# Multi-asset

*A diversified approach*

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OCTOBER 2017 | PORTFOLIO INSTITUTIONAL ROUNDTABLE

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## A diversified approach

A look at the many reports and press releases sitting in my inbox points to multi-asset being one of the hottest topics in the investment world right now.

It's not a new concept, but its popularity is growing. Some of the world's largest institutional investors, including Blackrock, HSBC and Janus Henderson, have launched multi-asset funds in the past 18 months.

The births of these products reflect the times that we are living in. They are marketed as funds that provide better capital protection at a time some fear another slowdown is on the horizon and expect further volatility linked to ongoing political events.

One such issue is the uncertainty over the terms of the UK's exit from the European Union (EU), where there is little sign of a breakthrough in the negotiations. Then there is the stand-off between Donald Trump and Kim Jong-un.

Funds that offer protection or growth are proving popular as many pension schemes have taken on more risk in the nine years since the financial crisis. With the cost of money negative in some areas and the risk-free rate collapsing to 1.4% at the time of writing, many schemes have shifted their strategies to find the income needed to pay member benefits.

This has seen the value of the industry more than treble in nine years. At the end of 2016, multi-asset and multi-manager funds were worth £127.2bn, up from £34.8bn in 2007, the Investment Association says.

Diversity is one attraction as investors look to spread their risk, by following strategies that lean towards certain equities or incorporate alternative assets.

It appears that the traditional 60%/40% equity to debt portfolio is falling out of fashion. Is this a result of asset managers selling pension schemes fear or greed, or are they just giving the market what it wants?

This is a growing market and with some big questions surrounding it we brought a trustee and a pension scheme together with asset managers and consultants to get under the surface of this area of the market.

Among the items on the agenda was discovering what the attraction of multi-asset is and how best to create such a portfolio? You can read the resulting conversation from page 4.

Mark Dunne
editor, *portfolio institutional*

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Alan Pickering

*"While there are benefits of diversification, we should not cheapen the concept by saying it's a free lunch – it isn't"*

*Alan Pickering, BESTrustees*

**How do you define multi-asset because it can mean different things to different people?**

**Alan Pickering:** As a consumer of products manufactured by people around this table, I don't want to be put off by a label that is dated or confusing. It is a challenge for the people in the engine room to transmit messages through the marketing departments that consumers like me find enticing, rather than: "This is old stuff dressed up under a new label." In all investment discussions the label is important, but it's much more important to read the table of contents that are underneath the label.

**Théodore Economou:** Asset owners are going into multi-asset because they recognise that eight years of zero and negative interest rate policies have challenged traditional portfolios. Portfolios are challenged in terms of capital protection, income and diversification because the fixed income pocket is facing a new paradigm and cannot deliver the same objectives as in the past. The growth part is challenged as well in that valuations are high and so is risk. As that realisation dawns, we see asset owners looking for an answer and multi-asset has some attraction.

**Alex Koriath:** What is the attraction to multi-asset? If you run a multi-asset portfolio, it's not that suddenly you have more assets. The asset class universe stays the same, so you must be doing something different to make this attractive.

**Suzanne Hutchins:** There are many different asset types you can have within a multi-asset vehicle to make it different, and the investment process and philosophy can be wide-ranging. Some strategies get involved in illiquid assets; others have more of an equity-bias or use alternatives or perhaps derivatives. So there's a broad spectrum of what can be classified within the multi-asset sector. The purpose of a multi-

asset fund comes down to defining what the investor wants to use it for; what is the outcome expected, what sort of risk do they want to take, and what sort of return is achievable for that level of risk?

**Pickering:** Being a trustee of a number of pension schemes, I want to extract value from the economy. I want to extract that value in different forms to meet the requirements of different groups of members who are at various points in the journey plan. I guess the challenge for someone like me is do my requirements for extracting value inhibit the creation of value, because that would be something of an own-goal. There are only so many slices in which you can cut up the cake. The bigger the cake, the bigger the slices.

**Kate Mijakowska:** One point to raise is governance. Asset owners simply don't have time to make decisions about whether their equity allocation should be 50% or 55% on a weekly basis. That's where the requirement for diversified growth funds came from and now it's slowly evolving into something else and thus products with maybe lower equity beta are created. They offer alternative sources of return and that's how they are using portfolios, but it all depends on the objectives and the objectives themselves are evolving all the time.

**Mirko Cardinale:** For institutional investors, multi-asset is the starting point because we apply the principle of diversification; the only free lunch in finance. The question is: do asset owners actually build a multi-asset portfolio themselves or do they outsource it? That's where multi-asset products come into play.

**Pickering:** Diversification is not a free lunch. I am prepared to pay for diversification, but I don't want random diversification. I want to avoid stuff that I don't want to hold or isn't appropriate for me. So while there are benefits of diversification, we should not cheapen the concept by saying it's a free lunch – it isn't.

**Andrew Cole:** Our multi-asset programme was born out of the dotcom bust when swathes of pension funds were let down by a fixed-weighted benchmark. Managers did some minor asset allocation, but come the big move they were never brave enough. To that extent what they found was that when it came to the benchmark they ended up with the tail wagging the dog. It had no real relationship between what they had in their benchmark and what they thought their liabilities or risk profile genuinely was. Our programme was born out of a notion of: "Well, you gave us a benchmark, we were asked to work against that. If your benchmark really is defined in other ways, i.e. I need a real return of two, plus an income of three, give us that as the objective and we'll think about the most appropriate assets to meet that at any given time."

A huge swathe of clients didn't have the corporate governance structure to make the big asset allocation switches that matter. It would take them far too long to take meaningful money out of equity to put into bonds or into something else. For us that still remains the overriding factor today that actually clients first and foremost require real returns. You can't retire on just having a great information ratio.

**Economou:** Alex, you asked how multi-asset can deliver something better. To answer that we have to accept that from an asset owner perspective, the overall asset allocation will always be made by asset owners themselves. What has changed under the "new paradigm in fixed income" is that you now need to have long-term allocations in most of the portfolio in order to capture excess returns. Be it in equities, using value calls, geographic sector calls and so forth, and waiting for those to be rewarded, or in fixed income which you increasingly have to hold until maturity. The price to pay for that, is that you then need a part of the portfolio that can simultaneously protect capital, deliver performance, and provide a source of liquidity when needed. From our perspective that's where multi-asset comes in. What a multi-asset manager can do is provide that additional liquid building block. It can be done with a very simple and liquid portfolio of indices and bonds, and using techniques to improve the risk-to-return and to control risk.

**What techniques are you talking?**

**Economou:** We're talking about enhancing the performance of a diversified portfolio by taking advantage of market inefficiencies, and by capturing trends. And at the same time enhancing its robustness by better balancing risks, and by controlling drawn-downs. These are the two big advancements that have emerged in the last 50 years and that can today enhance a portfolio of otherwise traditional securities.

**Pickering:** Most of my schemes are now cash-flow negative. That ought not to frighten me because pension schemes are ultimately meant to be cash-flow negative. We don't want any money in the kitty when the last member dies. But being cash-flow negative when we can't pay pensions out of contributions is focusing our attention on those cash-flows. I'm agnostic as to whether the cash-flows come from income generating products or assets that we had to sell. I do need to have an appropriate mix of things that are generating an income and things that can top up that income when the income generating tools aren't delivering what is needed to pay the monthly pensions. That is what is focusing my attention increasingly on different sources of liquidity to pay those monthly pensions without being a forced seller wherever possible.

**Cole:** One of the issues regarding multi-asset strategies is that we largely all come at the same performance objective, but actually a DB scheme in run-off has a different risk profile to a newly created DC scheme. Both might use multi-asset strategies, but actually they're very different. Do you blend it? What do you blend it with? A blended portfolio is another form of asset allocation and so how big or small should the allocation to multi-asset be.

Alex Koriath

**Cardinale:** There is a presumption that index-linked bonds are a risk-free asset but I don't think there is any risk-free asset, even for a DB pension scheme. If you had a 100% funded portfolio all with index-linked bonds it would not be risk-free because there are many other factors to be taken into account. Risk ultimately is not about changes in real yield, risk is about cash-flows not matching and if you think about it holistically, some less liquid assets that provide an income might be an even better match than UK index-linked bonds with a real yield of -1.5%.

**Cole:** Yes, but we have come from a period where in the context of UK DB schemes in particular, that at their outset there was deemed to be a risk-free rate available that was somewhere between 2% and 5%. The reality today is that that is negative. Even more pertinent is that in almost 20 years now, because of the impact from this falling real yield going negative, what you've seen is that corporate bonds had given you all of the return that you used to associate with equity, but has done it with less than half the risk. Clients and funds have got used to not taking too much risk to get the return they need. The reality now is that that's unrepeatable, and it's a reluctant move to say: "Am I going to keep my risk level and get poorer slowly, or am I going to tolerate more risk in order to stand some chance of achieving an objective?"

Where you are in your funding programme makes a huge difference to that. It's particularly pertinent after the global financial crisis, where trustees became fearful, with good reason, and to a large extent asset managers responded by selling them fear. "Have safe, have secure, this is less risky." Now we find ourselves in a "that's great, but it's now falling short of meeting my liabilities". From that we head into a period where clients say: "Actually, what I really need is returns." So we move from selling fear to selling greed.

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Mirko Cardinale

**Pickering:** Risk and volatility were often seen as the same thing. When a DB scheme is in its growth phase, volatility can be my friend as often as it can be my enemy. The employer has problems because of the accounting implications of volatility but now that I'm moving into run-off, volatility at the absolute level of my fund does frighten me because I need to able to produce cash on a monthly basis. I guess I'm quite relaxed about volatility at the level of the individual component, so long as the overall mix isn't so volatile that I become a forced seller on the 25th of the month.

**Cole:** We're in, to some extent by design, a period of financial repression where the risk-free rate is kept artificially low. One of the goals of that is to rob from savers to redistribute. That's what government does. It's the way it de-leverages in order to re-engineer its re-distribution. Those with savings did not have to take any risk to get richer but they can't do that anymore. That is an objective. So the regulatory environment that forces any number of savings institutions to take less and less risk but by the same token offering them less of a return on that is a way of redistributing savings.

**Are multi-asset funds better at protecting investors from market shocks and generating the real returns that trustees need?**

**Mijakowska:** It's an interesting question because the past decade was lived in fear of another 2008 and that's the kind of story a lot of diversified growth funds sold to the market. Someone looking at valuations, at different scenarios, analysing the markets on a regular basis has a better chance of positioning the portfolio in a right way and doing it quickly enough than if trustees simply try to do multi-asset on their own.

**Cardinale:** There are two approaches you can take to limit your downside. One is to be more dynamic, which means moving away from the starting benchmark. We know that draw-downs can occur because valuations are stretched. Usually when there is a correction in the market, if you read a business cycle correctly that can give you some forward-looking assessment about when to start using risk. The other approach you can take is to buy insurance, which obviously comes at a cost.

**Economou:** I would echo that. A multi-asset allocation that is liquid and dynamic can better protect capital than the rest of the portfolio. It can then serve as a reservoir of liquidity that allows you to even take advantage of draw-downs.

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Kate Mijakowska

*"Asset owners simply don't have time to make decisions about whether their equity allocation should be 50% or 55% on a weekly basis."*

*Kate Mijakowska, Redington*

**Pickering:** As a trustee I'm very comfortable with packaged multi-asset or multi-strategy products. I've lived through a lifetime where we started off with balanced management, and then we went to very sophisticated, very small parcels which often failed to pass the "so what" test. So schemes tried to create their own multi-asset portfolio, ending up with 2% in a particular narrow asset class. That narrow asset class was often driven by last year's star performance rather than what you're expecting to deliver next year. So even without going the whole hog of fiduciary management as a trustee of DB and DC schemes, I'm very comfortable in having a dialogue with a product provider who is going to talk to me about the asset or strategy mix that will be in my particular portfolio, helping me understand how that delivers what my sponsors or members want. I don't want to buy something which is static and have to move to another flavour of the month multi-asset portfolio. I would like to have ongoing dialogue with the product provider as to how they think their product is going to evolve and how that evolution will help me. There might come a time when the product that was really, really good for me five years ago is still a good product, but it isn't appropriate for me. So whenever I go into any of these asset classes, I want to know what the exit route is so that I don't end up with an argument at the time. It's like prenuptial with marriage. You hope the marriage will work out but you want an adult way out of it if it's no longer meeting the needs of both parties.

**We've talked a lot about risk and various assets, but when setting up portfolios is it ideal to go with risk in mind or just look at the various spread of assets?**

**Cardinale:** There is an approach that is very common in building multi-asset products which is to start from risk and build risk-rated funds. So you are bucketing investors into different categories according to their attitude to risk and then you build a fund that is basically targeted for a certain level of volatility. There are a few problems with that. One is that if you use a short-term window to measure volatility you can get a biased assessment of risk.

**Koriath:** That comes back to what Andrew said earlier in terms of the returns that need to be achieved going forward might not be achieved as easily as in the past. This is one of the criticisms that we have for a lot of multi-asset, diversified growth fund products in that we don't think they have taken enough risk in the past. If you break down the fees investors are supposed to pay for these products, fees per risk taken are actually not so dissimilar from some of the expensive hedge funds that are the devil's work, apparently. If you look at fees per unit of risk, it's very similar for a lot of multi-asset products and expensive hedge funds.

**Mijakowska:** I agree with Mirko when he said if you rely on risk as your guiding principle and how much you should allocate to each asset class, you're very dependent on the accurate measure of risk. What is a measure of risk? We could sit for a couple of hours and we would never agree on what it is. Therefore if you choose to look through the risk lens you should keep in mind what your capital allocations are and what your projected returns are. If you choose to look at the capital allocations instead, you should not forget about the risk. So you cannot divorce the two and decide to look at one and completely ignore the other.

**Pickering:** There are a number of risks. We can't just say: "How much risk do we want to take?" The employer has one view of risk in a defined benefit environment and that's the risk to his accounting numbers. Other people define risk as capital protection. I define risk as not being able to pay my benefits when they fall due.

**Hutchins:** It comes back to understanding exactly what the client needs in the first place. When you talk about run-off, your risk is very much about liquidity risk and capital preservation in order to pay your last pensioners. It's such a broad spectrum it has to come back to the clients' definition of what their risk appetite is and a realistic view on potential returns.

**Cole:** It's often helpful to flip to the other side of the fence and think about the users of capital. So whilst we sit there and think: "Well, the real yield is not really attractive and we think equity is expensive" the chief financial officer is thinking: "Right, let's ignore the pension fund problem at the moment." You sit there and say: "Hang on, in terms of our cost of capital and working capital as a business, why wouldn't I, because I know I've got a pension fund here that just because to a large extent regulatory risk keeps forcing them to buy debt, why don't I just keep on issuing it?" I'm able to issue close to zero real cost. Well, my equity is a lot cheaper than that. I'm just going to continue to issue bonds and buy the equity.

**Hutchins:** But that is assuming a steady state, and that interest rates stay at these very low levels.

**Cole:** The fact is that today you can duration out that cost of borrowing. Hypothetically, what happens when a company buys all its equity back? The board is usually incentivised by what the share price is doing. And the shareholders who tend to have the majority of the votes say: "Well actually, just keep issuing the debt and buy the equity back."

**Pickering:** That goes back to my earlier point. We do have to have in our mind's eye the economic needs of the users of capital. Last year Tesla were raising money through the equity market, this year they are going to raise money through the debt market because that's the way they think they can best run their business. I need my investment strategy to be calibrated in some way with the needs of the economy and its market participants.

**Economou:** You can finance the pension fund all you want, the question remains that a portfolio that is 60% equity/40% debt will not protect capital in the same way as it did 20 years ago. It will not give you the yield it used to give you, and you don't get the diversification you used to get. Therefore you need building blocks that will get you what is ultimately needed by the members. To get that you have to take a longer term view, and hold bonds and stocks for the long-term. But that comes at the cost of liquidity. So you need an additional building block that will provide liquidity at all times.

**Cardinale:** If we look at the full spectrum of investment opportunities there is a big distortion in developed markets. In sovereign bonds we have negative real yields in the UK but it is not a uniformed picture. There are many different opportunities that can be exploited. Even if you think about real yields, if I just look out there across the pond to the States, 30-year bonds will yield 1% positive. So there is a very big distortion. If you look at emerging markets in some countries we still have inflation-linked bonds with 4% real

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*Alex Koriath, Cambridge Associates*

yields. So there are many different opportunities, not just a uniform compression of evaluations. We could debate for hours on whether equities are over-valued or not, but it's safe to say they're not as over-valued as Japan in the 80s or in the tech boom.

**Cole:** Oh, they're certainly not as over-valued as bonds.

**Economou:** Multi-asset allows you to break from having just debt or equity as a choice. Multi-asset can reconcile stable returns with capital protection and liquidity. The starting point of a multi-asset portfolio should be long all assets all the time – a basic investment principle in my mind. That said, the edge of a multi-asset strategy is that it can generate additional return by taking advantage of market conditions,

whether it is by dynamically harvesting relative valuation differences, or by capturing momentum across asset classes. On top of this, multi-asset strategies can intervene actively to try to better protect capital when there is a crisis. So that's where we see interest from asset owners towards multi-asset: as an additional building block, in a context where the majority of a portfolio will always be either debt or equity.

**Hutchins:** Value can be added through 'alpha', stock selection. We can debate the valuation of equities per se, but beneath the index there are specific securities of businesses that are priced below intrinsic value that we think make great, solid, long-term investments. We believe specific government bond markets also offer value - North America, Australasia and select debt in emerging markets for example. Multi-asset provides scope to dig down in the discipline of the alpha generation, as well as to use tools such as derivatives on indices where you can take out some of the market beta as well.

**Koriath:** For me as a consultant it is important to differentiate between what the different multi-asset funds are doing. What really are they doing underneath and where is the supposed value coming from? I'm a sceptic so I think it's quite hard to add value there, so I want to understand exactly what the different funds are doing and how they are approaching it.

**Cardinale:** The old debate between active and passive seems to be focused on single asset products. In multi-asset you don't really have a choice. In dynamic allocation there is no well accepted method of passively allocating to multi-asset. Theoretically, you could try to allocate to a global market portfolio but no-one does that. In reality there is an active choice whenever you build a multi-asset portfolio, where there is the option of using passive vehicles if you want to allocate to US equities, multi-asset doesn't really have it.

**Cole:** There are no new assets. There's nothing new in terms of where your capital ultimately ends up because as asset managers all we are is the conduit between the owners of capital and the users of capital. Now, what part of the capital structure you decide to own has been an analysis that investors have done for a long time. Can we identify what parts of the capital structure looked mis-priced? I will put my cards on the table; I don't think equities are expensive. I don't see a recession coming any time soon and earnings remain a long way below trend.

We have a sense where the fear of a recession means that most people think there's a recession coming 12 to 18 months down the road. But if it doesn't, my guess is that corporate profits continue to grow and as a consequence your PEs aren't as high as you think they are. Any notion that we're going to see a huge sell-off in bonds that destroys the P is fanciful. Governments aren't going to allow it.

Andrew Cole

### Is there a role for alternatives in multi-asset portfolios?

**Pickering:** You have to keep redefining what an alternative is because when I was younger what was described as an alternative might now be mainstream. There are other ways of extracting value from the economy that transcends the corporate. One of the attractions to me of a multi-asset or multi-strategy portfolio is that it gives me access to other elements in the economy that might not have been captured by your traditional equity/debt split.

**Economou:** Whichever way you run a multi-asset strategy, whether it is arbitrages, debt versus equity calls, adding additional sources of return – which could be emerging market debt or sub-investment grade –you need to understand how it produces value. To be meaningful for an asset owner, a multi-asset strategy must be fully transparent.

Théodore Economou

*"Multi-asset allows you to break from having just debt or equity as a choice."*

*Théodore Economou, Lombard Odier Investment Managers*

**Pickering:** Where does the black box fit into transparency? Has it got a place?

**Economou:** It should not be a black box! It should be a transparent box, otherwise how can an asset owner become comfortable applying that on a large scale?

**Cardinale:** The usual framework when thinking about different asset classes is to divide a return stream into building blocks. You can pretty much do it for all assets, except those where the only premium you're accessing is pure skill, like hedge funds. If you get any other asset class you can think about the income you receive, the growth you're expecting and the change in valuation multiples. You can apply that framework to every asset, alternatives and traditional, to the extent that you can take a view on all those elements, build a framework to understand returns and the drivers of returns and wield the balance.

**Hutchins:** I agree. You can build it from the bottom up by understanding exactly what you own and why you own it. By focusing on specific characteristics, whether it is income-generation, free cash-flow, liquidity, pricing power and transparency; all of these considerations are absolutely key. If you are in a multi-asset fund which aims to preserve capital (as well as grow it) you need to find ways in which you can do that. That is quite a challenge because correlations between asset classes are constantly changing; if you go out and buy insurance it can be expensive, depending on what type of insurance you use. With multi-asset, you can diversify in your protective layer or your stabilising layer by using currencies, and direct and indirect hedges.

*“I will put my cards on the table; I don’t think equities are expensive. I don’t see a recession coming any time soon and earnings remain a long way below trend.”*

*Andrew Cole, Pictet Asset Management*

**Economou:** I would add to that that there is one technique which is underused in our view. As an investor you need to recognise that whatever model you build your portfolio on, at some point that model will fail to represent reality closely enough, and therefore not produce the return it should. In those cases you need to batten down the hatches, survive through the storm and then you put risk back on. That’s a technique that’s been used for about 20 years now and its time has come to be deployed in multi-asset portfolios.

**Pickering:** In DC land you have the ultimate of transparency. In DB land the employee is the client. You’re helping the client meet his promises. In DC land the client is the member and we’ve all had rough times recently when we’ve created default DC strategies that have been multi-dimensional and the savvy member says that a monkey throwing a dart at a dartboard to determine the bond equity split would have outperformed these diversified strategies that you’ve defaulted me into. That has been quite challenging for many trustees and a number of trustees have had their own G20 submit and gone through it, and more or less said if we had known then what we know now we would still have gone down the diversification route. What we didn’t realise is that the authorities were going to distort markets for as long as they have, but trying to explain that to a member in two paragraphs is quite challenging.

**Hutchins:** The problem also is that we have not had any significant drawdown in equity markets for some years, so everyone is always looking to equity markets and having regret risk. We believe volatility is likely to pick up, especially as policymakers start to tighten liquidity, and it is at this point that these multi-asset solutions will be tested to see if they do what they say on the tin.

**Cardinale:** There are some default funds which we try to broaden the investment universe to defer risk premium, build a diverse portfolio, and others are a collection of strategies trying to exploit skill and build up portfolios of specific ideas. So there are funds with that like GARS. This is very different from a multi-asset fund. This is more like a hedge fund concept, which has a place in a portfolio, probably as a default option. So it becomes difficult to overweight funds which have completely different investment propositions. The way we think about it at USS is first and foremost we set what the objective is. Then we set a portfolio based on a reasonably conservative assessment of risk premium available from mainstream assets.

**Economou:** There are three things we look for in multi-asset: stability of returns, better protection of capital and liquidity. Multi-asset can provide these outcomes simultaneously at the very core of the portfolio. Then in the rest of the portfolio you can deploy equity or debt strategies to further improve on those outcomes. With the help of advisers and consultants, and by taking long-term positions, you can achieve higher long-term returns.

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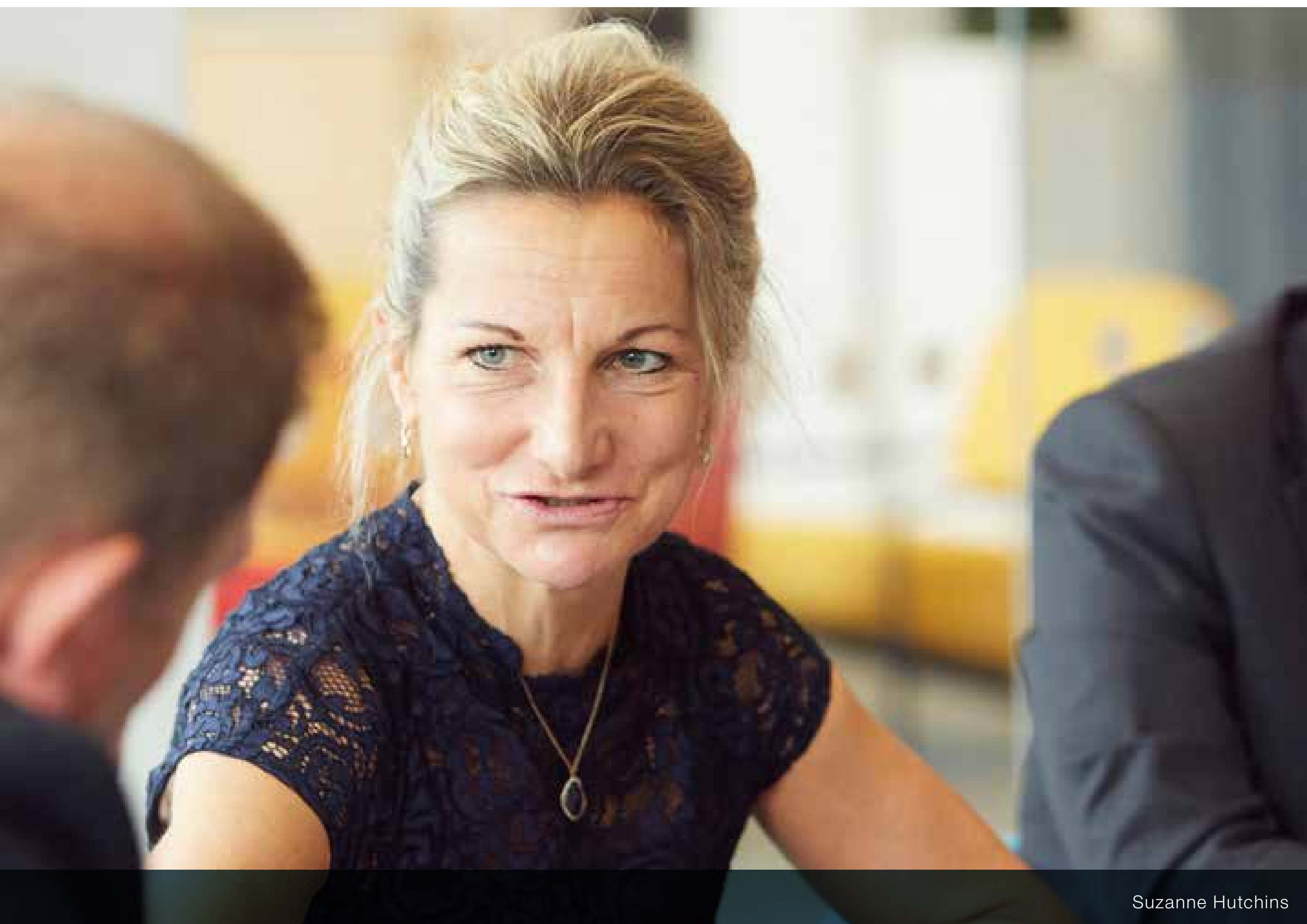
*Suzanne Hutchins, Newton Investment Management*



Suzanne Hutchins

# Rethinking asset allocation

*By Jonathan Clenshaw, Head of Institutional Sales Europe, Lombard Odier Investment Managers*

Faced with dramatic changes in bond markets and high equity market valuations, investors are being forced to rethink their approach. Lombard Odier Investment Managers' Jonathan Clenshaw discusses the challenges and explains how investors across the globe should shift direction to focus squarely on their investment goals and build their portfolios by assembling fit-for-purpose component parts.

For decades traditional "balanced" portfolio construction was the driving force behind long-term investment, and this served investors well.
In the past, traditional assets classes were associated with particular functions in well-diversified portfolios: investment-grade bonds provided yield, preserved capital, diversified against growth assets and were easy to liquidate if investors needed to boost their cash holdings. Meanwhile equities provided attractive returns. Today, however, these properties are being put to the test, and when asset classes struggle to do the jobs we have come to expect from them, investors need to rethink how they build their portfolios.

## Times have changed

Bond markets have undergone dramatic change following the global financial crisis with far-reaching implications.
First, bonds' ability to produce yield has been undermined by low interest rates. And for bonds to generate meaningful capital gains, rates would have to decrease significantly, yet there is not much further they can fall.
Second, bonds are less able to protect capital; their diversifying qualities are in question due to a rise in their correlation with equities. The average bond portfolio has also become more sensitive to interest-rate moves, making rate rises potentially more damaging.
Third, bond markets are now characterised by fractured liquidity, meaning investors cannot rely on being able to buy or sell bonds when they need to. The causes of this include that central banks own more of the total bond supply these days, and regulatory reforms, which have constrained big market players from trading as much as they once did.
For investors to earn yield from bonds in the face of these challenges, we believe that they should go back to basics. This means investing for the long term, aiming to hold bonds until their maturity date and collecting the regular coupons that bonds pay throughout their lifespan, while carefully managing default risk. This approach insulates against rate rises and has a lower reliance on market liquidity as it is lower turnover, but it also means sacrificing liquidity.
Meanwhile, the performance-enhancing ability of equities appears limited by high valuations and modest economic growth. Opportunities do exist, but we believe that – here, too – a long-term horizon is essential as these investments may take time to bear fruit.

## Time to find a new approach?

In the new paradigm where bond markets have fundamentally changed and investors must sacrifice liquidity to achieve yield and capital growth, we believe the traditional approach of dividing a portfolio between bonds and equities will no longer serve investors. In our view, the logical answer is to design the portfolio around each investor's goals – to adopt an 'outcome-oriented' approach. A key element of this is the need for a new building block capable of meeting investors' core liquidity requirements.

### Fit-for-purpose portfolio building blocks

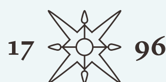
Given the changes to the investment landscape, investors need to find a new set of portfolio building blocks to address their key objectives. We believe investors should consider carefully their desired outcomes and look across asset classes for solutions capable of delivering these. And in the new investment paradigm, implementation matters.

- **Seeking yield:** With bond markets fundamentally changed, investors will need to take a longer-term investment approach, as explained above; investors should hold bonds until maturity to protect themselves against future interest rate rises, and focus their risk-taking on credit with a view to increasing yield. Default risk must be managed carefully by means of robust credit analysis.
- **Seeking growth:** For capital growth in a world where traditional asset classes offer lower potential returns investors must be more selective. In seeking out attractively-valued securities, investors may consider a country/region experiencing positive dynamics that have yet to be priced into the market. A further way for investors to seek to achieve capital growth is by taking advantage of long-term illiquidity risk premia, provided they can tolerate making long-term capital commitments into strategies such as private equity.
- **Sourcing the missing piece – the liquid core:** When they pursue their yield and/or growth goals investors will be forced to consider longer-term investment approaches, i.e. to sacrifice liquidity. Therefore, we believe they need to make a dedicated investment that caters for their core liquidity needs. As bonds can no longer do the job, we believe investors must look to other asset classes to meet these needs. In our view, a liquid multi-asset strategy is now best-placed to meet investors' core needs provided certain principles are followed – these centre around maximising diversification and actively managing against the downside.

### Purpose-built portfolio construction

To assemble each building block into a portfolio that works effectively for the investor, we believe a deep understanding of each investor's needs is as vital as the ability to explore new approaches. Given the complex and challenging investment landscape, investors' objectives must be defined and understood in terms of their liquidity requirements, yield needs, performance goals and risk tolerance, together with any ESG/Impact investment goals. Investors should resist being pigeon-holed into a broad category based simply on their risk/return preferences, and should instead demand that all of their needs are properly served.

For further information, please visit lombardodier.com

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# Reflation fade

*High hopes of a President Trump-sponsored injection into global growth have taken a hit. By Suzanne Hutchins, portfolio manager, Real Return team at Newton Investment Management.*

June 2017 marked an anniversary. On 30 June 2017, the current economic cycle was eight years old, making it the third-longest expansion in the post-war period. Looking back, it certainly hasn't been a normal recovery. The story of the period has broadly been one of a constant tug of war between the deflationary forces which have been the natural post-crisis tendency and the reflationary response provided by central banks' increasingly interventionist and experimental monetary policies.

Interest rates have barely got off the floor, and 'emergency' monetary policy has been in place almost throughout the last eight years (although the participants have changed). Despite this, nominal growth has remained very subdued, and corporate profits on a global basis have barely grown since 2011. Most striking of course is that financial-asset prices of almost all types have rocketed, sustained by persistent stimulus, a distinct lack of alternatives and the promise that a more 'normal' recovery was just around the corner.

## The reflation impetus subsides

With this thought in mind, the sight of world stock markets continuing their relentless upward march seems yet another example of 'situation normal' for today's financially charged world. Although geopolitical and economic uncertainty remain elevated, some of the risks previously jangling investors' nerves, such as those deriving from heightened political tensions, seem to have subsided somewhat. The wave of nationalist/populist feeling that threatened to sweep across Europe in the wake of the UK's Brexit referendum has failed as yet to get traction at the electoral level. Indeed, the recent election in France of Emmanuel Macron – seen as a liberal internationalist as well as a potential reformer domestically – and the improved electoral prospects of Chancellor Merkel's CDU party in Germany appear to have shifted the pendulum back in a direction more favourable to the European Union. This, and some stronger economic data (particularly in Germany), have combined to improve investor sentiment towards the region markedly.

In the context of this benign environment for taking risk, the underlying trend for most of the latest quarter has been market participants appearing to become progressively more sceptical about the 'reflation trade'. This more nuanced outlook has been echoed in economic surprise indices, which have fallen sharply. Growth sectors, such as health care and technology, not cyclicals, have until very recently driven stock markets. Industrial indicators such as US auto sales have fallen in every month this year (after having doubled from around nine million in 2009 to more than 18 million in December 2016), and inflation data has generally remained subdued. Core inflation in the US, excluding the effect of housing, which has been distorted by monetary policy, is very low (at less than 1%) and seems to be falling despite an apparently tight US labour market.

In the energy patch, OPEC's (Organisation of the Petroleum Exporting Countries) ability to control prices has again come into question as non-OPEC production has continued to rise (heavily influenced by production from the US, which is being exported for the first time in 40 years), causing oil prices to subside from the levels seen in December and January.

Predictably too, one might say, market participants seem to have come to the realisation that Mr Trump may not after all be able to transform growth in the US economy. Although his agenda continues to look distinctly shaky, investors do still seem to be clinging to the hopes of some tax reforms being agreed before the mid-term elections in 2018.

1) See, for example, http://www.nber.org/cycles.html
2) Reuters, July 2017
3) Bloomberg, July 2017

### Wishful thinking?

Once again, it seems we are being steered towards the idea that policy has finally created some kind of synchronous global recovery. The International Monetary Fund articulated the case for normalisation in its April World Economic Outlook. It argued that three successive shocks – the financial crisis of 2007-09, the eurozone crisis of 2009-13 and the commodity price deflation of 2014-15 – are moving into the past. It believes the global economy is moving back to equilibrium, with unemployment in the major economies having fallen, and that output gaps are likely to close further – leading to rising inflation.

While the idea of three successive shocks and 'it's finally over' certainly makes a neat story and is clearly the one policymakers want to tell, it is by no means the only possibility.

Key to the official narrative is that the experiment with monetary policy has been a success, in that it has shepherded us all (not just banks that were bailed out) through this difficult period, and saved us from a much worse fate.

The problem with this version of history is that the global financial crisis and subsequent crises were not unforeseeable exogenous shocks that came from outside the system, but were a direct result of policies and models which led mainstream economists to fail to see the last crisis, even when it had begun. The application of exactly the same models and policies today does not exactly inspire confidence.

Perhaps more important to policymakers is that there is a great deal of credibility hanging on the success of their policy choices, and part of the evidence for that will be their ability to exit. In addition to that, at eight years and counting, the probability that the end of this cycle is just around the corner is rising rapidly. Going into the next downturn with no interest-rate cushion would not constitute prudent central banking.

### What could a rate cycle look like?

Key for investors is how far interest rates could rise (assuming economies and financial markets permit the process at all). Market estimates of a 'neutral' real interest rate – i.e. the short-term interest rate adjusted for inflation that would neither have an expansionary nor contractionary effect on the economy – vary widely (anywhere between 0% and 3%) and may not be very useful. What policymakers and investors do seem to agree on is that structural factors like demography have brought this rate downwards – perhaps to between 0.5% and 1%. This would fit with history: each cycle in the US since the 1970s has seen the real interest rate peak and trough at a lower rate.

Interest rates can of course rise further but, perhaps not surprisingly, the world has become a much more interest rate-sensitive place, and there may be some surprise at how much lower than 'normal' an interest rate that starts to create problems might be.

The corollary of this, of course, is that interest rates are likely to settle even lower (and/or economies require more aggressively unorthodox policy support) in the next downturn.

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4) International Monetary Fund, World Economic Outlook, April 2017: Gaining Momentum? http://www.imf.org/en/Publications/WEO/Issues/2017/04/04/world-economic-outlook-april-2017

# Equities: Emerging from the shadows

*By Andrew Cole, Senior Investment Manager, International Multi Asset, Pictet Asset Management*

The global economic upswing has now lasted longer than a typical recovery (if there is such a thing). However, we think it would be wrong to look for another recession around the corner. Crucially, the rate of economic growth has been subpar, which means there is still plenty of room left for expansion.

That is particularly apparent when we look at the progress of corporate profits. In most parts of the world – including the UK and the euro zone – earnings remain some way below their previous peak. Even in the United States, where the recovery has been more pronounced, earnings have only just about reached their long-term growth rate.

We therefore expect that the slow-yet-steady economic and earnings recovery will continue through the rest of this year, into 2018 and beyond. However, another common trend of the recent past is running out of steam - namely the outperformance of bonds over equities.

Most investors have – in some shape or form – benefited as bonds persistently delivered an equity-like return with significantly less risk, basking in the glow of undershooting inflation expectation and generous central bank quantitative easing policies.

One of the consequences of this is that investors have forgotten how much risk, on average, one needs to take to achieve the kind of returns traditionally associated with equities. Markets are about to remind them.

When you look at today's pricing of bonds, you see that much of the world offers a negative real yield. That is true not just for government debt, but also for investment grade credit, where below inflation yields are becoming increasingly common. So, without further capital gains from falling yields or credit spreads (which we do not expect), bond returns look set to be negative in real terms and certainly a long way short of what investors have experienced over the last decade.

Of course for many investors – insurers, pension funds and the like – there has been an increase in regulatory pressure to lower their risk profile. That potential demand is likely to put a floor under the bond market. So while bonds are expensive, the chances of picking them up cheaply in the foreseeable future look pretty low.

Equities, in contrast, offer the prospect of exposure to continued earnings growth as the breadth and depth of the global economic upswing develops. Furthermore, for investors looking for an income stream, global stocks offer a dividend yield of a respectable 2.5% - nearly double the yield of global government bonds.[1]

We do not believe the global economy works to a calendar. Therefore, whilst this expansion has undoubtedly been longer than most, it continues to be supported by central bank stimulus – in the first half of this year, alone, they have printed around US$2trn of fresh money. We do not see any serious inflationary threats on the horizon that would motivate central banks to tighten monetary policy aggressively. Indeed, this summer has once again witnessed a period of falling inflation expectations and a corresponding lowering of forecast for interest rate rises.

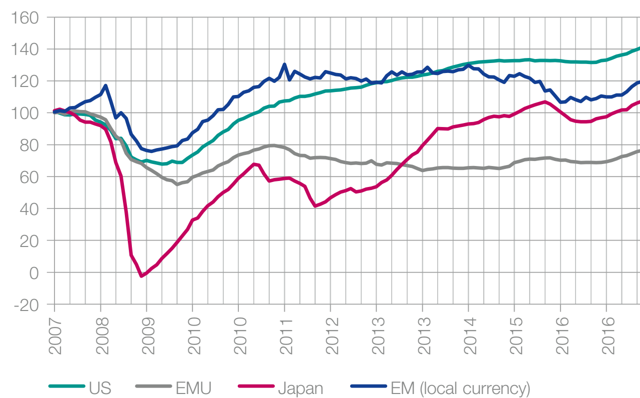
1) JP Morgan GBI, August 2017

Additionally, electoral forces are pushing governments around the world to retreat from the policies of austerity towards more stimulating fiscal policy. This, to our mind, suggests that a recession is still some way off. Latest Purchasing Managers' Index (PMI) data from the US and the euro zone supports this view, and our own business cycle indicators also signal economic resilience.

That being the case, we see a number of years of earnings growth ahead of us to the benefit of the equity investor. Europe, including the UK, has particularly attractive prospects in this area as it is around two to three years behind the US on the recovery path.

Our analysis suggests that the equity risk premium is above its historical average. If bonds remain expensive and continue to offer negative real returns, we expect that investors who seek positive real returns will increasingly look towards equities to provide that growth. And that will mean accepting the perceived increase in risk for doing so.

**Earnings on the rise across the globe**




Trailing EPS level since January 2008 (=100).
Source: JP Morgan GBI. Data from 31.12.2007-31.08.2017.

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Asset Management

# What to buy now?

High deficits, low gilt yields, expensive equities and forecasts of further volatility on the horizon – pension fund managers have plenty to navigate. *Mark Dunne* looks at how they are allocating their assets.

The Nationwide Pension Fund's portfolio has evolved this year. At the end of December 2016 the closed defined benefit (DB) scheme for the Nationwide Building Society was 20% invested in equities. By mid February its allocation had fallen to 15%.

This reduction is the result of chief investment officer Mark Hedges' rotation into higher yielding assets, such as infrastructure, private equity, private credit, ground rents and property. Private market investments such as these accounted for 20% of the £4.94bn fund's assets in the second month of 2017.

Hedges is not the only pension fund manager who is increasing his exposure to long-term, higher yielding assets that are less vulnerable to political and economic shocks. Others are taking similar steps to help meet their commitments in a low interest rate environment and head off a repeat of the volatility that hit the markets in 2016.

The stand-off between the US and North Korea and the messy negotiations on the terms of the UK's exit from the European Union (EU) could be catalysts for turbulence in the coming months.

Church of England Pensions Board (CEPB) chief investment officer Pierre Jameson is another working to alter his portfolio to avoid the low returns and potential market volatility ahead. The assets he is looking at investing in are infrastructure and low risk equity rather than low volatility equity.

"Low risk equity is very much like low volatility equity but does not carry the same connotations, shall we say," Jameson said, speaking to *portfolio institutional* earlier this year. "It is a little bit more than smart beta, but there are crossovers.

"Essentially, the kinds of managers we are looking to use are heavily quant-based," he adds. "So they will be screening historic data within universes for low share price volatility, low risk exposure to the whole range of potential economic and political outcomes. That tends to narrow the universe quite a bit. Then they apply forward looking judgements about how companies might react under new circumstances."

Also pursuing a specialist strategy to protect against market turbulence is the HSBC Bank Pension Trust.

Chief investment officer Mark Thompson, who is in charge of a £3bn defined contribution (DC) scheme, had an idea last year to create a better accumulation fund. This would be built around generating better risk-adjusted returns, include climate change protection and a stronger management engagement policy. Thompson approached Legal & General, FTSE and an investment consultant with the idea. "The upshot of that is FTSE launched a new index in November, Legal & General announced a new fund for that index and I said I would put £1.85bn in it," he says.

The idea is to produce a better risk-adjusted return by moving away from a market cap index to a smart beta factor index, based on a number of factors including value, quality and low volatility. "If you look at how that index would have performed from 2000 to last year, the market cap would have gone up by 7% per annum and the index by 9.6% per annum, but for lower volatility. So a better risk-adjusted return," he adds.

## NEW ORDER

JLT Employee Benefits senior investment consultant David Will says that the search for yield in the current low gilt return environment has gone beyond traditional asset classes.

"People have looked not just at corporate debt but have gone down the rating scale into high yield and other areas of the market," he adds. This includes floating rate senior secured loans, which are less vulnerable to interest rate rises than fixed income bonds, and commercial property.

The non-traditional and illiquid assets that Hedges has turned his attention to are what he sees as alternatives to investing in index-linked gilts. This means ground rents and property, which are hedged for inflation and generate long-term cashflows.

Hedges is considering investing in insurance catastrophe bonds as part of his search for return. "This is one of the reasons why we sold down our equity position to fund investment in those," he says.

He is not just looking for higher returns, but also to reduce risk. The private market assets that the Nationwide Pension Fund is moving into are less correlated to GDP and the general economic events that affect equities and gilts. Jameson's strategy is to have half the volatility of equities in his portfolio over a market cycle, but broadly the same return. "So 10% volatility but probably still getting 7% to 8% per annum return over time," he says.

"What you might call smart beta or low volatility strategies, these are the kind of strategies that you might expect to underperform in a rising market, but strongly outperform in falling markets."

Diversity is at the heart of Nationwide Pension Fund's focus on long-term income streams and de-risking. And not just by asset class. The scheme has exposure to Europe, the US and Asia. "The only free lunch in town is probably being diversified," Hedges says.

> **"PE ratios look overpriced at the moment, but the problem has been that there aren't any other assets to invest in because most other assets look overpriced."**
>
> Mark Hedges, Nationwide Pension Fund

## PRICE IS WHAT YOU PAY…

London-listed companies paid dividends totalling £33.3bn in the second quarter, a record for the period and 14.5% higher than they returned in the same quarter a year earlier. This makes certain equities attractive while 10-year gilts yield less than 1.5%.

However, investors increasing their exposure to equities trading in London could be forgiven for feeling they have paid too much for what they hope will provide access to more cash and potential capital gains. The UK's blue chip index traded on a PE of around 35% in September, compared to 33% at the end of 2016, and was more than double the 15% historical average.

US valuations do not make better reading. They currently trade on around 25 times earnings, compared to an historical average of 15.6 times.

Hedges' decision to reduce the scheme's exposure to equities was partly driven by the high valuation of company shares. "We thought the equity markets in January got quite high," he adds.

He believes that equities, and not just those in the UK, look expensive. "PE ratios look ridiculously high," Hedges adds. "They look overpriced at the moment, but the problem has been that there aren't any other assets to invest in because most other assets look overpriced.

"The problem for investors of late is that they continue to go up," he says. "You have had a number of record highs, but these PE ratios do not look realistic."

Jameson does not agree, believing that equities have further to go, although he does acknowledge that UK and US shares are as expensive than at any time since the mid 90s. "As always with markets it is a

discounting mechanism and what you have not seen come through yet in any great strength are earnings upgrades," he says.
"The other big uncertainty is around what happens fiscally and politically in the US," he adds. "Generally, forecasters have not embedded any new forecasts in yet because they do not have any numbers to put into their models. If I am forced to give a view, I think there is still some upside in the equity markets." Jameson is not alone in believing that equities have further to run.
"Just because something might look expensive does not mean that it can't get even more expensive," ponders JLT's Will.
Shoqat Bunglawala, who is responsible for Goldman Sachs Asset Management's (GSAM) multi-asset business outside of the US, believes that European and US equities will benefit from continuing economic growth. He does, however, warn of potential headwinds related to China's slowdown and increasing political risk in the US and Europe. "As a result, a number of asset classes are likely to be range bound and that includes equities," he adds.
"Therefore, we think it is important to be nimble and dynamic in your approach to trading the range because there can be temporary bouts of volatility in markets and we think that is going to be the case for equities."

> **"The only free lunch in town is probably being diversified."**
>
> Mark Hedges, Nationwide Pension Fund

## EMERGING MARKETS RETURN

For those moving up the risk curve and concerned about paying too much for developed market equities, they could always turn to the emerging markets.
These regions have suffered in recent years thanks to a toxic mix of slower growth in China and lower commodity prices. Then there is the US dollar, which the emerging markets have strong links to. If the US falls into recession or its currency weakens then there will be a knock-on effect in these markets.
Hedges is bullish. "In the longer term I would say you have got to expect that there are some value opportunities here, particularly in Asia where China is still growing," he says. "If it is growing by 6% that is still pretty dramatic, even if it is not the figure it used to be.
"There are a host of other Asian nations that are growing and they are creating demand," Hedges adds. "You are seeing more wealth being created there and they are going to spend money. That is more of a longer term trend rather than an immediate one."
Nationwide Pension Fund's exposure to the emerging markets includes infrastructure and property funds as well as investments that focus on consumer spending.
"There is potential value in creating those opportunities in an area that has a growing and wealthier middle class who are going to be spending," he says. "These countries are getting wealthier and there are a lot of people there."
Jameson has made what he describes as reasonable allocations to local currency emerging market sovereign debt and emerging market equities for the Church of England Pensions Board. "We are not currently looking to add any more funds to those areas, but we are still expecting reasonable returns from them," he says.
Jameson believes that the potential political risks from the US on emerging market sovereign debt are offset by the outlook for commodities and improvements in corporate governance and what he calls the "general situation" in some of those countries.
Will adds that the emerging markets are not homogenous and that some countries in those regions are more vulnerable to economic and political shocks than others. He says that this can be quite different depending on if investors are looking at commodity exporters or countries vulnerable to movements in the US dollar.
"Arguably there are some areas where there is some value to be had," Will says, but warns that some equities in these regions are looking "fairly fully priced," as well.
But GSAM's Bunglawala believes that while rises in US rates may pose some headwinds for emerging markets in the near term, on a medium term basis, given that "there has been a significant valuation adjustment in EM and an improvement in the macro imbalances of a range of emerging markets, their level of sensitivity to rising US policy rates has improved, particularly given higher levels of local debt issuance relative to dollar debt issuance. Overall, we expect EM outperformance relative to developed markets," he says.
This is one example of where opportunities can be found among the noise of the potential political and economic shocks ahead. Dealing with volatility is one issue; finding long term, high-yielding assets is another. Members of the above pension schemes should be content to hear that fund managers are working to achieve both.

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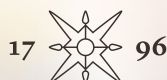

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