# CIBC MULTI-ASSET ABSOLUTE RETURN STRATEGY

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## 1. Introduction

High net worth and institutional investors have long had access to liquid alternative absolute return strategies. Recent regulatory changes made these strategies, including the CIBC Multi-Asset Absolute Return Strategy (MAARS), accessible to the broader retail investing public.

This change in accessibility is timely. Slowing economic growth and high valuations in many market segments suggest relatively low risk-adjusted expected returns from traditional, equity-centric strategies.

In this environment, investors can improve expected returns by using existing portfolio risk more efficiently. In this paper, we discuss how an allocation to MAARS represents part of the solution:

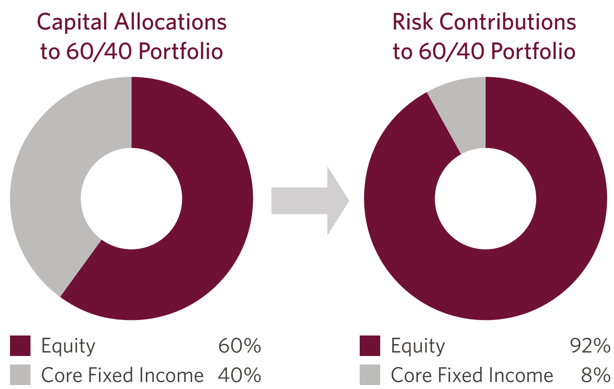
- MAARS is expected to diversify risk from traditional portfolios by encompassing a range of investment strategies across traditional and alternative asset classes, and multiple investment horizons.
- An allocation to MAARS is expected to reduce the sensitivity of portfolios to the prevailing equity cycle, and the macroeconomic environment.
- The CIBC Asset Management (CIBC AM) Multi-Asset and Currency Management Team (investment team) has substantial experience utilizing Absolute Return strategies.

The expected result is a smoother, more diversified portfolio performance than either single asset class or balanced strategies, with higher risk-adjusted expected returns, and less exposure to downside risk.

## 2. A challenging investment outlook

Traditional portfolio solutions often allocate most of an investor's capital to a mix of equity and fixed income securities, across domestic and global markets. Portfolio risk is typically dominated by equities, due to the relative volatility of equity returns (Figure 1). This risk concentration makes portfolio performance episodic and sensitive to the prevailing macroeconomic environment; performance tends to be relatively strong (weak) in periods of rising (falling) GDP growth and moderate (rising) inflationary pressure.

**Figure 1 – Traditional portfolio allocations**



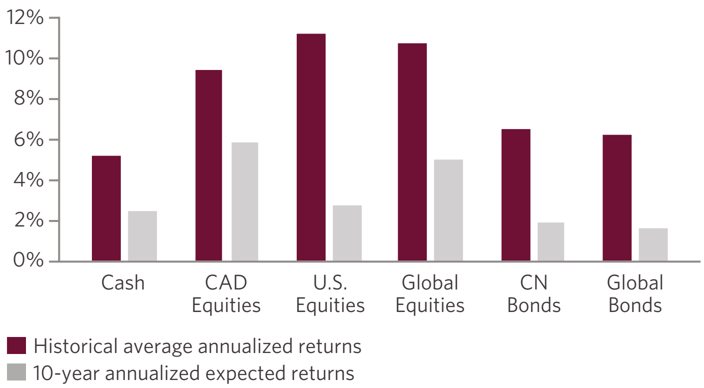

Source: CIBC Asset Management Inc. Illustrative example.

Annualized returns to equities over the period since 1950 as a whole were strong (Figure 2). In hindsight, a concentration of portfolio risk in equities over this period was not a significant problem.

Whole sample averages mask important shorter-term trends. There have been several sub-periods since 1950, some of which persisted for many years, in which equity performance was relatively unattractive. In these periods, a concentration of portfolio risk in equities was certainly a relevant concern for investors.

Reflecting our relatively downbeat outlook for expected Developed Market (DM) equity and, particularly, sovereign bond returns, this issue will remain relevant over the next 10 years (Figure 2).

**Figure 2 – Historical and expected asset class returns**




The information was prepared by CIBC Asset Management Inc. based on/using data from the following third party service providers: Bloomberg, Datastream, Zephyr. Historical returns 1950-2018. Expected returns as at February 2019.

Low expected returns and concentrated risk suggest traditional portfolios are ill-equipped to help investors achieve performance objectives on a forward-looking basis. Investors have two principal options:

1. Accept that investment outcomes derived from traditional equity-centric portfolios will likely undershoot performance targets;
2. Use investment capital more efficiently to raise expected portfolio returns by allocating to a broader, more diversified set of strategies.

We advocate for the second approach, and consider that absolute return strategies, including MAARS, can make an important contribution.

## 3. Absolute return investing

Many features differentiate absolute return solutions from traditional investment strategies:

- They are expected to diversify portfolio risk away from longonly equity and fixed income strategies.
- They are benchmark agnostic. Performance targets are typically set in excess of a cash interest rate rather than relative to an underlying index.
- They target positive returns in all market and macroeconomic environments by employing a diverse set of investment strategies across a broad asset universe. The performance of benchmark relative solutions is typically episodic, and closely tied to broad market cycles.
- The volatility of absolute return solutions is expected to be lower on average than portfolios dominated by equities.

## 4. MAARS

MAARS is the most encompassing investment strategy offered by CIBC AM. It targets an attractive, diversifying risk-adjusted return, with shorter and shallower capital drawdowns than traditional equity-centric strategies (Figure 3). Allocating risk to MAARS is expected to help achieve better, less volatile portfolio performance.

**Figure 3 – MAARS performance and risk targets**

**+5%** T-bills + 5% target return

**The return objective aims to achieve a positive absolute return by targeting, over rolling three-year periods, an annualized return of 5% in excess of Government of Canada 91-day treasury bills (gross of fees and expenses).**

**½** Volatility of global equities

**The strategy aims to achieve an annualized volatility, under normal market conditions, at a level that is generally half the volatility of global equities, represented by the MSCI AC World Index (CAD), measured over rolling three-year periods.**

**1** Seeks to provide capital growth

**2** Smoother investment experience

**3** Increased diversification

Source: CIBC Asset Management Inc. T-bills: 91-day Government of Canada; Global Equities: MSCI ACWI (CAD).

There are many competing absolute return investment solutions available to investors. The key differentiators of MAARS are our people, and our investment philosophy and process:

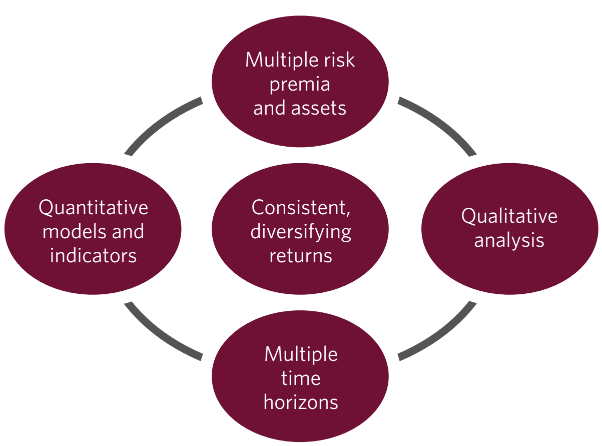
- **Continuity of team leadership:** The investment team's leadership has successfully managed Multi-Asset and Active Currency strategies at CIBC AM since 2002. The team is not new to absolute return investing. Continuity has ensured the team has embedded the same, broad investment philosophy, but has also been able to coherently evolve its thinking to capture new data sources, and to exploit innovative quantitative techniques.
- **Strength of team:** Average industry experience of the 15 team members is 18 years. The team's collective experience spans investment consulting, central bank policy advisory work, third party research, and proprietary trading.
- **Disciplined investment process that integrates quantitative inputs with qualitative fundamental research:** This approach has proven robust and diversifying across existing CIBC AM investment solutions. It results in a coherent process expected to perform well in different macroeconomic and market risk environments. The process also incorporates rigorous portfolio construction and risk management.

These differentiators can help increase confidence that MAARS performance targets will be achieved over the long term, and that MAARS represents a part of the solution to investors' low risk-adjusted expected return conundrum.

## 4.1. Investment philosophy

MAARS is built on three philosophical beliefs. First, a balanced and broad investment solution will achieve smoother, higher risk-adjusted returns than a concentrated strategy. We define balance and breadth in terms of investment style, strategies and horizon, and asset coverage (Figure 4).

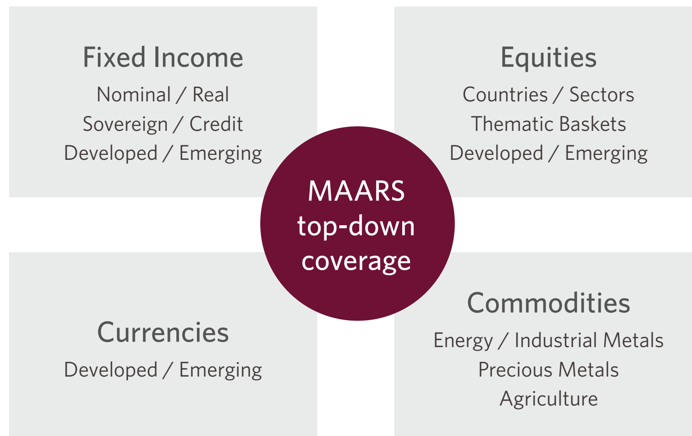
**Figure 4 – A balanced approach leads to more stable returns**




Source: CIBC Asset Management Inc.

The team identifies investment opportunities across more than 100 markets in equities, bonds, currencies, and commodities, using a range of quantitative and qualitative strategies (Figure 5). The resulting portfolio spans traditional long-only, long and/or short, long/short relative trading strategies implemented using a combination of physical securities and derivative positions. MAARS also incorporates a controlled use of leverage to maximize expected portfolio risk-adjusted returns.[2]

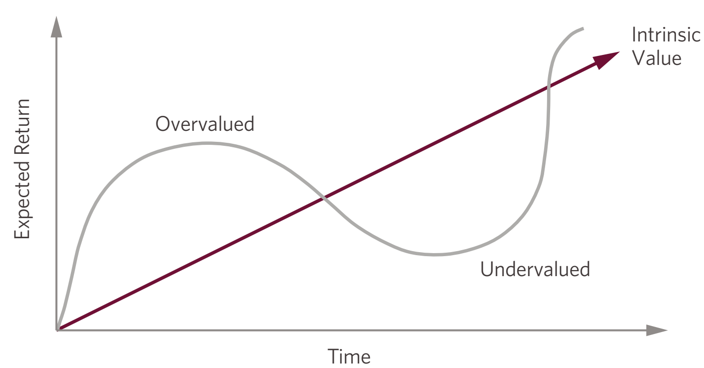
**Figure 5 – MAARS asset class coverage**




Source: CIBC Asset Management Inc.

Second, intrinsic value is a powerful long-term anchor to returns (Figure 6). Assets oscillate around well-defined equilibrium values, but can also deviate significantly from these levels over shorter horizons due to a range of cyclical factors. Identification of equilibria, as well as the sign, magnitude, and persistence of value misalignments represent profitable investment opportunities. To identify these opportunities, the MAARS investment process integrates proprietary quantitative inputs with qualitative fundamental research.

**Figure 6 – Intrinsic value is a powerful anchor to asset prices and returns over the long term**




Source: CIBC Asset Management Inc.. Illustrative Example

Third, efficient portfolio construction dissects asset returns into a set of well-defined factors, or risk premia. These premia measure the reward investors receive for accepting exposure to a variety of undiversifiable risks embedded in asset returns.[3] The most well-known is the Equity Risk Premium; others include bond duration and Emerging Market risk, as well as style-based premia such as Value and Momentum.

Constructing MAARS based upon risk premia allows the investment team to determine on an ex ante basis how much of each premium it wants exposure to. This decision is informed by an assessment of the risk-adjusted expected returns offered by each premium at any given time. The team then determines the most efficient asset implementation of these views.

For traditional portfolios organized by asset class, exposure to the various risk premia embedded in returns can only be determined on an inefficient, ex-post basis once portfolio positions have been implemented.

## 4.2. Investment process

The investment process encompasses three sleeves: Market Risk Premia; Alternative Risk Premia; and Tactical Opportunities (Figure 7). Each sleeve is expected to contribute equally to performance over rolling three-year periods. Over shorter periods, contributions will vary depending upon the perceived investment opportunity offered by each sleeve.

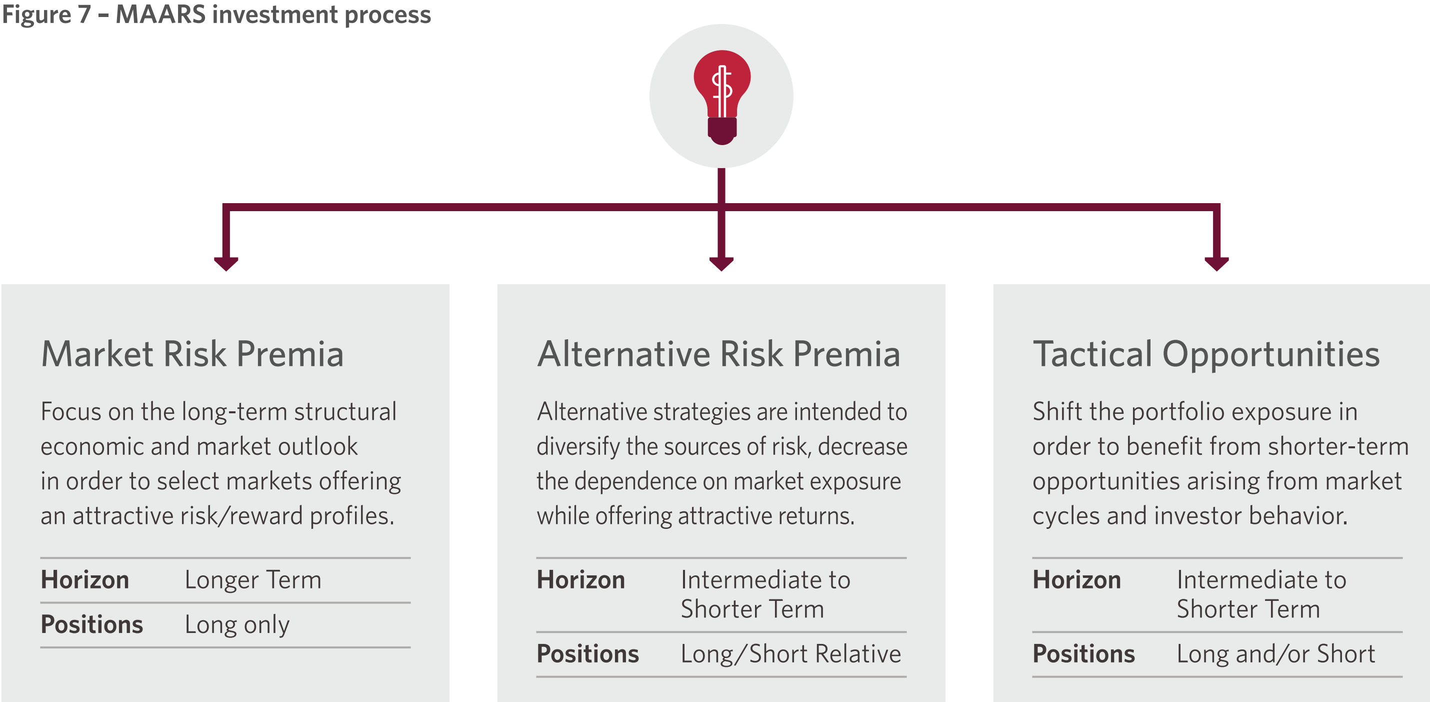
Total MAARS risk will also vary through time, conditional on the team's investment conviction. Sometimes strategy risk will be above its 3-year rolling target, and sometimes it will be below. Conviction will be informed by a continuous assessment of the macroeconomic and market risk environment using a combination of quantitative tools and fundamental judgment. For instance, as top-down macro-fundamental investment strategies like MAARS tend to perform relatively less well when markets are risk averse, investment conviction will be relatively low, and strategy risk below its long-term target, during these periods.

### 4.2. 1. Market Risk Premia (MRP)

This investment sleeve exploits long-only opportunities across equities, bonds—both on a fully currency-hedged basis—and DM and Emerging Market (EM) currencies.[4] These opportunities represent the reward for accepting exposure to a range of non-diversifiable risks. These include the risk of an equity market correction, or the increased risk inherent in exposure to long-term interest rates relative to short-term rates, or economic, political, and liquidity risks inherent in exposure to EM assets.

Expected MRP are determined by an analysis of the long-term economic and market outlook across the MAARS investment universe. Inputs include forecasts of economic growth and productivity, as well as qualitative analysis that isolates idiosyncratic themes that increase (reduce) individual MRP above (below) equilibrium levels at any given time.

**Figure 7 – MAARS investment process**




Source: CIBC Asset Management Inc.

### 4.2.2. Alternative Risk Premia (APR)

This sleeve targets returns from non-traditional style premiums such as Value, Momentum, and Carry. Each ARP rewards investors for accepting exposure to a specific nondiversifiable risk or market anomaly. In the case of the Value ARP, it is the risk of being exposed to value traps; assets that appear cheap sometimes trade at a persistent discount to intrinsic value because underlying fundamentals are actually distressed. The Turkish lira in 2018 is a recent example of a value trap.

We harvest ARP returns using a combination of quantitative models and qualitative judgment. Targeted exposures to ARP are realized by investing in appropriate long/short relative combinations of assets encompassed by MAARS.

ARP expected returns exhibit low correlation to long-only MRP. Combining risk allocations to MRP and ARP is expected to improve the smoothness of MAARS portfolio returns, as well as their diversification to traditional investment strategies.

### 4.2.3. Tactical opportunities

Tactical opportunities result from market cycles and investor behaviour not captured by either MRP or ARP. They also include systematic hedging strategies that mitigate tail risks during periods of unexpected market turbulence. Tactical opportunities are identified using a combination of quantitative indicators and fundamental judgment. They are realized by investing in appropriate long and/or short—versus cash, or inter-asset class—or long/short relative intra-asset class combinations of assets encompassed by MAARS.

### 4.3. Portfolio risk management

MAARS portfolio risk is calculated in three ways: portfolio volatility; Value at Risk (VaR)[5]; and scenario analysis that assesses portfolio performance under different market environments and risk assumptions.

The investment team monitors portfolio positioning on a daily basis to ensure compliance with risk targets. In addition, CIBC AM Investment and Risk committees oversee the activities and positioning of the MAARS investment team. As with any internal CIBC AM investment team, these committees ensure MAARS is appropriately managed and that the allocated risk budget is not exceeded.

## 5. MAARS in portfolios

MAARS can fulfill many roles within investment portfolios. It is relevant for return-seeking investors with either an equity or a fixed income bias, or for investors with a balanced investment profile seeking growth and income from a welldiversified portfolio, whether or not they have previously allocated to liquid alternative strategies (Figure 8).

**Figure 8 – MAARS in investor portfolios**

**1** To complement a portion of Equity allocation

Complements long-only strategies to reduce risk and enhance diversification

**2** To complement a portion of Fixed Income allocation

Complements long-only strategies to enhance return with moderate increase in risk

**3** To complement a portfolio's balanced allocation

A dynamic holding that provides a diversifying complement with attractive risk-adjusted returns

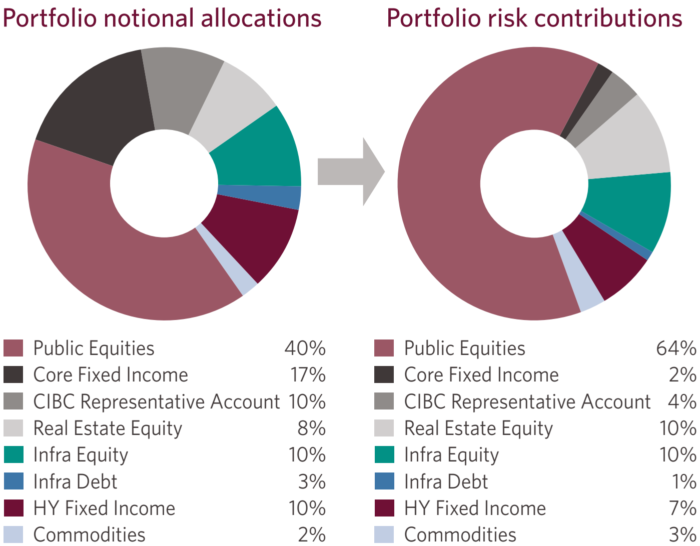
**4** Within a portfolio's alternative allocation

Alternative strategy anchor that can improve a portfolio's risk-adjusted returns while reducing risk

Source: CIBC Asset Management Inc.

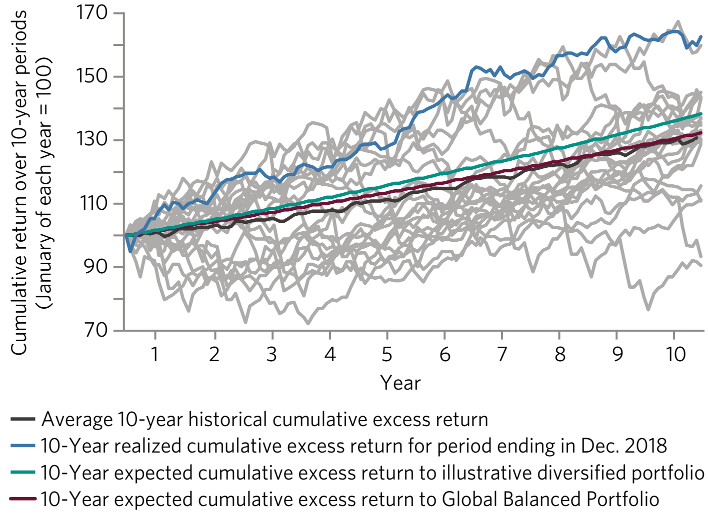
Optimal portfolio allocation will be specific to each investor. Figure 9 provides an illustrative example of an equity-centric investor who reallocates from an initial 60/40 balanced portfolio (as shown in Figure 1) to a more diversified asset allocation that includes liquid and illiquid alternative asset classes and strategies; the revised portfolio assumes a notional capital allocation of 40/30/30 to equities / fixed income / alternatives. The CIBC Representative Account (used as a proxy for MAARS) is the primary fulfillment for the allocation to liquid alternative assets and strategies; we assume an illustrative 10% allocation of notional portfolio capital to the Representative Account.

**Figure 9 – Illustrative diversified portfolios**




Source: CIBC Asset Management Inc., CEM Benchmarking, JP Morgan Asset Management, Pension Consulting Alliance. For illustrative purposes only. Asset class notional allocations selected to approximate average Canadian pension fund allocations (Willis Towers Watson, 2019).[6] Notional allocations and risk contributions based upon 10-year annualized expected returns and covariances. Data may not sum to 100% due to rounding.

**Figure 10 – 10-year cumulative and expected excess returns**




Source: CIBC Asset Management Inc., CEM Benchmarking, JP Morgan Asset Management, Pension Consulting Alliance, Bridgewater. For illustrative purposes only. Individual gray and blue lines report the historical 10-Year cumulative return to a Global Balanced 60/40 portfolio in excess of a 3-month cash interest rate starting in January of each sample year. Green and red lines as defined in legend. Historical sample is 1988 to 2018. Global Balanced portfolio constructed as: Equities (30% Canada (S&P/TSX), 15% U.S. (S&P 500), 10% EAFE®, 5% Emerging Market (MSCI EM)); Fixed Income (20% Canadian sovereign bonds (FTSE Canada Universe Bond Index), 20% US sovereign bonds (Barclays US Aggregate Bond Index)

The 40/30/30 portfolio is markedly different to the original balanced portfolio. Equity risk remains an important component of portfolio risk. But its contribution is noticeably lower, and has been complemented by an economically significant exposure to alternative assets and strategies that capture diversifying sources of return. The sensitivity of portfolio performance to the general equity cycle, as well as macroeconomic conditions, is commensurately reduced.

Figure 10 contrasts the expected 10-year cumulative excess return to our illustrative diversified portfolio with the historical and expected performance of a global balanced portfolio.

The last 10 years have been the best cumulative excess performance period for a global balanced portfolio since the late-1980's (blue line in Figure 10). Reflecting asset class valuations and underlying economic growth projections, its performance is unlikely to be as strong in the next decade. Based upon our illustrative assumptions, the cumulative excess performance of a balanced portfolio over the next decade (red line) is expected to be close to its average of the past three decades (black line).

The challenge for investors is to make appropriate investment allocation decisions that utilize portfolio risk more efficiently and raise risk-adjusted expected returns above this average outcome. Our illustrative diversified portfolio highlights one possible approach to this conundrum, by embracing an economically meaningful allocation to liquid and illiquid alternative asset classes and strategies, including those encompassed by the CIBC Representative Account (green line).

# 6. Conclusion

The investment outlook appears more challenging than in recent years. Expected returns for traditional, equity-centric strategies are relatively low. Investors can seek to improve performance by using existing portfolio risk more efficiently. In this paper, we have discussed how an allocation to MAARS represents part of the solution:

- MAARS is expected to diversify risk from traditional portfolios by encompassing a range of investment strategies across traditional and alternative asset classes, and various investment horizons.
- An allocation to MAARS is expected to reduce the sensitivity of portfolios to the prevailing equity cycle, and the macroeconomic environment.

The expected result is smoother, more diversified portfolio performance, with higher risk-adjusted expected returns, and less exposure to downside risk.

There are many absolute return strategies available to investors. The CIBC AM investment team has substantial experience in this investment space, spanning two decades. This experience, combined with continuity of team leadership, investment philosophy and process, represent the CIBC key differentiators.

# 7. References

[1] The authors are members of the CIBC Institutional Asset Management, Product Solutioning and Management, and Investment Solutions, Business and Channel Initiatives teams.

[2] MAARS may create leverage through the use of derivatives, short sales, and/or borrowing. The Fund's aggregate exposure, calculated as the sum of the following, must not exceed 300% of its NAV: (i) the aggregate market value of securities sold short; (ii) the aggregate value of indebtedness under any borrowing arrangements for investment purposes; and (iii) the aggregate notional value of the Fund's specified derivatives positions excluding the notional value of any specified derivatives used for hedging purposes. Leverage is often considered synonymous with higher risk. This is not necessarily correct. Leverage can be used to gear up a well-diversified strategy to achieve the same return with less risk than a more concentrated, riskier strategy. And leverage inherent in options can be used to reduce investment risk.

[3] Equivalently, a risk premium represents the price that a risk-averse investor has to pay in order to hedge against an undiversifiable risk (Baltas, N. (2018), The Impact of Crowding in Systematic ARP Investing. Goldman Sachs STS Insights #1).

[4] The expected MRP of each DM currency versus the Canadian Dollar (CAD) is approximately zero on average. This reflects the broad similarity of economic and political characteristics across DM countries, including Canada. But, expected DM currency MRPs will sometimes be non-zero, due to both relative economic cycles and idiosyncratic country risks. This facilitates an allocation to DM currencies in this risk sleeve. The average expected MRP of EM currencies versus CAD is not zero, reflecting compensation for exposure to EM economic, political, and liquidity risks.

[5] VaR is measured as Monte Carlo VaR, with parameters: 20-day; 99%; fat-tails.

[6] Willis Towers Watson (2019), Global Pension Assets Study 2019.

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