INVESTMENT WEEK

investmentweek.co.uk April 2015

Risk Factor Investing:

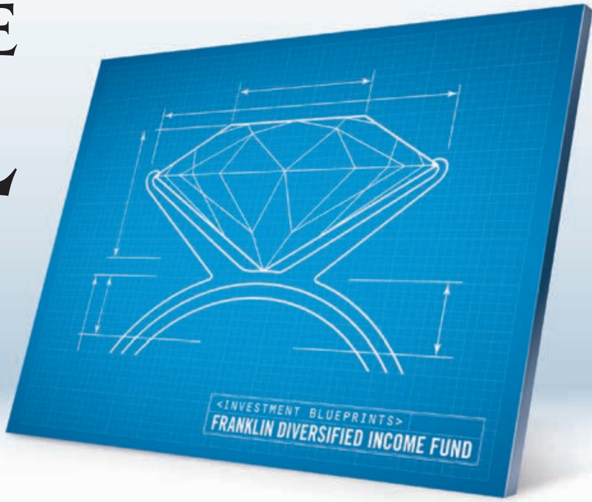
A new approach to an old problem

IN ASSOCIATION WITH

For professional advisers only

FRANKLIN TEMPLETON INVESTMENTS

ALL OF THE ROCK LESS OF THE ROLL



FRANKLIN DIVERSIFIED INCOME FUND

FOR ROCK-SOLID RETURNS WITH LOW VOLATILITY

Franklin Diversified Income Fund is a new type of fund. Aiming to deliver:

- ♦ **4.5% estimated yield**
- ♦ **Half the risk of equities**
- ♦ **Outcome-oriented strategy**

	3 months	6 months	Since launch
Franklin Diversified Income Fund W(inc)	3.90%	7.72%	9.09%
Bank of England Base Rate	0.13%	0.25%	0.38%

Find out more about this award-winning fund:
www.franklintempleton.co.uk/rock

FRANKLIN TEMPLETON INVESTMENTS

For professional investor use only. Not to be distributed to retail investors. The value of investments and any income from them can go down as well as up and you may get back less than you invested. Source: Franklin Templeton Investments and Morningstar as at 28/02/15. **Past performance is not a guide to future performance.** Copyright © 2015 Morningstar, Inc. All Rights Reserved. You will find further information at www.morningstar.com. Benchmark: Bank of England Base Rate. There is no guarantee that the fund will achieve its objective. Estimated Yield: As the fund was launched on 30/05/14 we do not have sufficient data to quote an historical yield. This figure is an estimated yield based on a forecast of the fund's ongoing charges and investments and is not guaranteed. The fund charges all or part of its management fees to capital. This could lead to a higher level of income but may constrain capital growth. Awarded best new multi-asset fund at the Professional Adviser awards, February 2015. Full details of the risks involved in investing are in the Prospectus, which is available from the following address. Issued by Franklin Templeton Investment Management Limited, Cannon Place, 78 Cannon Street, London EC4N 6HL. Authorised and regulated by the Financial Conduct Authority. © 2015 Franklin Templeton Investments.

Investors should try to avoid the old mistakes

It's been almost seven years since the collapse of Lehman Brothers which tested many of the established investing principles we had all thought unbreakable.

The first of those principles was that portfolio diversification by asset class would always protect investors from severe market stress.

The immediate aftermath of Lehman proved that most traditional asset classes were directly correlated, and that to mitigate against future episodes like this a different approach would be needed. Over the last few years the asset management industry has developed a new, more modern set of asset allocation funds that address some of these issues.

The approach offers the opportunity for a steadier set of returns – the 'sleep at night' factor that most investors want.

And if they want security, we know they need income – some investors have always wanted this, namely those in retirement.

But increasingly there are a pool of clients who need income for school or university fees, mortgages, or care home costs.

So clearly there is a need and desire for a multi asset-type solution that can deliver a steady and sustainable income.

A survey of 152 readers of Investment Week and Professional Adviser in February found that 76% wanted a multi-asset income solution to discuss with clients, while the others were looking at single strategy income funds.

This supplement, produced in association with Franklin Templeton Investments, discusses some of the issues advisers might be facing and suggests some solutions. I hope you find it informative and useful and I'd be very pleased to hear directly from you.

Lawrence Gosling, editorial director
Investment Week and Professional Adviser

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Time for a new kind

Investors want steady income and low risk, but can this be achieved in a single solution?

Set against a low-rate, uncertain global backdrop, advisers' investment decisions have become increasingly focused on two core themes in recent years: the desire for income, and the need to ensure portfolios are adequately diversified.

Clients' investment goals have not changed, of course. They still hope for a more comfortable retirement, and to provide a helping hand to their family. But investors, hurt by the events of 2008 and 2009, now crave a greater degree of reliability from their portfolios.

This has led to advisers, already burdened by the huge amount of regulatory change putting pressure on their business, being tasked with delivering clients low-volatility, income-producing returns in a market that looks increasingly volatile.

So it is no surprise that conventional multi-asset funds using traditional asset allocation methods have grown in popularity since the financial crisis.

Stability problems

But do these funds truly provide the diversification, and therefore the stability, that investors demand? There are reasons to suspect otherwise.

One lesson of the crisis is that asset classes which claim to offer diversification often do quite the opposite in times of market stress. Scenarios such as 2008 showed how different assets can move in the same direction at the same time, at which point the idea of a low-volatility multi-asset portfolio begins to break down.

Markets have been calmer since then, but arguably the risk to traditional multi-asset funds has never been greater.

With equity markets and bond prices at record highs, a typical 60% equity, 40% bond portfolio no longer looks very 'balanced'. Downside risks on either side of the portfolio make advisers' jobs much harder.

Do these funds truly provide the diversification that investors demand?

43% Percentage of adults concerned about managing retirement income to meet expectations

# of multi-asset fund

So, while more investors now see outcome-based solutions as a better way to meet their goals, achieving these outcomes may be easier said than done.

Another concern: as yields available from both cash and bonds continue to compress, generating a decent level of income is becoming more and more difficult for investors.

This suggests a big problem is emerging over the horizon. Investors' need for income is indisputable, particularly among ageing developed world populations. According to Franklin Templeton's 2015 Retirement Income Strategies and Expectations Survey, 43% of adults are concerned about managing retirement income to meet retirement expenses.

Pension reforms

Meanwhile, 2015 pensions reforms are set to prompt a more intensive search for low-volatility strategies which will work in accumulation and decumulation.

But as this demand for income grows and grows, pushing yields down further and further, conventional income-focused managers have found themselves forced to buy more risky investments in order to meet yield targets. That is jeopardising the stability of their portfolios.

Risk factor investing represents the next step forward for solution-based products

Is there a solution to these problems? This is where a more advanced sort of multi-asset fund comes in. These funds use derivatives and other instruments to answer concerns over correlations, income and diversification.

Franklin Diversified Income is the latest of this new breed of portfolios, based on a philosophy of risk factor investing.

Risk factor investing represents the next step forward for solution-based products, one which more fully incorporates the lessons learned from the financial crisis.

The strategy makes use of a larger financial toolkit, meaning it can focus on individual sources of portfolio risk – rather than entire asset classes which can end up moving in unison in the worst case scenario.

Are all multi-asset funds really the same?

In an investing environment of greater volatility, is the traditional asset allocation model really the right strategy for investors?

The rise of multi-asset solutions has been a rapid one, but the intensive growth has brought with it its own problems. In 2015, a 'multi-asset fund' can mean very different things to different people.

What's more, these products are spread across a variety of Investment Association sectors. Far from being confined to the old managed (mixed investment) sectors, funds can also be found in the targeted absolute return sector and, increasingly, the flexible or unclassified grouping.

The challenge for advisers and investors is to accurately assess the options available.

Many advisers were brought up on the so-called benefits of asset class diversification

An easier way to classify these portfolios is to split them into just two categories: those which use traditional asset allocation models to blend asset classes or underlying funds together, and those which use more sophisticated methods to target a defined outcome for investors.

This second approach seeks to address the portfolio construction issues which have caused problems for many traditional multi-asset funds at times of market stress.

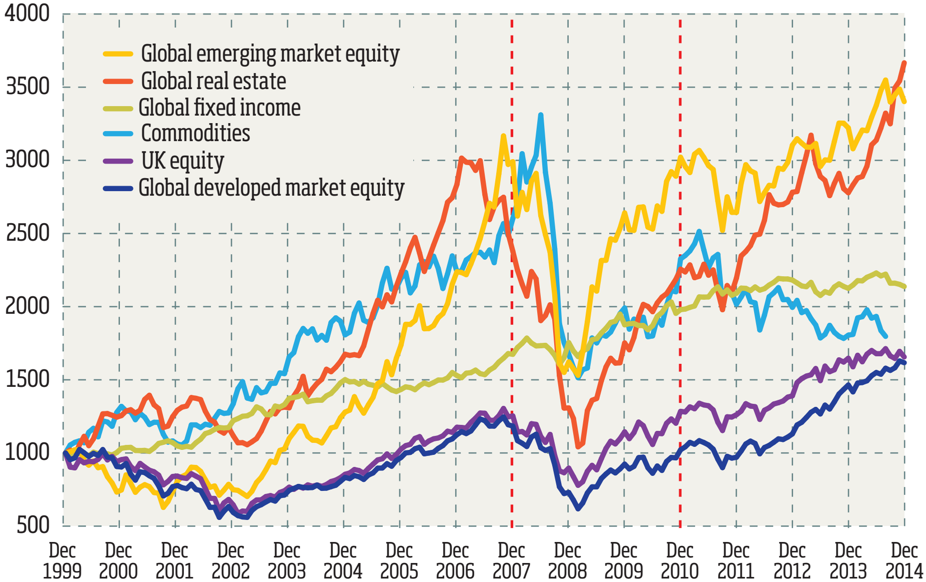
Many advisers were brought up on the so-called benefits of diversification but as the graph on page 7 shows, many asset classes have been more closely correlated in performance than they realised.

The graph illustrates how the period from 2008 to 2009 witnessed a simultaneous fall in asset classes. The result is that multi-asset managers have had to think harder about how they construct their portfolios.

"Diversification methods have

‘It’s not responsible to chase income at any cost, and in the same way it’s not responsible to diversify into an asset class which is going to produce a negative return just because it’s seen as an historical diversifier’ **Peter Elston, Seneca**

Cumulative returns of various asset classes



Source: MSCI, Barclays, FTSE, DJ UBS, JP Morgan via FactSet. Date: 31 December 1999 - 31 December 2014.

evolved significantly in the past few years. The old ‘60% equity, 40% bond funds are now out of date,” said Darius McDermott, managing director of the FundCalibre ratings service.

Peter Elston, chief investment officer of boutique wealth manager Seneca, believes that first and foremost investors want preservation of their capital, even when they have a need for regular income.

“It’s not responsible to chase income at any cost, and in the same way it’s not responsible to diversify into an asset class which is going to produce a negative return just because it’s seen as an historical diversifier,” he said.

“It’s difficult to call but it’s not a difficult decision to say to someone:’ do you want to invest in a five year index gilt which is yielding -1.31% as at 26 March this year.

“It means if an investor holds the gilt to maturity they will have lost money, even though they will have collected the coupon.”

Equally, achieving an income from total return type assets such as equities is forecast to become much trickier in coming years.

The pension fund manager GMO's forecast for the next seven years predicts a number of conventional asset classes – including US equities and non-US fixed income – will produce a negative annual return over that time period.

This hammers home the point that an investment philosophy based on traditional asset classes is no longer necessarily a wise idea. But investors require capital growth, and income, from somewhere, and the next generation of multi-asset funds are now able to provide the differentiated return streams that may prove vital in this regard.

"Multi-asset funds that produce income are quite an interesting segment. You can get specific sources of income from some of these funds that investors could not otherwise access," said FundCalibre's McDermott.

Franklin Templeton's Toby Hayes adds: "When you are trying to produce income, risk factor investing makes a huge difference. When gilt and other asset yields are below 2%, conventional income managers by necessity have to reach for yield – reducing government bond component of their portfolios and reaching into emerging market debt, high yield, and high dividend equities," he said. "These managers have to do that

When you are trying to produce income or reduce volatility, risk factor investing makes a huge difference

to hit their yield target. There is no other option. But they are actually just piling up on growth risk factors."

But balancing a steady income need not always come at the expense of portfolio stability. For instance, strategies designed to limit a portfolio's volatility can also be a reliable source of income.

Investing in volatility through a covered call strategy gives investors an income that increases when volatility rises – and this strategy is not just confined to equity markets. Commodity volatility is a little-used strategy, but produces a healthy yield given the price moves currently in resources markets.

For an outcome-orientated fund, having a wide variety of ways in which to produce yield looks more important than ever. Clients' income demands are rising at just the time when the yield available in traditional markets starts to fall.

As FundCalibre's McDermott concludes: "There is a huge desire among clients for multi-asset income."

Don't be scared of risk

By taking a risk-based investment approach, investors can benefit from global macro themes

Risk factor investing may represent a step change from the multi-asset methods of the past, but one aspect that remains constant across all top-performing portfolios is the strength of the underlying investment ideas.

This is especially applicable within the multi-asset space, where the go-anywhere nature of portfolios means the entire investable universe is available to managers.

At its heart, Franklin Diversified Income is a theme-based fund, and these forward-looking, macroeconomic themes arise from the extensive investment capabilities of the Global Investment Committee.

The Franklin Diversified Income Fund is currently focused around six or seven global macro themes. These themes are then converted by the management team into about 20 to 25 different investment strategies which are expressed through risk factor investing.

The firm groups risk factors into four buckets, depending on how they are likely to perform in a given environment: Growth, Opportunistic, Defensive and Stable.

Using risk factors gives Hayes' funds the ability to be flexible, at the same time

The four types of risk factor

Growth
Strategies that aim to find opportunities that are deemed to have good growth potential

Opportunistic
Strategies, either growth or defensive, that aim to capitalise on market dislocations or valuations that occur over short-term time horizons

Defensive
Strategies that aim to protect investors against significant losses from major market downturns

Stable
Strategies that aim to offer consistently higher returns than money markets while taking on modestly higher amounts of risk

as taking a more pinpoint approach that aids in delivering a specific outcome. The manager can opt to pick a collection of growth risk factors in order to maintain a cyclical bias, or can pick a portfolio of more defensive factors. The technique is more effective than traditional diversification methods, he believes.

"When you diversify across asset classes, quite often you have risk factors embedded in different asset classes that are actually the same. In a traditional bond and equity portfolio, for example, the returns of your high yield bonds are linked to the earnings power of corporates. That is exactly the same thing that drives equity markets," Hayes said.

Range of tools

Risk factor investing originated within the institutional and alternative investment space, and so brings with it the need for extensive resources – such as trading capabilities and risk controls.

Franklin Templeton's size means it is able to call upon everything from proprietary research, to a compliance process hardwired into its trading platform, to an independent body to monitor funds' risk levels.

For outcome-focused investing, this depth of resource is equally important at a portfolio management level, in order to ensure a fund stays on track to meet its objectives. "I don't think you can get away from using derivatives in order to have an efficiently managed portfolio nowadays," Hayes explained. "You cannot buy European equities without having a view on the currency, for instance. That has not always been the case but it is now."

Variety of options

Hayes and team analyse strategies' diversification benefits on both a pre-trade and a post-trade basis, and monitor risk models across short- and long-term time horizons, in order to guard against risk factors changing shape.

Risk factors are dynamic and subject to change, and the Franklin Templeton Solutions team look not just at correlations between strategies, but also how these four characteristics are correlated with each other.

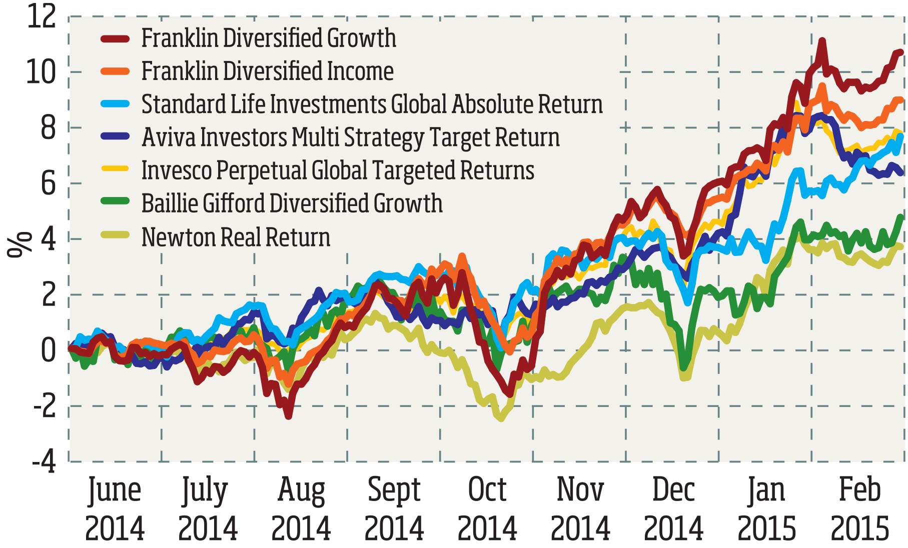
One recent example comes from Hayes' short euro and long European equity positions, strategies which effectively "turned into the same risk factor" once the European Central Bank rolled out its quantitative easing programme at the start of this year. "When the euro goes down, equity markets go up. This is very much what we saw in Japan. It meant that what was a diversified position suddenly became a very similar position," Hayes said.

"We saw that because our risk numbers jumped. When risk factors become correlated, and they do, you need to be cognisant of that and cautious as a result. Our risk systems pick up long-term correlations as well as short-term."

This kind of careful navigation, coupled with the idea generation provided by the Global Investment Committee and multi-asset insight from Hayes, has translated into a strong start for the two funds.

In the nine months to the end of February, Franklin Diversified Income and Diversified Growth have performed well when compared against a group of comparable multi-asset and targeted return peers, having produced performance of 9% and 10.8% respectively.

Franklin Diversified Income & Diversified Growth versus peers



Source: FE

'There's a unique element to our portfolio'

Toby Hayes, manager of the Franklin Diversified Income Fund, says risk factor investing is a strategy to derive a steady income with reduced volatility

Toby Hayes, manager of the Franklin Diversified Income and Franklin Diversified Growth funds, joined Franklin Templeton in 2013 having spent the previous decade running multi-asset solutions at firms including Armstrong Investment Managers and UBS Wealth Management.

Hayes was also co-manager of the Insight Diversified Target Return Fund, one of the first targeted return funds in the UK marketplace, from launch in 2005. At Franklin Templeton Investments, he is able to draw on the thinking of more than 650 investment professionals via the group's Global Investment Committee.

Here he speaks about some of the current themes in the Franklin Diversified Income Fund and how he is implementing them, why the need to be flexible is paramount in the current market environment, and how the size of Franklin Templeton helps his portfolios to stand out from peers.

Can you talk about one of the core themes in the portfolio, and how you use risk factor investing to express this?

China slowing is a big theme in the portfolio. In a traditional asset allocation space, expressing this theme would probably mean you are underweight Chinese equities or have cut them to zero.

The problem with this idea is that, like most equity markets, Chinese equities are driven by many factors. So you have to ask: who has been most affected by a slowing China? Australia and South Korea. Australia has had a 20-year commodity boom, driven by a 20-year credit boom. They are now aggressively cutting rates in response to the slowdown.

But if we were to buy Australian government bonds we would be taking on Australian currency risk, and the Reserve Bank of Australia has been quite adamant in saying it wants the value of the Australian dollar to come down. So we have used an Australian bond future to get exposure to just the duration risk, not the currency risk. It is about finding the bit you want and leaving the rest behind.

Multi-asset investing is about delivering long-term outcomes for investors, but how important is it to retain a degree of flexibility in positioning?

There is a tactical element to our portfolio. Given how fast the market moves now, and the fact that so many markets are distorted by quantitative easing, I just do not think you can take long-term strategic views, package up a portfolio and just sit by and let it run.

The traditional model, which held a

It is about finding the bit you want and leaving the rest behind

certain amount of equity, and a certain amount of bonds based on the age of client, is suddenly not a model for a long-term portfolio when bond yields are near zero.

We are not a trading portfolio, but you need the ability to react a little faster nowadays in order to build a fund that can deliver a clearly defined outcome.

Hedging is also very important, and something you cannot always do in a traditional fund of funds. There is a very real risk of a significant correction if certain macro events transpire, and you need to be able to protect a portfolio from that.

How does risk factor investing avoid the traditional multi-asset pitfalls?
Conceptually, it's quite simple. This reach for yield we are seeing leads managers to high growth assets, and that means multi-asset portfolios are not very diversified.

Risk factor investing has been around for a while. It has been part of institutional management in Scandinavian countries for some time. Some funds do use it, and those that do have typically had more success.

But if you look at the target return market, we are probably the only income fund to do risk factor investing.

I also benefit from an increased range of defensive factors. In my defensive bucket, where most people would just have corporate bond yields, I have equity, commodity, and bond risk factors.

There is a pyramid of macro views and expertise that is concentrated down in the portfolio

How does Franklin Templeton's size and scope help you in running these funds?
It is important to emphasise it's not just me on these portfolios. Franklin Templeton has a long history in multi-asset, as it has been present in the space since 1993. We have a wealth of expertise in multi-asset, and about £26bn in assets under management.

The funds are a distillation of all the asset classes, views, and departments in the company into broad themes. My job is to filter this down and construct the portfolio. There is a pyramid of macro views and expertise that is concentrated down in the portfolio.

The resources are in evidence at all stages of the process. We have a massive trading team globally, that operates 24 hours a day, and has huge expertise of all derivative markets. You need that when running this kind of fund. This is the benefit of working for one of the largest asset managers in the world.

Executive Summary
Franklin Diversified Income Fund - W(inc)

IA Sector	Flexible
Launch Date	30 May 2014
Benchmark	Bank of England Base Rate
Expected Fund Volatility	4-6%
Base Currency for Fund	GBP
Ongoing Charges	0.75%
Estimated Yield	4.50%

As at 28/02/15

CV: TOBY HAYES, CFA
Portfolio Manager
Franklin Templeton Solutions

Toby Hayes is a vice president and portfolio manager for Franklin Templeton Solutions (FTS). In this role, he is responsible for overseeing the Franklin Diversified Growth and Franklin Diversified Income funds. He is also a member of the Global Investment Committee.

Toby has13 years of experience in the financial services industry. Prior to joining Franklin Templeton, he was a multi-asset portfolio manager and a partner for Pacific Investments developing various derivative based alternative strategies. He was also a founding partner at Armstrong Investment Managers, a multi-asset boutique where he managed various global macro multi-asset portfolios. Previous roles included managing Insight's Diversified Target Return Fund as well as various multi-asset products for UBS Wealth Management.

He holds a master's degree in economics from Edinburgh University and is a CFA charterholder.