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Asset Allocation and Absolute Views - methodology

In this report we explain the methodology we use to present and monitor our relative asset allocation views (see Figure 1) and our total return absolute views (see Tables 1 and 2), both as of 1 June 2017.

Figure 1: Asset Allocation View

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	+2			
Asset class	+1	+1	+1	-1
Relative country views				
China	-1	-1	-2 (-1)	n/a
Brazil	-1	0 (-1)	+1 (+2)	-1
India	+2 (+1)	-1 (+1)	0 (-1)	n/a
Russia	+1	-1	+1	0
Mexico	0 (-1)	+1	+1	+2
Indonesia	+1 (+2)	+1 (+2)	+1	+1
Philippines	-1	0 (-1)	-1 (-2)	-1
Thailand	0	+1 (0)	-1	n/a
South Africa	-2 (-1)	-1	-1	-2
Turkey	+1	+1	+1	+1

Scale	
+2	
+1	
0	
-1	
-2	

Last month in brackets

The scores for our relative country views sum to zero in each column.

This publication is part of our EM service. Click here for more details.

Table 1: Current Absolute Views

Country	Asset	Market view	Units	Date opened	Open level	Current level	Performance to date
Russia	Equities	Positive	USD	8-Dec-16	576.0	536.4	-6.9%
Indonesia	Equities	Positive	USD	5-Apr-17	495.1	507.3	+2.5%
Turkey	Local debt	Positive	%	15-May-17	10.69	10.52	+1.5% (-17 bp)

Source: Bloomberg, TS Lombard.

Table 2: Closed Absolute Views

Country	Asset	Market view	Units	Date opened	Date closed	Open level	Performance to close
Russia	Equities, energy	Positive	USD	18-Sep-15	12-Jan-16	596.6	-17.7%
Brazil	Equities	Negative	USD	30-Jan-15	5-Feb-16	1,711.0	+42.6%
Brazil	10-yr local debt	Positive	%	7-Apr-16	7-Sep-16	14.24	+34.9% (+225 bp)
Philippines	Equities	Positive	USD	17-Jun-16	7-Sep-16	28.36	-1.4%
South Africa	Local debt	Positive	%	10-Nov-16	3-Feb-17	9.27	+9.7% (+19 bp)
Turkey	Sovereign credit	Positive	bp	27-Jul-16	7-Mar-17	322	+2.0% (+11 bp)

Source: Bloomberg, TS Lombard.

Asset Allocation

Overview

We update our asset allocation views every month

We revise our asset allocation views every month and publish them in heatmap form on the front page of our regular EM Strategy Monthly, most recently on 1 June 2017 (see Figure 1). A copy of the heatmap is also published in our weekly EM Watch, most recently on 5 June.

In the following paragraphs, we explain the methodology we use to present and monitor these views[1].

We aim to provide useful information at multiple decision levels

We recognize that asset allocators have different investment universes and that there are also many different approaches to structuring the asset allocation decisions that are used to divide up that universe in order to arrive at a set of investment recommendations. At its heart, however, asset allocation is a series of decisions – these decisions may be independent and for some firms will be made by different people or even outsourced to another company.

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[1] We have been using this same methodology since July 2016.

Top down asset allocation

We aim to provide useful information to EM asset allocators at multiple decision levels where we believe we can add value. The heatmap in Figure 1 illustrates the following series of top down asset allocation decisions that, taken together, describe our assessment of the outlook for EM assets.

- **Risk**. The overall risk environment for EM assets.

  A positive score may be interpreted as corresponding to above average leverage, or to an above average weighting of risky assets to cash, or to an above average weighting of EM vs DM assets.

- **Asset class**. Relative risk adjusted asset class dollar total return.

  A positive score for an asset class (equities, currencies, local debt and sovereign credit) indicates that we believe external and domestic conditions favour that asset class. The factors we consider include: external and domestic economic fundamentals and politics, geopolitics, market valuation and investor positioning. We aim to ensure that is always a mix of positive and negative numbers among our asset class scores, although we will not insist that these strictly sum to zero.

  We recognize that asset allocators will potentially use different methods for calculating risk adjustment. We consider historical volatility as a broad measure of risk for each asset class, but we are not intending to present a direct comparison of expected returns among different asset classes.

- **Country**. Relative dollar total return for each country, by asset class.

  In order to maximize the usefulness for EM asset allocators we ensure that the country selection views presented are relative, rather than absolute, and therefore that the scores for all 10 countries, for each asset class, strictly sum to zero (i.e., the columns of relative country views in Figure 1 sum to zero).

Time horizon

We typically present views that we expect to remain valid for the next 3 to 6 months. However, the frequency of our internal analogue of an asset allocation investment committee meeting is monthly (as is our publication cycle) and so the score itself reflects our view of the expected market move over the coming month.

We review the ratings of our views every month, with the score assigned in the previous month (if changed) shown in brackets.

Assigning scores

Our views are expressed according to an integer score from -2 to +2 that reflects both the expected relative performance and degree of conviction. A score of 1 is moderate and 2 is strong conviction. In order to maximize the usefulness to both asset allocators and total return investors we aim to ensure that 10-15% of the scores are 2s.

No numerical price performance parameters are implied, nor should they be inferred. TS Lombard expresses an opinion only on those countries and assets on which it has one.

Internal process

We have an investment committee process

As part of our internal process for producing the EM Strategy Monthly, we take detailed inputs from our country teams and analysts. During the week in which we publish the EM Strategy Monthly we hold the following conference calls and meetings to review the economic and political environment in each of the countries we cover.

- An individual conference call with each of our country based teams.

- A meeting with our London based economists.

We then hold a monthly investment conclusions meeting among senior strategists and relevant country specialists at which we assign scores for each element in the asset allocation heatmap. At this meeting we also review and stress test our existing and proposed absolute views.

Monitoring our asset allocation views

We perform a tactical asset allocation value added analysis

We monitor our asset allocation views by performing a tactical asset allocation "value added" analysis[2]. We use the following market indices for calculating the total returns for each asset class.

Equities	– MSCI indices in dollars
Currencies	– Total return in dollars, including carry
Local fixed income	– Bloomberg EM Local Sovereign Bond indices
Sovereign credit	– Bloomberg EM Sovereign USD Bond indices

Value added is determined by deviation from the benchmark

It is, of course, the deviations from the benchmark, rather than the benchmark country weights, that determine the value added. Hence, with no loss of usefulness, we base our value added analysis on an equal weighted benchmark consisting of asset class indices for each of the 10 countries we cover.

Because our country-level asset allocation is strictly relative, it is straightforward to construct a portfolio with country-index weights adjusted according to our asset allocation views. We convert a score of +/-1 to a 5% overweight or underweight allocation vs benchmark and +/-2 to 10% overweight or underweight.

A realistic asset allocation has many constraints

We recognize that asset allocators will use different benchmarks and, also that the deviations from benchmark that are permitted in a realistic asset allocation process are constrained by many factors, including the weight of each country in the benchmark index and the impact of any overweight or underweight decision on the overall tracking error of the portfolio vs the benchmark – which will depend on the volatilities and correlations of the component country indices.

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[2] Value added is calculated for each country as (portfolio weight – benchmark weight) x benchmark return; the calculation uses returns relative to the average return for the 10 countries in the analysis. All returns are total returns in dollar terms.

Our asset allocation view of each country has equal merit

Our aim is to present a useful input to a range of realistic asset allocation processes, rather than to ourselves recommend a realistic asset allocation. In order to both maximize usefulness and simplify the presentation, therefore, our asset allocation view of each country is given equal merit and contributes equally to the overall value added.

Monthly presentation of value added

We present a monthly value added analysis

In each edition of our EM Strategy Monthly we present the calculation of value added by our asset allocation views since the previous month. For example, Charts 1 to 4 appeared in our 1 June EM Strategy Monthly, along with a short explanation of the reasons underlying the best and worst performing asset allocation views.

Our aim is simply to monitor our views – the dollar magnitude of the value added is arbitrary (depending on our scheme for converting scores to overweights and underweights), and there is no risk adjustment calculation to allow comparison between asset classes.
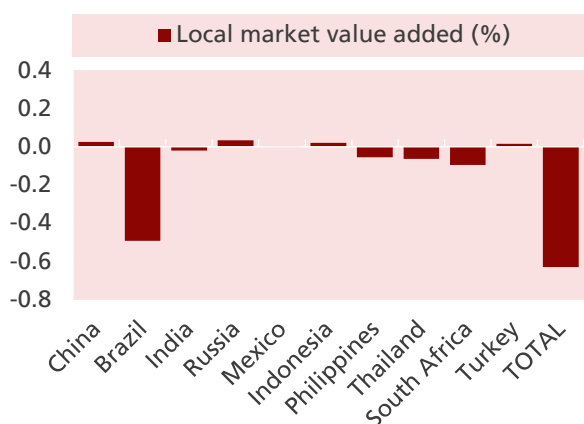
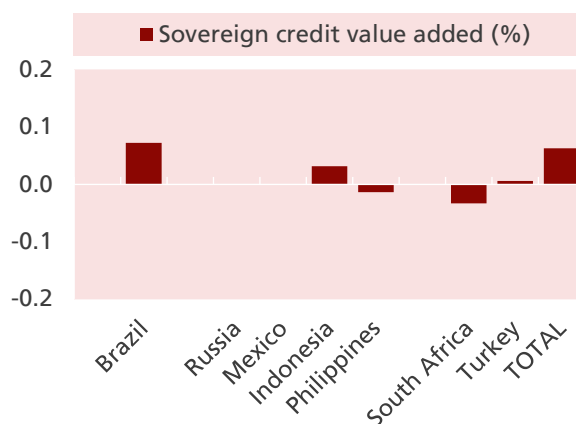**Chart 1: Equity value added since our 3 May asset allocation view (%, USD)**
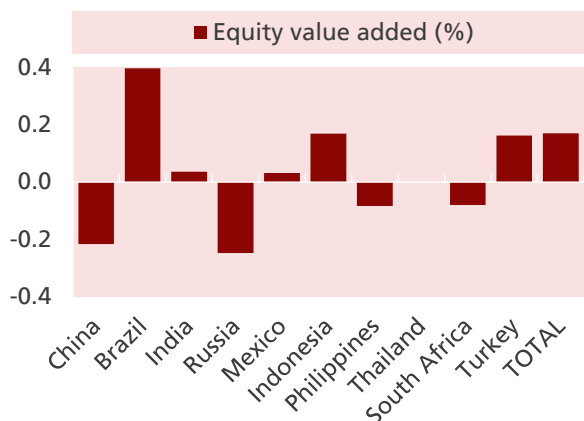
Chart 2: Currency value added since our 3 May asset allocation view (%, USD)
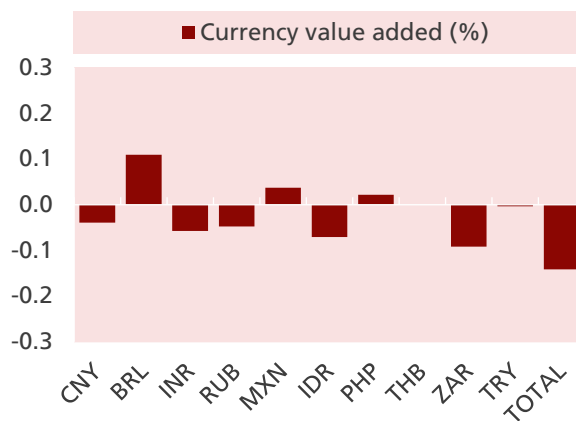
Chart 3: Local market value added since our 3 May asset allocation view (%, USD)

Chart 4: Sovereign credit value added since 3 May asset allocation view (%, USD)

Sources: Bloomberg, TS Lombard.

Absolute Views

Overview

The absolute views are our high-conviction total return views, presented in Table 1 and Table 2 above. These tables are revised weekly and published in our EM Watch, most recently on 5 June.

We will typically announce the addition of new absolute views, and the closure existing views, in our weekly EM Watch publication – along with an explanation of the reasons underlying that change.

On occasion, when a change is time sensitive, we may instead publish a separate flash report, and in that case the subsequent EM Watch will repeat the announcement and explanation of the change.

We will also publish Tables 1 and 2, updated with current market prices, in our EM Strategy Monthly, most recently on 1 June 2017. In the EM Strategy Monthly, for all open absolute views, we provide the reference to the edition of EM Watch or other report in which each absolute view was initiated. We also summarize our reasons for maintaining each open absolute view.

Time horizon

We typically enter a new absolute view with the expectation for it to remain valid for the next 3 to 6 months.

Total return calculation

Unless otherwise stated, we use the following market indices for calculating the total returns to calculate the performance each absolute view.

Equities   – MSCI indices in dollars

Currencies   – Total return in dollars, including carry

Local fixed income   – Bloomberg EM Local Sovereign Bond indices

Sovereign credit   – Bloomberg EM Sovereign USD Bond indices

Sovereign credit performance is calculated in dollars relative to a duration matched US Treasury hedge.

The performance is calculated using mid-market prices and does not include funding cost. Opening and closing levels are for London market close of business, obtained from Bloomberg. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports.

No numerical price performance parameters are implied, nor should they be inferred.

We update our high conviction views every week

We summarize all open views every month

We consider a 3-6 month time horizon

We use Bloomberg and MSCI indices