FIVE PENSION Index

The modern balanced portfolio

Munich RE

Today, balanced portfolios need to go beyond bonds and equities

1 Retirement investing: long-term investment horizon

2 Major drivers: diversification and compounding effects

3 Proven concept: the diversification effect explains the great success of balanced portfolios in the past

4 Modern: more robust diversification by complementing distinct return sources and higher compounding by using efficient market trackers

FIVE The modern balanced portfolio goes beyond bonds and equities – moderate adaption, potentially strong impact

WHAT are your benefits? FIVE PENSION Index

Beyond bonds and equities – powerful financial forces, deliberately used

- Diversification
  Attractive uncorrelated return sources lower your portfolio risk even more and extend the performance potential

- Compounding
  Get grip on genuine growth by reasonable fee structures and efficient passive trackers

Bloomberg VPENSION <Index>

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WHY should you reconsider your portfolio allocation?

Key investments: bonds and equities

These two return sources are cornerstone investments for many market participants. For a reason: they have proven to be persistent and they make intuitive economic sense. Taking the chances and risks of participating in the success of a company via ownership, or lending out money for an economic activity have shown to be reliable sources of attractive positive risk premia.

Key finding: mixing has been superior

Combining bonds and equities and thus avoiding concentrated portfolio risk has been one of the most successful investment strategies of the past decades. Investor returns have been very satisfying for both asset classes, and on top, often uncorrelated. In times of turbulent equity markets, bonds have acted as a safe haven.

Key question: time to RE-think?

It's always a good time to own bonds, equities or both. In the current environment of negative rates, quantitative easing and weakening diversification benefits from traditional risk premia as bonds and equities, it might make sense to re-think.

HOW can you refine your balanced portfolio?

Attractive and distinct, yet very liquid exposure can be provided by investment strategies aiming at harvesting alternative risk premia in the financial markets.

The most important alternative risk premia are momentum and carry. Momentum means investing in-line with the trend of an asset, while a carry strategy simply prefers high over low yielding assets. This is done in various individual markets and in a multi asset context.

Like bonds and equities, these dynamic investment strategies have an attractive track record. Yet they are different by design – and thus "alternative".

Passive trackers of these alternative return sources can be a good choice, because they are typically more cost-efficient than their actively managed counterparts.

Combining traditional ("TRP") and alternative risk premia ("ARP") has the potential to significantly improve performance quality.

This is a minor adjustment to the classic balanced portfolio which can make the difference.

Foundation and rationale

A simple and efficient concept: diversification in a nutshell

Did you know?

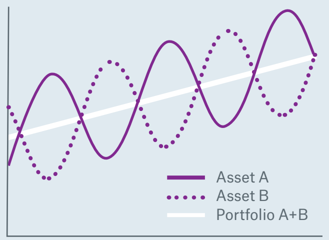
Combining four uncorrelated but return/risk-wise similar assets doubles your return at the same risk level compared to holding one asset on its own.

This is comparable to improving one's forecasting or stock picking skills by the factor of two and a simple math example to show the power of diversification.

Indeed, intra asset class and within traditional markets this example typically keeps being a theoretical showcase. By going "multi asset" and potentially "alternative" this example becomes actually tangible and a realistic case.

Power of diversification

In the right chart asset A and B share the same expected return. Furthermore, A and B show a perfect negative correlation (–100%). The combination of both has the same return perspective, but at much lower risk.



Source: Munich Re

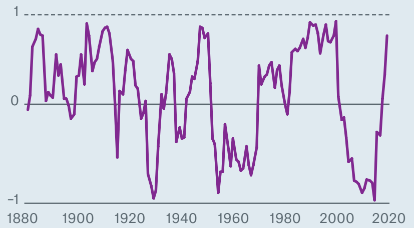
Go the full mile

While a full risk removal as in the extreme example above cannot be achieved in reality, a non-systematic dependence ("zero correlation") would be sufficient to make a strong difference. The correlation matrix with data from the past 20 years shows that correlation around 0 can be observed.

Correlation	EQUITIES	BONDS	ARP
EQUITIES	100%	-28%	-1%
BONDS		100%	32%
ARP			100%

Source: Bloomberg L.P., Munich Re

Bonds and equities experienced a negative correlation during that period which has been very favorable for balanced portfolios.



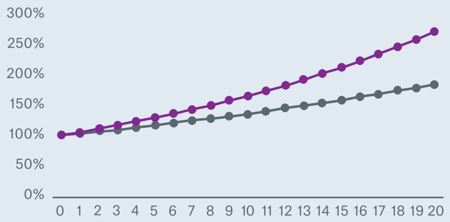
More than a century of bond/equity correlation. Correlations have been in a sweet spot during the last 20 years.

Source: Online data Robert Shiller on http://www.econ.yale.edu, Munich Re

History tells us that there can be times when bonds lose their characteristic as a safe haven asset and bonds and equities both lose in value at the same time. Alternative return sources which have a sound investment rationale, an attractive return expecation and only a weak co-behaviour by design can then act as potential safe haven.

Compounding matters

Fees may seem small, but they add up and compound in the same way as returns. Imagine starting an investment with $100,000 today. If your investment earns 5% per year with 0% fees, it will be worth $265,000 in 20 years.



However, with 2% fee drag it will only be worth $181,000. That's a difference of $85,000 underperformance solely due to fees. Every basis point counts.

Contact

Stephan Krügel
Munich Re Markets
skruegel@munichre.com

Dr. Markus Jaeger
Munich Re Markets
majaeger@munichre.com

Picture credit: Munich Re

NOT IF, BUT HOW