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Global equities focus:

An active approach

Ritu Vohora, head of equities investment comms, M&G

Active's turn

Ritu Vohora considers why pension funds should be considering active equity strategies

For more than 10 years, passive investing has gained equity market share at the expense of active investing. The market environment since the financial crisis has been distorted – characterised by accommodative monetary policy, low interest rates and periods of risk aversion. This has suited passive strategies, which have performed well and been viewed as a 'safer bet'.

The global financial crisis in 2008 scarred investor sentiment, generating demand for risk averse, safe and stable investments. Bond markets offered this in the beginning, but as prices rose and yields fell, investors had to look elsewhere to source returns. In the equity market, defensive sectors, and within them so-called 'bond proxy' stocks, offered the perceived safety investors sought. This pushed fundamentals to the sidelines and encouraged herd behaviour as investors shifted into defensive assets and crowded into more expensive non-cyclical growth areas, such as information technology. From a style perspective, growth stocks outperformed value stocks over this period.

This narrow market has benefited passive investing, with increasing flows driving up indices and bidding up the same stocks. In a low-growth environment, investors have been willing to pay over the odds for prospective growth and have been happy to gain exposure to the current bull market cycle via low-cost beta strategies. Those stocks are now becoming increasingly more expensive and stretched, and at some point, like an elastic band, could snap back causing a very painful correction.

The correlation between sectors and stocks during this period has remained elevated, providing a natural advantage for a 'set-and-forget allocation' that is suited to passive investing. When correlations are higher, the opportunities for active outperformance are lower. This now appears to be changing. Correlations have fallen to their lowest since 2008, indicating investors are focusing more on fundamentals than on macro 'noise'. Dispersions of stock returns are also starting to widen, providing an opportunity for investors to differentiate between stocks. This change of sentiment is crucial for active management.

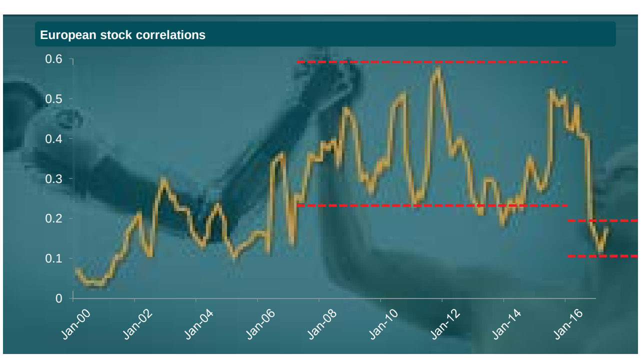
While we cannot ignore politics and macro noise, it is important to remember that there is always uncertainty in the markets. Today's headlines look almost identical to those of 15 to 20 years ago. Such issues are important, but how much can we genuinely know about the outcomes, let alone the likely market reaction? It is better to spend time looking at the facts and to focus on what is priced in today and how it could affect your underlying investments.

We believe there are four fundamental pillars underpinning the equity rally (see figure 3). As global central banks wind down quantitative easing and raise interest rates, companies' cost of capital and yield curves should begin to normalise. The world is moving to a period of stronger and more

Figure 1: Where has investor sentiment been?

Source: MSCI, Datastream 31 July 2017. Image source: Shutterstock/CatalinPetolea

Figure 2: Time for active? The great correlation collapse



Source: Factset, IBES, Bernstein analysis , August 2017. Image source: Shutterstock

Figure 3: Is the equity rally sustainable?

balanced growth, but a return of fiscal policy should support the reflation trade and lead to a more balanced global economy based on fundamentals.

For the rally to be sustainable, though, we need corporate earnings to be delivered. For the past few years, given all the ample liquidity in the market that has lifted all asset prices (multiple expansion), prices have moved higher, but earnings have not yet followed suit. For first time in six years, 2017 performance is being driven by earnings growth. That makes it more sustainable, particularly in areas like Japan, emerging markets, and to an extent, the Eurozone. In fact, we believe 2017 is likely to be the first year of synchronised global profit growth since 2010.

The search for yield has been the greatest challenge for investors. Since 2008, investors have been preoccupied with capital preservation and negative correlation with risk. Until June 2016, this focus was rewarded with equity-style returns in many government bond markets. But in the past 12-18 months, many bonds are starting to deliver the returns implied by their real yields. We are now in a world where investors realise that to make a return you must accept cyclical economic exposure and equity volatility. In addition, those 'safe' assets that are now very expensive are, as a result, potentially overstretched.

Figure 5 shows the real yield between equities and bonds. Equities appear the more volatile asset class, but the level of yield on offer – around 7 per cent earnings yield – is compensating for taking on more risk. Valuations are not cheap, but there is wide dispersion in markets and the large spread between the expensive and very cheap companies provides opportunities for stockpickers to differentiate and to achieve a higher probability of return.

Investors need to be aware that risk assets change between what is risky and what is not, and that nothing is safe if you pay too much for it. The key is to be dynamic and to be flexible, focus on portfolio construction and take advantage of value opportunities when they arise.

These are times when active management can prove its worth, generally performing better in the face of change and reversal. Headwinds of high correlations and low dispersion are dissipating and there appear to be more drivers of return variance and macro and political uncertainties, which may push volatility to higher levels. The net effect could be a more normalised and favourable environment for skilled managers.

Figure 5: Valuation signals are clear

Source: Datastream, Federal Reserve Bank of New York, 31 July 2016

Figure 4: Where are the risks and opportunities?

Source: MSCI, Datastream 31 July Source: Source: Datastream, 31 August 2017. Image sources: By Michael Vadon - →This file has been extracted from another file: Donald Trump August 19, 2015.jpg, CC BY-SA 2.0, https://commons.wikimedia.org/w/index.php?curid=42609338. Janet Yellen: United States Federal Reserve - http://www.federalreserve.gov/aboutthefed/bios/board/yellen_janet_rdax_161x201.jpg, Public Domain, https://commons.wikimedia.org/w/index.php?curid=40726336. By Foreign and Commonwealth Office - Flickr, OGL, https://commons.wikimedia.org/w/index.php?curid=32138289

Written by Ritu Vohora, head of equities investment comms, M&G

In association with M&G Investments

Actively seeking returns

Sandra Haurant explores whether pension fund portfolios are seeking active investment strategies to achieve greater returns

The role of equities in UK pension funds has evolved over the past decade, and precisely what pension funds look for in their equity allocations has also changed. While in 2008, UK pensions portfolios consisted of some 58 per cent equities, in 2017 the proportion had plunged and stood at just 29 per cent, according to the *European Asset Allocation Survey*, published by Mercer in June 2017. Allocation to bonds, by comparison, has increased from 38 per cent in 2008 to 49 per cent in 2017.

The move away from equities has been part of a broader strategy, explains M&G investment director Ritu Vohora, and one that is perhaps in need of a rethink today. "One of the key trends we have seen is that, largely, pension schemes have been de-risking, particularly as they draw closer to reaching their longer-term funding objectives," Vohora says. "And a result of that de-risking, particularly given the macroeconomic background, is that we have seen allocations to equities falling, as investors have become much more risk averse."

Pension funds, then, have been increasing the spread of assets they hold within their portfolios, upping allocations not only in fixed-income investment, but also in a range of alternatives. Infrastructure, debt, private equity and a number of other asset classes have all found their ways into diversified portfolios. "Pension funds have been diversifying into a whole host of other asset classes," says J.P. Morgan Asset Management's head of UK institutional, Paul Farrell. "If you look over the past 10 years or so, equities really have been the ATM that has funded pension funds' diversification here in the UK. Diversification is a good thing and something we think that pension funds should increasingly focus on. That will get them through what will arguably be tough times ahead."

Passive versus active

Within the equities sphere, too, there has been a significant shift, with investors pulling away from active management in favour of passive, index-based funds. In overall investments within equity funds within Europe, passive funds have grown from 5 per cent of market share in 2000 to 26 per cent in 2017, according to Candriam Market Intelligence. "Passive is rapidly gaining market share, for several reasons," explains Candriam Investors Group's global head of financial engineering and client solutions, Kristof Woutters. "The first reason is cost. Passive is generally much cheaper. The second reason is that active funds, in the more efficient segments of equity, have difficulty beating the benchmarks in a consistent way." Another reason, says Vohora, is governance. "For passive funds, there is a more limited governance requirement, compared to active management, and so passive funds are much more straightforward to implement; clearly, for pension fund trustees it has been an easier option," she says. The appeal of passive investment is easy to understand, explains Vohora: "Quite simply, in an environment where you have economic growth and bond yields were falling, if you set your allocation and forgot about it, it would have worked quite well for you in the past eight years, which very much suited passive investing."

But the investment environment is changing, and what have been relatively reliable areas over the past decade no longer provide the same performance. With what Farrell calls "tough times" potentially around the corner, it perhaps makes sense to reconsider the way pension portfolios are constructed. After all, as Farrell says; "If you are just holding a market portfolio when there is a downturn, you are going to bear the full brunt. This is where you can find good quality active management helps. They can help you navigate the tough times that are to come in a more sensible way." And JLT Employee Benefits head of strategy, investment consulting, Jignesh Sheth agrees: "Passive equity can make the investor a passenger of the index, strapped in for the ride wherever that index goes," he says. "Active management gives the manager the opportunity to potentially protect on the downside, avoid overvalued elements of an index, and manage volatility – all of this is subject, of course, to the mandate of the fund manager."

Risky business

And it's not just passive versus active equity that requires a rethink. Some argue that, while fixed income was once seen as a lower-volatility, lower-risk area, today it is frequently offering yields that are low or indeed negative, making this a less appealing section of the market for pension funds.

What's more, market behaviour is making it increasingly important to engage the right skills in order to identify sectors, and indeed stocks, which are most likely to deliver the performance that is needed by pension funds, argues Vohora. "Until more recently, it has been a very difficult period for active managers, as fundamentals have been pushed to the sidelines, with stocks moving in a similar fashion and prices not reflecting underlying fundamentals. But stock correlations have been falling and are currently at their lowest point since 2008, which means investors are starting to focus much more on company fundamentals rather than macro news – and this is more conducive to active management," she says. Goldman Sachs Asset Management's head of the fundamental equity client portfolio management team in EMEA, Luke Barrs, agrees. Barrs argues that correlations are at "multi-years lows," and says: "We believe a skill-based active approach will become even more invaluable in the current market environment."

Weighing up costs

Of course, cost still comes into the equation, and many argue that in value-for-money terms, passive equity funds have earned their place in pension portfolios. But there, says Barrs: "We think there is a place for both active and passive investment in a pension portfolio, and believe a variety of factors should be considered when determining the optimal mix between active and passive investments." After all, he asserts, passive investing is not free and costs can vary enormously, while costs associated with actively-managed funds may be lower than investors assume.

"Active management also provides the ability to capture compelling structural growth opportunities that a passive approach could overlook," adds Barrs. "Active performance varies by market given the differences in the efficiency of underlying markets, with a higher historical outperformance rate in small-caps and equity markets outside the US. Investors should therefore consider the higher opportunity cost of foregoing alpha in some markets."

And while the upfront costs of passive investment may appear lower, but with investments that are likely to be held for the longer term, an active manager who successfully engineers even a small improvement on benchmark returns could be a significant boon for a pension fund, argues Vohora. "In a hypothetical example, for your average run-of-the-mill active fund where you might pay around 0.5 per cent more than you would pay for a passive fund, but you might get a superior return of about 1-2 per cent with a good active fund manager," she says. "And this is why active management matters, because you may be paying a little bit more, but if you have even a slight outperformance, and you compound that over 30 years – that can deliver a significant return, and is something that pension fund trustees need to think about."

Long-term commitment

After all, pension funds do, in general, have that long-term advantage, allowing them the chance to ride out the bumps along the way. And for that reason, a relationship with an active manager should be viewed as a long-term project, argues Vohora. "Active management is not a short-term trading strategy; active fund managers are in it for the long haul and because of the long-term nature of the savings commitment pensions have, it is important that they should believe in the fund manager they choose, and stick with them during inevitable rocky patches," she says. How long is long term is a matter for debate, but Vohora suggests at least between five and seven years. "They may have periods of volatility, but over the long term, if they are genuinely skilled fund managers, that compounding aspect should come into play, if they are given more time to see their strategies through."

Written by Sandra Haurant, a freelance journalist