LIONTRUST

MULTI-ASSET PROCESS

An investment process for Target Risk Portfolios managed by John Husselbee and Paul Kim

Investment process

The Liontrust Multi-Asset investment process is designed to achieve two main objectives. The first objective is to target the outcome expected by investors in terms of the level of risk, as measured by volatility, of each model portfolio. This can enable investors to match the appropriate portfolio to their desired risk profile.

The second objective is to maximise the return for each model portfolio while still targeting the investor's level of risk.

These two objectives are pursued through a quantitative and qualitative approach. We use a scientific approach to target the risk outcome expected but consider the maximisation of returns to require an additional element of experience, knowledge and qualitative interpretation.

There are four key stages to our investment process, starting with strategic asset allocation, followed by tactical asset allocation, fund selection and portfolio construction. Risk management is central to each of these stages, and the model portfolios are designed to provide diversification across asset classes, geographical regions and investment style to enhance the risk-adjusted returns.

Strategic Asset Allocation

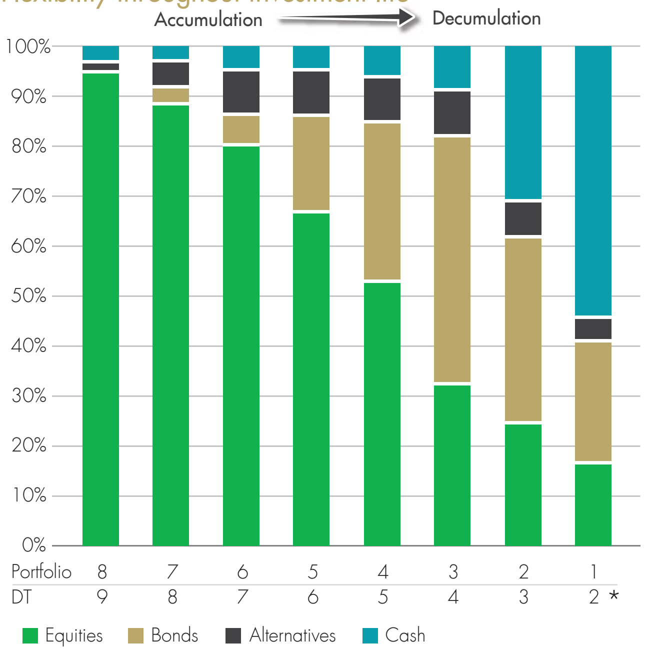
Each of the model portfolios has a distinct risk profile, expressed in terms of target volatility. A higher volatility will usually imply there is the potential for higher gains but also greater potential losses and thus represents a higher level of risk. The range of portfolios has been designed to meet most investors' risk and return objectives. Investors can stay in the service through the accumulation and decumulation phases of their lives, switching between portfolios as their risk profiles and objectives change.

On an annual basis, we collate and analyse historical returns and volatilities of a range of asset classes, as well as their correlations with each other, to determine the strategic asset allocation (SAA) that should meet the volatility targets for each model portfolio over the long term.

In constructing the SAA, we assume the long-term historic return characteristics of the different asset classes are a reasonable base expectation for their future behaviour.

The SAA produced is not only intended to meet the relevant volatility target but also to maximise returns for each volatility range. The SAA identified is essentially the default asset allocation should we have no views on the relative attractiveness of different asset classes. The long-term SAA is reviewed and updated on an annual basis to reflect the evolution of the historical returns, volatility and correlation data set.

Flexibility throughout investment life



*Distribution Technology (DT) is an independent risk rating service. The company trades under the name Dynamic Planner and further details can be found on its website, www.dynamicplanner.com

This chart is for illustrative purposes only and does not necessarily reflect the current positioning of the portfolios.

Tactical Asset Allocation

The primary aim of our tactical asset allocation (TAA) is to increase our exposure to an asset class when it looks cheap and reduce exposure when it appears expensive; our focus is on valuations rather than market timing. We believe that it is important to supplement the long-term benefits of the SAA with the flexibility to take advantage of valuation opportunities in the shorter term. To this end, the first step of our TAA process is to rate the overall investment environment – taking into account valuation levels and investor sentiment – to reflect our interpretation of the market's risk appetite. This helps us to understand if capital appreciation or capital preservation should be the objective of TAA adjustments. The environment is rated from 1 to 5, where 5 is most positive.

We then give each of the asset classes a score from 1 to 5 to reflect our tactical view, with 1 again being the most bearish and 5 being the most bullish. In practice, our scores typically range from 2 to 4. The weighting to each asset class is then automatically adjusted to reflect our tactical view. For example, if we increase our score to equities and Japan from 3 to 4 then the weightings to equities and Japan will be adjusted upwards in all the relevant portfolios.

There are a number of factors that we review in determining our scores, such as the macro-economic environment (such as growth, interest rates and inflation), where we are in the business cycle and valuations (both absolute and relative). We may also use technical analysis to help understand short-term market movements to aid the timing of such decisions, including moving averages, relative strength index and bull/bear ratios. We review the tactical asset allocation on a frequent basis, and at least quarterly.

We adjust our weightings to funds in the portfolios in line with movements in the TAA. Weighting changes may on occasion require us to sell a fund or add a new fund to portfolios. This can give us greater exposure to particular investment styles, such as growth or value, as well as asset classes. We often find that these tactical adjustments can be made most efficiently through the use of passive rather than active funds. This is because we fundamentally believe that good active managers deliver outperformance over the longer term whereas passives provide good beta exposure over shorter periods.

Fund selection

We invest in a range of funds and fund managers, including active, passive and alternative investment strategies.

Our analysis has shown that many funds with headline-grabbing cumulative returns have been remarkably inconsistent when analysed on a discrete basis. Often, one period of extreme outperformance can mask subsequent longer-term under-performance, so we will never look at cumulative performance in isolation. We believe the key elements that should underpin fund selection are: investment process, fund manager experience, fund manager knowledge and fund manager incentive (i.e. remuneration).

Our fund manager selection process incorporates both quantitative and qualitative analysis. Quantitative analysis allows us to highlight the relatively attractive opportunities that exist in the defined investment universe of approximately 5,000 funds. The objective is to identify fund managers who use an investment process that consistently outperforms an appropriate benchmark with little style drift and an appropriate level of investment risk (i.e. their returns are generated from the correct application of their investment process). The aim of this analysis is to determine if a fund's return has been generated by genuine fund manager skill or if it is more down to chance, and if the fund manager is consistent in the application of his or her investment process.

Having passed through the quantitative process, funds are then subject to a qualitative review which looks at additional characteristics and risks.

Fund size and flows

We look at the size of a fund and the degree to which the fund has recently enjoyed inflows or suffered outflows. This is becoming increasingly relevant as a smaller number of discretionary and wealth managers control an ever larger proportion of assets in the retail market. Funds can grow to a size that can detrimentally impact performance.

Investment style and style drift

We select funds and fund managers that complement each other in terms of their investment style. It is key, therefore, that the fund managers have a track record of maintaining their investment style and do not drift away from it. If they do, this is a reason for us to sell out of a fund.

Fund manager motivations

We identify the key personnel who have historically contributed to the fund's performance, whether the same people are in place to drive future performance and the impact of changes in personnel. We always meet the key individuals who are likely to have a material impact on future performance — we conduct over 100 detailed one-to-one manager meetings each year. We place an emphasis upon understanding the motivations of a fund's key contributors. This includes the remuneration of fund managers but we also evaluate changes in the contentment and commitment of managers which can be a warning signal of a future deterioration in performance.

Portfolio construction

As we look to add value from investment style and fund selection as well as tactical asset allocation, it is important that we consider both the weightings and the blend or interaction of our holdings. We want to ensure the funds are exposed to the segment of the market which we feel has the most potential for outperformance whilst reducing unintended risk. This process requires us to consider how each holding interacts with each other in terms of correlation, risk and return to ensure the benefits identified at the holding and sector levels are not diversified away when grouped together at the fund level. We are able to draw upon Liontrust's risk control resources throughout this process.

We create a portfolio for each risk profile which targets the appropriate volatility by combining our fund selections with the SAA, adjusted for the short-term tactical weightings. We then examine each portfolio from a top down perspective to ensure that its characteristics are in line with our risk controls.

For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

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