SAVVY INVESTOR

Portfolio Positioning in a Shifting Environment

Analysing how allocators can get ahead of the next investment cycle

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Trust the Process: Playing the long game without losing sight of the short-term

David Brannon
Head of Research
Savvy Investor

The seismic changes that have impacted the global economy and investing landscape over recent years are well appraised. The sorts of shifts that may have taken decades to develop in the past have been on an accelerated trajectory, with asset allocators having to react to a domino effect of disturbance.

Such shocks have demanded tactical intervention, and yet we are continually reminded that investing is best done with a long-term perspective. It may be time for investors to take a step back and assess which changes will be permanent or persistent, and what that means for their objectives and liabilities.

Making these strategic calls will be crucial, and yet the world does not stand still. Investors must keep on top of the short-term as well – understanding where opportunities may lie and where protection should be sought.

In Wellington Management's paper 'Pivot Points: Five Portfolio Positioning Ideas For The New Market Regime', they consider the long-run implications for portfolio construction. They outline five key areas where the world may be very different in the coming years, and provide practical advice on how allocators can prepare.

In our 'Ask the Expert' interview, we focus more on the short- and mid-term. Looking through a global lens, we discuss the big topics on investors' minds right now – including the ramifications of China's reopening and the uncertain outlook for Europe.

Report Sponsor

About Wellington Management

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Wellington Management is a trusted adviser and strategic partner to investors worldwide. We offer comprehensive investment management capabilities that span nearly all segments of the global capital markets.

Our investment solutions, tailored to the unique return and risk objectives of clients in more than 60 countries, draw on a robust body of proprietary research and a collaborative culture that encourages independent thought and healthy debate. As a private partnership, we believe our ownership structure fosters a long-term view that aligns our perspectives with those of our clients.

Adam Berger, CFA
Head of Multi-Asset Strategy and Portfolio Manager
Wellington Management

Adam leads Wellington's team of multi-asset strategists globally. The team's objective is to help their clients achieve better investment outcomes by providing them with relevant research, analysis, and advice.

Adam focuses on total-return-oriented investors. He develops research from an allocator's perspective, advises clients and prospects on a range of investment policy and governance issues, and serves as the portfolio manager for bespoke multi-manager investment solutions.

Adam shares his latest thinking based on the extensive meetings he has with allocators in his quarterly Top of Mind webcast, as well as a wide range of articles and white papers.

Before joining Wellington, Adam held roles at AQR Capital Management and Goldman Sachs Asset Management. He earned his MBA from the University of Pennsylvania and his AB from Harvard College.

Where independence meets collaboration

At Wellington, our private partnership model enables independence, and our culture promotes global collaboration and respectful debate. We're free to take the long view, innovate, and invest when others pull back.

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Featured Paper from Wellington Management:

What the Next Market Regime Could Look Like – and What to Do About It

WELLINGTON MANAGEMENT | INSIGHTS | CAPABILITIES | SUSTAINABILITY | ABOUT US

ASSET ALLOCATION

TOP OF MIND

Pivot points: Five portfolio positioning ideas for the new market regime

Adam Berger, CFA, Multi-Asset Strategist

EXPERT

Click to view the full paper

Are we witnessing a transition to a new market regime? Wellington Management delves into five key areas of change and explores how allocators can prepare.

1. Higher inflation

While inflation may come down from the highs of 2022, it could stay above 2% or even 3% over the next decade. Among the likely sources of price pressure are the end of the China-led low-cost labour boom, the reversal of globalisation, the expanded role of fiscal spending that began during the pandemic, and underinvestment in commodity supplies in recent years.

How should allocators respond?

Direct investment in real assets – Commodities have historically had a high beta to inflation, making them a potentially potent hedge. Those who aren't comfortable investing directly in commodities might consider a diversified real asset portfolio.

Tilts to inflation-sensitive sectors – There may be opportunities to add to natural resource equities, as well as other inflation-sensitive equities such as listed infrastructure. In fixed income, inflation-linked bonds can provide the inflation pass-through some are looking for.

Risk management at the portfolio construction level – If there's higher inflation ahead, the equity/bond correlation may be quite different from recent years. Allocators should consider their portfolio's beta to inflation and whether it presents a risk that needs to be more actively managed.

> **"Allocators should consider their portfolio's beta to inflation and whether it presents a risk that needs to be more actively managed."**

2. Volatile business cycles

Since the mid-1990s, Wellington's experts estimate the global economy has spent about 75% of the time in a "Goldilocks" environment marked by positive growth and disinflation. But this hasn't always been the norm. There have been long periods when economic conditions shifted much more violently – especially when inflation was a front-burner concern – and a similar level of cyclical volatility is expected in the coming decade.

How should allocators respond?

Retain diversification but stress-test correlation assumptions – Stick with traditional sources of diversification, but monitor their effectiveness (i.e., the equity/bond correlation, as noted above).

Seek "stability" in equities – Consider "compounders" (equity

“...allocators might want to consider the ability of certain types of hedge funds, including macro and relative value funds, to act as a complement to fixed income.”

strategies focused on companies with high and stable free-cash-flow yield and the potential to grow modestly but steadily over time) and defensive global equity strategies.

Think opportunistically and tactically – Volatile conditions often create market dislocations that opportunistic allocators can exploit. Tactical asset allocation may also play a role, helping to tap into not just the big dislocations but also the smaller bumps along the way.

Consider hedging – This is about knowing your own risk tolerance and the point at which volatility would become uncomfortable and worth bearing some cost to hedge.

3. Higher interest rates

There are several reasons to think we’ve seen the end of a 40-year downward trend in interest rates. Inflation is the key risk, but higher fiscal spending is also a potential contributor.

How should allocators respond?

Find the right balance between risks and opportunities – Higher rates can certainly be a headwind for duration in portfolios and may lead investors to rethink exposure in some cases. But for those whose time horizon extends beyond near-term headwinds, higher rates may signal more compelling forward-looking returns to fixed income in coming years.

Seek fixed income complements – If higher interest rates mean that bonds are less reliable diversifiers, allocators might want to consider the ability of certain types of hedge funds, including macro and relative value funds, to act as a complement to fixed income.

4. Stability and value over innovation and growth

While it can be difficult to remember after a long stretch in which growth stocks have dominated, there is clear historical evidence of a growth/value cycle and value may be due for a leadership turn. What’s more, if we’re entering a regime in which investors are seeking stability (after spending the post-Global Financial Crisis period seeking growth), that would tend to favour value (as well as income).

"The sector mix in the value universe, which tends to include areas like energy and natural resources, may also be more attractive in an inflationary regime."

How should allocators respond?

Value – Value could provide a margin of safety in volatile markets by selling off less. The sector mix in the value universe, which tends to include areas like energy and natural resources, may also be more attractive in an inflationary regime.

Stability – Stability-focused strategies typically outperform when volatility is high and markets are struggling.

Income – The immediate cash flow from equity income strategies may be more attractive in an inflationary world, and companies that are able to grow their dividends over time may also provide an element of quality and stability.

Growth – There is no guarantee that value's time has come, which argues for maintaining growth exposure. But allocators may want to consider the potential for a different kind of growth in the next decade – it could be a steadier, self-financing, and less-speculative growth. Thematic growth strategies, which seek to capitalise on long-term opportunities due to structural changes in the world, may also be more attractive.

5. Active management's moment

Macro and geopolitical uncertainty, alongside heightened market volatility, could drive more dispersion within securities, creating opportunities for security selection in equities and credit.

How should allocators respond?

Macro hedge funds – Macro hedge funds can apply a variety of tools and strategies in an effort to take advantage of market dispersion and dislocations.

Growth fixed income – Over time, conditions may create attractive opportunities for strategies focused on higher-return areas of fixed income, like credit, high yield, and emerging market debt.

Emerging markets – The past decade did not translate into favourable results for emerging market equities, despite economic growth. Results could be much stronger in the coming decade.

Thematic investing – Thematic investing may let investors take advantage of long-term growth potential in a market consumed with near-term risks and volatility.

Click here to download the full paper

Ask the Expert Interview with Wellington Management:

Around the World in 2023: An asset allocator's view of opportunity and risk

The new market regime looks set to reveal itself over the coming years, but what of the here and now? We spoke to Wellington Management as they revealed what allocators are doing currently. In a fascinating discussion, we covered regional and market views, the role of fixed income, and how best to go about portfolio implementation in this environment.

Moderator
David Brannon
Head of Research
Savvy Investor

Adam Berger, CFA
Head of Multi-Asset Strategy and Portfolio Manager
Wellington Management

Amid questions about China's economic prospects and geopolitical issues, how are allocators thinking about their exposure to the country?

I certainly think China has been more intriguing for allocators recently, given attractive valuations and hopes for the economy in the wake of the reopening from zero-COVID policy — though in many cases geopolitics are giving them pause. It is certainly possible that geopolitical challenges could overshadow the positives, but I think the long-term case for investing in China remains largely intact. It may be even stronger after what I think could be called a lost decade for equity investors. Over the 10 years ended in May 2022, Chinese equities (CSI 300 Index) were up about 4% a year. Global equities were up about twice that. So, a very compelling decade for economic growth in China was not fully reflected in market results — although this is not necessarily surprising, as GDP growth and equity returns are not automatically correlated.

Looking ahead, I think China's stock market could catch up with the growth and deepening of the country's economy. On top of that, we continue to view the market as being attractive for alpha generation.

What are your views on emerging market (EM) allocations more broadly?

I think many allocators currently have a healthy dose of scepticism about emerging markets broadly, given years of disappointing market results. But I think there are reasons to believe that EM equity performance could be much more compelling in the decade ahead. For example, it's easy to forget after a challenging decade, but emerging markets have delivered stronger performance than developed markets over the longer term, albeit with more volatility. In addition, after the market declines in 2022, EM equity valuations remain cheap relative to their developed market counterparts.

I also think economic development remains a secular tailwind for many emerging markets, meaning that their economies are not just growing, but they are transforming and deepening in ways that should support high-quality, sustainable economic progress. For example, they are becoming competitive in a

"...the long-term case for investing in China remains largely intact. It may be even stronger after what I think could be called a lost decade for equity investors."

broader set of sectors and seeing growth in their all-important middle-class populations.

What have you seen in terms of how allocators are structuring their EM exposure?

Many allocators continue to grapple with this question. I don't believe in a one-size-fits-all approach to separating emerging from developed markets. Instead, I see merit in integrated approaches benchmarked to global equity indices (e.g., MSCI All Country World Index) and in disaggregated approaches with distinct allocations to developed market equities (e.g., MSCI World Index) and emerging market equities (e.g., MSCI Emerging Markets Index).

Likewise, I do not believe in a one-size-fits-all approach to a China equity allocation within a broader EM portfolio. In general, we have seen five approaches for incorporating Chinese equities, ranging from global equity and global EM allocations to country/regional allocations that include a dedicated China allocation, and each has its own advantages and disadvantages.

Views are fairly mixed on Europe. Where do you come down on the macro and market environment there?

We've seen the region move towards more fiscal flexibility and structural deficits. This is a clear positive given a long period of austerity in the last cycle that dampened demand. At the same time, more fiscal spending will feed into more persistent inflation and higher interest rates.

Longer term, inflation and higher nominal growth may be a partial solution to the region's debt and demographic challenges. Higher nominal growth is a positive for both economic and corporate earnings growth following a prolonged period of disinflation in the region. Overall, our long-term expected returns for European equities are significantly higher than those for the US, partly driven by Europe's valuation advantage.

"...our long-term expected returns for European equities are significantly higher than those for the US, partly driven by Europe's valuation advantage."

One key issue we're keeping an eye on is energy policy in Europe. The US Inflation Reduction Act (IRA) included incentives for investment in green technology in America, creating a potential competitiveness gap with Europe. The European Union is fashioning a response to the IRA to help maintain competitiveness, driven in part by several large European companies talking about moving production to the US.

We've talked a lot about equity markets. Where does fixed income fit in this new, more volatile world?

For allocators who reduced their fixed income exposure over the past five to 10 years, I believe the new higher-rate environment justifies adding some back. For those who maintained their exposure all along, I'm not sure there's a strong case yet for going above target. While we see higher expected returns for bonds ahead, that may be offset somewhat by a reduced fixed income diversification benefit. Why? If the central bank battle against inflation continues, we are likely to see more scenarios like 2022, when both stocks and bonds fell at the same time, undermining a key source of diversification.

But while bonds may not have a bigger role to play, they could have a different role. In a world where fixed

income may not be quite as diversifying, investors may want to lean into bonds as a return generator. This may include adding to “growth fixed income” — areas such as emerging market debt and high-yield bonds.

There’s been a lot of volatility and dispersion in currency markets recently. What are the asset allocation implications?

In 2022, there were many large moves in currencies — not just in the US dollar but in the Japanese yen, the Australian dollar, and the British pound, among others. We expect that higher currency volatility will remain in place for some time, spurred on by elevated levels of economic and asset price volatility, as well as divergence in countries’ policies, cycles, and inflation challenges. The impact of government intervention in currency markets also bears watching.

All of this suggests that currency risk within portfolios may be elevated relative to recent experience — perhaps even occasionally overwhelming the impact of fundamental views on companies. Volatility and dispersion could also create opportunities to generate alpha through active currency management. The bottom line is that it may be time for a fresh look at the impact of currency on portfolio construction.

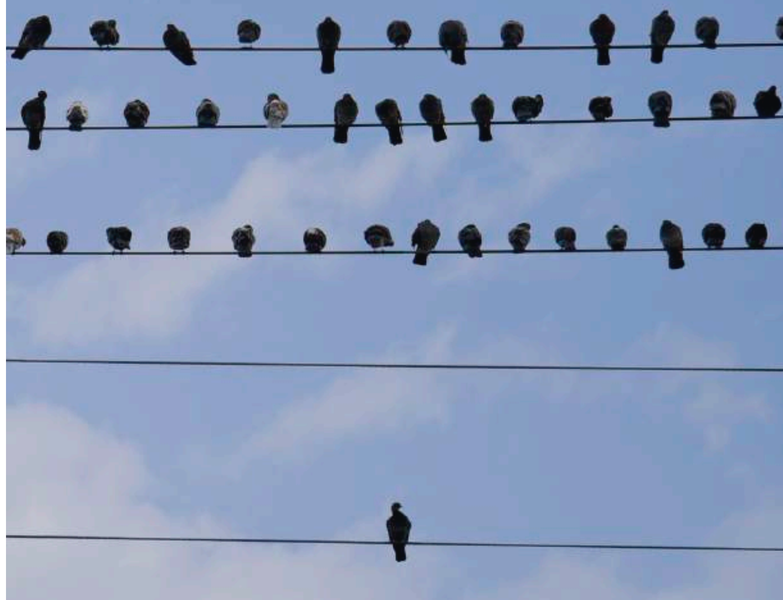
As a starting point, investors should be aware of the underlying currency exposures within their equity and fixed income allocations. Those insights will help sharpen the focus on specific currency approaches, ranging from structural approaches (e.g., fully hedge all currency exposure regardless of the market outlook) to active management (make currency exposure an active decision based on the outlook for the respective currency).

Of course, each approach brings with it certain trade-offs that need to be considered, including different levels of operational and investment complexity.

Globally speaking, there seems to be no shortage of investment ideas. Any final thoughts from an implementation standpoint?

It’s fair to say that since the global financial crisis, it has generally paid to be overweight US equities. But I think it’s time to consider a more diversified approach to regional exposures. It seems likely that we’ve entered an era of increased volatility, more frequent cycles, and structurally higher inflation. That, in turn, is likely to bring greater economic divergence between countries, with central banks and governments adopting a more individualised approach to policy rather than following the lead of US policy makers.

“The bottom line is that it may be time for a fresh look at the impact of currency on portfolio construction.”



I think this environment could make active management critical to an allocator’s long-term success. More uncertainty, both macro and geopolitical, should lead to greater dispersion across and within asset classes (e.g., at the regional and sector level). And higher market volatility may mean more crises (market or political), less liquidity, and more defaults and failures. These events could drive more dispersion within securities, creating opportunities for security selection in equities and credit. In short, I would expect a greater universe of opportunities for skilled active managers to identify winners and losers.

“In a world where fixed income may not be quite as diversifying, investors may want to lean into bonds as a return generator.”

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Our Top Pick of Asset Allocation Papers

Secular Outlook: The Aftershock Economy

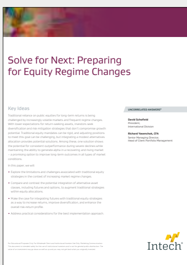
27/06/2023 | PIMCO | 12 pages

PIMCO shares their expectations for a period of heightened volatility with an array of potential aftershocks that may follow recent disruptions. They outline four themes they expect to resonate over the next five years.

The Road Ahead: Of Rocks And Hard Places

10/07/2023 | Man Group | 7 pages

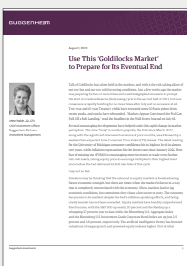
Man Group's models suggest US 60/40 might generate 5.5% a year over the next 10. If the average pension fund will need more like 9%, what's an investor to do? Read on for three simple solutions.



Solve for Next: Preparing for Equity Regime Changes

07/07/23 | Intech | 13 pages

With lower expectations for return-seeking assets, investors seek diversification and risk mitigation strategies that don't compromise growth potential. Could a modest alternatives allocation be the answer?



Use This 'Goldilocks Market' to Prepare for Its Eventual End

08/08/2023 | Guggenheim Partners | 5 pages

For the author, the market backdrop suggests that the current Goldilocks market, like those that came before, won't last. History shows that this calm before a storm is consistent with some of the worst market drawdowns.

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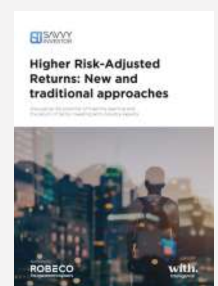

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