friday view

By Sebastian Cheek

Regular readers of the friday view will know how a few weeks back I wrote about exchange traded funds (ETFs) and how their 'marriage' with institutional investors has never really gelled. Well, I'm beginning to wonder if it's something to do with three-letter acronyms because this week it's the turn of target date funds (TDFs).

When the National Employment Savings Trust (NEST) opted for TDFs as its default investment strategy back in 2010 you'd be forgiven for thinking other employers and/or trustees updating or putting in place defined contribution (DC) schemes would do the same.

After all, NEST is a national savings scheme which has to shoulder the responsibility of potentially millions of people saving into a pension for the first time, so no doubt a lot of time and care went into choosing the investment strategy. But barring a few instances, it seems that the UK DC market has been slow to follow NEST's lead on this.

There are a number of reasons. For starters, the vast majority of DC schemes are currently invested in a lifestyle strategy and it is a huge task for employers to transfer existing members to a TDF. Then there is the shift from trust to contract-based provision which has meant asset managers need to convince insurance companies there is a demand for TDFs which there currently doesn't seem to be.

However, a big part of TDFs' stuttering start comes down to investment consultants, which as we all know are the 'gatekeepers' of investing, granting schemes access to strategies and asset classes they research and then rate.
I suspect in some, but not all, circumstances consultants feel their position in the value chain is somewhat threatened by TDFs. Consultants have typically added value by picking best of breed and packaging that together for clients, but with TDFs this process is removed. There is nothing in it for them and so why would they push it as a strategy to their clients?

Blackrock predicts assets in UK TDFs will quadruple to £8bn by 2018. Indeed, there are compelling reasons for their use as a default strategy: managing assets in a single fund is cheaper, less risky and more streamlined. They won't be right for everyone, but should be championed by consultants if it is the best strategy for their clients.

I believe TDFs will develop into the vehicle of choice for default DC and it is just a matter of time before consultants embrace the fear and TDFs become part of the investment toolkit they take to their clients. Only time will tell.

portfolio institutional

Some investment lessons from demographics

Picture: stockphoto

By Neil Dwane, CIO equity Europe, Allianz Global Investors

Many scholarly research reports, amongst them those from the US Federal Reserve, demonstrate that the baby-boomers have not only controlled the growth in asset classes, especially through housing and equity markets, but are now also starting to retire.

Over the next 20 years, this should lead to the rational realisation of their assets not only towards more income producing assets but also to capital protection rather than to further appreciation. This handover of course suggests that ideally they would 'sell these long duration assets' to the next generation, the millennials.

However, due to the size and success of the baby-boomers and improvements in healthcare, the millennials are simply not financially capable of servicing the country's extreme sovereign debt position, paying as they go into the tax and healthcare systems and buying up all the assets on sale. This is exacerbated in the US, and increasingly in the UK, by recent policy decisions which are encouraging the youth to take up student debt in order to complete their university education, so that they enter the real world with already high levels of debt; indeed, in the US, student debts now exceed US$1trn.

Additionally, history shows that home and family formation typically happens between the ages of 25 and 30 and this has allowed the generational handover to pass successfully. Statistics now show that millennials are living differently and it is not just Facebook but also a lack of enthusiasm for owning a car which suggests that this transition may be more protracted than previously. It is also now being exacerbated by the extreme generational unemployment, most notable in the European Union (EU), where between 30-60% of under 25-year-olds are unemployed. Needless to say, if not soon rectified, this situation will have dramatic and long-lasting negative consequences for the economies concerned as the millennials cannot pick up and take the slack caused by the retiring baby-boomers, let alone take the economy forward. So where will the buyers of these assets come from if this handover is to proceed smoothly?

Also at work currently is evidence that old and ageing populations prefer low inflation while younger populations prefer a higher level of inflation. Consequently, with most of the Organisation for Economic Co-operation and Development (OECD) ageing over the next 20 years, the world of financial repression may last even longer than we have so far surmised as it will be swimming against this dis-inflationary tide.

Perversely, this may lead to the conclusion that quantitative easing (QE) policies are here to stay for the next 20-30 years, not just the next five years, in our view.
The world's population (ex-Africa) will peak and top out in the next 10-20 years. We should, therefore, expect to see marked shifts in spending patterns as consumption, both conspicuous and resource-orientated, should be driven more and more by the emerging economies and the US – if they can increase consumption any more as a percentage of gross domestic product (GDP) from 72% currently – while the OECD should rebalance more towards healthcare and ageing related expenditures, as we are already witnessing in Japan. Rising living standards and ageing may thus benefit pharmaceuticals and health-related industries uniquely while many other sectors are both winners and losers around the global economy.

Demographics and their long-term, gradual yet almost inescapable consequences must influence and shape our thinking of the prospects for our economies and corporate profits prognosis as they unfold. They also allow us to contextualise the policy implications for governments and policy makers as they wrestle to emerge from the 'last war', fighting a global debt crisis, excessive consumer and sovereign debt and a paucity of productivity and innovation to fuel the next leg of growth.
Quantitative easing and its financially repressive friends seem to have forced more risk taking but, perhaps, demographics will militate lower returns regardless.

The case for managed volatility in EMs

Picture: stockphoto

By Susanne Willumsen, portfolio manager, Lazard Asset Management

Low volatility and emerging market equities are terms rarely found in the same sentence. However, a low volatility portfolio of emerging market equity investments may produce a smoother return pattern when contrasted with a market weighted benchmark or even a style-specific approach.

Such a strategy can help serve to mitigate the entry point risk and provide an opportunity to increase in allocation to emerging markets without necessarily changing aggregate portfolio risk. In addition, a low volatility allocation in emerging markets leads to more diversified economic exposures, such as more evenly disbursed sector weights; a cap-weighted benchmark tends to concentrate weightings in a few sectors and relatively few stocks.

Long-term investors have been more than rewarded with additional returns by assuming the risks of emerging market investing. Therefore, one might conclude that investing in higher risk emerging market stocks will surely lead to outsized returns compared to lower risk stocks. To test this hypothesis, we looked at the returns of high and low volatility stocks since 2000, with volatility calculated as daily price volatility over the previous 12 months. Linking a monthly set of returns for the most volatile and least volatile quintiles of stocks (equally weighted) from 2000 (the inception of the revised MSCI Emerging Markets Index) actually showed the opposite. In fact, there was a meaningful premium from investing in low volatility stocks. While turnover and transaction costs were not reflected, it is clear that, based on analysis over this period, there is a performance advantage in favour of low volatility stocks.

An issue in emerging markets equities is the long history of repeated speculative bubbles, which typically correct themselves in a sudden and painful manner, often to investors' dismay. Country and industry concentrations have routinely dominated the capitalisation weighted benchmarks through time and corrections can be both significant and painful. For example, the collapse in commodity prices has reduced the market index weight in materials by 30% in just the past 12 months. This same concentration also applies at the security level where today nearly 20% of the index is weighted in the top 10 companies. A low volatility portfolio tends to maintain a consistent, diversified exposure to sectors which are typically more stable and evenly distributed than the capitalisation benchmark. By maintaining a consistent exposure to sectors, an investor is less susceptible to such speculative excesses that can dominate a capitalisation weighted benchmark. Trading off systematic risks (interest rates, commodity prices) for stock specific risk can help to reduce overall risk while still allowing for the desired growth expected of emerging markets investing.

Another significant benefit is that the pattern of returns is differentiated from most emerging market managers. Without sacrificing long-term returns, such a strategy offers lower volatility and correlation to most emerging market equity approaches. The return pattern occupies a distinct point in the emerging market universe and is not easily duplicated by defensive or value oriented managers. For investors who are risk budgeting, an allocation to such a strategy can provide an opportunity to either permit an increase to emerging markets and/or reduce total portfolio risk without impacting long-term return expectations.

A low volatility strategy may also help mitigate entry risk. It is always difficult to commit to an asset class that has experienced such an extraordinary run. Low volatility strategies are designed to help mitigate losses in difficult market periods, partially insulating the investor from a poor entry point.

At the same time, a low volatility strategy is designed to participate in a significant portion of the upside gains in the event of a sharp rally.

At the whim of central banks

By Shaniel Ramjee, investment manager, global multi-asset group, Baring Asset Management

Anyone looking at the performance of financial assets in the opening months of 2013 would be forgiven for thinking that many of the issues plaguing economies around the world had been solved. In truth, while central bank policy has coaxed asset markets higher, there is still much to do.

It would be remiss to say that things aren't getting better. The US banking system continues to improve, allowing the cogs of the US economy to turn once again. Household balance sheets are healthier, with housing on a surer footing, and employment increasing. Much hope rests with the spending power of the US consumer.

Yet, there remains a serious problem, and it can be seen in the reduced contribution of corporates to the US economy. Many are choosing to return capital to shareholders over making investments, as a consequence of the tepid rate of growth prevailing across much of the world. With Europe dragging behind and China entering the process of transition to a more balanced economy, even the extraordinary monetary experiment conducted by the Bank of Japan is likely to get the world to average growth at best.
Perhaps the best way of explaining what we have seen in markets is to return to quantitative easing once again. One of the main effects of this type of unconventional monetary policy, as already noted by a number of central bankers, is to suppress the returns of "safer" assets down to unattractive levels, diverting investors towards assets further along the risk spectrum. It's not hard to see the outcome of this "portfolio balance" effect. Many bond investors now find themselves in peripheral Europe, emerging markets and high yield credit, while asset allocators have embraced equities so far this year.

It is instructive to look at the progress of the equity market in the US in more detail. With the recovery centred around financial and consumer health, a strong relative performance from those sectors of the equity market isn't surprising. Furthermore, the search for yield – and change in valuations of income generating assets as already noted – has also made the more stable, cash generating companies relatively more attractive for investors.

The unavoidable question, of course, is how much longer this trend will remain intact. It seems intuitive that, as an economic recovery is underway, the more economically sensitive areas of the market such as Materials and Industrials should lead the market. Curiously, however, this has not occurred.

A historical perspective suggests that during periods of relatively low growth and low interest rates, there has been sustained outperformance by sectors regarded as having "defensive" or "quality" characteristics. These periods are characterised by multiple expansion of these sectors, as investors demonstrate that they are prepared to pay more per unit of earnings from more stable areas of the market.

Looking across financial markets more widely, it is clear that investors are highly sensitive to the liquidity provided by central banks. Talk of "tapering" the level of quantitative easing, "adjusting the dial", or even the high levels of government bond volatility we have, seen inject a level of uncertainty into an environment where investors had become certain that central bankers would do what it takes.
Somewhat perversely, the return of healthier economic growth and a more normalised monetary environment would probably be accompanied with higher financial market volatility. While we expect improvement generally, however, challenges persist in many areas of the global economy. Unconventional monetary tinkering is, therefore, likely to become a permanent part of the central bank toolbox.

In the context of global assets, we remain constructive on the equity market, particularly in areas that have a better earnings outlook. The key catalyst for a broader, more traditional cyclical rotation in equities would, however, be corporate investment. Although this has not materialised so far, its absence has not precluded the market from moving higher.

portfolio institutional

Is size everything?

By Mark Johnson, head of UK sales, iShares

When awarding mandates or making investments into active mutual funds, pension funds and consultants often judge them on track record, their historical ability to achieve above market returns and deliver specific strategies.

In recent years passive investing has gained traction with pension funds due to an increased focus on cost and risk management, and exchange traded funds (ETFs) are a key component of this growth. A 2013 US survey by Greenwich Associates reported that 25% of US pension funds invest through ETFs. Similarly in Europe, a 2013 survey of 144 European pension funds by FinEx Capital Management indicated that 42% expect to increase their allocation to ETFs over the next three years.

But as more and more pension funds look to use ETFs in their investment process, the question arises: how do you select the right ETF? The criteria used to evaluate passive funds are different to those used to select active counterparties. One key illustration is around the size of a fund or its assets under management (AUM). In the active space, if a fund increases its AUM this can cause capacity constraints in implementing some strategies. However, increasing AUM can instead be beneficial in the passive space.

The AUM of an ETF can impact its cost of trading and its ability to replicate an index. For example, an ETF's liquidity is determined by the liquidity of its underlying exposure and its AUM. As the AUM of an ETF increases, its spreads generally decrease because there is more buying and selling activity in the secondary market.

In some cases, particularly in asset classes which are mainly traded over-the-counter such as fixed income, the on-exchange spreads of large ETFs can actually be tighter than the spreads in the underlying market. This difference in spread can be significant in reducing the cost of trading for large institutional investors, because they can trade into an ETF without needing to have new units created for them on the primary market.

Furthermore, as pension funds look to use ETFs to gain exposure to difficult to access markets, liquidity and size can be extremely important in determining which ETF to select.

Pension funds can also benefit from larger ETFs because size gives them an enhanced ability to replicate an index. For example, when funds first launch they usually have a low AUM which may make the purchase of all holdings in an index virtually impossible if the index is very large in size, so they hold a sample of the constituents of that index instead. The bigger the ETF becomes however, the more able it is to purchase more constituents of the tracked index and get close to fully replicating the benchmark index. Larger physical ETFs can thus provide superior replication

It is forecast that pension funds will invest through ETFs more and more. Although size isn't everything when evaluating an ETF, size can matter in passive management. Sub-scale ETFs are more likely to reduce the liquidity and increase the trading costs of a fund, and for this reason, size should be an important determinant in the selection process.

Have a nice weekend.

portfolio institutional is on twitter, follow us @portfolio_inst

Publisher
portfolio Verlag
Suite 1220 - 12th floor
Broadgate Tower
20 Primrose Street
London EC2A 2EW

Tel: +44 (0)20 7596 2875
Fax: +44 (0)20 7688 9118
E-Mail: london@portfolio-verlag.com

Editor
Chris Panteli
E-Mail: c.panteli@portfolio-verlag.com

portfolio institutional