

Private Bank



# Adaptive Valuation Strategies

**A New Approach to  
Strategic Asset Allocation  
2020 Mid-Cycle Update**



While the Adaptive Valuation Strategies' Strategic Return Estimates cover a 10-year time horizon, we believe the pandemic's impact on certain asset classes, particularly fixed income, is secular in nature.

Much changed in the world in the first half of 2020 as the spread of the COVID-19 virus shut down economies globally. Given the expected long-term nature of these changes, we decided to take the uncommon step of updating the Adaptive Valuation Strategies Strategic Return Estimates (SREs) and strategic asset allocations mid cycle.

**Figure 1.** A sample of the 2020 Mid-Cycle SREs and a comparison to the SREs from earlier this year.

	Strategic Return Estimates	
	2020 Mid-Cycle	2020 Annual
Global Developed Market Equity	6.2%	5.1%
Global Large Cap Equity	5.5%	4.4%
Global Small/Mid Cap Equity	11.6%	9.2%
Global Emerging Market Equity	11.7%	10.9%
Global Developed Investment Grade Fixed Income	1.1%	2.1%
Developed Government Bonds	0.7%	1.9%
Developed Corporate Bonds	2.6%	2.7%
Global High Yield Fixed Income	5.9%	3.5%
Global Emerging Fixed Income	6.2%	4.7%
Cash	0.6%	1.8%
Hedge Funds	4.4%	5.3%

Source: Private Bank Quant Research & Global Asset Allocation team. SREs for 2020 Mid-Cycle based on data as of April 30, 2020. SREs for 2020 Annual based on data as of October 31, 2019. Strategic Return Estimates are in US Dollars. All estimates are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Strategic Return Estimates are no guarantee of future performance. Past performance is no guarantee of future returns.

## Global Developed Market Equity

In the face of the market downturn, Developed Market Equity valuations over a 10-year horizon have improved. AVS's preferred valuation metric, cyclically adjusted price-earnings ratios (CAPE), have become more favorable. Near-term earnings are expected to be heavily impacted by the global economic shutdown. In fact, CAPE earnings have fallen. However, the impact is somewhat muted given CAPE earnings use a trailing 10-year window intended to capture full economic cycles and to smooth out shorter term shocks. In contrast, given the economic turmoil, current equity market prices have dropped substantially. The net effect is that CAPE ratios have become more favorable relative to 2019 year-end and has led to an increase in the Global Developed Market Equity SREs.

**Developed Small Cap Equity** SREs also increased. Small cap firms, and consequently their stock prices, have been hit hard by the turmoil and investor concerns about small cap firms' less diversified income streams and bankruptcy risks. As a result, small cap valuations have become more attractive, leading to higher SREs.

## Global Developed Investment Grade Fixed Income

Global Developed Investment Grade (IG) Fixed Income SREs are lower overall. However, within the category, there are opposing forces.

**Developed Government Bond SREs** have fallen as they are a function of interest rates with rates driven lower by central bank asset purchases.

**Developed Corporate Bond SREs** are determined not only by changes in rates but also by changes in credit spreads which widened during the pandemic. Since rates and credit spreads have pulled in opposite directions, there has been little impact on IG Corporate Bond SREs.

Because of this, the combination of the Developed Government Bond SREs with Developed Corporate Bond SREs, the net effect are lower overall Global Developed IG Fixed Income SREs. In fact, the Global Developed IG Fixed Income SREs are the lowest we have seen in 20 years.

## Global High Yield Fixed Income

Conversely, the Global High Yield Fixed Income SRE increased. High yield is heavily driven by its credit exposure rather than rates sensitivity. Similar to the direction of Developed Corporate Bonds, the High Yield credit spread widened significantly due to pandemic risks. Within the High Yield asset class, energy sector bonds were particularly hard hit.

## Global Emerging Fixed Income

Global Emerging Fixed Income SREs increased. Asia debt market volatility has been muted relative to LATAM debt markets, which have been heavily punished by investors. This effect pushed up overall Emerging Fixed Income SREs.

## Cash

In most cases, Cash SREs dropped significantly this year as many central banks cut interest rates in response to the pandemic.

## Hedge Funds

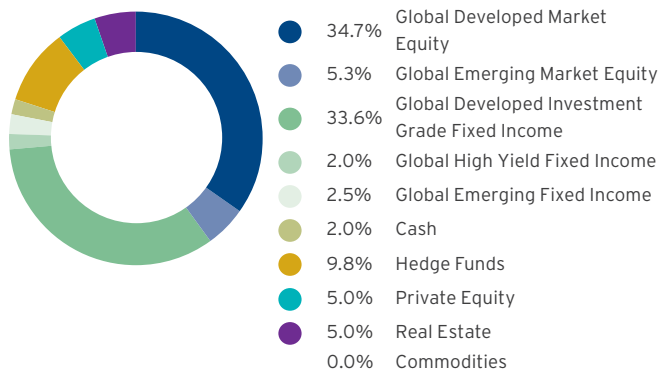
Hedge Funds SREs have also declined. Hedge Funds generally have characteristics of equities and fixed income. At the time of our mid-cycle assessment, the fixed income component had the most impact as the declining yield and interest rates market in the early months of 2020 led to a commensurate decrease in Hedge Fund SREs.

We believe that strategic asset allocations should be revisited when the assumptions that drive them change materially, as they did in the start of 2020. Our updated SREs reflect the new realities that long-term investors should not ignore. As a result, we recommend that portfolios be rebalanced to the mid-cycle strategic asset allocations. Please consult with your Private Banker or Investment Counselor to discuss further.

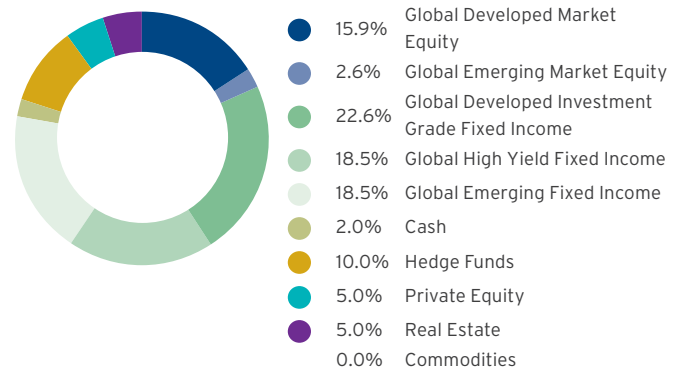
# 2020 Mid-year global allocations

Figures 2-17 show 2020 Mid-year Global Allocations including hedge funds and 10% illiquidity for the eight global profiles and eight home-bias profiles – Risk Level 3.

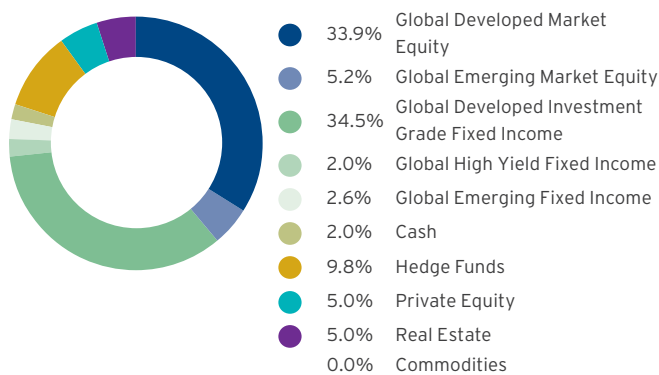
**Figure 2.** Global Allocation in US Dollars with Hedge Funds and 10% illiquidity – Risk Level 3



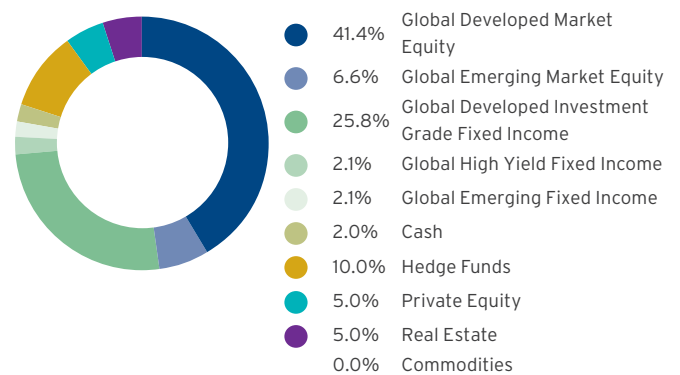
**Figure 3.** Global Income Allocation in US Dollars with Hedge Funds and 10% illiquidity – Risk Level 3



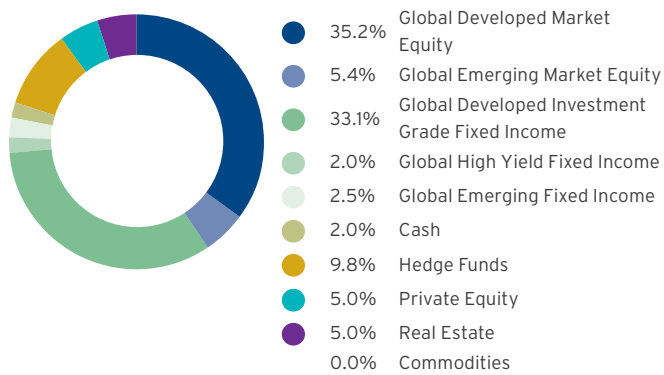
**Figure 4.** Global Allocation in US Dollars Taxable with Hedge Funds and 10% illiquidity – Risk Level 3



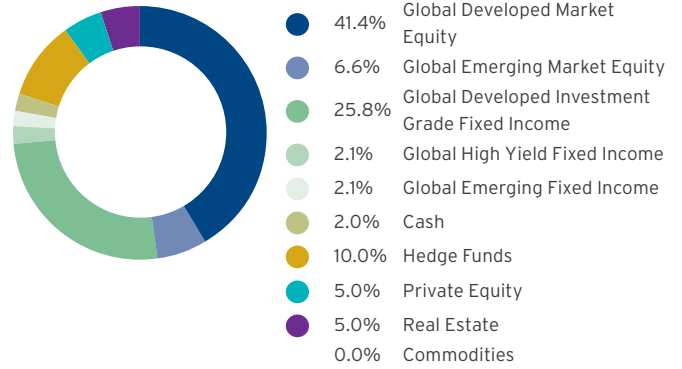
**Figure 5.** Global Allocation in British Pounds with Hedge Funds and 10% illiquidity – Risk Level 3



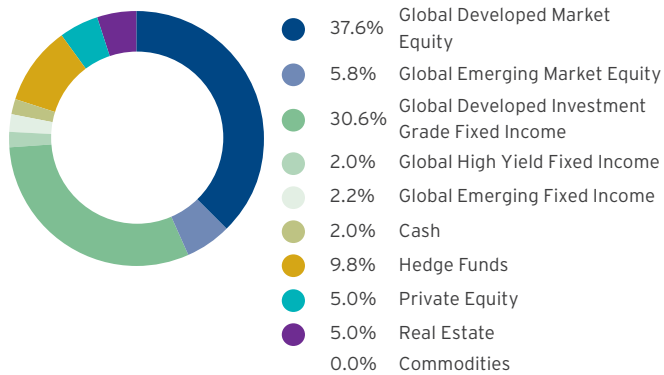
**Figure 6.** Global Allocation in Swiss Francs with Hedge Funds and 10% illiquidity – Risk Level 3



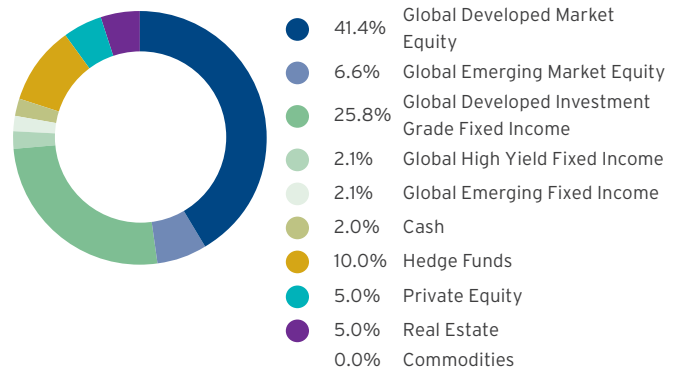
**Figure 7.** Global Allocation in Canadian Dollars with Hedge Funds and 10% illiquidity – Risk Level 3



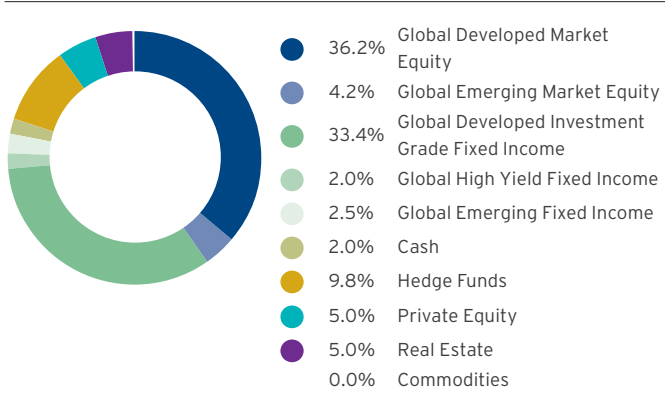
**Figure 8.** Global Allocation in Euros with Hedge Funds and 10% illiquidity – Risk Level 3



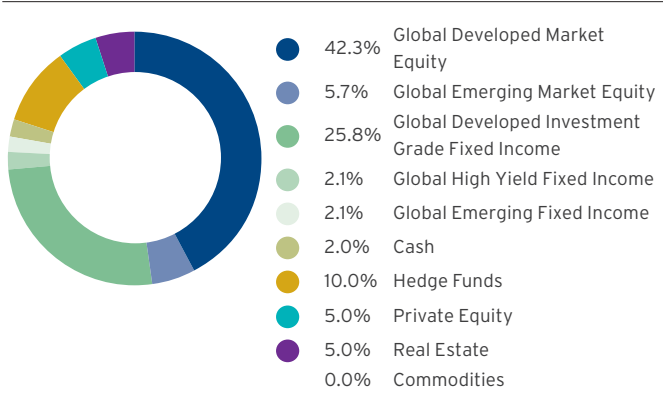
**Figure 9.** Global Allocation in Australian Dollars with Hedge Funds and 10% illiquidity – Risk Level 3



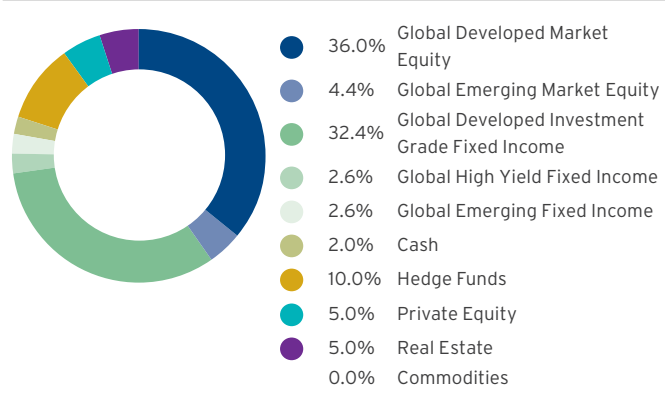
**Figure 10. US Home-Bias Taxable Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**



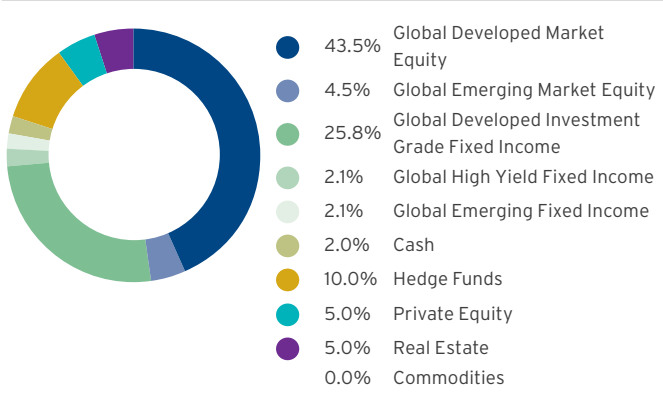
**Figure 11. Canada Home-Bias Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**



**Figure 12. US Home-Bias Tax-exempt Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**

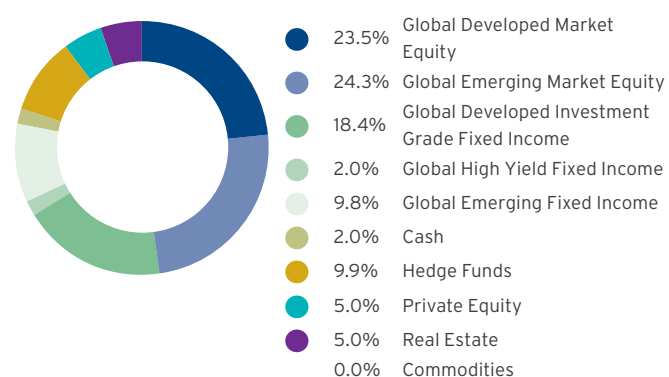


**Figure 13. UK Home-Bias Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**

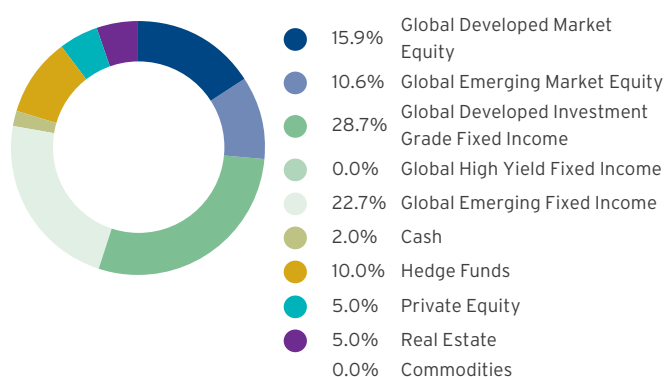


Please see Glossary for definition of terms. Allocations for 2020 Mid-year; based on data as of April 30, 2020.

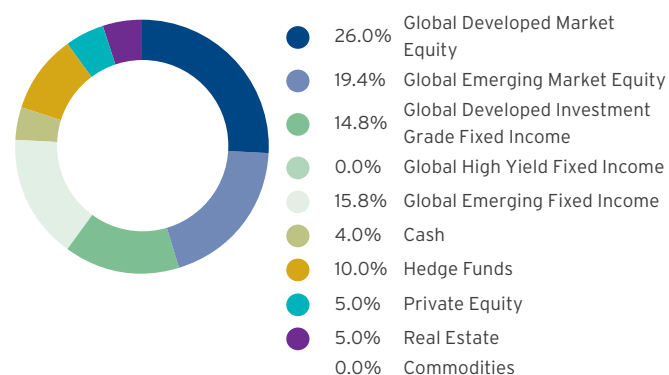
**Figure 14. Mexico Home-Bias Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**



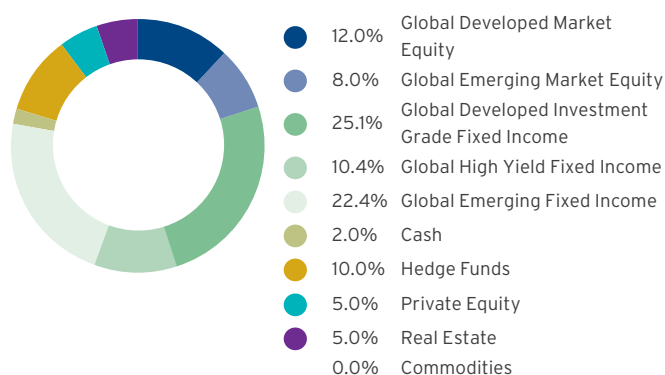
**Figure 15. Asia Home-Bias Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**



**Figure 16. Brazil Home-Bias Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**



**Figure 17. Asia Home-Bias Income Allocation with Hedge Funds and 10% illiquidity – Risk Level 3**



# Meet the asset allocation team

## Gregory van Inwegen

Greg is Global Head of Quantitative Research and Asset Allocation at Citi Investment Management (CIM), where he is responsible for two CIM teams: Global Asset Allocation and Quantitative Research. Greg also serves as Vice Chairman of the Private Bank's Global Investment Committee (GIC).



Greg was the Chief Investment Risk Officer at Ivy Asset Management/Bank of New York Mellon. Prior to his tenure with Ivy, Greg held Director of Research positions at Rydex Investments and Bankers Trust/Deutsche Asset Management.

Greg received an MS and PhD with a concentration in Finance from The Wharton School, University of Pennsylvania, an SM in Management from the Sloan School of Management, Massachusetts Institute of Technology, and a BS from the Haas School, University of California at Berkeley.

## Paisan Limratanamongkol

Paisan is a Director and head of Quantitative Research and Global Asset Allocation.

Previously, Paisan was a Quantitative Equity Portfolio Manager and Researcher at BlackRock. Prior to his tenure with BlackRock, Paisan was a Partner, responsible for stock selection and asset allocation, at Thunder Bay Capital Management, and Vice President at Deutsche Asset Management.



Paisan holds a Bachelor in Computer Engineering from Chulalongkorn University, Thailand, an MBA from Thammasat University and a PhD with a concentration in Finance from the Kenan-Flagler School, University of North Carolina at Chapel Hill.





## Gene DeSello

Gene DeSello is a Senior Vice President and Investment Quant Research Senior Lead on the Quantitative Research and Asset Allocation team at Citi Investment Management (CIM).

Prior to joining the Private Bank in 2015, Gene worked as a consultant for Goldman Sachs, BNP Paribas, Morgan Stanley, JP Morgan Chase and Nomura Securities. Gene has over 25 years of financial industry experience in software development, integrating and managing enterprise-wide applications and platforms, database design and administration.

Gene holds an MS and BS in Computer Science Summa Cum Laude from New York University Tandon School of Engineering, New York.



## Andy Zhu

Andy is a Senior Vice President and Investment Quant Research Senior Lead on the team.

Andy has ten years of quantitative research experience covering alpha generation, portfolio construction, performance attribution, and risk management.

Andy holds a Bachelor of Medicine from Shanghai Second Medical University, an MS in Epidemiology from Emory University, an MS in Computer Science from Emory University and an MS in Mathematics in Finance from New York University.



## Xin He

Xin is a Vice President and Investment Quantitative Research Lead on the team.

Xin holds a BS in Mathematics from Beihang University, as well as a Master of Science in Applied Statistics and a Master of Science in Bioinformatics from Indiana University Bloomington. She is a CFA Charterholder and an FRM Charterholder.



## Wenjing Wu

Wenjing is an Assistant Vice President and Investment Quantitative Research Senior Analyst on the team.

Wenjing holds a BS in Applied Mathematics and a BA in Quantitative Finance from Xiamen University, as well as a Master of Science in Mathematical Finance from Rutgers University New Brunswick. She is an FRM charterholder.



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