MARKET VIEW

Asset Allocation: Will 2016 Be the "Worst Year" for Alpha?

September 12, 2016

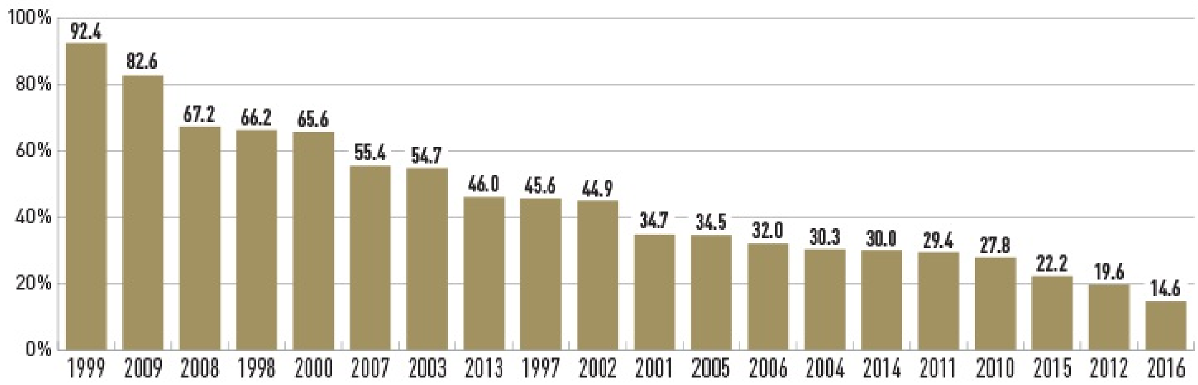
A recent report suggests that narrowing differences in return among major asset classes are making it difficult for multi-asset managers to outperform. We offer another view.

Back in January, we published the most-read article in *Market View* history, "**Why the 'Worst Year' Might Be a Good Time to Invest**." The inspiration for that piece was a December 31, 2015, article on cnbc.com about why 2015 was the hardest year to make money in the markets in 78 years. As we pointed out, while the broad asset categories featured in the cnbc.com piece did indeed generally put in flat, or negative, performances for the year, there were narrower areas of the market that provided attractive returns.

Fast-forward to September 2016: Circumstances now are quite different, with many equity and fixed-income categories enjoying solid, year-to-date returns. And yet, research featured in a Bloomberg article published on September 6 outlines a potential new difficulty that investment managers, specifically asset allocators, may face—not in terms of providing potential positive return, but in achieving outperformance.[1]

The Bloomberg article notes that a recent report from investment research firm CreditSights concluded that "the difference between various asset classes' returns [year to date through August 31] has been pushed to the lowest in almost two decades." (See Chart 1.)

Chart 1. Are Narrowing Return Differences among Asset Classes "Bad News" for Allocators?
Annual total return range: highest return asset class minus lowest return asset class, 1997–2016 (through August 31)



Source: CreditSights, BofA Merrill Lynch, S&P/LSTA, and Bloomberg. Data in the chart are referenced from the U.S.-dollar multi-asset-class total return quilt, a performance matrix of 15 broad asset classes over a 20-year period. Asset classes in the group include large-cap stocks (S&P 500), mid-cap stocks, the Nasdaq Composite Index, convertible bonds, emerging-market sovereign debt, high-yield bonds, municipal bonds, high-grade bonds, preferred stocks, U.S. government debt, mortgage-backed securities, bank loans, emerging-market equities, and emerging-market corporate bonds. The historical performance of each asset class is provided to illustrate market trends; it does not represent the performance of any specific portfolio managed by Lord Abbett or any specific investment. It is not possible to invest directly in an index. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Past performance is no guarantee of future results. Asset allocation does not ensure a profit or protect against a loss.

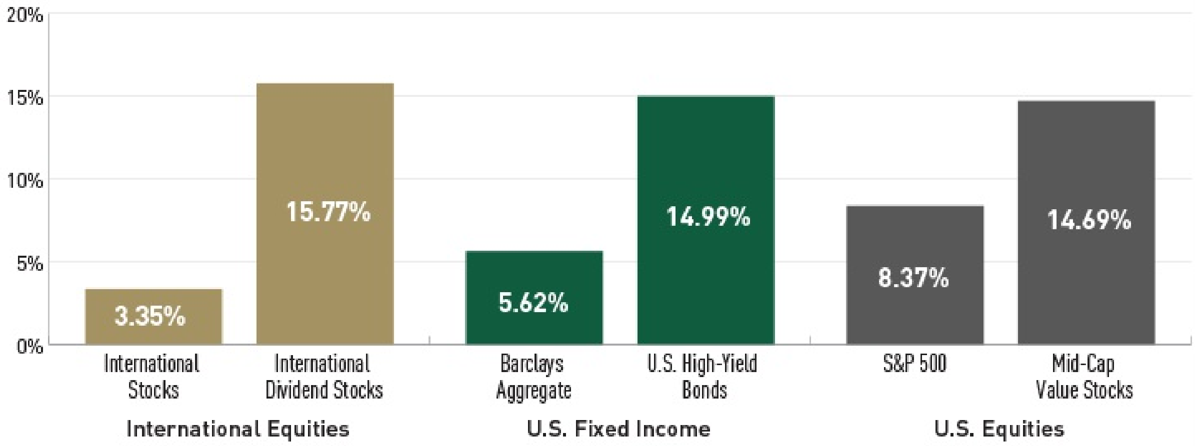
CreditSights derived a “total return range” by subtracting the total return of the worst performer among 15 broad asset classes in each of the past 20 years from the total return of the highest performer. As of the beginning of September, the differential for 2016 was 14.6%—considerably lower than the 22% and 30% spreads recorded in 2015 and 2014, respectively.

According to CreditSights analysts, “These results show another tough year for asset allocation 'payback' as it marked yet another year in this cycle—the worst six years out of the 20 years are from this cycle—for those looking to get paid for picking the winning asset classes." The trend is “bad news for professional investment managers who are paid to beat the general market or a broader index,” according to the article.

As with the cnbc.com survey of 2015 mentioned earlier, headline numbers describing broad investment trends don’t always tell the complete story. “When I look at the spread in returns within various investment categories,” says **Giulio Martini**, Lord Abbett director of strategic asset allocation, “it’s not as if there haven’t been opportunities to outperform this year. There were a lot of opportunities to outperform *through the asset allocation itself*” [emphasis added]. In other words, the opportunities for outperformance, then, have presented themselves *within* those broad categories. Indeed, a look at the return spread between sub-asset classes shows a wide range of differential, especially among risk assets.

Chart 2. Performance Divergences within Key Asset Classes Signal Opportunity for Allocators

Year-to-date total return for indicated indexes for 2016, through September 8



Source: FactSet and Bloomberg. International stocks represented by the MSCI EAFE Index; international dividend stocks represented by the S&P International Dividend Opportunities Index; Barclays Aggregate refers to the Barclays Capital U.S. Aggregate Bond Index; U.S. high-yield bonds represented by the BofA Merrill Lynch High Yield Master II Constrained Index; S&P 500 refers to the S&P 500 Index; and mid-cap value stocks represented by the Russell Midcap® Value Index.

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Martini notes that "there is a big divide" in the portfolio positioning of managers in the multi-asset category. On one side are those asset allocators who have remained risk-averse in the aftermath of the financial crisis, preferring conservative holdings amid concerns about equity valuations and sluggish global economic growth. (Indeed, one multi-asset manager cited in a recent cnbc.com article said his portfolio's level of risk exposure is "one of the … lowest in years."[2]) On the other side are managers who tactically have increased their exposure to higher-risk assets. And with recoveries in categories such as U.S. high yield, Martini notes that those managers who have opportunistically moved out on the risk spectrum "have been paid more than usual so far this year." [*Keep in mind just because an investment type or style may outperform one year, there is no guarantee that it will outperform the next.*]

"The story is that it has been possible to outperform … but it's up to the manager to recognize opportunities" within the broad asset categories, Martini says.

Unlike a static asset-allocation approach, actively managed multi-asset portfolios are uniquely positioned to capitalize on such performance divergences through tactical allocations, while maintaining the flexibility to reduce risk when warranted.

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[1]Tracy Alloway, “It's Shaping Up to Be Another Terrible Year for Anyone Looking to Beat the Market,” Bloomberg, September 6, 2016.

[2]Evelyn Cheng, “Why Big Investors, Including BlackRock, Are Buying Negative-Yielding Debt,” cnbc.com September 9, 2016.

IMPORTANT INFORMATION

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There is no assurance that past trends will continue into the future.

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. No investing strategy can overcome all market volatility or guarantee future results. Market forecasts and projections are based on current market conditions and are subject to change without notice. Due to market volatility, the market may not perform in a similar manner in the future.

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Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

The **BofA Merrill Lynch High Yield Master II Constrained Index** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BB-/Baa3, but are not in default. The BofA Merrill Lynch U.S. High Yield Master II Constrained Index limits any individual issuer to a maximum of 2% benchmark exposure.

The **Barclays Capital U.S. Aggregate Bond Index** is an unmanaged index composed of securities from the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indexes are rebalanced monthly by market capitalization.

The **CreditSights U.S. Dollar Multi-Asset Class Total Return Quilt** is a performance matrix tracking 15 broad asset classes over a 20-year period. Asset classes in the group include large-cap stocks (S&P 500), mid-cap stocks (Russell 2000 Index), the Nasdaq Composite Index, convertible bonds, emerging-market sovereign debt, high-yield bonds, municipal bonds, high-grade bonds, preferred stocks, U.S. government debt, mortgage-backed securities, bank loans, emerging-market equities, and emerging-market corporate bonds.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The **MSCI EAFE Index** consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

The Russell Midcap® Value Index measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000 Value Index.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

The **S&P International Dividend Opportunities Index** is designed to serve as a benchmark for global income-seeking investors. The index seeks to track 100 high-yielding common stocks from around the world excluding the U.S. while meeting diversification, stability, and tradability requirements.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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