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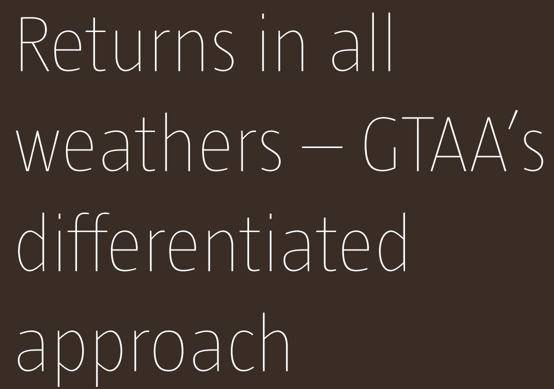


Returns in all weathers – GTAA's differentiated approach

INVESTMENT OPPORTUNITY

Robeco Global Tactical Asset Allocation

- Investors face a new market environment
- GTAA offers scope for positive and differentiated returns
- 5-year track record of impressive results

Returns in all weathers – GTAA's differentiated approach

The search for different sorts of returns

Investors have for years targeted the two main asset classes of equities and fixed income, using government bonds as a 'safe haven' if stocks became too volatile. The bull markets seen in both markets over the past 7 years provided a rich stream of profits… but now things are different.

The first rate rise by the Fed in almost a decade signaled for many a 'Return to Normalization', raising yields on US Treasuries. As yields move inversely to bond prices, rising yields means falling bond values, ending the Treasury market's role as a means of avoiding losses elsewhere. Meanwhile, equity market volatility has increased amid heightened geopolitical risk and uncertainty over whether China's economic miracle is sustainable. The US rate rise has also brought with it a paradoxical fear that higher borrowing costs will trigger a global recession.

Investors stuck between a rock and a hard place have two choices. They can stick to their old strategy and accept that volatility has increased, with lower future expected returns as an added 'bonus'. Or they can try to search for different sorts of returns that can lead to a more stable portfolio, or even make money if markets fall.

Robeco's Global Tactical Asset Allocation (GTAA) fund is a systematic absolute return strategy designed to generate these kinds of differentiated returns, regardless of market conditions. It is able to go 'long' and 'short', meaning it can use derivatives to monetize those times when markets rise and fall. It relies on market timing and direction, rather than a need for security prices to always go up, and has built an impressive track record since it was launched over five years ago.

"Some 90% or more of the market return from traditional long-only funds comes from markets rising," says Portfolio Manager Klaas Smits, who runs GTAA jointly with Shengsheng Zhang. "However, equities are experiencing rising volatility and are prone to economic risk, and the traditional cushion of government bonds is gone for now."

"If you offer a different pattern then that in turn can offer you diversification, and if that return is also positive, then you can get a much better risk/return profile than being long only, and it can be useful in mitigating drawdowns."

Performance table

Annualized						**31/12/15**
	Dec	**YTD**	**1 year**	**3year**	**5 year**	**Inception**
Return	-5,28%	3.90%	3.90%	16.42%	1175%	11.54%
Volatility			16.18%	16.01%	14.15%	14.34%
Sharpe ratio			0.25	1.02	0.81	0.78

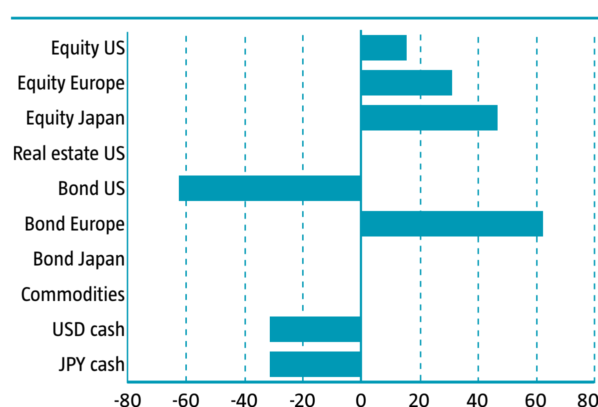
Calender year

	2015 (YTD)	**2014**	**2013**	**2012**	**2011**	**2010**
Return	3.90%	9.29%	38.94%	15.34%	-4.24%	6.55%
Volatility	-	15.62%	16.28%	9.48%	11.79%	-

GTAA in a nutshell: neither top-down, nor bottom-up

Markets move in cycles, which in traditional long-only funds means an investor is carried along with the cycle, in good times and bad. A better alternative would be to try to profit from short-term deviations by being long in an asset (believing that the price will rise), or short (believing that it will fall), at the right time. This strategy lies at the heart of tactical asset allocation, and we exploit this asset cycle behavior in two ways. First, there is the absolute approach, timing trades either long or short in individual markets. Second, there is a means of gaining relative returns by profiting from the fact that different asset cycles do not move in synch, so it is possible to allocate either long or short between different asset classes.

Figure 1 | Example of GTAA portfolio holdings



Source: Robeco

It means that the GTAA strategy does not follow the top-down market mantra that a 'rising tide floats all boats' which is necessary for returns in a long-only fund. Neither does it follow the bottom-up philosophy of stock picking, which aims to generate relative returns against the benchmark that it tracks, but is still prone to absolute losses. Instead, the fund looks for the area in-between, seeking returns from market directionality in equity and bond regions, and asset allocation between asset classes such as equities, bonds and currencies. For this we use a systematic strategy driven by proven models and quantitative factors.

"Our models don't care whether asset returns go up and down, as we can go long or short," says Smits, who has been with Robeco since 1997. "We can be as short as we can be long, and we don't have a traditional benchmark which would restrict what we can follow. Instead we operate within a fixed universe which pre-defines what we do and what we do not do. We do not seek any alpha coming from stock or bond selection: we are not stock picking. We make returns which are not dependent on the general market environment as a whole. We cannot always predict exact turning points in market cycles, but we can identify periods in which our models expect certain asset classes to deliver positive or negative returns."

So how does it work?

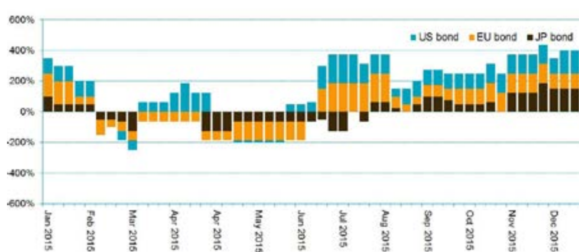
We use market timing and asset allocation in a purely systematic way based on solid, proven indicators such as valuation, momentum and seasonality. These factors are proven to work by academic research as well as through the live track records of our quantitative models. And it utilizes a highly diversified approach, with the ability to work across all the major asset classes.

Example 1: Using GTAA in a tactical fixed income allocation

The global bond market started off strongly in 2015, with declining yields and rising bond prices. In anticipation of the ECB bond-buying program the 10-year German bond yield declined to an all-time low in April of close to 7 basis points. We were long on bonds during this time, so we enjoyed good returns.

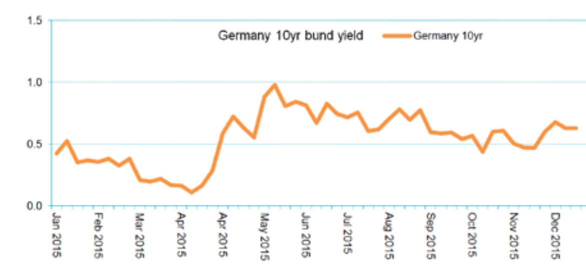
Then the GTAA strategy which had been advocating a long positon in bond markets since the start of the year turned negative, due to rising equity markets and recovering commodity prices. It signaled optimism about economic growth, which is good for equities but bad for bonds. So we went short. Bond yields subsequently rose sharply in May and June, resulting in the worst quarterly global government bond return in 20 years, and because we were short, this benefited GTAA significantly. This is shown in Figure 2 and Figure 3.

Figure 2 | GTAA government bond positions (January - December 2015)



Source: Robeco

Figure 3 | The development of the 10-year benchmark German government bond yield, January - August 2015



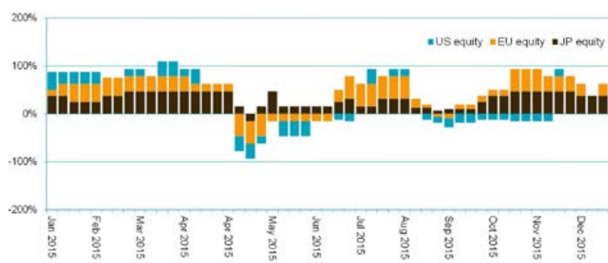
Source: Bloomberg.

Example 2: Using GTAA in a tactical equity allocation

There is an old adage that what really moves markets is 'greed and fear' – where human nature ultimately always intervenes, no matter how sophisticated markets become. GTAA taps into a branch of behavioral finance that acknowledges the very human habits that can dictate market direction, whether they are rational or not. A good example of this is seasonality and the 'Halloween effect', which builds on another market adage: "Sell in May and go away, but don't forget to come back in November". This is related to what is called 'the optimism cycle': towards the year end, investors start to look towards the new year, often with overly optimistic expectations. This results in attractive returns for stocks. As the year passes, this initial optimism becomes more modest and the stock market experiences a summer lull. "And this kind of behavior makes intuitive sense. Ultimately it's all about economic behavior, where people continuously make the same decisions, and we can monetize that," says Smits.

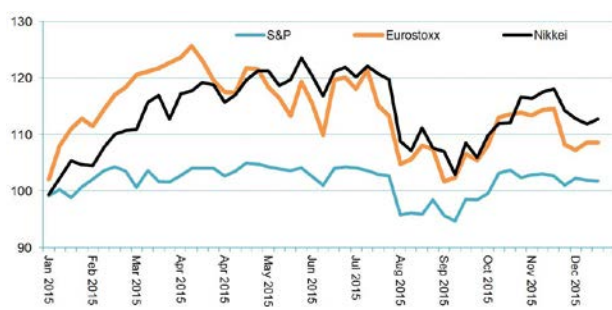
We have experienced this last year as well: the European and Japanese equity markets strongly rallied in the first four months of 2015. GTAA was long on all equity markets and so benefited from this rally. Our models then gave a negative signal for equities in May, due to seasonality and unattractive valuations, and we reversed all our positions in equity markets just as prices started falling. This is shown in Figure 4.

Figure 4 | GTAA equity positions (January - December 2015)



Source: Robeco.

Figure 5 | The development of equity indices (January - December 2015)



Source: Robeco.

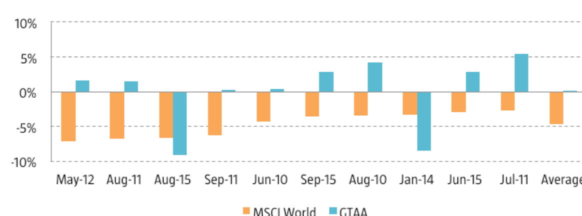
"We use derivatives and leverage to implement the strategy and don't hide from that, but we manage it very robustly," says Smits. "If for example you have a global equity portfolio and the VIX (Volatility Index) jumps, then the volatility of the underlying assets will go up. Traditional equity portfolio managers don't do anything with that; what we can do in this case is actively reduce positions, scaling down long exposure, to get a more consistent contribution."

GTAA's time horizons are also vastly different from traditional long-only techniques. "A traditional portfolio will probably hold a stock or bond for a number of years to be able to take the rough with the smooth," says Smits. "Our trades have a horizon of on average two to three months, whether or not that period is rough or smooth, and that's a wholly different source of return. It is true tactical asset allocation, where every week we decide whether we have the right positioning, or whether we need to look at alternatives. We do this on a quantitative basis with proven results, and so we can show that it adds value."

What can GTAA do for your portfolio?

The principle advantage of GTAA is its ability to diversify the risk characteristics in a portfolio, moving it away from the dominance of equity risk or interest rate risk. This enables the fund to deliver more stable returns within the context of the client portfolio's overall purpose. Such diversification is set to become increasingly necessary as government bonds such as German bunds no longer offer the cushion for volatile equities that investors have become accustomed to.

Figure 6 | Ten worst months for equity markets (May 2010 - December 2015)



Source: Robeco.

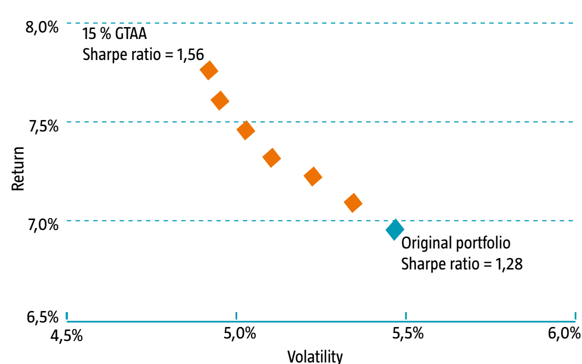
Smits says the changing market environment means investors now have to look for these kinds of alternative sources of return. "For years we've been in a strong bull market where just about every asset class has boomed, and now we're in a very low-yielding environment, despite the Fed rate rise," he says. "Ten years ago, interest rates were 7%, so every 10 years your wealth would double. Now, the German bund 10-year yield is 50 basis points, so it will take you 140 years to double your money."

"The biggest source of return up until now for investors has been capital appreciation coming from the equity or bond bull markets. That was the only game in town. We're now in a very different environment from the past; it's not necessarily better or worse, it's just different. This different environment is perfect for GTAA. Investors need to find sources of returns, and that's a big challenge if you're long-only in equity or fixed income. The Fed rate rise has improved yields in the US, but in Europe, which is still engaged in quantitative easing, government bonds are still yielding 1% or less, and in some cases they are negative. This means being long-only in European bonds is a challenge as well."

"Traditional long-only assets funds have benefited greatly from the past seven years since the financial crisis, when central banks have been the largest provider of liquidity. If they pull

out, as the Fed has done, we are going to go through a new period of market volatility where GTAA can potentially benefit significantly. The long bull run is over, and we expect more volatility, and higher volatility means more opportunity for us."

Figure 7 | Adding GTAA to a balanced portfolio



Starting point is the original portfolio, consisting of an allocation of 50% to global equities and 50% to global bonds. In steps of 2.5%, we replace part of the equity allocation with an allocation to Robeco GTAA, up to an allocation of 15%. The graph shows the improvement in Sharpe ratio as the allocation to GTAA increases.

Source: Robeco.

GTAA's best use is as a differentiator within an existing portfolio, replacing either stocks or bonds, says Smits. "These kinds of differentiated products are for different buckets in a client portfolio," he says. "A client may have one bucket for equities which targets a market return, and another one which is there to be defensive and contains government bonds. But you should have a bucket for part of your portfolio which is going to provide diversification. We can provide more stable overall portfolio returns."

"There are two ways to look at it. The first is to use GTAA as a diversifier for equity, because the fund has an equity-like return but with a better risk/return profile than equities over the normal market cycle. This means it can reduce risk while providing similar or better returns. This is shown in Figure 7.

The second is to use it to replace bonds, and then the overall risk of the portfolio will be roughly the same, but the return will improve. Or combine the two of course," says Smits. "We can run custom analyses for clients using a proprietory in-house developed toolbox, that can help clients gain insight into the potential added value of GTAA in their portfolio, in a range of market environments."

What are the risks?

An approach such as GTAA's offers different kinds of risks to traditional fund management. The main risk to a long-only fund seeking absolute returns is when the market falls, while for those seeking relative outperformance, the principle risk is in picking the wrong stocks. GTAA does not need to rely on rising markets (it can go short), or security selection, but is vulnerable instead to two extremes: higher than expected volatility, or nothing happening at all.

"Since what we do is tactical allocation, if the market is very, very volatile, jumping about all over the place, then the models may not keep up with real-time events, making it riskier to invest at that particular time," says Smits. At the same time, these are typically the kind of environments where our models actively reduce the exposures in the portfolio. "Conversely, if there is no dispersion between asset classes in terms of valuation, then this is an environment in which it is very difficult to add extra value."

"The worst thing that could happen would be if everything stays the same. If nothing moves, or if everything moves all at once – up today and down tomorrow – then that is bad for us. In short, the worst environments are ones which are not captured by the models. In almost all other environments – down, up or moderately volatile – then we can do well. The period during which the US was engaged in quantitative easing, and then tapering, is a good example of when our bond market timing model did fairly well."

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