Flexible Allocation Funds

Special Report

In the report, flexible allocation funds are defined as diversified funds whose allocation ranges vary greatly, left at the discretion of the portfolio manager, depending on market conditions. They differ from traditional balanced funds whose allocation ranges are relatively more stable.

Challenging 2011 Even for Top Performers

Disappointing Performance on Average: In 2011, funds in the EUR Lipper Flexible categories (-9.3%) underperformed more traditional balanced funds (-6.3%). Flexible funds have proved popular since 2008 as investors look for asymmetric returns.

Top Performers Fulfilled Objective: Despite disappointing average performances, a number of funds stand out. A third of flexible funds have had returns higher than -5% last year and 8% of funds had positive returns.

Heterogeneous Sector: The dispersion of performances (10% interquartile difference) reflects the variety of investment processes within the flexible category. Fitch Ratings identifies three segments within the category: stock picking funds with active beta management, former balanced funds with more allocation latitude and judgemental or systematic global macro funds.

Complex Environment in 2011: Last year was challenging, even for top performers. In 2008, the top quartile of flexible funds outperformed the top quartile of traditional balanced by 10%. By contrast, the difference was less than 1% last year, reflecting a complex environment for all strategies and managers. Volatility shocks, high correlations and an uncertain economic outlook penalised even the most agile managers.

Concept Valid, Improvement Needed: Fitch believes flexible allocation funds continue to make sense for a wholesale distribution clientele that is looking for low volatility products. Nevertheless, the recent lack of downside protection calls for an improvement in investment processes and questions the capacity of some managers to be tactical allocators.

Managing Market Exposure: Performance patterns of flexible allocation funds and global macro hedge funds have been quite similar from 2009 to June 2011. Global macro managers drastically cut risk when volatility spiked in the second half of last year, unlike flexible funds. In Fitch's opinion, the inability of flexible allocation funds to reduce risk to the same degree reflects the long biased culture of traditional managers and calls for an adjustment in the decision making processes to fully use the flexibility offered.

Volatility Impairs Risk Management: Simulations show that strategies aiming to limit downside risk generate a better pay off over the mid term than those trying to capture most of the upside in markets. In a market without trends and with volatility shocks, limiting downside risk requires investment processes that focus on volatility driven signals and avoid excessive portfolio trading activity. In 2011, trading ranges and volatility resulted in miscalibrated stop losses and option-based hedging strategies that hurt performance.

Flexibility in More Fundamental Strategies: Most flexible allocation funds have adopted a tactical style with a short term time investment horizon. Nevertheless, Fitch believes that flexibility is not only a question of reactivity but also of freedom in the choice of asset classes, themes and sectors. Investment processes would gain in complementing the tactical engine with a more fundamental, unconstrained, mid-term layer based on assets' risk/return profiles.

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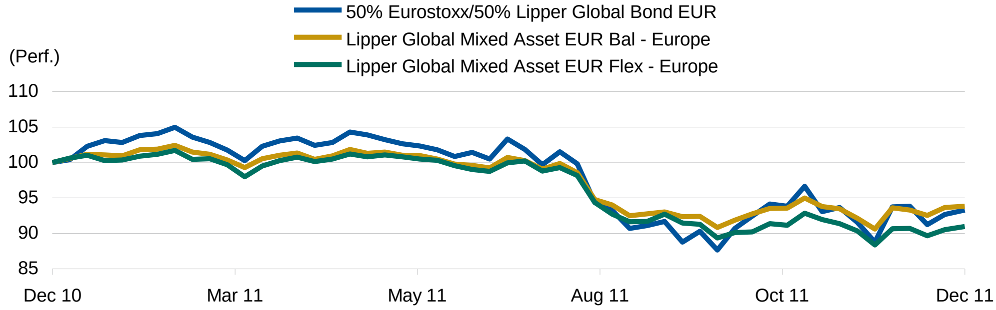
- On average, flexible allocation funds have not done better than traditional balanced in 2011, nor over the past five years.

No Better Than Traditional Balanced

Figure 1

Flexible no Better Than Balanced in 2011



Source: Fitch, Lipper

Flexible funds aim to provide asymmetric returns (ie, more and higher returns on the upside and fewer and lower returns on the downside), relative to a balanced bond and equity allocation via changing market risk exposures.

When considering the Lipper categories, and as shown in Figure 1, flexible allocation funds have not done better than traditional balanced in 2011. From a longer perspective (eg, 5 years), one can observe the same lack of differentiation. For investors that have been attracted in the recent years by the better return prospects of flexible allocation strategies, results are on average disappointing.

But Top Performers Fulfilled Objective

Constituents of the flexible allocation categories are very heterogeneous resulting in high performance dispersions. While the interquartile gap (quartile 1 minus quartile 3 performance) in 2011 was 5% for traditional balanced, it reached 10% for flexible funds (see table below).

- 2011 returns higher than -5% for one flexible fund out of three.

In absolute terms, a third of flexible funds have had returns higher than -5% last year and 8% of funds were in positive territories. In other words, the best funds in the flexible allocation category have met their objectives and explain why fund investors and selectors are still actively looking for candidates in this segment of the market.

Figure 2

Quartile Performances – Flexible vs. Balanced Funds

	Limit Quartile 1		Median		Limit Quartile 3	
	Flexible	Balanced	Flexible	Balanced	Flexible	Balanced
2007	4.0	4.1	2.3	2.1	-0.1	0.1
2008	-7.8	-17.8	-17.1	-21.1	-29.0	-24.0
2009	21.0	18.3	14.3	15.2	6.7	12.6
2010	7.8	5.9	3.7	2.4	0.1	-1.3
2011	-3.6	-4.3	-7.9	-6.4	-13.9	-9.2

10.3% interquartile difference

4.9% interquartile difference

Funds in the Europe & Eurozone categories
Source: Lipper, Fitch

Different Fund Profiles

In Fitch's opinion, this dispersion of returns result from the fact that the category consists of different types of funds profiles, with different volatility targets. Fitch identifies three segments of flexible allocation funds:

Related Criteria

Fund Quality Ratings Criteria (September 2011)

Three different profiles:

- stock picking with active beta management using cash or futures;
- former balanced with more allocation latitude; and
- judgmental or systematic global macro.

- stock picking funds with active beta management: confronted with investors' aversion in the face of equity risk, many equity managers have launched funds with an active management of the market exposure, using cash or futures. It can be performed by the equity portfolio manager himself, or as an overlay, by a distinct team or via a sub-advisor.
- former balanced with more allocation latitude: after both 2001 and 2008, balanced funds were criticised for not adjusting their market exposures in a meaningful or timely manner. As a result, managers have launched or redesigned balanced funds, offering broader allocation ranges, adding more eligible asset classes (eg, alternative, emerging market debt, gold). Additional quantitative techniques can also be implemented such as options or portfolio insurance. A significant proportion of these funds are managed as funds of funds (as of end January 2012, 37% of all flexible allocation funds were funds of funds, as per Lipper database).
- judgemental or systematic global macro: like their hedge fund counterparts, those funds allocate very tactically to multiple asset classes, using futures extensively. The decision making process can be discretionary, quantitatively based or a mix of the two.

As illustrated in the table below, each of these management styles has its own potential drawbacks, which explain the poor performance of certain funds last year.

Figure 3
Different Philosophies Present Different Drawbacks

Investment style	Potential drawbacks
Stock picking with flexible beta	• Allocation too much influenced by bottom up selection • Equity beta sole lever for changing market exposure
Balanced with broader, unconstrained allocation ranges and, in some cases, option protection or portfolio insurance	• "Benchmark culture" hamper use of full allocation range • Lack of reactivity/anticipation • Costs of portfolio insurance techniques
Judgemental global macro	• Wrong directional bets • Miscalibration of stop-loss in volatile markets
Quantitative tactical asset allocation	• Inability to capture performance in trendless markets

Source: Fitch

A Complex Environment in 2011

- Volatility and liquidity shocks, high correlations and limited macroeconomic visibility penalised even agile managers.
- Quantitative strategies have performed better

2011 has been particularly challenging, even for the managers that navigated well through 2008. Stock-picking funds have suffered from the dichotomy between the macro and micro pictures, and increased equity beta to capture upside potential offered by perceived cheap stock valuations. Former balanced funds suffered from the lack of trends and the volatility shocks. Finally, many judgemental macro funds have been caught with credit exposures that they built throughout 2009 and 2010. Quantitative global macro type funds as well as strategies based on equal risk weighting[1] have performed better.

Overall, funds suffered from volatility and liquidity shocks, high correlations and limited macro visibility, which penalised even the most agile managers.

Ability to Cut Market Exposure is Key

Most flexible funds were designed on the assumption that portfolio managers would adjust their market exposure to market conditions, notably that they would cut risk when it is not rewarded. 2011 shows that implementing such flexibility is more complicated than initially thought.

Processes suffered from multiple drawbacks, notably a long only culture, inertia in decision making and risk management too backward looking (like value at risk). Put differently, flexible allocation processes have not used the full allocation ranges and have not moved quickly enough. As shown in Figure 4, the performances of global macro hedge funds and of flexible allocation funds have been very similar from 2010 to mid 2011. Then, unlike most of their

[1] Equal risk weighting refers to an asset allocation strategy where risk is equally distributed between asset classes or macro factors

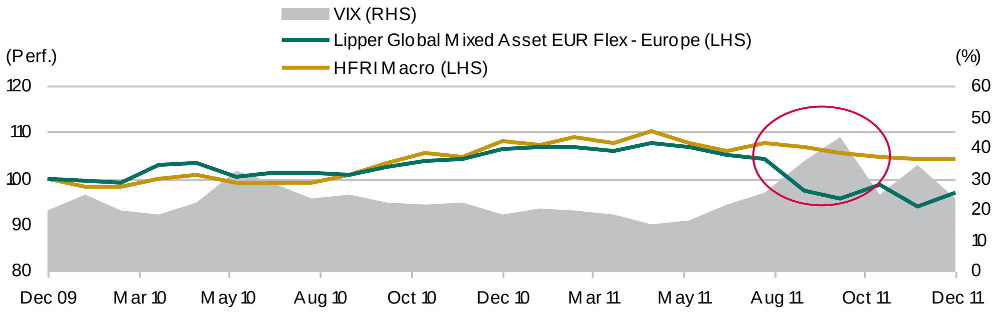
traditional peers, hedge funds cut very aggressively their market exposure when volatility accelerated.

- Long only culture hampered ability to cut market exposure.

For Fitch, it illustrates that, confronted by the same market context, hedge fund managers benefited from their experience in running absolute return strategies while many flexible fund managers appear to have suffered from their long biased culture. Notably, hedge fund managers limited their trading activity in the high volatility environment of the second half of last year and certainly benefited from quantitative techniques (for decision making and risk management) with higher reactivity (eg, based on instantaneous market volatility or liquidity indicators). Being leveraged, global macro hedge funds exhibit a higher aversion to downside risk and indirectly benefit from early signals like haircut increases by prime brokers.

Figure 4

Flexible vs. Global Macro Hedge Funds



Source: Fitch, ThomsonReuters

The tail risk protection mechanisms using options or stop-losses also proved ineffective because they were poorly calibrated. Large trading ranges in 2011 resulted in stop-losses or entry points being hit too early, which ultimately hampered performance. Some scenario-based tail risk hedging techniques or option strategies were not in place in the portfolios, either because these risk management techniques were still in a development stage or because they were considered too costly to be fully efficient in the second half of 2012.

Room for More Fundamental Strategies

- Alongside TAA that dominates the sector, there is room for more fundamental, mid-term oriented strategies.

Most flexible allocation funds follow “tactical asset allocation” (TAA) strategies on a three month horizon. Nevertheless, the original mandate of these funds was to offer decent return over a typical 5 year time horizon by rotating between asset classes. Alongside the TAA strategy, Fitch believes that there is room for more fundamental approaches that allocate freely across asset classes, themes and sectors on a risk/return basis with a mid-term view. However, combining more flexibility in longer term bets with downside protection in the shorter term remains a challenge in volatile markets. Implementing mid term bets also requires investors’ tolerance to short term performance drawdowns.

Appendix: League Tables

Figure 5

Largest Funds with a Lipper Leader Score of 5 over Three or Five Years (Consistent Return Score)

At end-December 2011

Fund Name	Promoter	Size (EURm)	Domicile
Carmignac Patrimoine	Carmignac Gestion	24,686	France
Ethna-AKTIV-E	Ethenea IND Investors	2,588	Luxembourg
Universal Invest Global Flexible	Banque Delen	1,764	Luxembourg
UniRak	Union Investment	1,574	Germany
BL Global Flexible EUR	Banque de Luxembourg	1,017	Luxembourg
Carmignac Investissement Latitude	Carmignac Gestion	995	France
AZ Fund 1 Trend A AZ FUND	Azimut	976	Luxembourg
DWS Vorsorge Dachfonds	DWS Investments	815	Luxembourg
R Valor	Rothschild	718	France
Ikano All Seasons Fund	Ikano	625	Luxembourg
Agipi Ambition	AXA	554	France
DNCA Evolutif	DNCA Finance	532	France
Carmignac Profil Reactif 50	Carmignac Gestion	487	France
Optalis Equilibre Cap	Credit Agricole	412	France
Credit Suisse MACS Dynamic P	Credit Suisse	409	Germany
LBBW Balance CR 75	Deka	361	Luxembourg
Pioneer Target Equilibrio A	Pioneer Investments	339	Italy
Anima Fondattivo	Anima	332	Italy
HSBC Trinkaus Strategie Dynamik	HSBC	266	Germany
Aviva Multigestion	Aviva Investors	258	France

Only includes funds within Lipper Global Mixed Asset EUR Flex - Europe, EuroZone and Global categories domiciled in Luxembourg, Italy, Spain, France, Germany or UK, with Lipper Leader scores for consistent return of 5 over five years (top quintile) on the primary share class in the country of domicile as defined by Lipper
Source: Lipper, Fitch

Figure 6

Best Sellers Over One Year

At end-December 2011

Fund name	Promoter	Net flows (EURm)
Ethna-AKTIV-E	Ethenea IND Investors	651
DWS Bond Flexible	DWS Investments	595
db PrivatMandat Comfort - PRO Deutschland	DWS Investments	399
Universal Invest Global Flexible	Banque Delen	228
M & W Privat	LRI	214
JPM Access Conservative EUR	JPMorgan	198
Gestielle Internazionale A	Aletti Gestielle	185
DWS Sachwerte	DWS Investments	175
BL Global Flexible EUR	Banque de Luxembourg	163
Wegelin (Lux) Global Diversification	1741 / Wegelin & Co	147
Fonditalia Flexible Growth	Fideuram	144
Groupama FP Flexible Allocation	Groupama	141
HVB Vermoegensdepot privat Balance PI	Pioneer Investments	140
Altivalor	Conservateur Finance	128
WvF Strategie-Fonds Nr.1	DWS Investments	126
HVB Vermoegensdepot privat Wachstum PI	Pioneer Investments	124
Edmond de Rothschild Europe Flexible	Ed de Rothschild Group	110
EIS Flexible Duration 1	Eurizon Capital	98
Credit Suisse MACS Dynamic P	Credit Suisse	84

Only includes funds launched prior to 1 January 2011 within Lipper Global Mixed Asset EUR Flex - Europe, EuroZone and Global categories domiciled in Luxembourg, Italy, Spain, France, Germany or UK
Source: Lipper, Fitch