ticker

Seeking Constant Diversifiers

Traditional stocks and bond funds generate returns that are reflective of their asset classes and are subjected to the volatility that come with the risks they take. David Millar and his team aim to provide equity like returns with half the volatility of global equities using an unconstrained research process.

What is the role of alternative funds?

The question that always comes to my mind is alternative to what? In the US marketplace, investors think mainly in terms of stocks and bonds, while all other investments are considered "alternative."

And here's why investors have to be careful about what type of "alternative" investments they are considering. There is a wide gamut of funds in the "alternatives" category — from private equity funds, to real estate funds, to hedge funds like long and short funds.

Are we offering an alternative to a traditional stock or bond fund? Yes. Through the Invesco Global Targeted Returns Fund, we try to deliver equity-like returns with less volatility. We seek to offer investors a smoother ride, particularly those who are nearing retirement or are looking to draw down funds in the next five to 10 years, and would like to avoid being caught in a bear market at the wrong time, like some pre-retirees faced during the 2008-2009 financial crisis.

When looking at the mutual fund space, alternative funds also have the added benefit of offering the potential for daily liquidity, transparency and oversight.

What is the history of the fund and strategy?

The Invesco Global Targeted Returns Fund was launched on December 19, 2013. We launched our fund in the UK a few months earlier, in September. But the portfolio management team, which includes Dave Jubb and Richard Batty, has been managing these types of multi-asset strategies since 2008.

How has the strategy has evolved?

The Invesco Global Targeted Returns Fund has two targets. One is a gross annual return target of 5% over three-month U.S. Treasury bills over a rolling three-year period, with a target volatility of less than half that of global equity markets, over the same rolling three-year period.

Our investment approach is based on harnessing the power of diversification through an unconstrained research agenda. While the fund seeks diversification through exposure to different asset classes, because of its concentration in cash or near-cash as cover for our significant derivatives exposure, it is classified as non-diversified by the SEC. We want the freedom to look for risk-adjusted, long-term returns across all asset types and classes regardless of geography. But this unconstrained approach to sourcing investment ideas is subject to the very tight risk controls and constraints involved in the construction of the portfolio.

This concept of ideas is very central to the fund. Macro ideas can come from different sources. And each of these ideas has to deliver a positive return in our central economic scenario on a two-to-three year basis. We currently have 24 ideas in the portfolio and expect every one of them has the potential to deliver a positive return. If we have confidence in each of our investment ideas then we can have confidence in the portfolio as a whole.

How do you judge every single idea in the portfolio?

Every idea has to be judged on the basis of whether it will deliver a positive return in our central economic scenario. Every single idea comes with "independent risk" — its own volatility. An equity idea will have its associated volatility just as an idea that comes from emerging markets will carry its own

David Millar is head of the Multi Asset team for Invesco Perpetual and lead portfolio manager of the Invesco Global Targeted Returns Fund. Mr. Millar joined Invesco in January 2013 and is based in its Henley-on-the-Thames office outside of London.

After starting his investment career with Scottish Widows in 1989, where he qualified as an actuary, Mr. Millar joined the Fixed Interest team at Scottish Widows Investment Partnership in 1996 and became head of Bond Strategy and chair of the Bond Policy group. In 2008, he joined Standard Life Investments as an investment director of the Multi Asset Investing team. He was one of the portfolio managers on their absolute return fund and chair of their Bond Investment group.

Mr. Millar earned a BSc (Hons) degree in mathematical statistics from the University of Cape Town and is a Fellow of the Institute and Faculty of Actuaries.

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volatility. When including an idea in the portfolio, we want to see how it interacts with the other ideas, in terms of the combined overall volatility of the fund, and what diversification benefits it offers.

Can you explain in details your investment process?

There are basically three steps to the process. First is the research, the second is the risk-based fund management, or combining ideas together into the portfolio, and the third is the implementation process.

Our job really begins with harvesting ideas through what we call our unconstrained approach to research. This includes our own research, talking to sell-side boutiques and investment banks and leveraging other investment teams across Invesco, including its Chief Economist John Greenwood, who we believe is one of the most respected economists in the business. It's important we have enough new ideas feeding through our research process so that we can constantly evaluate them to determine whether they may have a positive return in our central economic scenario and/or offer improved diversification.

We call our research process T-E-A-M. Each letter stands for a part of the research process

• "T" stands for "theme", which means you have to be able to explain in words why this is a good long-term investment idea.

• "E" stands for economic justification.

• "A" stands for analytics, which is essentially valuation – there have to be strong valuation arguments as to why this is a good long-term investment idea.

• "M" stands for managers, because on every idea we will have a discussion with our colleagues, our fellow managers, including in our offices in Henley-on-Thames in the UK. We don't always have to agree, but we'll always articulate the use of our fellow managers in our research process.

So that's why we call it T-E-A-M because it covers the theme, the economics, the analytics, as well as the use of all of the other managers around us. We believe that if every single idea, regardless where it comes from, successfully passes through that research process and is then evaluated against our long-term economic outlook to deliver a positive return, then it's worthy of consideration for inclusion in our investment portfolio.

But the research process only gets you so far. It's like getting ideas on a menu. Our role as fund managers is to choose what we take off that menu and put into a portfolio.

For example, we have taken a view on US interest rates and used pair trading by going long on the US 30-year bond and taking a short position on the US 10-year bond. We want to try to combine this idea with others in the portfolio, with varying levels of independent risk – like being outright long in certain equity markets – and see how the blended portfolio acts.

Another example is emerging markets, where given our cautious outlook this time last year, we have identified potential pair trades you can put in place. In our case, we've been long the Brazilian real and short the Chilean peso, which accomplished several things. First, it helped neutralize some of our emerging market concerns. And by pairing one commodity currency against another commodity currency, we neutralized some of the commodity volatility while benefiting from the interest rate differentials between the two economies.

We believe that our ability to do more than long-only investments, including pair trades in emerging markets or in bond markets or any other markets or asset types, gives us access to diversification benefits.

What is your research organization? How people are assigned responsibilities?

We have seven people in our multi-asset team, whose mission is to go out to explore and find ideas that they feel have a positive return potential. We can also leverage the vast global investment management capabilities at Invesco. The incentive is to always have enough new ideas coming down the pipeline.

We all have different backgrounds. I'm an ex-global bond fund manager, who started his career in the U.K. Gilt market. And before that I was an actuary in a life insurance company. So bond and currency ideas are my natural place to explore. Richard Batty has a Ph.D. in financial economics, so he's very comfortable exploring the relationships between bonds and equities and all the different asset classes and different sectors and geographies. Econometric analysis is his starting point. With Dave Jubb I believe we have one of the best equity derivative experts in the multi-asset business and so he often takes the volatility angle. The point is that while we all come from different backgrounds, it doesn't preclude us from looking at ideas from any area wherever we think we can find value. I think this is what makes the team such an attractive proposition in terms of doing the research.

Each member of the team sponsors a potential idea that they will then shepherd through the process. And because of our different backgrounds and strengths, the process looks different for each of us. For example, because Richard Batty is the econometrician of the group, the economic analysis will naturally be the cornerstone of his idea proposal. But in order for the idea to get through the process, Richard also has to articulate the theme behind the idea and evaluate whether it is a good long-term investment that will ultimately make money. In doing so, he has to gain the support of Dave Jubb for the idea, whose approval confirms the valuation work and provides additional merit to the idea.

Once the idea is in the portfolio, it's monitored on a day-to-day basis. But, at least once a quarter every idea is reviewed in the portfolio. We also have a research meeting once a month in which we review a third of the existing portfolio, and we get other new ideas as well. So if we currently have 24 ideas in the portfolio, every month we're reviewing eight of them and we're also looking at new ideas.

What makes an idea attractive?

An idea is attractive if we believe it can deliver a positive return on a two-to-three year view in our central economic thesis. However, that economic view does not drive where the research is done because you have to remember we're trying to deliver positive returns over a rolling two-to-three year period, regardless of the market outlook.

There will also be times when our central economic outlook is wrong. So we do a lot of work in terms of looking at different economic scenarios and what impact these different scenarios could have on the portfolio. Some ideas in the portfolio that are attractive in our central economic thesis could also do extremely well in other alternative scenarios, because they have additional attributes that will bare themselves out in those alternative scenarios. For example, for the fund to be long volatility in a way that also delivers a small positive return in the central economic scenario, could give you a larger upside if equity markets were to falter.

Recall that each idea on its own has to deliver a positive return, with some ideas delivering a larger return than others. In the portfolio, the ideas will be sized according to our expectation of that return, so the ideas are not equally weighted. We also take into consideration the volatility of the idea, such that no idea can represent more than 25% of the independent risk I described before.

Do you consider scenarios that can enhance or damage the portfolio?

Absolutely. Part of the process involves having a discussion about scenarios or events that could damage the portfolio. One of the scenarios we considered is something called "regional war" – it's a scenario that involved a regional conflict in Eastern Europe or the Middle East that manifests in markets in the form of a hike in oil prices and a concurrent fall in European equities. Against this scenario, our risk manager, Gwilym Satchell, stress tested the portfolio and how the ideas would perform.

Let's go back to our central economic thesis. It's one that I would describe as "cautious optimism" that's characterized by a slow global economic recovery, in the context of a low interest rate and inflation environment. At the same time, we are concerned about potential volatility in markets, and that's where the scenario and stress testing come in. They help us explore better risk-adjusted implementation of ideas, especially if these scenarios could lead to draw downs.

Can you share some examples?

Sure. One idea involves European equity markets, where we favor UK equities versus Swiss equities. Our valuation work supports the thesis that UK equities are cheaper at this point than Swiss equities. The Swiss stock market also has strong currency headwinds to contend with. So we want to be long UK equity and short Swiss equity.

The most obvious way of implementing the idea would be equity market futures, namely by being long the FTSE 100 Index and short the Swiss Market Index. We believe this idea will work in our central economic thesis. But what if something causes the stock market to fall sharply? This is not part of our economic thesis, but it's a scenario we've considered. In this case, because we believe that the UK market is more cyclical than the Swiss market, the UK stock market could get hit harder on the way down. What does that mean in terms of implementing the idea? Instead of using equity market futures to implement the idea, we'd use call options with the long call option on the FTSE and the short call option on the SMI index. In doing so, we're still favoring the UK to Switzerland, but we're able to isolate our exposure to a rising market environment, and limit our exposure on the downside.

How do you review your research process and look for ways to improve? Do you step back and look at the how the strategy has performed over a decade?

Again, our focus is on a two-to-three year time horizon, which we believe represents a full market cycle. There's too much noise in a short or near term time horizon, and we're trying to look through that. On the flip slide, I'm not sure all investors have the patience to wait 10 years for an investment idea to produce results.

We are always open to improving our research process. There's no harm in looking back and evaluating how the performance drivers have evolved. It's also a good idea to look at how long-term trends could impact the near term or they manifest in a two-to-three year time horizon. Let's take a look at China, for example. Right now, China is going through some economic rebalancing accompanied by moderate growth. The longer-term question is will China get rich before its population gets older? The answer to that question could, in the nearer term, impact China's stock, bond and real estate prices. It could also impact the currency trajectory. How China moves from investment-led growth to consumption-led growth could impact Asian equities and the global economy more broadly. These are the kinds of things we need to research to see if there are positive return trades that we can find and add to the portfolio.

When do you decide to terminate an idea based trade?

Every idea will get reviewed at least once a quarter, at which point, we'll evaluate it again in the context of our central economic thesis within the next two-to-three year cycle to determine whether it's still valid in the portfolio.

Invesco Global Targeted Returns Fund

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Source: Company Documents

For example, if we had a view that an idea would deliver 5% annually over three years and it delivered 10% in the first six months, we'll review it again, including going through the T-E-A-M process again. It could be that our return target needs to be changed as a result of some change in the economic or market environment, or that the return target hasn't changed but it only has so much more return to deliver, in which case we may need to reduce the weight or remove it from the portfolio.

On the other hand, if there's an idea in the portfolio that we expected to go up 5% per annum and it's gone down for the last two months, we're not going to wait until the third month to review. We're going to make sure we review it at the next meeting, and determine whether we need to remove the idea from the portfolio.

The point is that regardless of whether an idea is working too well, exactly as expected or not at all, it will be reviewed at least once a quarter by the investment team.

What drives your portfolio construction?

Every idea comes to the table with an expected return, and it's sized in the portfolio to target between a quarter and a half percent per annum performance, in order to meet the fund's annual gross return target of 5% over three-month Treasuries over a rolling three-year period.

For example, one of our views is that the Australian interest rates won't go up as quickly as the market expects because global interest rates are likely to remain lower for longer. The Australian two-year interest rate in two years' time — the forward swap rates where the market thinks two-year swap rates will be in two years' time — is hovering around 4% and 4.5%, while short-term rates in Australia are only 2.5%. Our view is that 4.5% in two years' time is too high and that it will come down. We estimate the volatility of the instrument we are using to implement this view to be low, which means that we can hold a larger position in this instrument — keeping with the portfolio's volatility target — in order to target a quarter percent per annum return at the portfolio level.

Our starting point is that every idea should have roughly the same contribution to the fund's return, and we can adjust the sizing at the margin. Our risk manager sits with us during this part of the process to help determine how the overall risk of the portfolio will be affected, and how much diversification is being achieved by combining these ideas. Let's say you wanted to add a 25th idea to the portfolio, we would put the revised portfolio through the risk model again to determine the overall risk and return attributes of the fund.

We do this with the help of a third-party model that uses three-and-a-half years of weekly returns to predict the correlation between the assets going forward. It's a robust risk model that covers all the different asset types that are used. This risk model gives us an initial indication of how much diversification we have in our portfolio, which we can always challenge. T

Important Information

About Risk

Commodities Risk. Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Commodity-Linked Notes Risk. Commodity-linked notes may involve substantial risks, including risk of loss of a significant portion of principal and risks resulting from lack of a secondary trading market, temporary price distortions, and counterparty risk.

Credit Risk. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Currency/Exchange Rate Risk. The dollar value of foreign investments will be affected by changes in the exchange rates between the dollar and the currencies in which those investments are traded.

Debt Securities Risk. Debt securities are affected by changing interest rates and changes in their effective maturities and credit quality.

Derivatives Risk. Performance of derivative instruments is tied to the performance of an underlying security, index, or other asset. In addition to risks relating to the underlying assets, use of derivatives may include other, possibly greater, risks. Derivatives may be more volatile and less liquid than traditional investments and are subject to market, interest rate, credit, leverage, counterparty and management risks. An investment in a derivative could lose more than the cash amount invested. These risks are greater for the Fund than most other funds because its investment strategy is implemented primarily through derivatives rather than direct investments in more traditional securities.

Emerging Markets Securities Risk. An investment in emerging market countries carries greater risks compared to more developed economies.

Equity Risk. In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Exchange-traded Funds Risk. An investment in exchange-traded funds (ETFs) may trade at a discount to net asset value, fail to develop an active trading market, halt trading on the listing exchange, fail to track the referenced index, or hold troubled securities. ETFs may involve duplication of management fees and certain other expenses. Certain of the ETFs the fund invests in are leveraged, which can magnify any losses on those investments.

Exchange-Traded Notes Risk. Exchange-traded notes (ETNs) are subject to credit risk of the issuer, and the value of the ETN may drop due to a downgrade in the issuer's credit rating, despite the underlying market benchmark or strategy remaining unchanged.

Foreign Securities Risk. The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Fund of Funds Risk. The Fund is subject to the risks of the underlying funds. Market fluctuations may change the target weightings in the underlying funds and certain factors may cause the Fund to withdraw its investments therein at a disadvantageous time.

Interest Rate Risk. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Investing in the European Union Risk. Many countries in the European Union are susceptible to high economic risks associated with high levels of debt, notably due to investments in sovereign debts of European countries such as Greece, Italy and Spain.

Large Capitalization Company Risk. Larger, more established companies may be unable to respond quickly to new competitive challenges such as changes in consumer tastes or innovative smaller competitors. Returns on investments in large capitalization companies could trail the returns on investments in smaller companies.

Leverage Risk. Leverage created from borrowing or certain types of transactions or instruments may impair the fund's liquidity, cause it to liquidate positions at an unfavorable time, lose more than it invested, increase volatility or otherwise not achieve its intended objective.

Liquidity Risk. The Fund may hold illiquid securities that it may be unable to sell at the preferred time or price and could lose its entire investment in such securities.

Management Risk. The investment techniques and risk analysis used by the portfolio managers may not produce the desired results.

Non-Diversification Risk. The Fund is non-diversified and can invest a greater portion of its assets in a small number of issuers or a single issuer. A change in the value of the issuer could affect the value of the Fund more than if it was a diversified fund.

Short Sales Risk. Short sales may cause the Fund to repurchase a security at a higher price, causing a loss. As there is no limit on how much the price of the security can increase, the Fund's exposure is unlimited.

Small- and Mid-Capitalization. Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

Subsidiary Risk. By investing in the Subsidiary, the Fund is indirectly exposed to risks associated with the Subsidiary's investments, including derivatives and commodities. Because the Subsidiary is not registered under the Investment Company Act of 1940, as amended (1940 Act), the Fund, as the sole investor in the Subsidiary, will not have the protections offered to investors in U.S. registered investment companies. Changes in the laws of the United States and/ or the Cayman Islands, under which the Fund and the Subsidiary, respectively, are organized, could result in the inability of the Fund and/or the Subsidiary to operate as described in this prospectus and the SAI, and could negatively affect the Fund and its shareholders.

Tax Risk. The tax treatment of commodity-linked derivative instruments may be adversely affected by changes in legislation, regulations or other legally binding authority. If, as a result of any such adverse action, the income of the Fund from certain commodity-linked derivatives was treated as non-qualifying income, the Fund might fail to qualify as a regulated investment company and be subject to federal income tax at the Fund level.

US Government Obligations Risk. Obligations issued by US Government agencies and instrumentalities may receive varying levels of support from the government, which could affect the fund's ability to recover should they default.

Volatility Risk. The Fund may have investments that appreciate or decrease significantly in value over short periods of time. This may cause the Fund's net asset value per share to experience significant increases or declines in value over short periods of time.

All data as of April 30, 2014, unless otherwise specified.

Diversification does not guarantee a profit or eliminate the risk of loss. Past performance does not guarantee future results.

The fund seeks a positive total return over the long term in all market environments.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Swiss Market Index (SMI)** is an index of 20 blue chip companies in Switzerland and is considered a benchmark index for Swiss stocks. It consists of large cap companies and is weighted for market capitalization, meaning price changes for companies with higher market caps affect the price of the index more. An investment cannot be made in an index.

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Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the fund(s), investors should ask their advisors for a prospectus/summary prospectus or visit invesco.com/fundprospectus.

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