All Asset All Access: Tactical Repositioning in a Changing Global Market
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SUMMARY

- As cross-sectional asset class volatility increases, our All Asset strategies seek to take advantage of price dislocations, as evidenced by a rise in tactical portfolio shifts.
- As we’ve selectively adjusted our risk posture amid this year’s turbulent markets, the All Asset strategies have rebounded through 31 July since their lows on 23 March.
- Research findings related to momentum turning points and relative value implementation have the potential to support the evolution of the All Asset strategies’ investment process.

Founder and chairman of Research Affiliates, Rob Arnott, and CIO Chris Brightman discuss portfolio positioning shifts in today’s evolving market conditions. Cam Harvey, partner and senior advisor of Research Affiliates, shares recent research efforts pertaining to the ongoing evolution of the All Asset strategies’ investment process. As always, their insights are in the context of the PIMCO All Asset and All Asset All Authority funds.

All Asset All Access is published quarterly.

Q: How has the positioning of the All Asset strategies evolved in this year’s market environment?

Arnott: When markets are quiescent, so are we; when markets are turbulent, we respond. Over the past few months, our portfolio shifts have been markedly dynamic. At the onset of the COVID-19 health crisis, the All Asset strategies were positioned defensively, as we discussed in our previous All Asset All Access. During the “take no prisoners” sell-off across global risk assets in the first quarter, we experienced two firsts – the fastest equity bear market from peak to trough in history and the highest spike in volatility – paired with even more tumult in other markets (oil briefly trading at $40 per barrel negative?!). (Sources are the S&P 500, the VIX, and WTI oil prices.)

As markets indiscriminately sold off during the “peak fear” months of March and April, we shifted into a more risk-on posture in the All Asset strategies. We trimmed our defensive positions and selectively rotated into what we saw as bargains with elevated multi-year return prospects, including EAFE stocks (Europe, Australasia, Far East), commodities, U.S. small-cap stocks, and REITs (real estate investment trusts).

The economist Ben Graham liked to distinguish a temporary loss of value from a permanent loss of capital: The former is a rebalancing opportunity; the latter is a disaster. Unfortunately, any bargain usually gets there for a reason: It looks to many like a risk of a permanent loss of capital, whether or not it really is. Bargain hunting usually means buying whatever is most out of favor – and whatever is out of favor generally has a reason it could continue to flounder. I’ve always believed that the right long-term strategy is to selectively and patiently buy what’s cheap. We believe haste is a mistake, because we’ll never catch the bottom price; whatever is newly cheap may very likely get cheaper before it turns. So value investing can be a deeply uncomfortable strategy before the market rebound. But, comfort is rarely rewarded, and never for very long.

Markets have now sharply recovered to pre-pandemic levels in most cases, fueled by aggressive quantitative easing measures, rate cuts, fiscal stimulus, and buoyant market sentiment. After re-risking following market declines, our strategies have shifted back to a more defensive stance as we look to take profits from resurgent risky assets, buy long bonds, and in the case of All Authority increase its U.S. short equity position. From the lows on 23 March 2020 through 31 July 2020, All Asset and All Authority have rebounded, delivering cumulative net-of-fee returns for the Institutional Class Shares of 23.40% and 24.41%, respectively.
The next round of stimulus may push riskier assets higher, but at a cost of even lower long-term prospective returns, and even higher risk of potential inflation (albeit not immediate) as the ultimate “solution” for addressing the monumental level of U.S. debt. Yet our research suggests that assets that hedge inflation are – with few exceptions – currently trading at deep discounts relative to mainstream stocks and bonds.

Q: What has led to the rise in tactical shifts within the All Asset strategies, and how have your long-term capital market expectations changed in these volatile markets?

Brightman: Volatility often creates opportunity. Accordingly, tactical shifts in our positioning correspond to market volatility. As cross-sectional asset class volatility increases, we tend to find more opportunities and consequently make more aggressive tactical shifts within the portfolio. Elevated volatility in the most recent quarter corresponds to an annualized portfolio turnover of 200% for All Asset and over 300% for All Authority (see Figure 2). These latest turnover levels are significantly higher than the average historical turnover levels of the strategies, which hover near 50% for All Asset and 75% for All Authority. Though let’s not forget that the multi-year period prior to 2020 featured some of the lowest levels of market volatility ever (as measured by the CBOE VIX Volatility Index).

Following the broad market declines in the first quarter, our models forecasted a huge rise in expected returns; our long-
term real return estimates for the equally weighted portfolio of diversifying asset classes we label Third Pillar\(^{[i]}\) (real return, high yield bonds, emerging markets) doubled from 2% to 4% per annum. Then, during the second quarter, market prices snapped back. Our estimated real return for the S&P 500 fully reverted to its near-zero level pre-COVID. Yet, our estimated return for diversifiers remains well above its 2019 year-end level, at about 3% in July.

Q: What research efforts pertain to the ongoing evolution of the All Asset strategies’ investment process?

Harvey: Early in my career, I published a paper called “The Variation of Economic Risk Premiums.”\(^{[ii]}\) The idea was simple. Certain sources of risk are persistent — and usually predictable. In the depths of a recession when markets have fallen, risk premiums tend to be higher. Of course, identifying persistent and predictable sources of risk are equally as important today.

Rob’s research has demonstrated that factors tend to exhibit momentum-like behavior. This information has proven useful in the creation of multi-factor equity strategies that dynamically adjust factor allocations. PIMCO offers these strategies, and we employ them in the All Asset funds.

Recently, Rob and Chris have overseen a new key research initiative: a suite of quantitative models that attempt to identify and exploit periods of persistence that are complementary to the All Asset funds’ existing tactical models and the underlying strategies already engaged in this endeavor. Two recent papers, “Momentum Turning Points”\(^{[iii]}\) and “Breaking Bad Trends,”\(^{[iv]}\) explore an important finding of this research initiative.

Many models apply a static momentum strategy, for example, a 12-month or 1-month lookback window to generate buy or sell short signals. The 12-month lookback (which we refer to as “slow”) may result in missing a price rebound or correction. In contrast, a 1-month lookback (which we refer to as “fast”) may increase the risk of whipsaw from price noise, believing a turning point has materialized when it has not. We find benefits in employing a dynamic weighting scheme across fast and slow signals, contingent on where we believe each asset is in its own market cycle.

The result, in our analysis, is that improved risk-adjusted return is possible relative to generation-one trend-following approaches, particularly in and around market turning points. Given that trend-following portfolios of all types (both fast and slow) tend to suffer around market turning points, and given turning points have tended to occur at higher frequencies over the last decade than they have in the past, we view this approach as uniquely applicable to navigating today’s evolving investment environment.

A second research initiative has reexamined how relative signal-level strategies operate. The standard implementation may be to overweight the assets with the highest signals and underweight those with the lowest signals. For example, with 15 assets we could have five overweights and five underweights. Alternatively, we can approach this type of strategy as a series of relative signal-level pair trades. For example, you could look at the 105 different pair strategies among 15 assets and select pairs with the best track records. The latter approach leads to different assets being selected with different weights on these assets and potentially to higher expected returns and lower drawdowns in the historical data.

These research projects, among others, are ongoing and promising. We are optimistic that the portfolio managers and the Asset Allocation team can apply these insights to the All Asset funds’ large (and growing) opportunity set of available exposures and incorporate them into the investment process.

The All Asset strategies represent a joint effort between PIMCO and Research Affiliates. PIMCO provides the broad range of underlying strategies — spanning global stocks, global bonds, commodities, real estate, and liquid alternative strategies — each actively managed to maximize potential alpha. Research Affiliates, an investment advisory firm founded in 2002 by Rob Arnott and a global leader in asset allocation, serves as the sub-advisor responsible for the asset allocation decisions. Research Affiliates uses their deep research focus to develop a series of value-oriented, contrarian models that determine the appropriate mix of underlying PIMCO strategies in seeking All Asset’s return and risk goals.

DISCLOSURES

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund’s prospectus and summary prospectus, if available, which may be obtained by contacting your investment professional or PIMCO representative or by visiting www.pimco.com. Please read them carefully before you invest or send money.

The performance figures presented reflect the total return performance and reflect changes in share price and reinvestment of dividend and capital gain distributions. All periods longer than one year are annualized. The minimum initial investment for Institutional, I-2, I-3 and Administrative class shares is $1 million; however, it may be modified for certain financial intermediaries who submit trades on behalf of eligible investors.
Investments made by a Fund and the results achieved by a Fund are not expected to be the same as those made by any other PIMCO-advised Fund, including those with a similar name, investment objective or policies. A new or smaller Fund’s performance may not represent how the Fund is expected to or may perform in the long-term. New Funds have limited operating histories for investors to evaluate and new and smaller Funds may not attract sufficient assets to achieve investment and trading efficiencies. A Fund may be forced to sell a comparatively large portion of its portfolio to meet significant shareholder redemptions for cash, or hold a comparatively large portion of its portfolio in cash due to significant share purchases for cash, in each case when the Fund otherwise would not seek to do so, which may adversely affect performance.

Differences in the Fund’s performance versus the index and related attribution information with respect to particular categories of securities or individual positions may be attributable, in part, to differences in the pricing methodologies used by the Fund and the index.

There is no assurance that any fund, including any fund that has experienced high or unusual performance for one or more periods, will experience similar levels of performance in the future. High performance is defined as a significant increase in either 1) a fund’s total return in excess of that of the fund’s benchmark between reporting periods or 2) a fund’s total return in excess of the fund’s historical returns between reporting periods. Unusual performance is defined as a significant change in a fund’s performance as compared to one or more previous reporting periods.

A word about risk:

The fund invests in other PIMCO funds and performance is subject to underlying investment weightings which will vary. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be appropriate for all investors. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market’s perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in securities of smaller companies tends to be more volatile and less liquid than securities of larger companies. Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. government. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Entering into short sales includes the potential for loss of more money than the actual cost of the investment, and the risk that the third party to the short sale may fail to honor its contract terms, causing a loss to the portfolio. The use of leverage may cause a portfolio to liquidate positions when it may not be advantageous to do so to satisfy its obligations or to meet segregation requirements. Leverage, including borrowing, may cause a portfolio to be more volatile than if the portfolio had not been leveraged. Derivatives and commodity-linked derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Commodity linked derivative instruments may involve additional costs and risks such as changes in commodity index volatility or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Investing in derivatives could lose more than the amount invested. The cost of investing in the Fund will generally be higher than the cost of investing in a fund that invests directly in individual stocks and bonds. Diversification does not ensure against loss.

Portfolio structure is subject to change without notice and may not be representative of current or future allocations. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

Third Pillar asset class proxies / indexes are as follows: Bloomberg Barclays U.S. TIPS Index is an unmanaged market index comprising all U.S. Treasury Inflation-Protected Securities rated investment grade (Baa3 or better), have at least one year to final maturity, and at least $500 million par amount outstanding. The Bloomberg Barclays U.S. Corporate High-Yield Index the covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities
are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. Bloomberg Commodity Index Total Return is an unmanaged index composed of futures contracts on a number of physical commodities. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. The futures exposures of the benchmark are collateralized by US T-bills. The FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property. The JPMorgan Government Bond Index-Emerging Markets (GBI-EM) indices are comprehensive emerging markets debt benchmarks that track local currency bonds issued by Emerging Market governments. The index was launched in June 2005 and is the first comprehensive global local Emerging Markets index. The J.P. Morgan ELMI+ Composite (Unhedged) Index tracks total returns for local-currency-denominated money market instruments in a range of emerging market countries. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. It is not possible to invest directly in an unmanaged index.

The MSCI World Index captures large and mid-cap representation across 23 developed market (DM) countries. The Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The ICE BofAML U.S. High Yield BB-B Rated Constrained Index tracks the performance of BB-B Rated U.S. Dollar-denominated corporate bonds publicly issued in the U.S. domestic market. Qualifying bonds are capitalization-weighted provided the total allocation to an individual issuer (defined by Bloomberg tickers) does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face value of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis. The Dow Jones U.S. Select Real Estate Investment Trust (REIT) Total Return Index is a subset of the Dow Jones Americas Select Real Estate Securities Index (RESI) and includes only REITs and REIT-like securities. The objective of the index is to measure the performance of publicly traded real estate securities. The indexes are designed to serve as proxies for direct real estate investment, in part by excluding companies whose performance may be driven by factors other than the value of real estate. It is not possible to invest directly in the index. Prior to April 1st, 2009, this index was named Dow Jones Wilshire REIT Total Return Index. The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers. The Bloomberg Barclays Global Aggregate ex USD Index is a measure of investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. Bonds issued in USD are excluded. It is not possible to invest directly in an unmanaged index.

The terms “cheap” and “rich” as used herein generally refer to a security or asset class that is deemed to be substantially under- or overpriced compared to both its historical average as well as to the investment manager’s future expectations. There is no guarantee of future results or that a security’s valuation will ensure a profit or protect against a loss.

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