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Russell Investments,

Multi-asset investing: the importance of seeking to manage the downside

By: Rob Balkema

Multi-asset investing is currently a hot topic in our industry. An increasingly wide range of investors want the dynamic allocation and broad diversification attributes that a well-managed multi-asset portfolio can provide. Many investors also want to ensure their multi-asset fund uses skilled money managers and strategies in every asset class, to seek to generate the extra performance that is so vital in a world of low returns. But fewer investors appreciate the importance of downside protection - the range of techniques designed to reduce the probability and magnitude of losses in a portfolio.

Why is this key for clients seeking consistent portfolio growth? Because big losses are hard to recover from! For example, if a client's portfolio suffers a -30% drop in value, a 43% rise will be needed to get the portfolio back to its starting point. That's where a multi-asset approach that also emphasizes managing downside risk is so valuable, even if they don't protect against all losses or guarantee a profit.

To explain why, let's recollect Aesop's fable about the race between the tortoise and the hare. In the original story, the tortoise beat the hare by being more consistent. In a multi-asset portfolio context, two hypothetical portfolios are racing:

- One has a lower average annual arithmetic return (runs slower) but is well diversified and so exhibits lower volatility. Let's call this one *multi-asset*.
- The other has a higher average arithmetic return (runs faster) but is concentrated in a single asset class, higher volatility portfolio. Let's call this one *equities*.

Because the hypothetical, lower volatility multi-asset tortoise has fewer and/or shallower setbacks to recover from, its lower average returns can compound more smoothly to achieve an equivalent geometric return to the higher volatility portfolio.

The setback penalty for the higher volatility portfolio is known as 'volatility drag.' And that's why the multi-asset tortoise has a good chance of matching or beating the equity hare over one or more full market cycles, all other things equal.

Why is this such a big deal for investors? Because many investors can't stomach market downturns and turn to cash. And individuals approaching or post-retirement can't afford big losses.

In fact, the impact of volatility on a client's portfolio becomes more adverse once the client starts making cash withdrawals. Imagine what happens if a retired client's portfolio suffers that -30% fall, and maybe that timing coincides with the client needing to buy a new car, or finance expensive medical treatment? The client may have to withdraw cash from their retirement portfolio at the worst possible time. Even if the portfolio subsequently enjoyed strong returns, it may *never get back to its starting level within the retiree's lifetime*!

The impact of withdrawals on portfolio performance is known as *cash-flow drag* - and certainly among baby boomers, it's becoming a more relevant consideration. Viewed from a cash-flow drag lens, the slower but more consistent multi-asset portfolio may start to look like a much more compelling investment option than the faster but more volatile equity hare.

The bottom line

For investors who have the most money on the table that they are ever going to have, a big stumble at this point could be crippling. That's why it's so important for investors now to look at downside risk in a different way, to start focusing on wealth preservation in the here and now, and to get away from an exclusive focus on long-run average rates of return.

In a nutshell, that's why managing downside risk is one of the key ingredients of an effective multi-asset strategy. We believe these core ingredients *comprise broad diversification, skilled money managers in every asset class and strategy, and dynamic management* - and last but not least, downside protection. Such an approach can't protect against all losses or guarantee a profit, but it may help reduce the probability and magnitude of losses in a portfolio.

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