Regime-Based Allocation—
Using economic factors to build portfolios

- Long-term investment success requires striking the right balance across varying economic and market conditions.
- Traditional balanced portfolio allocations do not always fulfill this requirement.
- We use a regime-based allocation in seeking to design a portfolio capable of delivering consistent, risk-adjusted returns.

A regime-based approach to investing considers risk in terms of exposures to common economic risk factors. This approach is based on the view that investment returns are influenced by a wide variety of factors, and the influence of any given factor varies considerably from asset to asset. However, intuition, as well as a broad body of research, indicates that certain common factors simultaneously impact the returns of many distinct asset classes across the capital markets. An understanding of these common factors can help an investor comprehend the characteristics of (and relationships between) asset classes, and why these characteristics and relationships change over time. While any number of such factors could be identified, we believe two dominant influences contribute immensely to overall capital market returns: economic growth and inflation.

Clearly, economic growth, which reflects production and profitability in the overall economy, influences the cash flows generated by risky assets. Inflation, which is a rise in the overall level of prices (or conversely, a decline in the relative value of money), affects both purchasing power and the level of interest rates. A one-time rise in prices erodes the real value of existing financial assets, while a sustained increase in expected inflation raises the return that investors demand on their assets. Because this higher demanded return increases the discount rates used by investors to value financial assets, it reduces the market values of all assets except those with cash flows directly linked to the rate of inflation.

While each asset class is influenced by these factors in its own way, certain relationships seem at first glance to be particularly strong; for example, equities should perform well in response to positive growth surprises, fixed income should outperform during periods of deflation (as their fixed cash flows become more attractive in real terms), and commodities should thrive during periods of rising inflation. Exhibit 1 demonstrates the differing economic environments created by varying economic growth and inflation.

Given that asset classes perform differently in varying environments, regime-based investing adapts its asset class assumptions accordingly. By comparison, traditional diversification approaches use of single point estimates—one expected return, one point estimate of volatility (or standard deviation) and one set of correlations—throughout dynamic market environments. By taking a more flexible approach, regime-based investing is less reliant on historical data as an input into future expectations.

SEI believes that the regime perspective presents a considerable enhancement to traditional asset-allocation approaches. The strength and consistency of our research across many different environments yields several salient observations. For instance, high-quality fixed income performs a crucial role in periods when other risky assets underperform most severely (such as falling growth, falling inflation environments). Additionally, inflation risk exposes a major weakness of traditional portfolio allocations; the addition of commodities, which historically outperform during periods of unexpected inflation, seems prudent.
Our Strategies

At SEI, our research into the role of regime-based thinking in asset allocation is an ongoing process. While we continue to enhance our understanding of the impact of economic regimes on asset-class performance, we already take regime influences into account in our asset-allocation decisions, both strategic and tactical. We have introduced the Objectives-Based Funds and incorporated additional measures of regime sensitivity in determining allocations within our models. In our continuing search to make our offerings more robust and keep them relevant to our clients, we believe we can help investors better manage the economic risks that matter most to their financial well being.
Definitions

Risk-adjusted Return: A measure that relates the amount of return generated for the amount of risk taken in an investment.

Standard Deviation: Statistical measure of historical volatility. A statistical measure of the distance a quantity is likely to lie from its average value. It is applied to the annual rate of return of an investment, to measure the investment's volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment’s return will be. A standard deviation of zero would mean an investment has a return rate that never varies.

Correlation: A statistical measure indicating the relationship between the movements of two variables.

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There are risks involved with investing, including loss of principal. Current and future portfolio holdings are subject to risks as well. Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. Past performance does not guarantee future results.

For those SEI Funds which employ the ‘manager of managers’ structure, SEI Investments Management Corporation (SIMC) has ultimate responsibility for the investment performance of the Funds due to its responsibility to oversee the sub-advisers and recommend their hiring, termination and replacement.

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