Societe Generale & Risk Derivatives Conference 2018

DRIVING RETURNS THROUGH DERIVATIVE SOLUTIONS

Conference insights

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Multi-asset juggling act

Is it different this time around? That is the big question all speakers at the *Societe Generale & Risk Derivatives Conference 2018* tried to answer in different contexts. The event kicked off with a keynote address by political journalist and international broadcaster Nick Robinson, who considered the various scenarios for Brexit, and concluded with futurologist David Smith, who looked at how the financial services industry, and particularly banks, need to embrace innovation and change

A panel of leading multi-asset portfolio managers focused on two key questions posed by moderator Kokou Agbo-Bloua, global head of flow strategy and solutions, financial engineering at Societe Generale: does asset allocation evolve over the business cycle, and are machines more efficient than humans?

The discussion examined the options and strategies employed by asset managers and owners when trying to juggle a multi-asset portfolio at the end of the business cycle.

First was a look at correlation, rebalancing portfolios and timing the end of the cycle. For many of the panellists, the job of managing a multi-asset portfolio was about dynamic management of assets and risks.

Diversification was identified as one of the main benefits – and challenges – of a multi-asset portfolio. Managers struggle to balance competing strategies with benefits and risks, adding more risk premia beta to replace other strategies, or look for pure diversification through the likes of volatility, relative value, convexity payouts, positive carry and others.

Unlike hedge funds, which are strategically tactical going in and out of positions, most of the panel managed long-term positions able to withstand shocks. This contrast was illustrated by comparing the styles of boxers Muhammad Ali – "floating like a butterfly and stinging like a bee" – and Rocky Marciano, whose approach was to take lots of punches but persevere regardless. Panellists favoured a combination of both ideas.

Most agreed that going in and out of stocks was essential, though not as aggressively as a hedge fund would. "Investment is a long-term goal," said cross-asset portfolio manager Leo Niemeläinen at Finnish pension fund Ilmarinen, which manages €45 billion.

"Our approach is to seek structural imbalances in order to build better risk/return in the longer term. We accept we may not be fully hedged at all points, but at times carry positions to maturity and create a good risk/return profile."

He admitted that one of the challenges in pursuing this strategy was communicating the nature of the positions taken and their value in one or two years' time upwards in the organisation. This meant that, at times, the fund would take a hit but over the long term there would be a solid return.

From top left: Kokou Agbo-Blou, Societe Generale; John Bilton, JP Morgan Asset Management; Sunil Krishnan, Aviva Investors; Roderick MacKenzie, BlackRock; Leo Niemelainen, Ilmarinen; and Talib Sheikh, Jupiter Asset Management

One of the risks of running a multi-asset portfolio was identified as correlation. Diversification is not necessarily insurance against correlation. This tends to go up and down as with volatility and pricing, noted John Bilton, head of global multi-asset strategy at JP Morgan Asset Management, which has $250 billion under management. "You are not managing for one moment. You need to think about tails as well as distribution. Diversification can add beta when you don't want it."

If every position comprises four elements – buy, sell, borrow and lend – breaking those elements down to spot a structural distortion is a way for managers to think about timing, he said.

At Jupiter Asset Management, Talib Sheikh, head of multi-asset strategy, is looking after a fund seeded with €55 million and is in the process of building a multi-asset portfolio. He believes positions are based on the blend of assets needed to solve an investment objective. "We build diversification across asset classes. Clients don't really care about the assets but are focused on the solutions. Prior to the [financial] crisis most investment solutions were traditional, but quantitative easing has extinguished this approach and it is unlikely to come back. So multi-asset – a more innovative use of assets – is needed," he said.

As asset prices are influenced by emotions and the randomness of human nature, Agbo-Bloua wondered if humans still have value. The question of humans versus machines – or discretionary compared with pure quantitative solutions, particularly in regard to timing a change in a business cycle – was something most on the panel said needed to be balanced. Systematic strategies have a role to play, but all believe the human element is crucial. Systematic strategies are by nature disciplined and not caught up in the emotional side of investing, noted Sunil Krishnan, head of multi-asset funds at Aviva Investors, which runs around £100 billion in a mix of traditional balanced and absolute return products. The trick when covering a wide range of markets is to spot opportunities and incorporate them into the portfolio.

"It's about spotting regime changes. We have 100 years of relevant history, and if none of that history is relevant we have a problem. What machines can do is spot the relevant parts of that history and apply it," he said.

Agbo-Bloua asserted that, with the explosion in data points that can be used, the amount of noise has increased exponentially, making it even more difficult for machines and humans to find signals. "The challenge for systematic strategies is finding the signals and interpreting these, combining them with the human element. The combination of the two is powerful," he said.

For discretionary to work, managers need to pick the right information at the right time. That means applying a more systematic, disciplined approach and not getting caught up in the emotional side of the market. "It's about finding the positions that are best for the portfolio in today's environment," added Agbo-Bloua.

Others agreed that the human element was important.

Roderick MacKenzie, who manages multi-asset strategies at BlackRock, allocates to both volatility and risk premia products. "As a multi-asset fund, we think about alpha in asset allocation and this is most important in driving our returns." Timing, he conceded, is difficult to gauge at any stage in the business cycle. "We don't change the recipe too much. We look at ways of adding convexity to the portfolio without having to pay for it if the timing is wrong."

Overall, the panel agreed that humans add value to the investment process. JP Morgan's Bilton believes it is about combining quantitative and systematic strategies successfully in the portfolio design. "You need to use all the information you have to blend both," he said. "Machines are better at looking at combinations, but no matter how good machines get at natural language processing, they are reactive, not predictive. They recognise information within a systematic, repeatable framework. But that cannot tell you how it will evolve in the future. A strong multi-asset portfolio recognises the weaknesses and strengths of systematic strategies, with the manager making the judgement of how to use them."

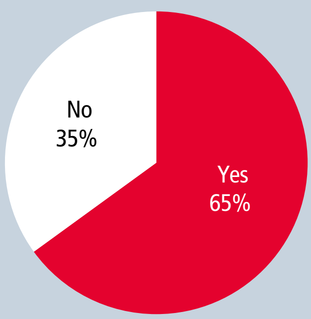
Aviva's Krishnan believes no matter how a portfolio is positioned in whatever part of the business cycle, liquidity is crucial. In the end, he said, the job of the portfolio manager is to ensure there is sufficient liquidity within the portfolio, and maintains liquidity risk is now much more of a focus for managers.

Trying to time markets and the business cycle is futile, said Bilton. "None of us know when a [business cycle] will end. We do know that that most of the returns are made not by timing a recession but by how we behave at the dip. We're not good at being contrarian as an industry. That's one of the reasons we need systematic strategies. But the human element is also needed. Perhaps risk premia are the new equilibrium."

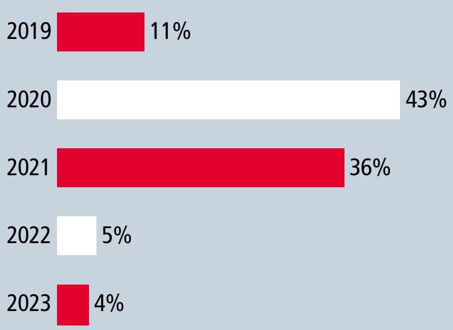
Returning to the boxing metaphor, Agbo-Bloua noted that plans are great, but once you are punched in the face, they evaporate. Human behaviour is that punch for portfolios, and managers need to roll with those punches and limit the downside impact. ■

AUDIENCE POLLS

Do you currently invest in multi-asset strategies?



When do you think the US will enter into recession?



Endurance of systematic strategies

Everyone is a systematic trader, declared Ewan Kirk, founder of Cantab Capital Partners, now part of GAM Systematic. His conclusions are based on the fact that systematic trading is a wide term, encompassing any form of rules-based trading. "Trend following, risk parity, alternative risk premia, exchange-traded funds – all of these are systematic trading. In every sphere of human endeavour we are seeing systematisation, a rules-based approach," he said.

Alternative risk premia, for example, Kirk sees as simply a different market segment of systematic trading, a way to go short risk. "Ultimately it's just taking a risk to get a premia."

He describes systematic trading as "a good story", as it is evidence-based and he believes it will continue to be a part of investment portfolios in the future.

Kirk, who started Cantab after he left Goldman Sachs, likes mathematics and programming as well as using research to create an edge in investing. He agrees investors may find it difficult to choose between systematic programmes compared with the easier-to-differentiate discretionary investment processes. However, he sees culture, research processes and technology as the key elements that differentiate between systematic strategies.

He maintains that machines, not humans, are the way to understand a complicated world. "Are humans going to react faster than a computer?" he asks. He thinks machines are the best way to understand ever-growing datasets and apply rule-based investment systems.

Models change and are dynamic and adaptive to market conditions. In the future, machine learning and artificial intelligence (AI) will continue to play a role. "We've used what we call machine learning for more than 10 years, but we used to call them adaptive models. Now we call them machine learning and AI because that's what people want to hear," he said.

More insights into systematic trading and alternative risk premia products came from Sushil Wadhwani, founder and chairman of Wadhwani Asset Management. His move into hedge funds was inspired by the intellectual challenge he saw as well as by his 'hero' John Maynard Keynes, who in the 1920s ran an investment syndicate that today would be called a hedge fund.

This year, Wadhwani launched his first alternative risk premia product, in an area he has studied for a number of years. While a lot of money has gone into this area, he believes some risk premia products are vulnerable to crowding and 'no fee' scenarios over time.

Wadhwani believes that a product more transparent than a conventional hedge fund, but more sophisticated than textbook risk premia products, could fill a gap in the market.

Ewan Kirk, Cantab (part of GAM Systematic)

Sushil Wadhwani, Wadhwani Asset Management

"My sense is that it is still early days, but that's where the industry will converge," he said.

The key issue for textbook risk premia products, or what Wadhwani terms 'vanilla', is a lack of innovation. "It is critically important to time the allocation to allow for crowding and the fact that, in different macro environments, different risk premia work. There are very good macroeconomic reasons that trend following does less well in certain environments," he said. At certain points in an economic cycle, quantitative trend-following strategies should be "downgraded" by investors while upgraded at other points in time.

Observing the current macroeconomic environment, he acknowledged it is "more challenging" for global macro strategies. What he defines as risk premia may be defined by others as inefficiencies.

"Everything we do is either exploiting a market inefficiency or risk premia. I don't take a dogmatic view on this. We use the whole spectrum, everything ranging from trend, carry, value and pursuing time-varying approaches with a mix of strategies. We use strategies that don't conventionally get counted as risk premia," he explained.

At the same time, different monetary regimes mean strategies and models need to adapt. Central banks have moved from conventional inflation targeting to risk-averse policies in the form of guidance and quantitative easing. When that happened, models needed to adapt.

As the transition away from quantitative easing occurs, models will again need to adapt. "We have built alternative contingency macro models in case of regime changes. We do this two to three years before the expected change," Wadhwani confirmed. Over the past nine to 12 months, he said, pre-financial crisis models were becoming more relevant. ■

Deal or no deal? – The Brexit saga

Negotiating with 27 individual countries and their overarching institutional structure was never going to be easy. Talks between the UK and the European Union and its 27 member states are more complicated than any business negotiation could ever be, admitted Nick Robinson, political journalist and international broadcaster.

The calculations for the UK government, in all political areas, boils down to a simple ability to count votes – in this case votes in the EU and UK parliaments.

The numbers are even more crucial for a prime minister without a majority – as is the case with Theresa May. "What underlies political statements is power," he explained. For the current prime minister, power is precarious given the divisions within her own party and her reliance on other parties such as the Northern Irish Democratic Unionist Party (DUP).

May's tactics so far in the game of Brexit is to play long and avoid decisions, saying as little as possible and providing few clear details. While that does not convey much to the public or to politicians, it does make it easier for the government to negotiate.

The current plan appears to be to find a third way of creating a bond with the EU that is not quite the same as Norway's – which includes all the benefits of membership but no influence over policies – and Canada's, which is a much looser trade relationship more suitable for a country thousands of miles away than neighbouring ones. Creating a third way, however, is not something the EU is keen to pursue.

At the same time, the idea of "no deal being better than a bad deal" is equally difficult for both sides. "The UK government is terrified of a no-deal scenario. No one really believes that is acceptable or tolerable," Robinson said.

For the EU, the same sentiment applies – there is no desire for the UK to crash out of the union. The dislocation to the EU economy that would result is not attractive.

The remaining EU members are keen to keep trade and borders open, while ensuring access to the UK's contribution to the EU's coffers in the short term. The present UK payment to the EU is worth around half a percentage point of total EU GDP. While not huge, it is considerable in a group where there are few net contributors.

Without a deal including a payment schedule, wealthy countries – particularly Germany – would be left holding the bag. That is not something the German government is keen on.

Nick Robinson, political journalist and international broadcaster

Robinson put the chances of there being no deal agreed at around 30%. This probability factor is with an eye to sheer political miscalculation. It is one thing for May to sell the idea of a Brexit deal to the UK public and parliament, but quite another to sell it to the EU. The gap between the two was in stark relief with the outcome of the meetings in Salzburg earlier this year when the EU bluntly rejected May's Brexit plan.

Robinson is equally sceptical of the likelihood of an early general election or a second EU membership referendum in the UK. Both would take a considerable amount of time and would be possible only long after the March 2019 deadline has passed.

The probability of the EU extending the negotiation process, however, is more likely, but only if the UK asks for it.

Another consideration is the EU's intention of preventing the process of leaving being too easy, in order to deter other nations considering an exit. Robinson cautions that some EU member states want to ensure the exit process is difficult so that other countries – particularly those with populist, right-wing, anti-free-trade parties waiting in the wings – do not see leaving as a viable option. ■

Resistance is futile

Looking into the future is no simple task for David Smith, futurologist and chief executive of Global Futures and Foresight, a strategic futures research organisation. His view of the future for banking and financial services challenges current practices, perceptions and structures.

Thinking about the future, he believes, is essential – particularly for a segment of the financial services industry that has seen little change since it was formed.

Changes in work practices and demographics alone are factors that will impact the future of all work. Increasing financial technological developments means different types of banking, such as sharia-compliant Islamic finance, will change in the future. Looking simply at population figures, the future banking population is likely to be predominantly Muslim – a big culture change for an industry traditionally based on a Judeo-Christian world.

The world's population is expected to reach 8.6 billion in 2030, according to the UN. This number will support a very different middle class than it currently does. They will want to access assets differently and have expectations centred around the creation of 'ecosystems'. A combination of finance platforms is likely to address their needs better than a single brand.

The changing landscape for products and services and the current digital dimension means future technology will help people do things differently with lower cost bases and in ways not even thought of at present, said Smith.

This means services such as managing assets or money are likely to be changed significantly by the likes of quantum computing, blockchain, open digital platforms and technology that transform the nature of how people interact and share information.

Waiting to find a new role is "a dangerous strategy", warns Smith. The speed of change is fast and companies need to embrace innovation now, using new tools to proactively drive the industry.

Even derivatives are not protected, he said. In the future, distributed ledger technology and quantum computers can be used in dramatically different ways. For example, cryptocurrencies could be used to reduce the cost of settlements, and AI is already changing businesses and how consumers behave in the real world.

"It's about data and sources of data overlays," said Smith.

David Smith, Global Futures and Foresight

"It's about harnessing data from all aspects of life to create new insights and products, to do things differently. This will happen from inside and outside organisations. It's a whole new proposition."

In the future it is likely there will be a network of players in the banking ecosystem with customers and providers collaborating to bring better value. "Becoming open, multi-providers, collaborating – that's the way ahead. In banking we need to have more people that want to play in this space," said Smith.

He acknowledged, however, that many people could find it challenging to cope with change – it will be particularly difficult in areas such as financial services, where there are set structures and a known hierarchy. Those that do not achieve cultural and operational transformations are likely to be left behind. Smith cautions that as much energy needs to go into innovation as the improvement of services.

"Leaders will want to change culture and be more open to new ideas, take more risks and be more entrepreneurial. They will need to do things in a different way," he said. In every industry there is a push for operational efficiency and new methods and means to deliver services and products. Leaders in every organisation need to respond to this in a positive way or face being left behind. ■