INVESTMENT MANAGEMENT

Dynamic allocation Controlled risk Sustainable approach

For over a decade, Andrew Harmstone, Head of Global Balanced Risk Control (GBaR) strategies, has managed risk-controlled portfolios. In a recent conversation, Andrew explained how GBaR is different from other multi-asset managers.

Congratulations on 10 years of managing risk-controlled portfolios. But you've been managing money for much longer than that, right?

Yes, that's right. I've been the lead manager of the GBaR strategy for the last 10 years, but have over 30 years of experience in managing multi-asset portfolios. I've managed through roaring bull markets, through stable markets and through downturns. My team and I have learned a lot over the years, yet we are always open to fresh thinking.

What makes you different from other multi-asset managers in the industry?

So many things make us different. A key differentiator for our strategy is that risk is our starting point, not an afterthought. Our risk exposures are intentional and controlled. We like to say that we employ an academically rigorous investment approach in a real world setting. I truly believe that we are both book smart and market smart.

Everything we do is grounded in portfolio theory with enhanced application of efficient frontier analysis. But we combine that with a fundamentally flexible investment approach, quantitative implementation tools and, importantly, human judgment. I have tried to create an environment that encourages independent thinking and healthy debate. Over time, this has allowed us to attract and retain top talent.

You are known as the 'risk control' team. Talk about what that means.

We believe taking risk should be intentional and well rewarded, and that this is the best way to achieve the optimal return for the risk taken.

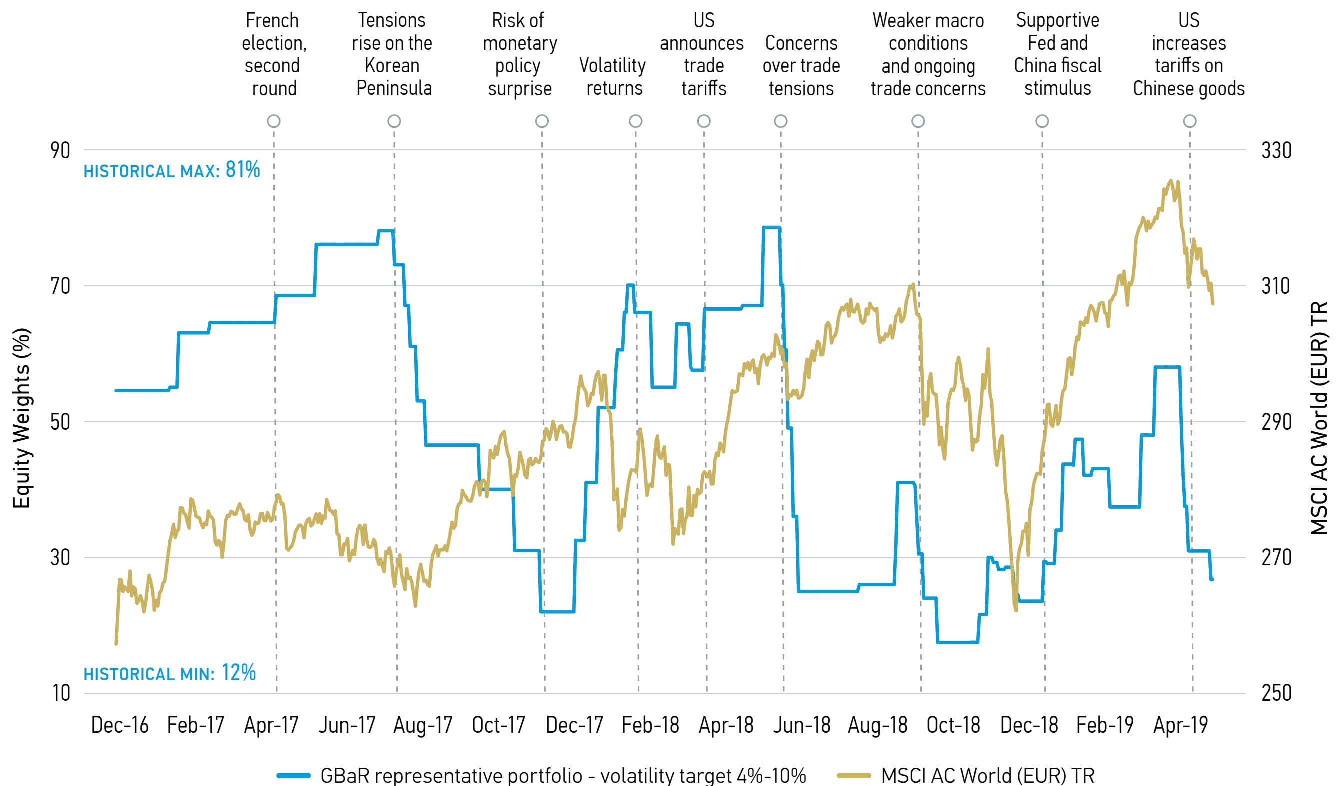
In the simplest terms, we do this by determining the overall asset class mix of equities, fixed income, commodity-linked and cash, three major assets classes that are essential for portfolio diversification. By dynamically adjusting our exposure to each, we can flexibly shift our asset allocation in anticipation of changing market conditions. Additionally, we simultaneously control the amount of risk we take within a range, with an overall goal of maintaining a stable risk profile.

Exactly how do you maintain volatility within a specified range?

We first determine a volatility target for every portfolio we manage, and then constantly manage to that target. This means we are always trying to anticipate events that might be a source of market volatility. We then dynamically adjust the portfolio's broad asset mix to meet our volatility target. Typically, this means increasing our exposure to equities in calm markets and reducing equities if we anticipate future volatility. The aim is to mitigate downside risk through defensive positioning.

DISPLAY 1

Equity exposure adjusted as we anticipate changes in volatility



Source: GBaR representative portfolio, MSIM, DataStream, 31 May 2019. Subject to change daily. Provided for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the asset class shown above. Each portfolio may differ due to specific investment restrictions and guidelines. Accordingly, individuals results may vary.

Give us an example of a "risk event" that caused you to adjust the portfolio's allocation.

In the second half of 2018, there was an escalation in trade tensions and we anticipated that this could have an impact on global growth, which was indicated among other things by an initial softening in business fixed investment. By September we had also identified that equity market divergence in performance between the US vs the Rest of the World was approaching excessive levels. The US's outperformance was driven partly by the market's view of the US as a safe haven and insulated from the trade tensions. In anticipation of a market correction, we decreased our equity allocation to reduce overall risk in our portfolios. This allowed us to protect our portfolios during the subsequent October market correction *(Display 1)*.

Has your investment process changed over the past 10 years?

We have learnt a lot in the last 10 years, but nothing has compelled us to change our fundamental process and strategy. However, we are always looking at ways to enhance our current capabilities, our ability to access areas of outperformance, continue to innovate and be ahead of the curve.

For instance, we recognise the importance of incorporating environmental, social and governance (ESG) factors when considering investments and we launched our first ESG fund three years ago. Nowadays more and more managers speak about ESG, but since we started considering these factors earlier, we believe it gives us a competitive advantage. We continue to research and develop capabilities in this evolving area.

What do you have in store for the next 10 years?

Going forward, we plan to develop new solutions as client needs evolve. I love the academic rigour of this business, and the challenge of making investment decisions in a world that changes literally every day. Quite frankly, I can't imagine doing anything else!

About the Portfolio Manager

ANDREW HARMSTONE
Managing Director

Andrew Harmstone is a senior portfolio manager in the Global Multi-Asset team and heads the Global Balanced Risk Control (GBaR) strategy. He joined Morgan Stanley Investment Management in 2008 and has 38 years of industry experience. Andrew developed his asset allocation experience in the early stages of his career, during his years working at JP Morgan Investment Management (1986–1997). During this period, he also honed his skills using derivatives in an asset allocation context and was appointed a consultant to the Presidential Task Force on Market Mechanisms investigating the 1987 Market Break. Andrew subsequently spent time with Bear Stearns and Lehman Brothers, heading European Quantitative and Derivatives research, being voted 1st place in the 2004 Institutional Investor Survey for European Derivatives Research. Andrew received an M.A. in Business Economics from the University of Pennsylvania, and a B.A. (Honors) in Economics from the University of Wisconsin.

Risk Considerations

There is no assurance that the strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology** and assumptions regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked** notes involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall. In general, equities securities' values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. The use of **leverage** may increase volatility in the Portfolio. **Diversification** does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

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