ORIGO
ADVISORY SERVICES

27 July 2020

Asset Allocation Update:

The recommended risk allocation is slowly falling below neutral after an extended period of elevated risk exposure. Several factors are changing yet again and none of the changes are for the better. USA's failure in handling the CoVid-19 pandemic is now beginning to impact global growth, slowing the recovery.

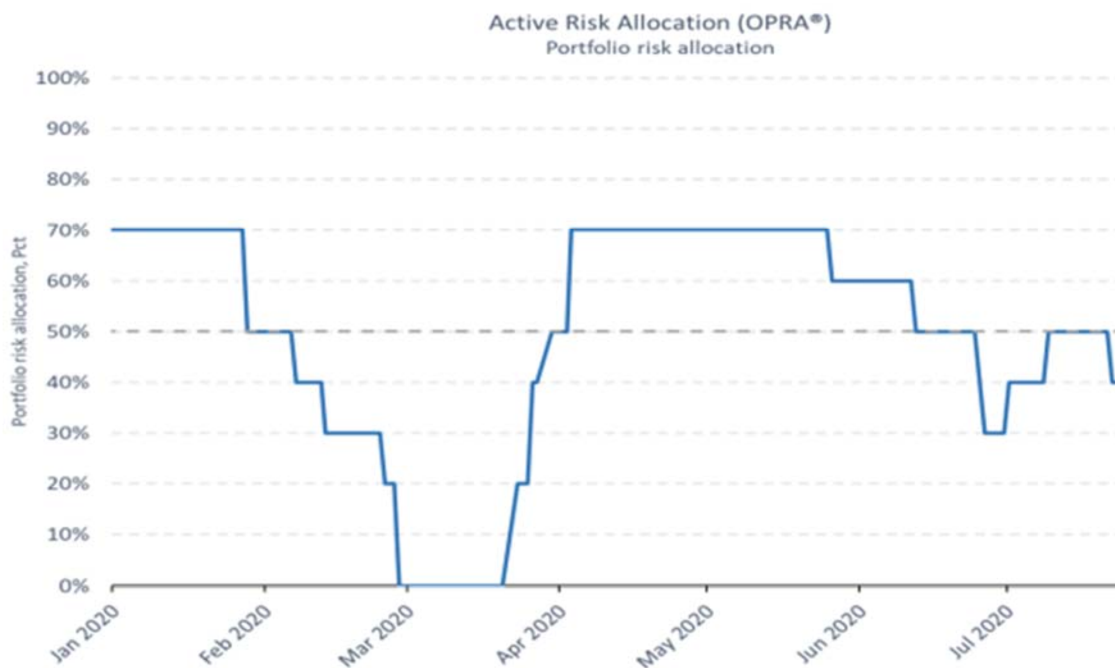
Factor group	Tendency
Fundamentals	*Weakening*
	The initial post-covid-19 recovery is already fading
	Stock market expectations are still that a strong economic recovery will happen in Q3.
	USA's CoVid19 fight is out of control and is likely to delay any recovery. US weight in global economy will impact global recovery.
	Many support packages were predicated on a full reopening by 1 July. More help to come but less significant than in March
Risk & Volatility	*Increasing*
	Coordinated monetary and fiscal expansion have lifted all asset prices. It means that correlation between asset classes have increased and diversification gains have diminished.
	Markets are more vulnerable, as last seen in February.
Market Intelligence	*Factors underpinning upbeat stock markets are fading*
	Stock markets have tried to "look through" to the end of the pandemic. This is now slowly changing to a focus on potentially longterm effects of the pandemic.
	Economic surprises are now heading south and will be in negative territory early August. On current trends market sentiment could take a hit later in August.
	Real interest rates are low and unlikely to fall significantly lower. No further support to risk assets from here.
Technicals	*Divergence in otherwise stable trends*
	Trends in stock and bond markets simultaneously point upwards. Stock markets on pro-grown, Treasuries (and gold) on the opposite, both can't be right.
	Increasing risk that the stock markets end up disappointed while prices in overbought territory.

Proprietary indicators

Our Portfolio Risk Allocation indicator has had a dramatic run this year, from a 70% count in January and in April-May.

In February as well as in June, the fall in the indicator is mainly a reflection of the increased correlation in the main asset classes and the corresponding lack of diversification (except for cash). Add that stock market sentiment is weakening and macroeconomic fundamentals fading.

Macroeconomics do not develop quickly. Given the fading speed of the recovery and the likely tapering off of the economic stimulus packages we would be surprised if the downtrend indicator were to revert any time in the near future.



A primer on our approach (nerdy)

Origo's Asset Allocation advice is built on a simple observation: Much of the portfolio theory taught in (Business) school is useless. Not because it is wrong, but because it does not deal with real life situations.
We believe it is necessary to be systematic and pragmatic at the same time. In practical terms this means that follow the same indicators day out and day in, but we do not expect them to play the same roles all the time. In particular, we look for changes – short term and long term – in the correlations between the main asset classes.

We have classified all the 150 or so variables we monitor daily in four broad groups:

Macro- and microeconomic factors (the Fundamentals)

These always win in the long run. But while waiting for this to happen, important possibilities may have been lost. So while this group of factors are very important, mostly they give the background.

Risk and volatility factors

This group of variables are based on actual day-to-day observations. We consider cross-asset correlations, volatilities and diversification risks. Certain correlation patterns are important indicators of trouble to come

Market Intelligence

This is a headline for all data indicating the ephemeral “market sentiment”. A large number of survey data exist giving indications of the markets’ perception of risk. Some markets, in particular swap markets, as well as short term money markets and fx markets give important real-time indications of the shifting market sentiments

Technicals

No introduction necessary. Technical factors are valuable but cannot stand alone. They need to be seen in conjunction with other variables. When used carefully, they can be used to identify major turning points in both directions.

Proprietary indicators

Our understanding of the market dynamics needs to be made actionable

Hence, we have taken the most important of the factors mentioned above and aggregated them into two main indicators, a market risk indicator and a portfolio risk allocation indicator.

Our market risk indicator combines some fundamental factors, some volatility and correlation element as some sentiment data to give an indication of the current risk situation. We call this the Origo Market Risk Indicator, OMRI.

A strong asset allocation is the basis for any satisfactory long-term return. Asset allocation is always built on a diversified portfolio where unfortunately the correlations between assets change over time. We have found it very useful to bundle assets in “risk assets” and “non-risk assets”.

Our portfolio risk allocator (OPRA) summarises the max recommended holding of risk assets in a diversified portfolio – based on any “strategic” limitations a given investor has to consider. An institutional investor may eg hold between 25 and 75% in risk assets. So when our OPRA says 30%, this investor should hold 25% in risk assets plus 30% of the difference between min and max allocation. This client should hold 40% + 15% equals 55% in risk assets.

Portfolio composition

We construct a portfolio my minimising the risk dispersion, subject to the constraints set by OMRI and OPRA and any constraints set by a higher authority, such as the law or the board of directors.