

Fiona Frick: The internal flux in asset allocation

Investors are changing tactical allocations

Fiona Frick

22 June 2023 • 4 min read

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Image: Fiona Frick (pictured), of Circe Invest

Who said: “The only constant is change”? Confucius, Heraclitus, or Benjamin Franklin?

This principle has guided my evolving investment journey. I recently left my CEO role at an asset management firm to launch my own enterprise.

My mission? Supporting asset owners and managers by integrating risk, return, and sustainability considerations into their capital allocation strategies. This allows me to adapt, while remaining true to my core values.

Former Unigestion CEO Fiona Frick launches asset management consultancy

Among these values, I cherish the sharing of ideas and perspectives. That is why I am excited to write this *Investment Week* column in my new capacity.

Now, who coined that phrase? It was Heraclitus - 2,500 years ago - and for sure ‘change is the only constant’ in the world of investment.

Like a living ecosystem, the financial market flourishes in a state of perpetual transformation. Events shape investment outcomes and make the status quo evolve.

Investors, who once basked in the warm glow of a low-inflation and low-interest-rate environment, now find themselves navigating stormier seas.

Adjusting tactically to a new normal

In recent months, I have had numerous exchanges with investors on navigating an environment riddled with potential inflation, recession, and geopolitical risks.

Investors are now working on changing their tactical allocations to navigate these rough waters.

While the Modern Portfolio Theory (MPT) is still relevant for long-term asset allocation, many are complementing it with shorter-term dynamic allocation frameworks.

MPT's resilience has been tested in recent years. We have seen that correlations are unstable and that traditional diversification patterns can fail us.

In 2022, the 60/40 allocation model faltered as rising inflation diminished the defensiveness of bonds, causing them to plummet along with equities.

It also became clear that risk assessment is more complex than just estimating volatility and correlation.

The UK gilts crisis of September 2022 and the bank crisis of 2023 reminded us that risk assessment needs to include liquidity. Flows matter and there is no such thing as a 'risk-free' asset, particularly as inflation rises.

Equity and private equity allocation on standby

Interest rates have not traded at their current levels for quite some time, prompting investors to consider less risky alternatives to other asset classes.

More and more investors are now thinking about adopting a more defensive stance, moving away from equities, and challenging the previously held belief that equities were the sole avenue for generating returns.

LSEG Lipper: Bond funds take lion's share of asset flows for 2023

This shift symbolises a larger trend of investors drifting from a growth-centric approach to a more income-centric approach.

In the realm of private equity, price discovery is underway, albeit at a slow pace, with valuations remaining anchored to historical standards.

Private equity is currently experiencing the denominator effect, where investors find their portfolios overallocated to the asset class due to the decrease in value of listed assets. This force them to make a pause or decelerate their investment pace.

Uncertainty remains in terms of private equity valuation, exemplified by the broad bid-offer spread noticeable in the secondary market.

Investors are waiting for next quarters' valuations to gauge the market stance as private equity valuations lag several months behind the public equity while being affected by the consequence of rising rate on the economy.

The revival interest from investors for fixed income

Fixed income, after a long hiatus, is once again drawing investor interest.

The shift in yield benefits asset owners, who can achieve acceptable returns with less risk. Moreover, bonds, at their current yields, provide again portfolio diversification and can serve as a hedge against equity performance.

However, not all fixed income instruments are created equal. Choosing the right duration and credit risk is vital.

Current trends favour short-duration bond allocations as inflation, an insidious threat, could depreciate traditional bonds if it outpaces their yields.

Additionally, high yields might be inopportune given the expected increase in losses and defaults, and the prevailing basis points spread might not sufficiently offset the rising default rates and poor liquidity.

A decade ago investors had begun shifting part of their liquid fixed income allocation toward private debt, a response to the growing trend of asset management firms competing with banks for a slice of the business financing pie.

From 2010 to 2022, global private debt assets grew fourfold, breaching the \$1.4trn threshold.

This trend shows no signs of abating, but conditions are evolving in favour of investors.

With higher interest rates and decreasing liquidity of public markets, banks are currently struggling to lend to corporates, who are consequently turning to the private credit market.

Although available, investors are more defensive and capital allocation to credit comes with stricter covenants, less leverage, and higher targeted yields.

Under these conditions, private credit is seen as offering an attractive risk-return profile mimicking equity returns with bond-market volatility assuming careful selection of corporate credit.

Indeed, like Heraclitus, investors understand that change is the only constant. The resurging interest in fixed income appears to be a classic comeback tale in the financial narrative.

The new norm seems to be more tactical moves, less equity, and more bonds to adapt to a world of uncertainty around growth, inflation, and central bank policies.

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