



# Invesco Perspective

Q&A with Scott Wolle, CFA®  
CIO, Invesco Global Asset Allocation

April 2009

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## A Risk-Balanced Approach to Asset Allocation

The protracted downturn in both the credit and equity markets has compromised many asset allocation strategies that did not adequately account for total portfolio risk in recent years. Yet this is hardly the first instance of underperformance from traditional mean-variance-based asset allocation. Significant draw-downs have occurred repeatedly during bear markets and corrections, undermining the intended goal of asset allocation – to mitigate risk.

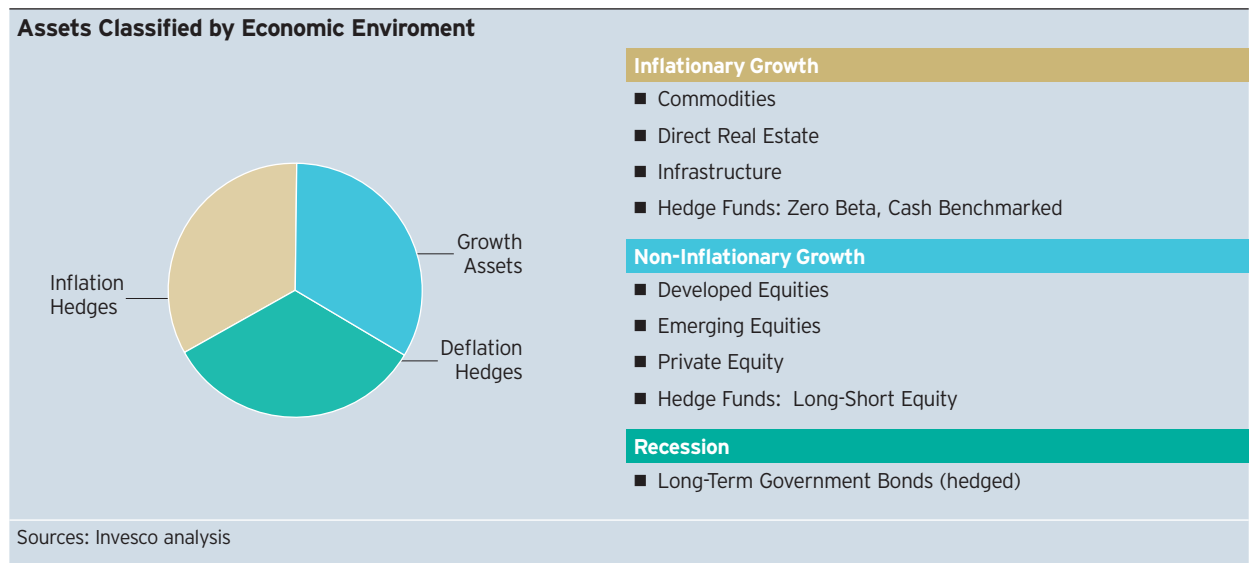
Over the past 40 years, the model of optimizing equities, bonds, and a small dose of cash has experienced equity-like volatility and performance through each significant market downturn. The bear markets of 1973-74, 1981-82, 1990-91, 2000-2002 and the current financial market crisis have all shown the decided inability of a traditional 60/40 stock/bond allocation to offset sharp downturns in the equity market. This inability is largely due to the dominance of equity risk in these asset allocation strategies.

Invesco's Global Asset Allocation team, led by CIO Scott Wolle, CFA®, manages over \$6 billion in assets for clients through asset allocation solutions. As an alternative to the mean-variance approach of traditional asset allocation that is largely predicated on return estimates, the Global Asset Allocation team believes that balancing risk should be the guiding principle behind asset mix in a portfolio. The ultimate goal of this approach is to generate equity-like returns with bond-like risk over time. Invesco recently introduced a risk-balanced strategy, Premia Plus, based on these principles.

Scott recently sat down to discuss the philosophy behind this approach and how investors may consider these types of strategies within the context of their portfolios.

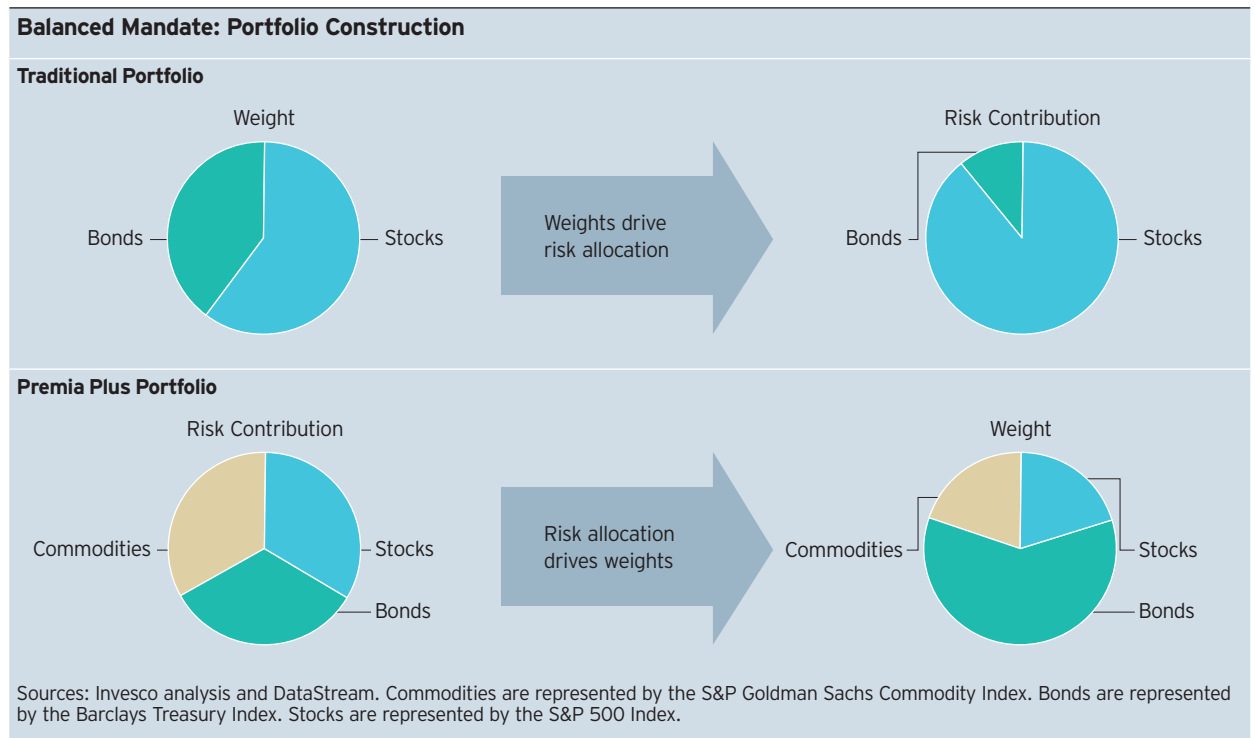
**Q: What is the philosophy behind a risk-balanced strategy?**

A: In our view, the best strategic allocations are those that defend the portfolio in various or differing economic environments while still participating in economic growth. To do this, investors must not only be mindful of their asset selection, but must also reconsider how they mix these assets when constructing their portfolios. We believe investors would be well served owning assets that cover all of the three major types of economic environments: recession, non-inflationary growth, and inflationary growth. The majority of investors have portfolios that are biased toward assets that do well in periods of non-inflationary growth such as stocks. Allocations to bonds, which are the best defense against recessionary periods, are often too short in duration and too oriented toward credit risk. Historically, the best assets for a recession have been long duration, hedged, government bonds. Additionally, investors are often under-exposed to assets that do well in inflation-driven markets. Direct real estate is an excellent example and commodities can play an important role as well.



**Q: How does this differ from a traditional balanced portfolio?**

A: If we use the simple example of a traditional balanced portfolio consisting of 60% equities and 40% fixed income, we might initially view this as a well-balanced portfolio – after all, the weights are nearly equal. However, the portfolio does not adequately consider the risk exposure to the asset classes. In a 60/40 portfolio, about 90% of the risk comes from stocks because they are so much riskier than bonds. This means that balanced portfolios often perform poorly in periods that don't favor stocks – recession and inflationary growth. An alternative approach is to build a portfolio that has an equal amount of risk come from assets representing each of the economic environments discussed above. We believe this approach to portfolio construction can help mitigate large losses in capital and improve the portfolio's reward relative to the risk taken (i.e., Sharpe ratio).



**Q: What are the benefits of using commodities as an asset class within this strategy?**

A: There are three main benefits of commodities. First, they have historically performed well in inflationary periods, exhibiting a low correlation to both stocks and bonds. Next, they have attractive expected returns relative to cash, which is particularly true if the commodity exposure is constructed properly. Balancing risk within commodities across the major commodity categories – energy, precious metals, industrial metals, and agriculture – can result in improved performance relative to a common benchmark like the S&P GSCI commodity index, which is dominated by exposure to energy. Lastly, commodities are one of the most liquid ways to obtain the desired inflation protection.

**Q: How should investors set their performance expectations for risk-balanced portfolios? How would these expectations change as the market environment changes?**

A: One of the primary objectives of a risk-balanced investment strategy is to build a portfolio that can perform well in different economic environments. Investors should expect that a risk-balanced portfolio should capture most, but not all of the performance of a 60/40 portfolio in a non-inflationary growth environment, when equities typically perform well. The true benefit of the risk-balanced approach comes in recessionary environments where the strategy is designed to protect on the downside, preserving portfolio value. The strategy may also outperform a traditional 60/40 portfolio in inflationary growth environments due to the commodity exposure in the portfolio. The result is a strategy that is designed to provide downside protection while providing the opportunity for higher compounded returns over time.

**Q: What applications might investors consider for risk-balanced strategies?**

A: Investors may consider risk-balanced products in various contexts within a portfolio. The high degree of diversification in a risk-balanced portfolio means that it can have a substantially higher Sharpe ratio than traditionally balanced portfolios and may be able to minimize excessive losses associated with equity-dominated portfolios, potentially without a loss in expected return. Stand-alone risk-balanced products would be well suited as an alternative to the traditional balanced account.

Another way for investors to think about these portfolios is in the context of a fund-of-hedge funds allocation. In the same way that balanced portfolios have struggled because of their exposure to equities, hedge funds have struggled because of their over-reliance on market beta. Simply put, most hedge funds aren't really hedged – they don't eliminate the market exposure. Based on our simulations, a balanced-risk portfolio has a relatively high correlation (0.5) with the HFRI Fund-of-Funds index, but its fees are often a fraction of typical fund-of-fund fees and can be found with daily liquidity, daily pricing, and no lock-ups.

Finally, some investors may consider using this strategy as an overlay or portable alpha solution. For example, we have worked with clients to create an alternative to a core plus fixed income portfolio by combining it with passive bond exposure. The logic for it is simple: as a group, core plus managers tend to consistently overweight higher-risk bonds. This means that they are effectively betting on a single risk premium-credit. An approach that has a more diversified set of risk premia exposures could have considerably higher excess returns and fewer significant draw-downs.

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For more information on Invesco Global Asset Allocation, please visit [www.institutional.invesco.com](http://www.institutional.invesco.com).

Data as of 12/31/08.

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