK Equity 9.1 | US Large Cap 14.8 | UK Equity 7.1 | US Large Cap -38.0 | US Large Cap 27.5 | Global Equity 12.4 | Global Equity -5.7 | US Large Cap 15.7 | Real Estate 3.7 | Global Bond 0.6 |
| US Small Cap 7.7 | Sterling Bond 14.8 | Cash 5.2 | Global Equity -41.2 | Commodities 18.9 | UK Equity 11.0 | Real Estate -6.5 | Sterling Bond 11.0 | Cash 0.2 | Cash 0.2 |
| US Large Cap 5.7 | Global Credit 7.3 | US Large Cap 5.2 | Europe -48.0 | Global Credit 16.8 | Europe 5.9 | Europe -12.3 | Global Credit 10.8 | Emerging Markets 0.0 | Emerging Markets -1.7 |
| Cash 3.4 | Global Bond 6.6 | Sterling Bond 5.0 | Real Estate -48.2 | Sterling Bond 16.5 | Global Credit 5.6 | Japan -12.5 | Japan 7.5 | Global Credit -0.1 | Japan -3.6 |
| Sterling Bond -3.1 | Cash 5.1 | US Small Cap 1.0 | UK Equity -49.4 | Global Bond 6.9 | Global Bond 5.5 | Commodities -13.3 | Global Bond 4.3 | Sterling Bond -0.8 | UK Equity -4.8 |
| Global Credit -3.1 | Commodities 2.1 | Japan -5.2 | Asia Pacific -53.6 | Japan 4.8 | Sterling Bond 4.7 | Asia Pacific -17.1 | Cash 0.2 | Global Bond -2.6 | Europe -6.8 |
| Global Bond -4.5 | Japan 2.1 | Real Estate -7.4 | Emerging Markets -55.5 | Cash 0.3 | Cash 0.3 | Emerging Markets -19.4 | Commodities -1.1 | Commodities -9.5 | Commodities -17.0 |

WEAKEST PERFORMANCE

Source: Russell Investments, for illustrative purposes only.

# Dynamically managing the asset allocation

› **What and why?**

› Shorter-term changes to asset allocation

› Capture opportunities

› Protect portfolio returns

› Risk management

› **Critical elements**

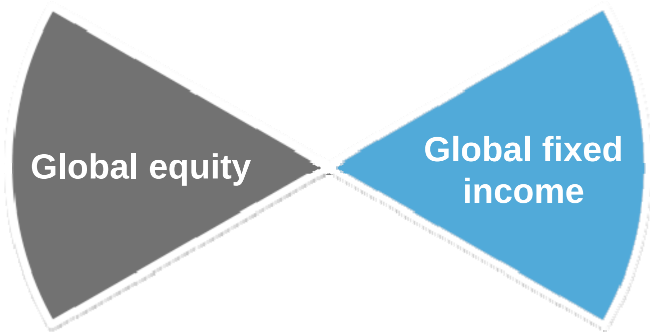
› You must have a structured, disciplined process

› Cost a key consideration

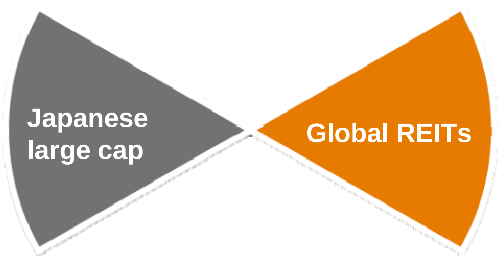
› Sell discipline

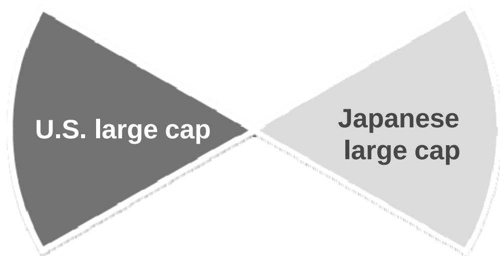
› Remove emotion!

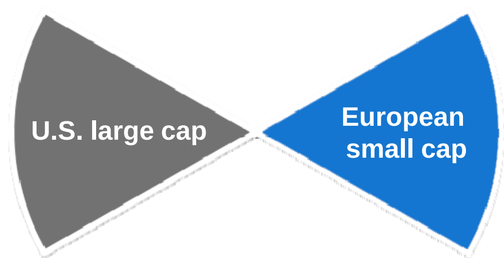
# What should be considered?




A multi-asset perspective i.e. knowing when global equity may be misvalued relative to global fixed income, or Japanese large cap to REITs, that helps build an *investable* insight.



# A comprehensive, rules based process

## CYCLE

Identifies changes in the macroeconomic environment that influence asset class behaviour

### INPUTS

- Central bank policies
- Government fiscal actions
- Political and geopolitical events
- Corporate earnings

## VALUATION

Measures return potential across asset classes, but is the smallest weight in the tactical framework

### INPUTS

- Historical context
- Risk premiums
- Consensus expectations

## SENTIMENT

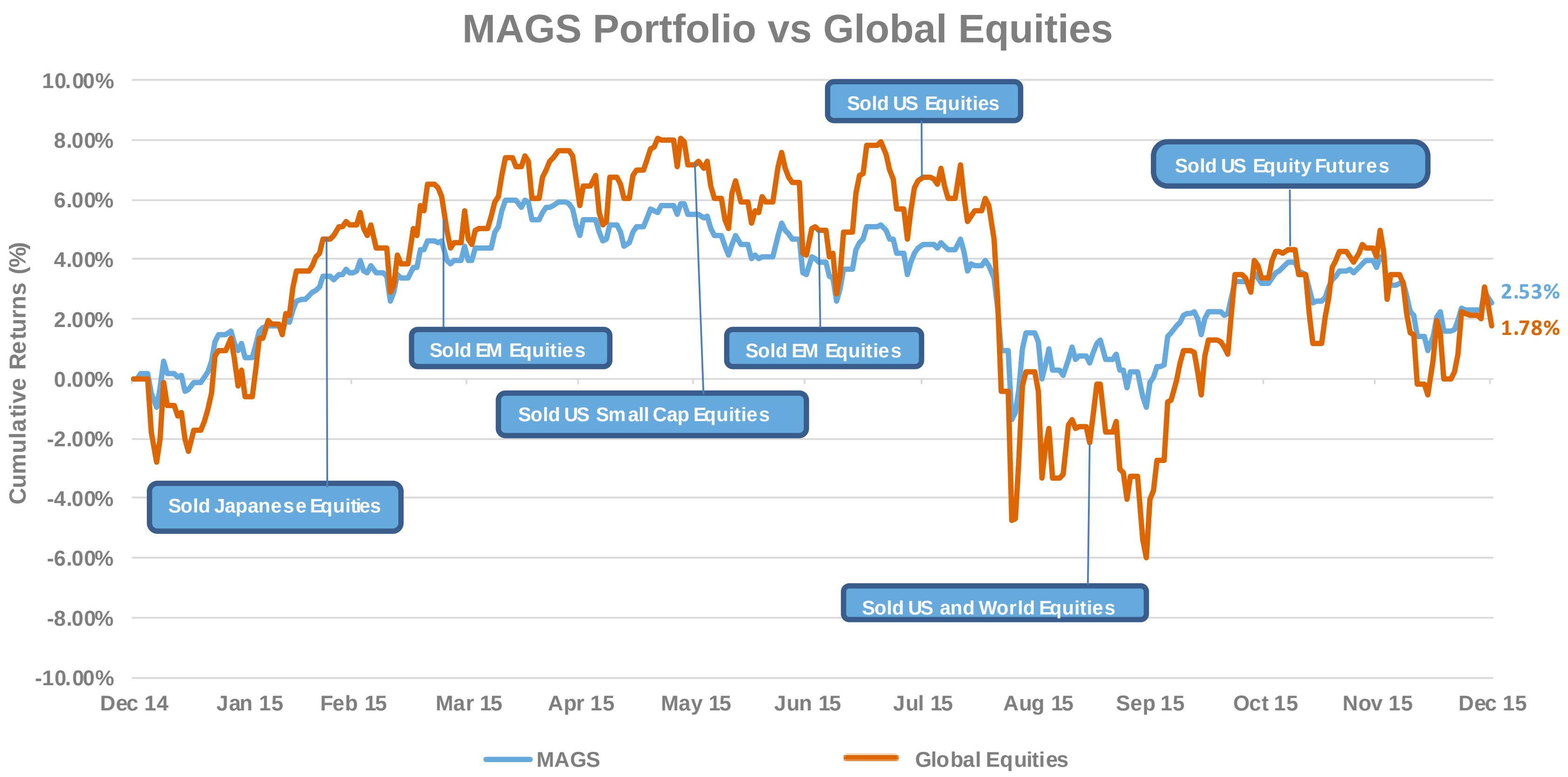
Looks at price momentum versus contrarian indicators that signal overbought/oversold conditions

### INPUTS

- Fund flows and popular positions
- Short term technicals
- Investor behaviour and risk appetite
- Economic surprise indices
- Investor sentiment surveys

Source: Russell Investments. For illustrative purposes only.

# Dynamic asset allocation in practice




- Equity weight at 1st January 2015: 51%
- Equity weight at 31st December 2015: 33%

Source: Russell Investments as at 31 December 2015, net of fees.

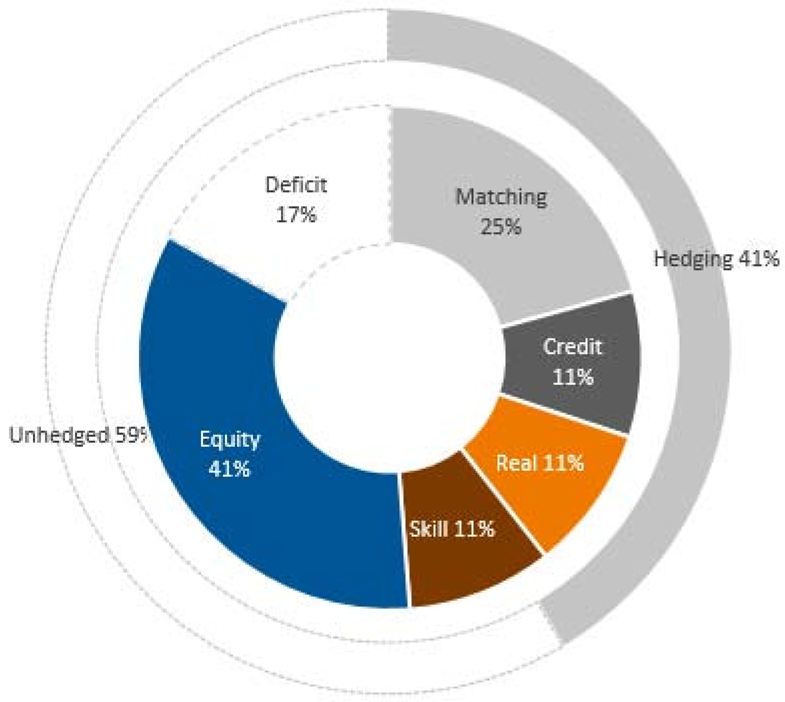
# Risk management

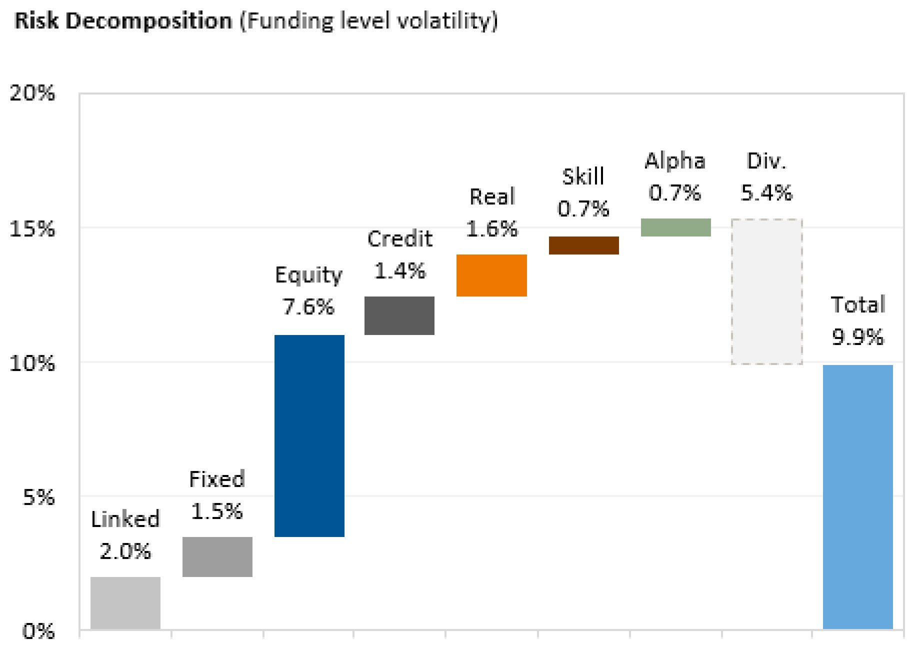
"Risk is like fire: If controlled it will help you; if uncontrolled it will rise up and destroy you"

*- Theodore Roosevelt*

# 1. Integrated risk management reporting

› Know what factor exposures have the greatest impact on your funding level




Source: Russell Investment. For illustrative purposes only. Gross of fees.

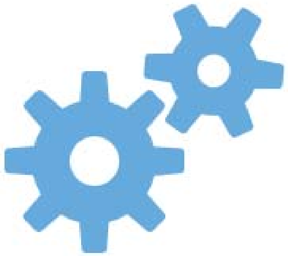
# 2. Market risk management

Evolution

| | Primary Cost |
|---|---|
| **Strategically de-risk**<br>e.g. Hold less of the risky asset | Lower expected return |
| **Diversify**<br>e.g. Introduce additional asset classes | Residual tail risk |
| **Change the drivers of return sources**<br>e.g. Introduce Defensive Equity, Low Volatility, etc. | Lower expected return |
| **Tactical Hedging**<br>e.g. Buy/Sell puts & calls, equity replacement | Premium paid or Forgone upside |
| **Strategic Hedging**<br>e.g. Dynamic downside protection/derisking | Potential Forgone upside |

NB: Although steps can be taken to reduce risk, it cannot be completely removed.

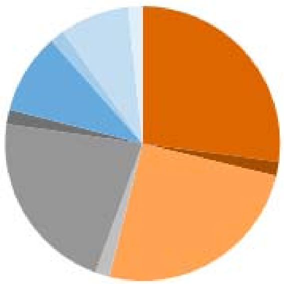
# Managing market risk



## Tactical Hedging

### Derivative Overlays provide flexibility to adjust equity risk

- Futures to adjust exposure immediately
- Options for soft floor or hard floor protection
- Requires tactical timing decision and a specific view on the market



## Strategic Hedging

### Ongoing overlay program to limit risk contribution and asset draw-downs from equity exposure

- Hedging with listed futures
- Limits downside risk
- Improves wealth compounding (avoid negative returns)
- Allows for beneficial asymmetry in annual return distribution

The referenced solutions are representative and not all inclusive.

# Downside protection

Specific strategies to protect against market drawdowns

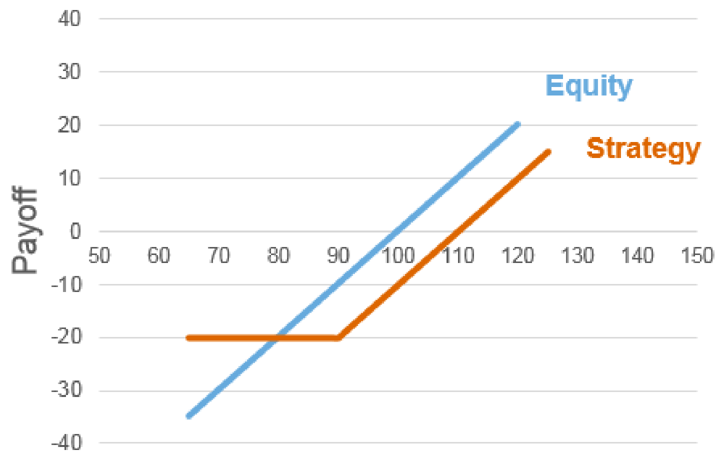
# Downside protection

- **What and why?**
- Taking action to reduce exposure to a potential market downturn
- Protect portfolio returns
- Reduce risk

- **Critical elements**
- Establish the cost structure
  - Pay a premium
  - Forego upside
- Determine timeframe
- Select instruments

# Buying puts has its pros and cons

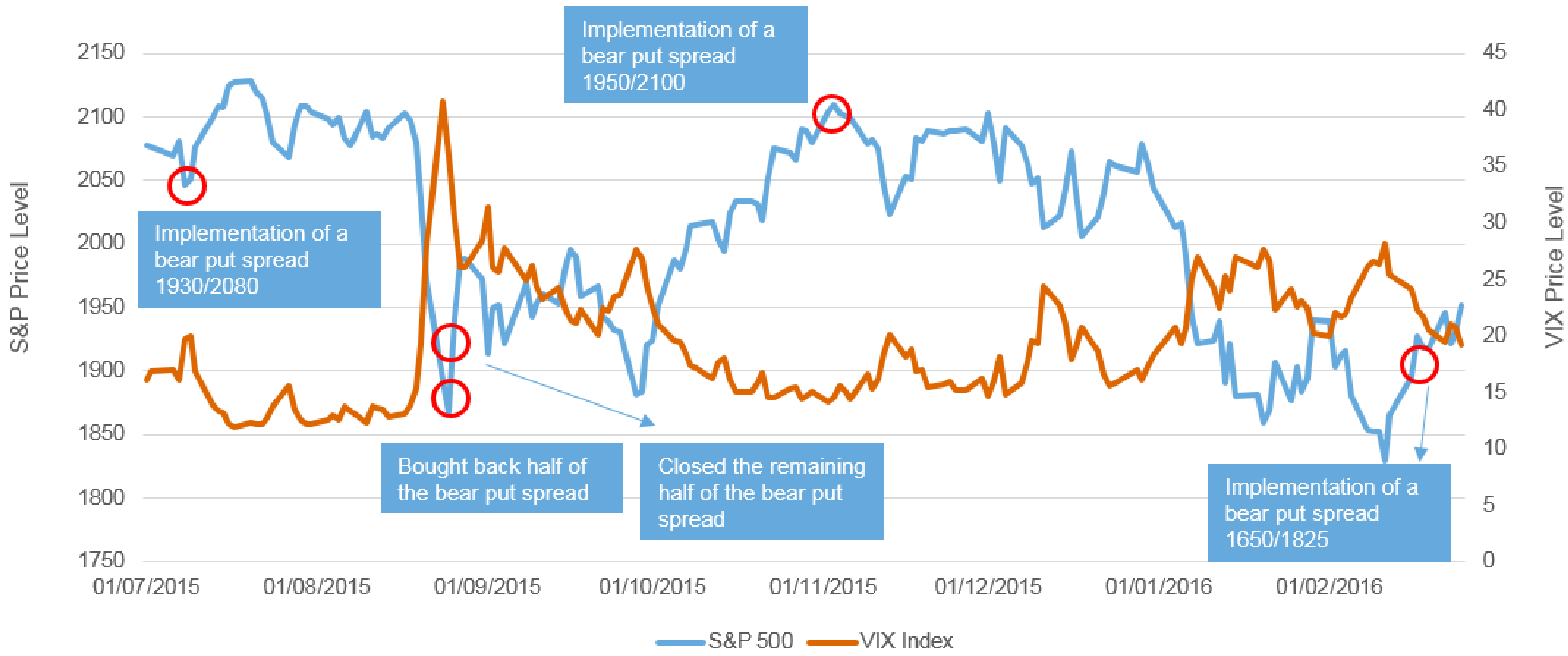
- **Description:** The simplest equity hedging strategy is to purchase an ATM or OTM put option. The strategy reduces risk by limiting losses to the premium paid plus the difference between the spot price and put strike at initiation.
- **Market View:** Long puts can make sense in times when tactical, short-term downside protection is desired. Long puts provide true tail risk below the strike level.
- **Risk:** The main drawback to a long put strategy is cost. During market stress, near the money put options are very expensive due to high implied volatility. Long put hedges should not be considered strategic hedging solutions. A systematic long put option strategy that perpetually buys protection has a high probability of eroding portfolio value over the long term.


Source: Russell Investments. As of 29 May 2015. For illustrative purposes only

# Downside protection in practice

## Protection: S&P 500 Bear Put Spread (2H15 & YTD)




**Downside protection through derivatives in key to capital preservation**

Source: Bloomberg as at 25th February 2016.

# Alpha

Value added by investment manager skill

# Alpha

- **What and why?**
- Gaining additional return through investment manager skill
- In a low return environment, it's never been so valuable
- Uncorrelated source of return at total portfolio level
- Certain strategies are alpha only

- **Critical elements**
- Cost versus 'value for money'
- Hiring / firing
- Open-architecture
- It is really a question of resources

# It’s not simply ‘active or passive’

- Passive is lower cost than active, with a lower expected return than active management
- Some strategies are alpha only e.g. tactical asset allocation, downside protection, hedge funds
- Additional portfolio-level return from successful active relieves tension on the asset allocation
- Active should mean flexibility to deliver a specific ‘outcome’

# Controlling all costs (Tricks of the trade)

Your value to asset managers is not only in the management fee you pay them

# Your other valuable assets…

- Trade flow
- Trade commissions
- Foreign exchange transactions
- Transition activity
- Custody

- **What can you do about it?**
- Commission management
- Multi-venue pure agency trading
- Agency FX
- Disclosure of pre- and post-transition costs

# Thank you

# Important information

- For Professional Clients Only.
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