



In a world of low yields and reactive monetary policy, the difference between chasing return and portfolio construction has become vital

By Maha Khan Phillips

“May you live in interesting times.” Reputed to be a legendary Chinese curse, this saying is frequently used in English-speaking countries during periods of disorder and difficulty. There is no evidence to suggest that the phrase ever originated in China, but that is of little consolation. China is going through its own “interesting time,” having devalued the yuan to its lowest rate against the US dollar in almost three years and set off a period of global volatility and shock in markets. The country’s decision was an important policy shift brought about by a weakening economy, but it had its repercussions.

Illustration by Robert Meganck

“Developments in Chinese equity markets and the devaluation of the Chinese currency have caused a lot of nervousness across the globe, in particular in countries which have close trade relationships with China and in commodity-exporting countries. The nervousness reflects a concern that the growth slowdown could be more important than initially thought,” explains William de Vijlder, group chief economist, BNP Paribas.

Didier Saint-Georges, managing director at the €58 billion asset management firm Carmignac Gestion, points out that lack of confidence in Chinese authorities will be a key issue for investors going forward. “Not only is their transparency very poor but also their management of the domestic equity market bubble has been pitiful, so has been the management of its bursting, and later their decision and communication on the RMB,” he says. “This loss of trust should not be underestimated; it is critical to capital flows.”

China’s decision affects other policymakers whose decision making is critical to capital flows as well. In September, the US Federal Reserve announced that it would hold interest rates at the same level. Fed Chair Janet Yellen referenced concerns about China in her press conference as one of the issues that had to be taken into consideration.

The cycle of reactive policymaking, with investors second-guessing that policymaking, looks set to continue. For investors, this will bring its own set of challenges. For example, investment management firm Schroders warned that the Fed’s decision will affect UK defined-benefit schemes through both their liabilities and their growth asset strategies.

And it’s impossible to ignore the fact that central banks, particularly those in developed markets, have printed so much money that yields in bond markets are now depressed. Some bonds are even costing investors money to hold. In a world of central bank intervention and possible further financial repression, investors will struggle with asset allocation.

FINANCIAL REPRESSION

Frances Hudson, global thematic strategist within the multi-asset team at Standard Life Investments, notes that, in some cases, investors have had little choice in what they hold. “The financial repression we’ve seen this time around is mainly in developed markets, and it has a couple of interesting additions to low and negative interest rates,” she says. “There is also a regulatory hit. Banks and financial institutions were initially mandated to hold government bonds, pushing them into an asset class which would anyway under financial repression see elevated price in yields. The challenge for any investor, whether a pension fund or an individual, is to recover some of the income that’s been taken away by the repression element.”

But the general outlook does not look promising. According to Northern Trust Asset Management International’s annual long-term forecast of the economy and capital markets, structurally low global growth will persist over the next five years, weighing down financial markets even as central bank monetary policies continue to support valuations of risk assets.

Economic growth is forecast at 2.6% per year globally, and just 1.7% in developed market economies, constrained

by aggregate debt levels, aging populations, and the slow pace of consumer demand from emerging markets. Meanwhile, warns Northern Trust, low inflation will allow central banks to continue easy-money policies that have aided a cyclical upswing in equity prices.

“Most asset owners and investors are trying to deal with a low global growth scenario, especially with the US economic recovery (which is not perhaps nearly as strong as people had expected a few years ago) and China. The backdrop is a modest one in terms of growth,” explains Wayne Bowers, CEO and CIO of Northern Trust.

So where does that leave investors, particularly pension funds with funding requirements?

POLICY CRUNCH

Investors need to recognise that they are living in a new world, according to Nick Samouilhan, senior fund manager in multi-asset funds, Aviva Investors, which manages £65 billion in multi-assets. “Pre-crisis, you could distil asset allocation to what you thought was going to be the correct valuation for something, what bonds should normally be worth, and what they would go back to in a reasonable timeframe, but that is no longer the case,” he says. “Now, we don’t think about valuations. We spend our time thinking, ‘What is a particular policymaker going to do?’ Those decisions are driving markets far more than economies and valuations are, because policymakers are intervening far more frequently.”

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This reality means re-tooling or building a new skill set, according to Samouilhan. “Valuations still matter, because policymakers will look at them as well,” he says. “If you think bond yields are very low, what do the influencers and buyers think they should be priced at? And that’s where they are going to go. We’ve had to change our prism to incorporate the fact that to a policymaker it doesn’t matter if you will make money from bonds or not, it’s about what those bonds will do for the rest of the economy.”

Atul Shinh, CFA, an investment specialist in the multi-asset team at Investec Asset Management, says that three criteria are important from an asset allocation perspective. “You have to be flexible, you have to have breadth of opportunity set, and you have to be discriminatory,” he says.

Regarding flexibility, institutional investors need to do away with benchmarks so they are not “forced to invest or not invest based on arbitrary allocation,” Shinh explains. “We’ve seen the industry move away from that generally, but we need to continue to move away.”

Shinh believes pension funds need to be more reactive and make faster decisions. “I haven’t seen any evidence yet

that institutional investors such as pension funds have been particularly reactive in making decisions in response to the recent spike in volatility. Often it takes a while to see if this has happened. We've seen little evidence thus far that such clients have been redeeming in recent weeks. My suspicion is that the very sophisticated schemes will have certainly been active, but the vast majority will not have been."

Investors also need to expand into such assets or markets as infrastructure, re-insurance, commodities, emerging markets, and frontier markets; take short, selective views; and construct relative value positions. "For some people, the concept of shorting is a dirty word," says Shinh, "but actually, if you believe things can go up and you should buy it, then why can't you believe that before things go down, you should sell?"

He also believes investors need to be more discriminating about what they own and how they own it. "For example," he says, "if you think that one way to get exposure to Chinese equities is via the HSCEI index, well then that market is heavily linked towards financials, so by owning that index you are taking a view on financials in that area, whether you like it or not."

BEING OPPORTUNISTIC

Institutional investors are splitting between those who are searching for alpha and those who are focusing on liability management, observes Jeffrey Levi, a partner at investment advisory business Casey Quirk.

"The legacy, purely channel-oriented institutional investor landscape is no more, in the traditional sense," he says. "Investors are actually bifurcating in terms of how they invest. Increasingly, you have groups that have very different objectives in terms of what they want from their investment portfolio."

According to Levi, some plans that used their earnings to outperform in the past and got burnt are changing their approach. "A lot of corporate funds are moving to liability-driven strategies; the idea of gambling with the portfolio is off the table," he explains. "There's another group of investors who maintain the old mind-set of an absolute return bias and are taking more illiquid positions like real estate, infrastructure, real assets, direct lending, and illiquid credit."

Earlier this year, Casey Quirk launched two surveys focused on institutional buyer dynamics. The results indicate that consultants and institutions are less worried about structural disruptions and have shifted focus to meeting absolute return targets. Also, use of in-sourcing has grown as a result of cost and control benefits.

"A lot of the larger, more sophisticated investors are saying that external managers are really expensive and that they can do some of the investing in-house. They are building their own internal capabilities to cut costs and to have greater control of their portfolio," says Levi.

In-house investors are the heaviest users of passive exposure, according to data from Casey Quirk. The firm's research findings indicate that core and passive mandates are the first to be brought in-house, which results in decreased costs. External mandates are more likely to consist of alternatives and other high-fee products instead.

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Many funds, such as the Ontario Teachers' Pension Plan, AustralianSuper, and various large Dutch industry schemes have been insourcing for years, but this trend looks set to continue across the board.

According to a 2014 survey by State Street, *Pension Funds DIY*, 81% of pension funds globally say they intend to increase the proportion of their portfolio that is managed in-house. According to State Street, larger schemes are already competing for talent. They are also deploying advanced tools and technologies to help them manage complex investment portfolios.

EXPANDING HORIZONS

Investment consultancy Mercer argues that institutional investors may need to make use of a wide range of return drivers and embrace a "broader perspective" on risk management in order to meet their objectives. In a report, *2015 Themes and Opportunities*, the firm outlines a number of ideas. The first is that there is more volatility and dispersion in markets—for instance, with growing differences between the best- and worst-performing stocks. Because returns from alpha are becoming increasingly important, portfolios should be tilted from beta to alpha.

The consultancy also argues that while it is difficult to predict which strategies will enjoy the most favourable conditions over the next few years, the likelihood of a rate rise in the US and further stimulus in Europe and Japan, together with the rise of currency wars, may create opportunities for macro hedge fund strategies. Rising stock level dispersion and lower intramarket stock correlation could provide long/short and unconstrained long-only equity investors with more attractive opportunities. Also, continued merger and acquisition activities could create a more fertile environment for distressed debt investors. Low yields and credit spreads (which significantly reduced liquidity in credit markets) and large inflows from retail investors into credit-based, exchange-traded funds mean that risks to traditional index-focused bond strategies may have increased. In this environment, argues the firm, absolute return bond and multi-asset credit strategies offer more benefits than traditional approaches to bond investing.

PLAYING THE LONG GAME

The consultancy also wants investors to think long term. On the asset class level, genuinely long-term investors should seek to harvest opportunities available only to investors with a long-term horizon, such as those that require a long holding period. Illiquidity budgeting is also a sensible step.

But long-term management has always been the goal for most schemes, though this is difficult to implement in

theory, a fact acknowledged by Phil Edwards, European director of strategic research at Mercer Investments. “It’s always been a challenge for genuinely long-term investors, because everyone is faced with the same short-term constraints of one thing or another and career risk affects everyone in the industry,” he says. “But we’re trying to highlight certain ways that investors who do see themselves as long-term can generate these investments.”

He says private markets provide many opportunities at the moment. “The reason private markets are interesting is because you see huge bank de-leveraging in Europe, which creates an opportunity for another investor to come in and provide finance at an attractive value. It’s actually quite an interesting diversifier,” points out Edwards.

Finally, the firm believes that investors should look for assets or strategies that provide some protection against tail events without sacrificing too much in return. Safe-haven sovereign debt offers protection against deflationary recession, and though cash may not be appealing in the present environment, it does offer some dry powder to deploy in stressed market conditions. More direct approaches to managing downside risk include option strategies and tail-risk funds.

TO HEDGE OR NOT

For Kerrin Rosenberg, chief executive of Cardano UK (an investment advisory, risk management, and fiduciary services firm), it is important to recognise the distinction between chasing return and portfolio construction.

“There’s definitely a really challenging piece of thinking around ‘How do you find investments that actually give you a decent piece of return in a world of low interest rates and dominant central banks?’ But the other important aspect is ‘How do you get the right portfolio construction or balance?’ Any one investment has scenarios in which it works and in which it doesn’t work. The more we talk to people the more we realise that idea generation and portfolio construction are not always given enough emphasis as two separate aspects.”

Most idea-generation processes embed the investor’s central view of the world, argues Rosenberg. “Mediocre” ideas are replaced by “better” ideas so that the idea-generation process ultimately tends to gravitate towards investments with the highest expected returns. Portfolio construction is then performed using the pool of ideas that have passed through the idea-generation process. “This means that one is trying to build a portfolio with ideas that have all been

European Pension Funds Re-Think Investment Approach

European pension schemes are rising to the challenge of low returns in their asset allocation approaches. Jaap van Dam, managing director for investment strategy at PGGM (which serves as the pension manager of the €134 billion healthcare scheme PFZW in the Netherlands), and Günther Schiendl, chief investment officer at the €6 billion VBV Pensionskasse (Austria’s largest multiemployer pension fund), talk about the challenges of asset allocation.

What are the biggest asset allocation decisions you are making at the moment?

SCHIENDL: Being overweight equities, being massively overweight European equities, and being massively underweight US and emerging market equities. Having no exposure to European core government bonds (Germany, etc.) and having neutral exposure to European “peripheral” government bonds. Zero hedge fund exposure and very low commodities exposure.

VAN DAM: We typically do not make dynamic allocation decisions as a function of market circumstances.

Have “alternatives” become mainstream?

VAN DAM: Illiquid alternatives like private equity, real estate, infrastructure, and insurance are important core components of our portfolio. Within the realm of public equities, we invest a substantial part of our portfolio in alternative beta strategies to harvest available factor premiums. We have exited hedge funds because of a combination of complexity and opacity, high cost, and a limited contribution to the overall characteristics of the investment solution.

SCHIENDL: We completely exited alternatives in the sense of hedge funds last year, about a month before CalPERS announced their exit from hedge funds.

Where are the biggest investment opportunities in terms of returns?

SCHIENDL: Private capital markets, especially private debt markets—for example, direct lending, project finance, and real estate finance.

VAN DAM: Expected returns have diminished substantially all over the full investment opportunity set. We are not in favour of adding risk (e.g., illiquidity risk) by hunting for yield. That being said, expected returns on return-oriented assets are less depressed than expected returns on high-quality, “risk-free” government bonds.

Has hedging risk become a bigger component of how you manage your portfolio?

VAN DAM: No. Two important arguments:

1. Hedging liability risk is extremely costly at the current low yields.
2. Risk not only means “solvency risk” but also “shortfall risk.” Hedging more of your (short-term) solvency risk decreases expected return and therefore increases (long-term) shortfall risk.

SCHIENDL: Tactical and/or risk-based hedging has been a core part of our active pension fund asset management process for some years now.

What are your biggest risk management challenges?

SCHIENDL: Low interest rates for long years to come. Generally tight risk budgets because of low rates. Risk budgets and path dependency. Developing appropriate risk models.

VAN DAM: Low interest rates for long years to come, overly expensive pensions because of low expected returns, and the risk of disappointing returns over a prolonged period of time.

through the same filter. It's not surprising that supposed diversification often fails when you need it," he explains.

The problem is that portfolio construction follows idea generation as an afterthought, he argues.

"A better way to do it is to start with portfolio construction. What returns profile do we want? Our portfolio construction process is aimed at delivering robust results that are acceptable across a range of different economic scenarios. Whether we enter a recession or experience high inflation, we need to be confident that the outcomes will be acceptable for our clients. We are, therefore, consciously seeking ideas that fit each scenario. Portfolio construction informs the idea-generation process. We are then able to identify ideas that perform well in each of the scenarios we are trying to manage the portfolio against. Some of these ideas may actually have a poor expected return, and they wouldn't make sense as a stand-alone investment. However, they are very useful in the portfolio, as they perform well when other assets perform poorly."

He believes pension funds need to hedge their liabilities more, particularly when it comes to interest rate risk. "One big challenge at the moment is whether to make a call on interest rates," he says. "It's important for pension fund investors because interest rates are how they value their liabilities, and if they aren't completely hedged against that, it's going to have a big impact on funding and solvency. Our mental mind-set is that our liabilities are 100% bonds, so we aren't starting from a position of, 'Should we buy a bond?' We start from a position of, 'We own a bond, should we sell it?' If you don't have a view, what do you come back to? If we like an asset much more than bonds then we may not sell the bond, but we may turn it into a derivative to free up the cash or buy swaps to replace the interest rate exposure."

In August, UK financial services company Punter Southall argued that hedging interest rate risk by 50% could improve

pension funding levels by 10%. But the number of schemes hedging these risks in the UK is still relatively low, and it is likely that less than 50% of UK defined-benefit pension funds are currently hedged (the firm did not look at global pension schemes).

In the same month, however, James Maggs, principal at Mercer Investments, argued in *Financial News* that if rates rise rapidly, the value of the swaps and their underlying collateral would be at risk. Economists widely believe rates will rise in the US and the UK fairly soon, but Rosenberg points out that these predictions have been wrong in the past.

"When pension funds started introducing liability-driven investments around 2000, most in the industry said it was not the time. Then they said it was really not the time. Now they say it is really, *really* not the time. There's big regret risk; trustees don't like to make revolutionary changes because with the benefit of hindsight they may have huge regret, so they prefer gradual changes," he says.

Amongst all these active approaches, there is also a point to be made about passive investing and asset allocation. "Asset owners are taking asset allocation more seriously than they did 10 or 15 years ago. There is more dynamic movement. There are low-single-digit swings on a monthly and quarterly basis. For that you really need liquidity, and passive works really well, either as exchange-traded fund platforms, index funds, or customised segregated mandates. Passive is still very much in vogue," says Northern Trust's Bowers.

Whatever strategy they employ, institutional investors will have to be quick on their feet in this low-yield environment, especially if there are more shock moves like China's or if there are delays in anticipated interest rate rises by policymakers or other types of intervention in markets. Interesting times, indeed.

Maha Khan Phillips is a financial writer in London and author of the novel *Beautiful from This Angle*.

How Is the Investment Environment Changing?

| Crisis Management (2009–2014) | Tentative Normalisation (2015–2020 and beyond) |
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| <p>Huge monetary stimulus—synchronised policy:</p> <ul style="list-style-type: none"> • Heightened risk premia • Falling volatility (with bouts of stress) • Falling dispersion | <p>Uneven stimulus:</p> <ul style="list-style-type: none"> • Reduced risk premia • Higher volatility • Higher dispersion |
| Dominance of monetary policy | Gradual normalisation of monetary policy Greater focus on fiscal policy and structural reform |
| Many cheap assets: Buy beta | Few cheap assets: Tilt towards alpha and the need to be more opportunistic |
| <p>Risks/concerns:</p> <ul style="list-style-type: none"> • Focus on deficit reduction • Uncertain impact of monetary stimulus • Euro crisis • The "fragile five" | <p>Risks/concerns:</p> <ul style="list-style-type: none"> • Focus on reducing overall debt burden • Uncertain impact of monetary normalisation • The rise of nationalism and potential fall-out from geopolitics • Chinese debts and reform program • Inflation asset price bubbles and "crowded trades" |

Source: Based on the report "Mercer 2015 Themes and Opportunities."