Investing in a lower return world

Talib Sheikh and Matthew Morgan consider how pension funds can grow their assets while minimising risk

Pension schemes face a difficult balancing act. Fast-maturing DB schemes are becoming cashflow negative, but still have ground to make up. In DC, members are looking to make returns up to and into what can be a very long retirement period. The conundrum is: how can I grow my assets when I need income, and can't afford to take too much risk?

This is now the longest US expansion on record, and the past 10 years have been a great time for investors. A simple 50-50 portfolio of equities and bonds has delivered a return of about 8% p.a. over the past 10 years, for around 6% risk*. We in the Jupiter multi-asset team are more optimistic about the future than many of our peers: we have consistently said that this low-growth expansion can continue and have been pushing back against the recession doom-mongers for some time.

However, what we can say with some certainty is that valuations are extended. This is true in equity markets, where the US market is at 17.5x forward earnings, a level we last saw in early 2018; and is even more pronounced in fixed income. Lending money to the UK government for 10 years offers a return of 0.75% per annum, before inflation. Over $12 trillion of outstanding global bonds offer a negative yield. Many traditional assets such as investment grade credit offer very low yields, and elevated valuations can point to greater risk of loss in future. This means that, in our view, returns to that 50-50 portfolio are likely to fall from 8% to less than half that.

Decent returns for reasonable levels of risk can be found, but investors need to take a different approach to succeed in a late-cycle, low-return environment. For us at Jupiter that means being very flexible about where you invest, embracing active management, and being disciplined about risk.

When traditional sources of return are compromised by high valuations and low yields, investors need to look elsewhere. Our multi-asset strategies ignore developed government bonds and investment-grade credit as sources of income, because we don't think we are rewarded for the risk we take in those asset classes. We like global high yield instead, and invest in less common, innovative strategies like emerging market credit, financials debt and private markets. For most schemes, managing these asset classes needs understanding and expertise, and all but the most sophisticated need to use a multi-asset approach.

In a low-return world, additional performance from active management can make a big difference. Jupiter has decades of commitment to high conviction, unconstrained active management, which we embrace throughout our portfolios. In a late cycle environment characterised by sharp swings in sentiment, the ability to move portfolios quickly and tactically can cushion against losses and earn additional performance. Stock selection alpha can earn valuable extra returns.

If our solution to the challenge of the environment we find ourselves in is to be more flexible and active, managing risk is critical. There is no such thing as a free lunch: investors must take risk to be rewarded, but we recognise that pension investors are risk aware. Within our multi-asset strategies, we aim to keep risk below half that of the equity market. We also recognise that trustees are ultimately responsible for their scheme's assets and therefore we need to be open and transparent about how we are delivering performance: we don't believe that complex, opaque strategies always serve their investors well over the long term.

We remain optimistic that in a world that is learning to get used to trade wars, deglobalisation, government by Twitter, negative yields and quantitative easing, good risk-adjusted performance is available if you know where to look. What has changed, and what investors must get used to, is that multi-asset approaches that worked in the recent past, especially those that invest passively across markets, are unlikely to be successful in future. A more active, flexible and disciplined approach is required to deliver returns for the next decade.

Written by Talib Sheikh, head of strategy, multi-asset, and Matthew Morgan, product specialist, Jupiter

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*Source: Jupiter/Bloomberg. A simple portfolio of 50% MSCI World Index (euro hedged) and 50% Bloomberg Barclays Global Aggregate Bond Index (euro hedged) 7.6% p.a. from 31/12/08 to 31/12/18 with a volatility of 5.8% p.a.

Source: Bloomberg

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