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Liontrust Multi-Asset investment process

PHILOSOPHY

The Liontrust Multi-Asset investment process is based on a number of core beliefs. These beliefs have been accumulated over the long combined careers of the Liontrust Muti-Asset team and have developed over many years. The Liontrust Multi-Asset team believes that:

- Investment markets are not fully efficient and the degree of inefficiency varies between them
- Sentiment can cause market prices to move away from their fundamental value over the short term
- Over the long term, markets tend to revert towards levels justified by their fundamentals
- Active management of asset allocation can add value through exploiting mispricing and their subsequent return to normal
- We believe that equity markets remain the key driver of long term real returns
- But we acknowledge that the volatility of the equity market is not suitable for all investors
- Within equity markets, factors such as value, growth, quality and size have inherent tailwinds due to either behavioural or market structure inefficiencies
- Each of these factors in isolation can be volatile but a combination of these factors should outperform the broader index over time
- We believe that, with time horizon and budget allowing, active management will, on average, outperform passive exposures
- Exceptions to this are deep, liquid and efficient markets such as government bonds and indices with low cross sectional volatility or high concentration
- Asset allocation is the means by which we combine complementary asset classes together to create a risk and return profile that is appropriate for different investor cohorts
- We believe that an appropriate time horizon is essential and as a result, a long term, disciplined, robust and repeatable process will give investors the best chance of long-term outperformance

Asset allocation

The Strategic Asset Allocation (SAA) is the primary determinant of suitability and long-term risk and returns for investors. The Tactical Asset Allocation (TAA) is used to seek to enhance investors' risk-adjusted returns while ensuring the funds and portfolios' risk profiles are being met. Active management of asset allocation can add value for investors through exploiting mispricing in the market and the subsequent return to pricing justified by fundamentals.

Drivers of returns

The Multi-Asset team believes investment markets are inefficient to varying degrees, with the most efficient being government bonds and indices with low cross-sectional volatility or high concentration. Sentiment can cause market prices to move away from their fundamental value over the short term and revert to levels that are justified by their fundamentals over the long term. Good active management will, over the long term, outperform passive exposures as they exploit inefficiencies and mispricing in investment markets.

Equity markets are the key driver of long-term real returns. Within equity markets, factors such as growth, value, quality and size in isolation are volatile. But when combined within portfolios, these factors should outperform the broader index over time.

PROCESS

Strategic Asset Allocation (SAA)

Numerous studies have demonstrated that the SAA informs the majority of the risk and return of a portfolio over the long term. The SAA is essentially the default asset allocation should the fund managers have no views about the relative attractiveness of different asset classes. In determining the SAA, historical returns and volatilities of a range of asset classes, as well as their correlations with each other, and other market dynamics are collated and studied.

Each Multi-Asset fund and portfolio has its own SAA, which is a function of its suitability, which in the context of risk profiled funds focuses primarily on the investment risk preferences of investors. The SAAs for the Liontrust Multi-Asset funds and portfolios are updated annually and have a long-term (15 years) time horizon. Where the Multi-Asset team perceives there to be meaningful departures of market pricing from fundamentals, they may decide to exploit these mispriced securities through the TAA.

Tactical Asset Allocation (TAA)

TAA is the process through which the Multi-Asset team has an overweight or underweight exposure to an asset class or sub-asset class when compared to the SAA. The TAA may increase or decrease overall strategy risk depending on the Liontrust Multi-Asset team's view of the stage of the market cycle. Even if the Multi-Asset team decides to adopt a neutral risk position, it is still possible to express a view between asset classes and sub-asset classes without meaningfully altering the overall portfolio risk from neutral to the SAA. The Multi-Asset team refers to this as an Efficient Allocation (EA).

The TAA is reviewed and updated quarterly and follows these four steps:

STEP 1: SECRET SCORING

- All the Multi-Asset team members provide a score for each asset class, sub-asset class, the overall market environment and a handful of other factors. The scores are between 1 and 5, with 1 being the most negative, 3 neutral and 5 being the most positive.
- Each Multi-Asset team member scores more than 20 different categories and provides a justification for their scores. The scores are collated ahead of the TAA meeting at which they are debated.

STEP 2: QUANTS

- Ahead of the TAA meeting, the team collates and digests a range of quantitative inputs. These are designed to provide either justifications for – or arguments against – the thrust of the views expressed in the Secret Scoring.
- The quants data cover a wide array of asset classes and sub-asset classes and provide a quantitative perspective on, for example, the relative attractiveness of an equity market both against other markets and against its own history.
- The output and component parts of the quants are assessed in the TAA meeting and are used as an objective complement to the more qualitative inputs from the Secret Scores.

STEP 3: TAA MEETING

- In the TAA meeting, the Liontrust Multi-Asset team collates all of the inputs from the above two steps and debates alongside other views expressed. Every team member is encouraged to contribute.
- The output from the TAA meeting is the first cut of the team's asset class scoring grid, with each of the asset classes and sub-asset classes allocated a score of between 1 and 5.
- The overall market environment is also scored out of 5.

STEP 4: INDEPENDENT INPUT

- The Liontrust Multi-Asset team is acutely aware of the risks of group think and of anchoring to previous quarters' scores.
- To reduce these risks of group think, the team comprises a group of individuals with different backgrounds and experiences to ensure there is a significant amount of cognitive diversity.
- To further combat the risks of group think and anchoring, the Liontrust Multi-Asset team employs an independent consultant to challenge the first cut of the asset class scoring.
- At the conclusion of the TAA process, scores that have stood up to scrutiny are accepted and those that have not may be adjusted modestly.
- The output from this meeting is the final TAA scorecard for the quarter.
- This scorecard informs the risk budget and the over- and underweights that the Multi-Asset team expresses through portfolio construction.

Portfolio construction

- The purpose of the portfolio construction is to take a fairly abstract concept in the form of a TAA and to express it in an investable form for each strategy that the Multi-Asset team manages.
- The portfolio construction takes account of the output from the TAA as well as the input from the manager selection process.

The portfolio construction consists of five steps:

STEP 1: FACTOR SELECTION

- Different equity factors such as value, growth, quality or size have significantly different performance characteristics. We believe these factors have inherent tailwinds to long-term performance predominantly due to behavioural investment shortcomings or due to other inefficiencies, such as shortcomings inherent in market cap weighted market indices.
- These factors have demonstrated long-term outperformance when compared to market cap weighted indices but the performance of each factor when viewed in isolation can have significant tracking error and outperformance can be sporadic.
- Blending factors can overcome some of these shortcomings and result in a performance profile more akin to the market cap weighted reference while maintaining good prospects for long-term outperformance.
- We believe it is essential to apply a rigorous research process to the combination of different factor blends in each region rather than rely on arbitrary weightings methodologies.
- We test the performance and interaction of factors versus each other over the long term and we identify a blend which we believe will provide the most effective risk-adjusted exposure to the equity region in question.
- This blend forms the target factor allocation which we look to implement through manager selection.
- The outputs from this process are reviewed annually but the Multi-Asset team may undertake tactical deviations away from the long-term targets as part of the quarterly TAA process.

STEP 2: ACTIVE AND PASSIVE

- The majority of the Liontrust Multi-Asset funds and portfolios make use of active and passive vehicles.
- The decision of where to use passive vehicles depends on two main considerations: availability and suitability.
- Due to the significant growth in passive vehicles over the past couple of decades, there is now a wide range available, meaning that most asset classes or sub-asset classes can be invested in passively.
- Suitability is, therefore, the prime determinant of whether a passive or active vehicle is chosen.
- Suitability can depend on a wide array of factors such as the time horizon and the nature of the asset class, for example its efficiency, liquidity and index composition.
- Within equity markets, active managers have historically found more success in some regions than others.
- The Liontrust Multi-Asset team has developed a robust and repeatable method through which to identify the appropriate blend between active managers and passive vehicles in different equity regions. The three key inputs are:
  1. Cross-sectional volatility of a given index.
  2. The percentage of stocks that have historically outperformed the index.
  3. The level of index concentration.
- Indices that demonstrate high cross-sectional volatility, a high percentage of stocks outperforming and a low level of index concentration have tended to provide the greatest opportunities for manager outperformance.
- The outputs from this step are target percentage allocations to active managers or passive vehicles which are embedded in the portfolio targets.
- The outputs from this process are reviewed annually but the Multi-Asset team may undertake tactical deviations away from the long-term targets as part of the quarterly TAA process.

STEP 3: TARGETS SET

- The combination of TAA aligned with factor selection and decisions on active managers and passive vehicles create a detailed set of parameters to inform portfolio construction.
- The output from these stages combined with the manager selection are consistent target manager allocations for each region, asset class or sub-asset class.
- Each asset class or sub-asset class is assigned a weight through the TAA process and the combination of the target manager allocations and the TAA weights provides a target holding size for every manager in each of the Liontrust Multi-Asset funds and portfolios.

STEP 4: RISK CHECKS

- The Liontrust Multi-Asset funds and portfolios are managed to carefully considered mandates and risk parameters and, ahead of implementation, the team tests the new portfolio targets to ensure they comply will all appropriate portfolio rules and restrictions.

Manager selection

The Manager selection process contains a number of distinct steps.

STEP 1: UNIVERSE FILTERING

- Investors in funds or managers are fortunate to have tens of thousands of potential investments available to them. The potential downside of such an abundance of choice is that without effective filtering, it is possible for a research process to become overwhelmed.
- The Liontrust Multi-Asset team has access to a number of industry recognised databases which enable effective, proprietary, universe definition and filtering.

STEP 2: QUANTITATIVE AND QUALITATIVE RESEARCH

- The overall manager selection process cannot rely solely on quantitative or qualitative inputs. Rather it is a blend of both forms of analysis that underpin the Liontrust Multi-Asset team's investment manager choices.
- Managers are subjected to significant levels of quantitative analysis to ensure that the Multi-Asset team understands current and past positioning in detail.
- This aids the team in interpreting the manager's true investment style and whether that style has been expressed persistently in the past.
- Past performance is a useful indicator of past success but it cannot be relied upon as an indicator of future performance.
- Indeed, analysis of past performance is less about the outright level of performance - although serial underperformers would not be attractive to the team - but most important are the characteristics within performance. This relates to the stylistic exposure of managers, which is assessed through holdings-based style analysis. Performance is also considered on a disaggregated basis to identify the attributed drivers of performance.
- Active managers should demonstrate skilful stock picking over and above other factors which can be more akin to luck. The qualitative side of fund manager research is extremely helpful in this regard.
- The sorts of areas that the Liontrust Multi-Asset team will consider are manager philosophy and process, team structure, business structure and incentivisation, stock selection process, portfolio construction as well as historical and current positioning.

STEP 3: OPERATIONAL DUE DILIGENCE AND SECURITY SET UP

- Operational Due Diligence (ODD) is an oft overlooked element of the manager selection process. In fact, it is an essential part of taking on managers to ensure that the funds are appropriate from non-investment related considerations and to ensure that trading and implementation take place seamlessly.
- ODD matters because without it the ability of the Multi-Asset team to efficiently trade and rebalance the funds and portfolios would be reduced.
- ODD is split into two main areas - initial DD and ongoing DD – and the purpose is to ensure that the selected funds are suitable not just from an investment perspective but also from an operational and compliance perspective.
- Dealing information is requested and specific questions are answered to ensure the investment is possible and also suitable for the Multi-Asset funds and portfolios, such as whether the Fund is a UCITS regulated scheme and is there a minimum investment.
- Once invested, ongoing DD is performed.

Implementation

- The implementation process varies slightly between Liontrust Multi-Asset funds and portfolios.
- The principles behind the implementation of either are the same, however, ensuring the Multi-Asset team implements in a manner that treats customers fairly, creates consistency across the ranges wherever possible, finding an optimal balance between trading and portfolio turnover, and ensuring the implemented holdings reflect the Liontrust Multi-Asset team's views generated through the investment process.
- Underpinning all of this is the need for the funds and portfolios to remain suitable for investors from a risk and mandate perspective.
- While the Liontrust Multi-Asset team takes its fiduciary duty to investors extremely seriously, they also ensure there are effective checks and balances internally. These include pre and post-trade compliance checks and regular performance reviews.
- This ensures the Liontrust Multi-Asset funds and portfolios are scrutinised and reviewed to verify that the team is fulfilling its commitment to investors.

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