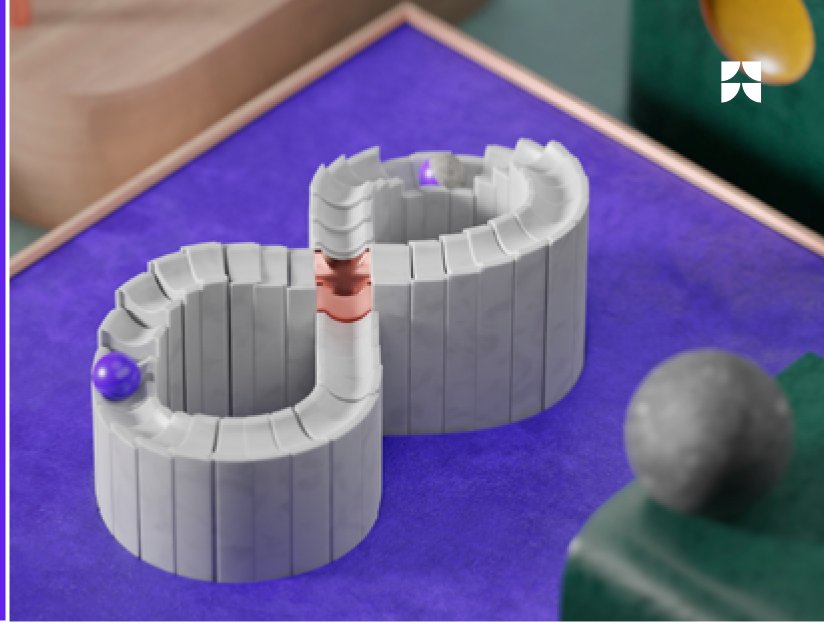

REBALANCING IN SIDEWAYS MARKETS

Lessons from the boxing ring

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Systematic ways to protect portfolios from heightened risks

Professional boxers are trained to endure unavoidable hits and get back up when they're down. They know to protect their weak spots where the risk of losing a match is concentrated. They combine defensive skills rather than count on a single technique against all opponents. They also know they cannot win if they remain in a defensive stance. Each move is a confidence-weighted calculation of risk.

These athletes may be the embodiment of resilience, inspiring multi-asset investors to thrive, even when markets seem to be moving every way but up. In an environment of heightened risks, it's difficult to know how to allocate assets or rebalance portfolios. Investors ought to think like a professional boxer—being strategic when they can, tactical when they must, and always realistic about what they can expect from their portfolio.

Punching above their weight

According to modern portfolio theory, the whole portfolio can be greater than the sum of its parts. How much greater depends, in large part, on how the investor allocates across those parts. A combination of tools can help multi-asset investors determine their optimal portfolio mix and how to execute it efficiently, as no single tool is tailor-made for all investors and all market environments. Here we focus on four investment techniques that investors can combine, depending on their own views and the prevailing market environment:

01 Strategic and tactical allocations

02 Capital and risk allocations

03 Asset class and factor allocations

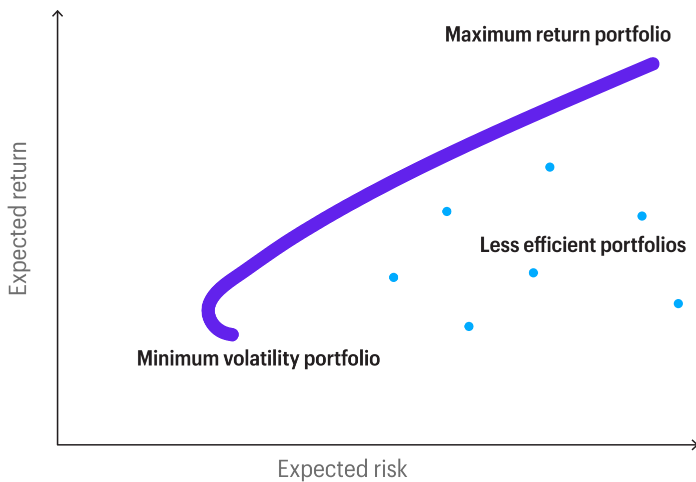
04 Dynamic risk hedging

01 Strategic and tactical allocations

The strategic asset allocation provides a base case for investment decision-making by setting long-term expectations of risk and reward over a full market cycle. Tactical asset allocation adds flexibility to fine-tune investment decisions based on short-term views of where to reduce risk exposure and where to take advantage of opportunities.

Theoretically, investors should aim to achieve an optimal portfolio allocation, also known as the maximum Sharpe ratio portfolio (Figure 1). The optimal portfolio allocation typically starts with a minimum volatility portfolio (a mix of securities that is expected to have the lowest risk). Added to this is a strategic asset allocation (SAA) portfolio overlay (determined by the investor's long-term financial goals, risk tolerance, and other factors) and a tactical asset allocation overlay (which incorporates short-term investment views). The SAA portfolio often includes long-term expected asset returns and risks, known as capital markets assumptions.

FIGURE 1: HYPOTHETICAL EFFICIENT FRONTIER OF PORTFOLIOS



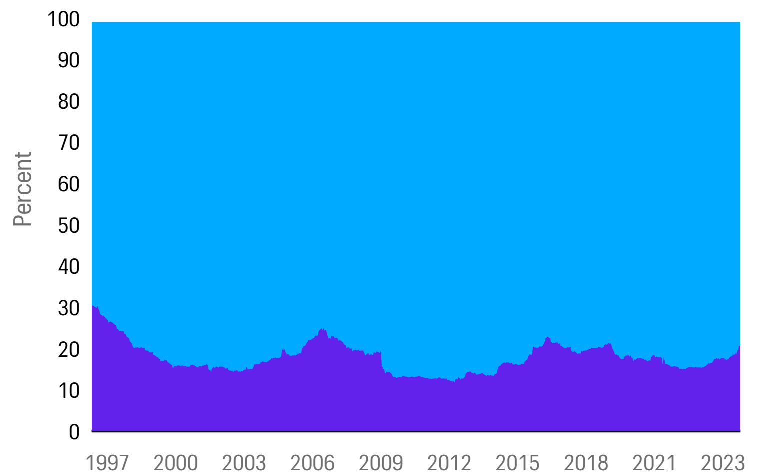
Source: Allspring

For example, global supply chain disruption, the Russia-Ukraine war and its effects on energy supply, and global inflation shocks can lead to different portfolio adjustments from strategic versus tactical perspectives. The effects may be transitory or more lasting, and related risks can be fed through the portfolio framework to help guide tactical trades or strategic rebalancing and align the portfolio with the investor's views. Framing investment decisions along the dimension of strategic and tactical allocations may help investors adapt as risks arise and markets react.

02 Capital and risk allocations

Portfolios with static capital allocations, such as the 60/40 stock/bond portfolio, are known to have overall risk levels that continuously and unintentionally shift over time, while portfolios with targeted risk allocations require dynamic capital allocations to align the risks to the targets (Figure 2). Both approaches require dynamic rebalancing.

FIGURE 2: CAPITAL ALLOCATIONS OF A PORTFOLIO WITH 50/50 RISK ALLOCATION TO STOCKS AND BONDS



Sources: Allspring and Bloomberg, January 1997 through April 2023. Stocks are represented by the S&P 500 Index; bonds are represented by the Bloomberg U.S. Aggregate Bond Index.

Can a risk-based portfolio improve resilience as risk varies? A risk-budgeting approach starts with a set of desired risk allocations and target risk at the total portfolio level. Expected asset returns consistent with the optimal risk allocations are then derived and used to construct a portfolio frontier at different levels of returns and risks, considering the investor's preferred risk level.

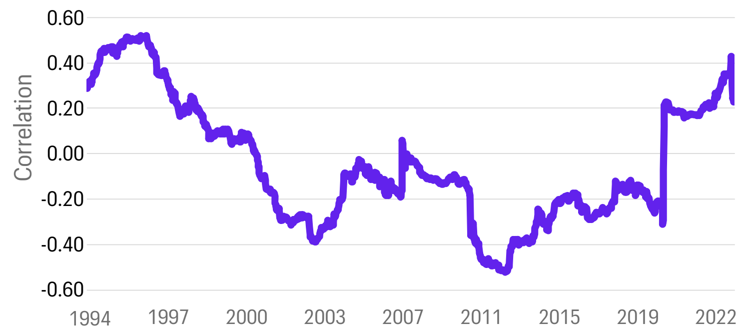
This approach gives investors flexibility to adjust risk budgets in light of macroeconomic, market, or other concerns. That can include a climate-aware asset allocation, for example. Investors can adjust their risk budgets to reflect a preference for climate-resilient assets without needing to precisely quantify the climate risk premium. The potential for deglobalization or onshoring is another example, where the effects on industries, regions, and even asset classes can be incorporated into the risk budgets. Pragmatism is a key characteristic of the risk-budgeting approach, with flexibility to address a variety of risks.

03 Asset and factor allocations

Asset pricing models prescribe the factors that drive risks and correlations of all assets, which then determine the makeup of expected asset returns. Factors have come from established theory (such as the market factor in the Capital Asset Pricing Model); empirical research into historical data; and investment practices such as environmental, social, and governance (ESG) strategies. Not all investable themes become material factors. Certain themes can prevail at certain times, but they may not be pervasive enough across the asset universe nor persistent enough through time to endure. One example is the stay-at-home factor, which added value at the beginning of the COVID-19 pandemic but became largely irrelevant in driving risks post-pandemic.

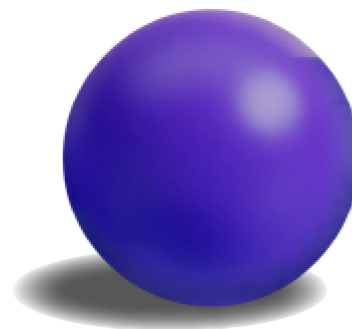
Factor structure within asset classes has generally been more mature and persistent than factor structure across asset classes, as asset classes can have relatively unstable factor sensitivities. Uncovering the underlying fundamental factors and structure across asset classes has proved to be far more challenging but potentially valuable—particularly when stock-bond correlation varies. A portfolio that looks well diversified across asset classes may be more concentrated when viewed through the lens of factors. Market performance from the past year demonstrated this quite clearly, as inflation sensitivities of both stocks and bonds moved in the same direction (Figure 3).

FIGURE 3: ROLLING THREE-YEAR CORRELATION OF STOCK AND BOND RETURNS



Sources: Allspring and Bloomberg, January 1997 through April 2023

Instead of alleging the death of stock-bond diversification, we believe it is more constructive to focus on what *can* drive stock-bond correlation. Studies show promising results from dynamics of economic output, inflation, interest rates, and supply-versus-demand shocks, among others. Investor behavior (such as changes in risk aversion) can also affect asset behavior; demographics may offer valuable insight for managing multi-asset portfolios in the future. Any portfolio technique that is shown to diversify traditional portfolio diversifiers is worth exploring.



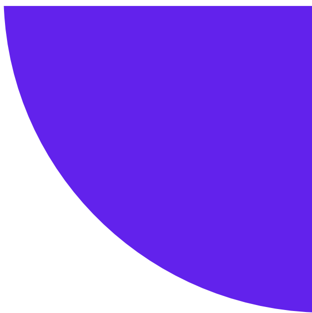
04 Dynamic portfolio risk hedging

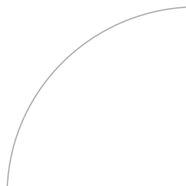
We can start combining these three techniques in a multi-asset portfolio, assigning risk budgets to fundamental factors' underlying asset classes such as growth, interest rates, and inflation. Based on their perceived exposures to these factors, factor risk budgets can be translated into asset risk budgets, with which expected returns assumptions can be derived to generate a portfolio frontier with different capital and risk allocations for a range of risk/return targets. Strategic exposures to fundamental factors, such as inflation, are inherently built into these portfolios. Transitory inflation shocks can then be expressed through tactical portfolio adjustments.

Lastly, investors could run dynamic risk hedging at the total portfolio level, combining customized option strategies, trend-following strategies benefiting from higher long-term volatility, and futures-based dynamic trading strategies, among others. Diversifying portfolio diversifiers and adding protection may improve multi-asset portfolio management.

A powerhouse combination

Investors can take a lesson from the boxing world to determine the combination of portfolio techniques that fits their needs and that may help protect portfolios from heightened risks. Especially as uncertainty rises and risks unfold, we suggest allocating along the three dimensions of strategic and tactical, capital and risk, and assets and factors, complemented by a mix of dynamic portfolio risk-hedging strategies. This powerhouse combination may be a more constructive approach to maneuver across a multitude of environments.





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