# The danger of avoiding risk

## Percival Stanion explains why it is now time to take more risk

For many investors, risk is the four-letter word they fear the most. However, as the world economy finally recovers from a string of crises, the biggest threat to investment returns arguably comes from taking too little risk.

Over the past decade, investment managers have been heavily focused on controlling risk, effectively yielding to their clients' fears in the wake of the global financial crisis. UK multi-asset funds, for example, now allocate an average of 21 per cent of their portfolio to fixed income, up from just 15 per cent 10 years ago.[1]

At first glance, the approach appears to have paid off: volatility-adjusted returns have generally been satisfactory. But dig a little deeper, and it quickly becomes clear that this outcome was only possible thanks to the unusually strong performance of government bonds.

The problem is that era is coming to an end. We believe that bonds will face significant hurdles over the short to medium term as global economic growth picks up. Our global leading indicators are at their strongest levels since December 2013, with the recovery now more or less established across all the major regions. At the same time, central banks are starting to withdraw liquidity, interest rates are rising and inflation pressures are back in the picture.

Cautious, bond-heavy strategies are therefore going to become a lot less effective, delivering what could turn out to be quite miserable returns. And it's not just bonds that will be affected. Other income-generating securities could suffer too. Within equities, investment flows have until now been disproportionately concentrated in high quality, highly stable, defensive stocks with bond-like characteristics, which are relatively insensitive to changes in economic growth. These so-called "bond proxies" – which have been particularly popular among absolute return funds – tend to lag the wider equity market during times of economic strength.

As we enter a period of sustainable growth, it is imperative for investors to allocate more of their capital to areas of the market that can benefit from the improvement in economic activity and the accompanying moves of the yield curve. In our view, now is the time to take more risk, which means dialling down fixed income and raising exposure to equities.

In our own multi-asset portfolio we have reduced the allocation to fixed income – both government bonds and credit. Most notably, we have more than halved exposure to US high yield debt after the asset class's terrific performance in 2016 and a significant narrowing of its yield spread over government bonds. We have also removed defensive equities with bond-like characteristics.

Instead, we have been investing in the financial sector. Rising bond yields will enable banks to lend more profitably by widening the gap between borrowing and lending rates. Also, Donald Trump's US administration has signalled that it wants to halt – or possibly even reverse – the last decade's increase in the regulation of bank capital (The Dodd-Frank Wall Street Reform and Consumer Protection Act). The banking and financial sector, having been under pressure from increased regulation for years, could now face a more benign environment.

We also like Japanese equities, particularly the industrial sector, which is highly sensitive to global economic growth. Similarly, we have increased exposure to emerging markets in general – and to China in particular – in the belief that a revival in Western consumer demand will further boost those countries' exports. Indeed, exports from emerging markets economies have already improved steadily over the course of the past year and are now growing at an annual rate of 2.8 per cent compared with a decline of over 10 per cent 12 months ago. To us, this suggests emerging markets companies should be able to deliver the forecast 15 per cent rise in profits over the next 12 months, their best showing since 2011.

Political risks will remain significant for at least the medium term, as the world struggles to adjust to shifts in the sources of its economic growth and changes in demographics. Countries are therefore likely to continue experimenting with alternative economic models (potentially including universal income, border controls, automation taxes and more) in a bid to find the best response to those structural trends, with varying degrees of success. Retaining the ability to be nimble and flexible – in terms of both geographies and asset classes – is essential.

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[1] *Morningstar GBP Flexible Allocation Peer Group, 28.02.2017*