Opportunities In An Uncertain Era

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Opportunities In An Uncertain Era

From the left, Peter Miller, an Insurance Research Strategist, and Neil Blundell, Global Head of Client Solutions, at Invesco; Michael Hughes, Senior Vice-president and Client Portfolio Manager at GuardCap Asset Management, a wholly-owned subsidiary of Guardian Capital Group Limited (GCG); and Chris Marx, Senior Investment Strategist at AllianceBernstein; shared their views on how institutional investors are re-thinking investment strategies in order to thrive in the uncertain markets they currently face at the Benefits and Pensions Monitor Meetings & Events 'Pension Investment Strategies' session.

In the face of today's challenging environment, institutional investors are re-thinking investment strategies and seeking ways to innovate with portfolio construction in order to thrive in the uncertain markets they face now and for the foreseeable future.

At *Benefits and Pensions Monitor Meetings & Events* 'Pension Investment Strategies,' featured speakers from Invesco, AllianceBernstein, and GuardCap Asset Management, a wholly-owned subsidiary of Guardian Capital Group Limited (GCG), shared what they are hearing from their institutional clients and the solutions they are offering.

Invesco's Neil Blundell, Global Head of Client Solutions, and Peter Miller, an Insurance Research Strategist, said conversations are moving to modelling liabilities and determining when cash flows are needed. Chris Marx, Senior Investment Strategist at AllianceBernstein, delved into the issue of volatility which he said may be here to stay, while Michael Hughes, Senior Vice-president and Client Portfolio Manager at GuardCap Asset Management, a wholly-owned subsidiary of Guardian Capital Group Limited (GCG), outlined the opportunities for returns for long-term investors.

"In conversations we're having with asset owners, the key trend that threads through everything is asset class returns in capital markets assumptions," said Neil Blundell, Global Head of Client Solutions at Invesco.

In the 10 years since the global financial crisis, historical returns in balanced portfolios have been relatively phenomenal – roughly an 11 per cent return with a seven per cent risk. That landscape has changed, however. Return expectations are now about a four per cent return with nine per cent risk.

So conversations now are about "what is driving the portfolio," he said, and is the current portfolio aligned to expectations.

'Return Bogey'

A second conversation increasingly is "instead of thinking of just a return bogey," managing the portfolio in a liability-relative context, he said.

Conversations are moving to modelling liabilities and determining when cash flows are needed. This means finding the right balance of duration hedging and growth seeking assets within a liability-driven or cash flow-driven investment framework. "This is something the insurance industry has been doing forever and it's now bleeding into the pension space," said Blundell.

Once the portfolio is understood, attention turns to asset allocation and mix to navigate through the market cycle.

Primary Driver

Five-year and 10-year forecasts help determine this. The latter is the primary driver for developing a strategic asset allocation, but comparing this with a five-year forecast shows how returns differ on shorter versus longer horizons. "Our view is we are late cycle so most returns across the board are going to be lower on a five-year basis versus a longer term basis. That really indicates the need, again, for diversification to make sure that you're weathering any sort of downturn that might be in front of us," he said.

This longer-term strategic asset allocation has resulted in "barbell" portfolios.

On one side, clients have moved towards passive strategies in a significant way due, in part, to active managers with static factor bets in their portfolios. Static factor bets, such as momentum or value, can be directly implemented within the aggregate portfolio, potentially at a lower cost than for active management. Separating the beta components and factor exposures means the focus can be put on manager selection for the alpha component which does come with a higher cost.

However, there are two conversations taking place here: "Do you believe in factor-based investing and, if so, how do you effectively utilize rewarded factors in your portfolio," he said. There are lots of factors and many factors will actually explain volatility. However, there is a limited set of rewarded factors – momentum, value, quality, low volatility, and carry among them.

"In many cases, you can use factors if you have a sense of what market regime we're in to potentially tilt your portfolio towards a potential outcome," he said.

The other side of the barbell is alternatives exposures to generate income. Core real estate, real estate debt, and infrastructure are all asset classes that can have a significant income component. If more alpha is needed in the portfolio, it can be tilted more towards private markets assets that have a growth bias.

Peter Miller, an Insurance Research Analyst at Invesco, discussed a case where a client is already allocating to private markets – in this case, real estate. As a Canadian investor, they were largely skewed towards their home real estate market and "wondered if they could do better. Really, it was more a conversation around risk, as opposed to return; and you could obviously approach it from either angle," he said.

'More Granular'

Looking across different global markets and different risk strategies – core to value-added to opportunistic – "obviously you can get a lot more granular, but you can basically achieve an outcome which leads you to a better and more efficient portfolio," said Miller.

As well, looking outside of the Canadian/U.S. markets, Europe is relatively low volatility, but Asia-Pacific can be more volatile. By combining these, an investor can benefit from that lack of correlation across strategies and across markets. On a standalone basis, this combination of what looks to be higher risk assets actually provides a modest risk portfolio and a better Sharpe ratio.

This highlights the power of diversification especially with higher risk real estate strategies.

"However, we also want to make sure we're being practical and what we're ultimately recommending is implementable, practical, and that you can utilize it," he said, as at the end of the day "what we're trying to do is solve for a better outcome in theory, but also in practice so we can actually implement it."

"The last few years have been a real illustration of how market volatility can change," said Chris Marx, Senior Investment Strategist at AllianceBernstein. "If we just looked at 2017, it was a fantasy year of everything going up and nothing going down. Everyone got lulled into complacency. Then we went into 2018 and had exactly the opposite experience where markets sold off and everyone was reminded of the fact that capital markets are volatile."

In 2017, there was almost no volatility in the market. Last year, almost once a week there was a day where the market moved by more than one per cent and volatility is likely to stick around as there are many forces out there, economic and political, that will continue to drive uncertainty.

Two Dips

Of the two dips in 2018, in the early part of the year it was caused by concerns that interest rates and inflation were going up. The second half of the year was all about concerns that everything was slowing down.

With this uncertainty, the "rules that we all lived with for most of our careers need to be put aside" and things not in "our decision set" contemplated, he said.

While investors will likely have to get used to living with this volatility, "what we're talking to clients about is you don't just have to accept that. You can actually manage around it in the way you construct portfolios," he said.

Volatility is more than just a statistical measure; it's actually a fear of loss and the impact that it could have on the ability to meet needs. "What we experience is a much more emotional or visceral reaction

PENSION INVESTMENT STRATEGIES

to this and it can manifest in a lot of different ways," said Marx.

The fear of loss and what that can entail is much more prominent in discussions with clients. Where people once just thought about relative performance and tracking error, "it's become much more conditional on how a portfolio would behave in different environments because that's going to have an impact on the plan's ability to pay out its liabilities.

In periods of pullback, fears of how much money could actually be lost and whether obligations can still be met become prevalent. But just as important is the sense of emotional loss. "We think this is an individual investor thing, but I've been working with institutions for long enough and institutions and boards often react emotionally to these conditions as well."

Thinking of volatility beyond just statistical measures of standard deviation and in the experiential realm is important for how volatility is assessed and managed. "If you truly are going to put this in the Al Gore lockbox, lock it in the drawer, and never touch this portfolio for 10 or 20 years, then you really don't care about it," said Marx.

In part, that's what happens with some illiquid investments. But for the liquid side, it does matter.

Pleasure And Pain

Understanding the relationship between pleasure and pain and how we react to it is illuminating. The field of behavioural finance and the interlinking of psychology and economics shows that people don't assess decisions rationally. "We don't assess loss and gain the same way; we assess them very differently and that fear of loss, that emotional or utility loss that comes along with loss, can cause people and plan sponsors to make decisions that may not be optimal over the long term," he said.

Potential Loss

More volatility causes more potential loss and people can act irrationally and sell out of those asset classes at the times when they really shouldn't.

While the first lesson learned is 'buy low; sell high,' that's the exact opposite of what many people do. They chase performance and wait until things get better to get back in the market.

One of the keys to staying invested in light of human emotion is to try to reduce that volatility and manage it in such a way that "you can stick with the plan that you worked so hard to optimize and build out."

Volatility can come in a lot of different forms. It isn't just a statistical measure; it's an emotional measure, it's a loss, it's an inability to meet your needs, he said. "It isn't a mystery; it's actually something we can analyze the sources of at the fundamental company and industry level and manage around. If we do that, we can reduce volatility in a portfolio and deliver a more consistent set of returns," said Marx.

In many respects, fund managers can often be the authors of their own doom, said Michael Hughes, Senior Vice-president and Client Portfolio Manager at GuardCap Asset Management, a wholly-owned subsidiary of Guardian Capital Group Limited (GCG). They have at times produced portfolios which are index-huggers, but charged active fees. "More perniciously, perhaps, they might have built up exposures to factors which have gone on to outperform near term, but this outperformance isn't necessarily maintained. Creating a portfolio of risky stocks in a risk-on environment may work for a while, but that does not amount to sustainable performance," he said.

In the headlong rush towards passive investing or its close cousin, factor-tilted passive investing, "we think this is perhaps generating some opportunities that weren't there before. However, there are some useful hints as to the kind of managers that may be able to sustainably generate significantly better returns than you would expect to get from index-type investing," said Hughes.

A place to start is the academic research which shows a strong correlation between managers who have high active share (who don't tend to replicate what's in the index with their portfolios) and outperformance.

Another academic paper entitled 'Patient Capital Outperformance' shows that among the high-active share managers, those with the longest investment time horizon tend to perform the best so "just concentrating on high-active share managers with long-term time horizons can tilt the whole thing back in your favour," he said.

'Extremely Short'

This is interesting because in recent years investor time horizons have become "extremely short – everything now seems

PENSION INVESTMENT STRATEGIES

to be driven by the here-and-now, the what's-just-happened, the what's-just-about-to-happen," he said. This trend to shorter holding periods than ever before has given rise to "real investment opportunities."

He pointed to one stock to illustrate this – "by no means the only one I found." Stryker is an American company that provides surgical implants and tools for hip replacement surgery. Demand for its products is driven by demographics – as populations get older in the developed world – and increasing obesity. "One way or another, the demand for hip replacement surgeries is rising," he said.

Over the last 25 years, Stryker has grown its earnings per share sustainably by 16.9 per cent a year and has 17.3 per cent compound growth. While not a particularly high-flying household name, it's a "sustainable, steady-growth stock," he said.

To sustainably outperform then, all you have to do is to buy into companies like this and hold onto them for 25 years or so. However, if markets are efficient, it shouldn't be this simple. "The market is not there to let you beat it," said Hughes.

The problem lies with the fact that the market uses short-term information. Companies give guidance on expected earnings and brokers write forecasts for two years into the future. Fund managers invest in companies for "one, two, or maybe three years at a time." That means that nobody in the market is giving proper thought to companies that are not just growing now, but may still be growing five and 10 years from now. "That's what creates the opportunity to invest, so long as you stick with them to get the strong double-digit returns over a long period of time," said Hughes.

The other big factor whether you're investing in a passive way, semi-passive, or active way is that disruption is the big part of our future. "Whoever said: The world is going to change more in the next 10 years than it did in the last 100 years, is absolutely right."

'DORA Days'

To deal with this, GuardCap holds regular 'DORA Days (Days Out Researching Anything). "Our portfolio managers break from their normal routine, which is having their nose pressed up against a screen and punching numbers into a spreadsheet, to think about the long-term future of companies." Anything can be the subject of a DORA Days paper. GuardCap has so far produced about 70 of these papers which discuss the way the future threatens the established normal way of thinking about the future of markets and companies.

The most important point, he said, is "disruption is now definitely a part of everyday life. If you want to avoid unknowingly bringing disruption into your portfolio with negative consequences, you need to have a high degree of selectivity in how you go about investing." **BPM**

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