

ETFs – a smart basis for multi-asset portfolios

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Exchange-traded funds (ETFs) have become widely spread for asset allocation strategies due to product specific characteristics: low dispersion compared to benchmark, transparency, high liquidity and cost efficiency. Especially for market timing strategies, ETFs offer a variety of fields for providing a passive underlying which is then managed actively.



One of the classics – multi-asset portfolios still enjoy great popularity

Stable returns under all market conditions are what the majority of investors aim for. Multi-asset portfolios offer the means to achieve this aim using optimal asset allocation, key risk factor diversification and downside risk management. Such funds are characterised by unlimited upside potential for strong long-term gains and the comfort of downside protection from market declines. As a result, superior risk-adjusted returns can be achieved.

Quantitative decision-making framework

The growing universe of actively managed equity, bond, cash, commodity as well as alternative strategies can provide investors with a portfolio with low correlation to single asset classes, reduced volatility and higher long-term returns.

One possibility to achieve this goal is a quantitative approach towards the investment process using a multi-factor model. Applying a systematic approach aims to ensure a high consistency and repeatability of all decisions made. Additionally, it helps to channel decision-makers' emotions and prevents some ill-advised counterproductive decisions often made under stressful circumstances. In principle, discretionary interventions are reduced to continuous supervision of the functionality of the model architecture and especially the reliability of the decision criteria. The investment decisions made on a quantitative basis offer the advantage of highly efficient analysis and the limitation of key risks associated with decision-making.

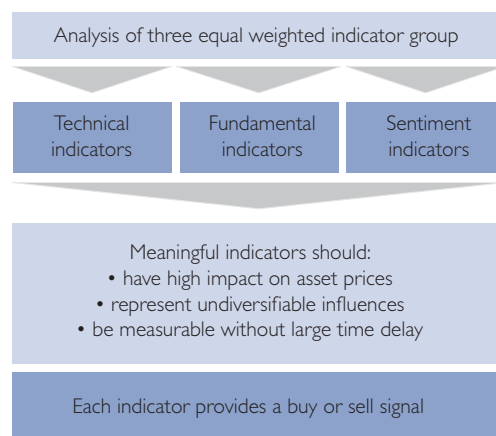
Berenberg Bank has created a multi-factor model named DyMACS (Dynamic Market Adaptive Combined Scoring) where the classic fundamental approaches towards market prediction interact with elements of behavioural finance. In the decision-making process, three groups of criteria are distinguished: fundamental, technical and sentiment indicators. All of them reflect the decision-making

process of investors, which ultimately influences asset prices.

The economic fundamentals help to identify the phases in the business cycle with varying risk premiums of asset classes, whereas sentiment and technical criteria are important factors that add value by exploiting the markets' path dependence and systematic changes in the behaviour of market participants. Examples of the indicators to be analysed are: expected economic growth, ISM manager index, business confidence, development of interest rates, inflation, credit spreads; trends in asset prices, technical criteria and volatility. Using various factors should increase the stability of our decisions. The specific importance of each factor has been reflected in different indicator weights in our scoring method. Figure 1 shows the details of our analysis.

The scoring method aggregates the individual factors and provides us with a market view represented by a scoring value. In order to avoid frequent rebalancing (costs), a definition of scoring ranges is essential. Each scoring range accounts for one market view, for example, negative, neutral,

Figure 1: DyMACS – multi-factor model



Source: Berenberg Bank

Figure 2: Differentiation between market views

Scoring range	Market view	Respective investment degree
84% – 100%	↑ Very positive	100%
67% – 83%	↗ Positive	75%
50% – 66%	→ Neutral	50%
0% – 49%	↓ Negative	0%

Source: Berenberg Bank

positive or very positive, and determines the investment degree as you can see in Figure 2.

Varying the indicators enables us to use the model for different asset classes, e.g., equities and fixed income. The results of the market analysis are also integrated in our option strategies.

An example of embedding ETFs in multi-asset portfolios

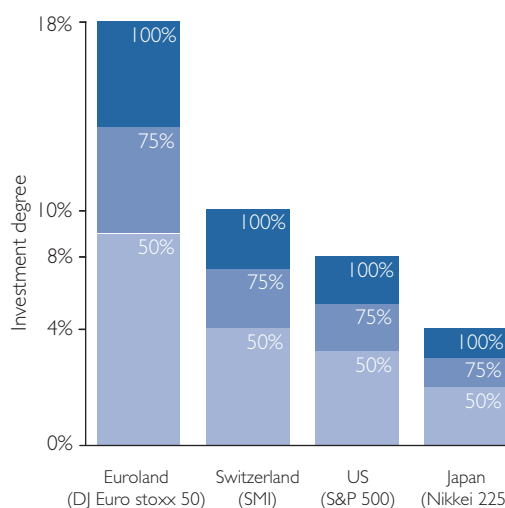
As many of our strategies are characterised by market timing decisions, ETFs can represent the core holding in such portfolios. They provide us with highly liquid, transparent as well as cost-efficient beta exposure to a broad range of asset classes. Using ETFs enables us to easily comply with index rules and to avoid potential difficulties linked to the liquidity of certain securities.

In our case, the multi-asset portfolio contains a variety of investment strategies for equities, fixed

income, options and gold. Figure 3 shows detailed asset allocation, with a fully invested equity part.

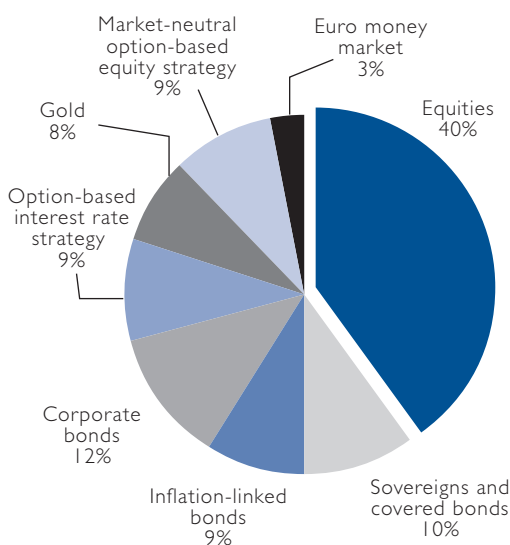
As equities have the highest volatility in this multi-asset investment, managing their portfolio weight plays a key role. If the result of the analysis of fundamental trends and market sentiment indicates a falling market, the equity investment will be reduced in favour of the euro money market or also partly in favour of Swiss francs. If equity markets are expected to rise, the equity ratio can be expanded to up to 40% of the fund volume. As already mentioned, this strategy is focused on timing and not on single stock selection. Therefore, one of the most efficient ways to replicate global equity indices is through the use of ETFs in our segregated accounts. The application of ETFs enables us to have cost-efficient market beta that can be managed effectively using corresponding index futures. A detailed view of the equity market allocation is shown in Figure 4.

Figure 4: Regional allocation of the equity part



Source: Berenberg Bank

Figure 3: Asset allocation with a fully invested equity part



Source: Berenberg Bank

Another component of asset allocation is the investment in an option-based equity market-neutral strategy, which provides continuous positive earnings independent of the market environment.

Besides covered bonds, government bonds and corporate bonds, the investment spectrum of European bonds in our portfolio also contains an innovative investment in inflation-indexed bonds. By adding inflation-indexed bonds, the portfolio can benefit from rising inflation in contrast to classical bonds. Here, we are focused on active duration management via our multi-factor model with passive bond selection. To diversify the investment instruments, the portfolio is also invested in an interest rate option strategy.

As exchange-traded commodities and exchange-traded funds on commodities are an easy way for mutual or special funds to invest in commodities under German investment law, we are invested in gold ETFs backed by physical gold to track the gold performance.

Conclusion

In general, multi-asset portfolios offer investors lower volatility and low correlation to single asset classes. Using ETFs ensures well diversified passive underlyings within the asset allocation. The approach of Berenberg Bank is furthermore characterised by a systematic investment process based on a multi-factor model. This proprietary approach provides investors with reliable

downside protection as well as risk-adjusted excess returns in comparison to the money market.

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