Rothschild Risk Based Investment Solutions (RBIS)

R Risk-Based Target Square

15 March 2016
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1. Traditional approaches
1.1 Rothschild RBIS Ltd
A specialist arm in risk-based strategies within Rothschild Global Asset Management

**Active / Conviction**
- **Location:** Paris, New York
- **Expertise**
  - European Equity *(Large & Mid cap)*
  - US Equity *(Large, Mid and Small cap / Core, Value, Growth)*
  - Eurozone Corporate Bonds
  - European Convertible Bonds
  - Balanced - Global

**Open Architecture**
- **Location:** Paris, New York, London, Zurich
- **Expertise**
  - Long-only fund of funds
  - Fund of mandates
  - Fund of Hedge Funds
  - Single alternative UCITS
  - Managed accounts

**Risk-Based / Smart Beta Strategies**
- **Location:** London
- **Expertise**
  - Index Provider / ETF
  - Advisory for equally-weighted risk contribution strategies *(ERC 2.0)*
  - Customised solutions
  - Capabilities across all asset classes *(Global Equity, Gov. Bonds, Corporate Bonds, Commodities)*

Source: Rothschild & Cie Gestion – 2015
2. Traditional Target Date Funds
2.1 Target date funds

Key characteristics

- Traditionally one-stop shop solution for life-cycle investment needs
- Allocation mainly based on time horizon and/or age of the end-investor:
  - Typically decreasing allocation of the share of risky assets over time until the target date

- Simple product leading to a great success of TDFs both in US and in Europe over the past years with also some concerns on performances when markets underperform
  - In the US, Retail TDFs AUM= $724 billion in Q3 2015 down $37 Bn from Q2 first time for 4 years
  - In Europe, UCITS TDFs AUM= Eur 36.1 Bn collecting 3.2 Bn in 2015 (source Morningstar)

- Several methods of allocation have been developed to lower the risk at the date of maturity (among others):
  - from more straightforward (rule of thumb, constant decrease, age linked) …
  - … to more sophisticated (life path, glide path)
2.2 TDFs: Several visions for the same purpose

Static versus Dynamic allocation

- 3 typical approaches to target maturity funds (with equities and bonds):
  - Constant mix (constant proportion portfolio over time: 50% equities and 50% bonds)
  - Age linked (“you should hold your age in bonds and the rest in equities”, John C. Bogle)
  - Glide path (proportion of stocks has to decrease as the individual ages)

- During this period, the 3 approaches outperform the MSCI Europe over the last 15 years
- The 3 approaches have a simple and understandable allocation to equity

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2.3 TDFs: Several visions for the same purpose

Dramatically reducing the risk of the fund

- The Maximum Drawdown is dramatically reduced
- The volatility of the fund is halved
- The constant mix (50% equities and 50% bonds) has the best risk/return profile
  - An annualized excess return of 236bps (compared to the MSCI Europe)
  - The volatility reduction is about 52%
  - The maximum drawdown reduction is about 47%
2.4 Target date Funds: what are the challenges?

The debate

Target date funds have provoked debate around their…

- Allocation level to risky assets vs date of retirement

- Ability to take into account relative prices of risky assets at different times

- Consideration of the end-investors’ level of risk aversion

- Ability to dynamically allocate between assets in reaction to changing market conditions

Our objective aims to put investors risk profile at the heart of the process and to adapt to changing markets dynamics.
3. The Rothschild RBIS approach
3.1 Risk Based philosophy
Putting the investor risk profile at the core of the investment process

- **Capital preservation**
  - The goal of the portfolio manager is to avoid losing what has been earned before
  - The RBIS approach targets reduced volatility and drawdown

- **No free lunch**
  - Taking excessive risk has never been a guarantee to generate more return
  - Some risk is necessary → focus on risk likely to be rewarded

- **Rewarding risk**
  - Regardless of the investment, it is crucial to distinguish the rewarding risk from the unrewarding risk
  - Eliminate unrewarded risk from the portfolio

- **Hidden assets**
  - Once you have more than one asset in the portfolio, there are “hidden assets” in the form of correlation and volatility
  - Correlation and volatility are both traded (i.e., they have a value), by using these as inputs, we unlock the value of these “hidden” assets
3.2 RBIS: a smart answer to cap-weighted index limits

Innovative alternative to traditional indices

In traditional asset management, the focus is usually on determining portfolio weights; risk parameters are derived from the portfolio allocation.

RBIS places risk management at the heart of the process by using risks parameters to determine portfolio weights.
3.3 Risk Based for equities
Putting the investor risk profile at the core of the investment process


- **Least Risky Stocks**
  - S&P500 Index (Cap Weighted): -51.8%
  - ERC 2.0: -41.3%

- **Riskiest Stocks**
  - S&P500 Index (Cap Weighted): -62.1%
  - ERC 2.0: -41.3%

**Cumulative return (25 Jan 2008 – 31 Dec 2014)**

- **Least Risky Stocks**
  - S&P500 Index (Cap Weighted): 116.3%
  - ERC 2.0: 69.4%

- **Riskiest Stocks**
  - S&P500 Index (Cap Weighted): 89.7%
  - ERC 2.0: 116.3%
3.4 Risk Based for bonds

Innovative alternative to debt-weighted indices

- Bond indices are typically issuance-weighted
  - This concentrates risk in the most indebted countries without consideration for their ability to repay that debt
  - Duration is random and unrelated to the target duration of the investor
  - It is difficult for countries to reduce spending during economic slowdowns; this can prompt countries to issue more debt as their fiscal position weakens
- RBIS has developed a range of strategies that seek to improve the risk profile of a bond portfolio relative to a conventional issuance-weighted approach

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<th>Risk Budget Approach: 3 inputs to risk budget</th>
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</table>

- Reflects economic risk of a sovereign
- Reflects investor’s risk appetite
- Improves liquidity profile of portfolio
4. The Target Square approach
4.1 Understanding the Target Square

Simplicity and transparency of the concept

Glide path

Equity / Bond allocation

Step 1

To replace the traditional glide path by a volatility glide path (target volatility)

Step 2

To replace the fixed maturity bonds portfolio by a duration glide path (target duration)

Target Square

Having a decreasing volatility level and a decreasing duration that depend on the time to the date of retirement
4.2 Enhanced with a Risk-Based approach

With or without Risk-Based?

**Target Square**

Having a decreasing volatility level and a decreasing duration that depend on the time to the date of retirement

**Risk-Based Target Square**

Introducing Risk-Based for Equities and Bonds

**Accrued performance**

Target Square (iBoxx & MSCI Europe)  
Glide path  
R Risk-Based Target Square
4.3 Equity/Bond allocation

Increasing the equity proportion

- Introducing a Risk-Based approach for equities increases dramatically the proportion of equity
  - Because of the volatility reduction

- Introducing a Risk-Based approach for bonds increases slightly the proportion of equity

- From 35% to 49% in average
4.4 Replacing Capi/Debt weighted by Risk-Based

The volatility behaviour is very similar

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4.5 Replacing Capi/Debt weighted by Risk-Based

Important impact of the equity part on the performance
5. Target Square Analysis
5.1 Analysis roadmap

Focusing on specific criteria

The analysis objective is to highlight the behaviour of the strategies regarding very specific criteria:

- The equity/bond allocation and its impact
- The risk/return profile: annualized returns, volatility and Sharpe ratio
- The maximum drawdown
- The market timing
- Monthly returns comparison
- Tail risk analysis
- Short term investment

What about the introduction of the Risk-Based approach in the Target Square?
5.2 Equity/Bond allocation

To take into account market conditions

**Age linked**

**Glide path**

**Constant mix**

**R Risk-Based Target Square**

- **Equities**
- **Bonds**
- **1 year average VIX Index**
5.3 Comparing strategies

X axis is volatility and Y axis is annualized returns

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5.4 Market timing

A robust approach

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5.5 Performance statistics

Monthly returns

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5.6 Daily returns distribution
Reducing the tail risk

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5.7 Short term investment

Rolling 3 years investment

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5.8 With or without Risk-Based

Same stability but the Risk-Based improves the risk/return profile

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6. Conclusion
6.1 Conclusion

Risk-Based Target Square is an interesting strategy

- The target square strategy provides an interesting risk profile and takes into account some market conditions.
- Adding the Risk-Based philosophy, the target square characteristics in term of performance are improved.
- The Risk-Based Target Square is definitely more efficient than the 4 strategies presented:
  - Pure equity strategy (MSCI Europe)
  - The constant mix strategy (50% MSCI Europe + 50% iBoxx Euro Sovereign)
  - The age linked strategy
  - The traditional glide path
6.2 Conclusion

The traditional glide path is quite disappointing
6.3 Conclusion

The Target Square is ...

...  

- Simple  
- Transparent  
- Achieves a balanced objective in terms of risk control  
- Combines efficiently equities and bonds  
- Keeps consistent the strategy throughout the time  
- Keeps consistent the P&L  
- Takes into account market conditions (volatility and correlation)

What next?

- Our solution does not account for differences in risk aversion  
- Using more asset classes to diversify the approach (real estate, alternatives, ...)  
- Manages the inflation risk (inflation-linked bonds)  
- Optimizes the process taking into account more information: welfare costs, risk aversion, ...  
- ...
63 Contact

CIO and Deputy CEO
catherine.adibi@rothschild.com

Product Specialist
katrina.price@rothschild.com