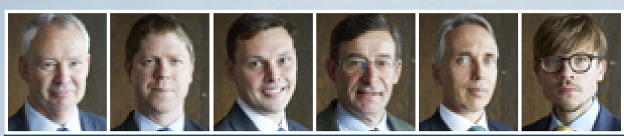
Global equities

Targeting real returns with worldwide growth



In conversation:

Lance Phillips | Richard Dell | William Parry | Giles Craven | Graham Mason | Sebastian Cheek

SEPTEMBER 2015 | PORTFOLIO INSTITUTIONAL ROUNDTABLE

Sebastian Cheek
deputy editor,
portfolio institutional

Lance Phillips
head of equities, Legal & General Investment Management

Graham Mason
head of investment – equity, multi-asset & retail fixed income, M&G

William Parry
investment consultant,
Buck Consultants

Richard Dell
principal,
Mercer

Giles Craven
chairman,
Waterways Pension Fund

Targeting real returns with worldwide growth

Equities have been a decent investment in recent years as a number of global stock markets have hit record highs. The current equity risk premium of around 4% remains attractive for institutional investors against most bonds, particularly with the UK 10-year government debt yield hovering around 2%.

And despite the longer term trend for reducing equity allocations, pension funds remain loyal to the asset class as a means of providing capital growth and income in their portfolios.

But today’s market environment poses questions about current allocations.

The outlook for interest rates, expected to increase in the near future on the back of strong US growth, is still not clear. A sharp spike could spell trouble for equities, particularly from investors with hedging triggers in place, whereas a gradual rise would perhaps be absorbed more easily.

Elsewhere, parts of the market believe equity valuations are becoming too hot to handle. If so, it might be wise to seek areas where valuations are not so swollen – for instance some areas of emerging markets which have seen a bit of a bounce back of late.

As always, whichever sector or geography investors choose, manager selection is paramount and often a truly active, unconstrained approach can best seek out the opportunities.

But active comes at a cost and investors are also seeking defensive equity strategies which provide some protection in falling markets, as well as looking to cheaper solutions in the form of exchange traded funds (ETFs) and smart beta.

This roundtable sees a panel of asset owners, managers and investment consultants discuss the global equity market, the role equities play in portfolios, including as part of multi-asset funds, and the impact of a rising rate environment on the asset class.

Sebastian Cheek
deputy editor, *portfolio institutional*

Lance Phillips

"For most of the outcomes people care about, you almost can't do it without equities. Trying to do cash-plus-five without equities is going to be really tricky."
Lance Phillips

There's a lot going on in global equities at the macro level at the moment, but what role do equities play in a portfolio today? Is the global equity risk premium still worth it?

Graham Mason: When we look at the equity risk premium, it's probably at 4% or more. Over time, that is worthwhile, so the real return on equities is about 6% on a sustained basis. Bonds, real term maybe 2%, and that's a big gap, 4% per year, over 10 years is 50% differential in return.

William Parry: A lot of actuaries start their discount rate calculations with bonds, then look at other assets that will do better and help erode any deficit. So equities have to be included in the asset allocation alongside bonds because they feed into the target or benchmark. Which is well worth bearing in mind from a pension scheme point of view.

Richard Dell: The overall return you get from equities is probably lower than it's been historically. The same is true for most asset classes, so it comes down to what your objectives are, and what your liabilities are, and how you're trying to match those.

As assets have increased, and schemes have the ability to take risk away, that means taking it out of equities and putting it into something which matches their liabilities. It's not risk-free, but from an actuarial point of view, it reduces the risk on their balance sheet.

Some clients are targeting some kind of real return and so equities are vital, as one of the few places to try and generate a real return in excess of 3, 4 or 5%.

Parry: Diversified growth funds were popular when equities performed poorly, but they have looked relatively weak as equities have had an excellent run in recent years. While I know people never try and


Graham Mason

"[Emerging markets] have underperformed for the past five years, so it may be time to up weight. We've seen the most interest and inflows in this area over the last six months." Graham Mason

judge things on past performance, there's always that anchoring bias to performance as a measurement metric that people have.

Because equities have been stronger over the last five or six years, people are more willing to stick with long-term equity allocations rather than move into diversified growth. They realise equity-like returns are harder and harder to achieve using anything other than equities.

Dell: There are some clients who are now looking at their equity exposure and the strong run means valuations are fairly high, compared to where they've been historically, and considering how, or whether it should or could be hedged. Or, alterntively introduce other growth style returns, that provide a slightly different diversification of return profile, which could be diversified growth funds.

Mason: I'm not sure valuations are high. The US is pretty fully priced on a long-term basis, but it's difficult to make that case across the rest of the world, whether Europe, a large part of emerging markets or North Asia, which are all looking reasonable.

Lance Phillips: It's very difficult to ever talk with confidence about the absolute value, but on a relative basis, equities are broadly where they are because of bonds. So equities look okay and in the context of absolute, it's less comfortable.

Dell: That's where people have concern, particularly if there are rate rises, that they want to consider their exit programme – is there a way they can hedge some of that risk?

Giles Craven: Well, they don't want to buy bonds.

Phillips: For most of the outcomes that people care about, you almost can't do it without equities. Trying to do cash plus five without equities is going to be really tricky. And while DB has seen steady buyouts and a move to bonds, DC is still predominantly equities. And the biggest moving part on a risk basis is equities, so the importance of equities within DC is as big as it has ever been.

How important is active management in this area?

Phillips: We're working on funds that produce income that grows by more than inflation. When you get down to trying to select securities that will fulfil that goal, that's a very active decision.

You wouldn't want to look at equities on average for that, but the specific equities which make sense in the context of the goals you are being asked to meet. That's very active and passive finds that difficult to achieve.

Mason: Within the markets in broad sectors and between markets, we've seen some immense dispersions and in order to take advantage of these dispersions, it needs an active manager. Some markets, like the US, are looking fairly fully priced, but having said that, sectors like financials would benefit from rising rates. But some markets in the emerging space in particular, are looking very cheap on traditional metrics. A passive strategy couldn't capture those divergences.

Dell: It's been quite a tough period for active management, and you've had a very good return on your equities, as well as other asset classes. If you assume that's not going to continue then alpha – the ability to generate an excess return above a modest equity risk premium – becomes even more important.

It's really challenging to say we know that now's a good time for active management when we can only look back and say that the last five years has been quite a challenge for active management. The next five years may not be like the last five years, which might make the case for active management being more important, particularly with the number of macro risks in the economy at the moment.

William Parry

Phillips: Active management provides you with the opportunity to sift out the things that are most suitable for the goals that you're now running towards, and global equities isn't just about running against a market cap weighted benchmark. Increasingly it's going to be less so.

Parry: Active management needs to become more innovative, to retain its attractiveness. It has become harder [to be more innovative], but the emergence of more predominantly equity funds, with objectives like inflation-plus, seems to resonate with trustees. It's not just the traditional market cap-weighted target plus two per cent outperformance, which has less appeal over a simple passive mandate.

Phillips: The goals we're used to in a DB client environment change quite a bit when you get into DC and that has opened up the opportunity to look at things in different ways. So we would see the growth opportunities around DC type investors, around DC type of goals, which are different than the traditional goals within DB.

But is determining just how 'active' an active manager is an issue for investors?

Dell: What has changed is the idea of how much risk you're taking against the benchmark, and making sure you're paying for true active management. We've always done this, but there's been more focus on absolute risk since 2008, and people have been more aware of the idea that tracking error risk, or active share, is not the same as absolute risk.

Craven: Manager selection is key. Our sponsor is anxious for us to keep the absolute risk up – it's not interested or worried about the balance sheet and and so equities and global equities have a very important role to play in what we do. Far more important than five years ago, frankly.

Has there been a trend towards more actively-managed mandates?

Mason: It's mixed, but the multi-asset and outcomes-based space is really where the growth has been. Many investors are handing asset allocation procedures over to the managers to give the manager the freedom not only within each of the pockets of equities or fixed income, but between the asset classes as well.

Craven: If you hand over the keys like that, the trustees really don't know what's going on.

Dell: It's very hard to assess how well somebody's doing in that department.

Mason: Yes, but it's the outcome that's really the test.

Phillips: We're an active business, within a large passive business and we feel we add value versus passive. The analysis of cash flows is easier than the analysis of ratings, and we feel we add some value on income. We don't do global equity plus two or three, as we don't feel we add enough in that area to justify active management.

Which areas of global equities are attractive at the moment?

Phillips: When you look within a multi-asset portfolio, if 60% of the asset allocation is towards equities, more than 80% of the risk is equities, so really, from a management perspective, it's an equity fund with some other things. We also regard multi-asset as a branch of global equities, rather than a separate group. If 80% of your class of your risk is global equities, global equity stock selection, we think that justifies the label as global equities.

Parry: Unconstrained has been a trend that's increased, so the core-type manager targeting plus one or plus two has all but disappeared.


Richard Dell

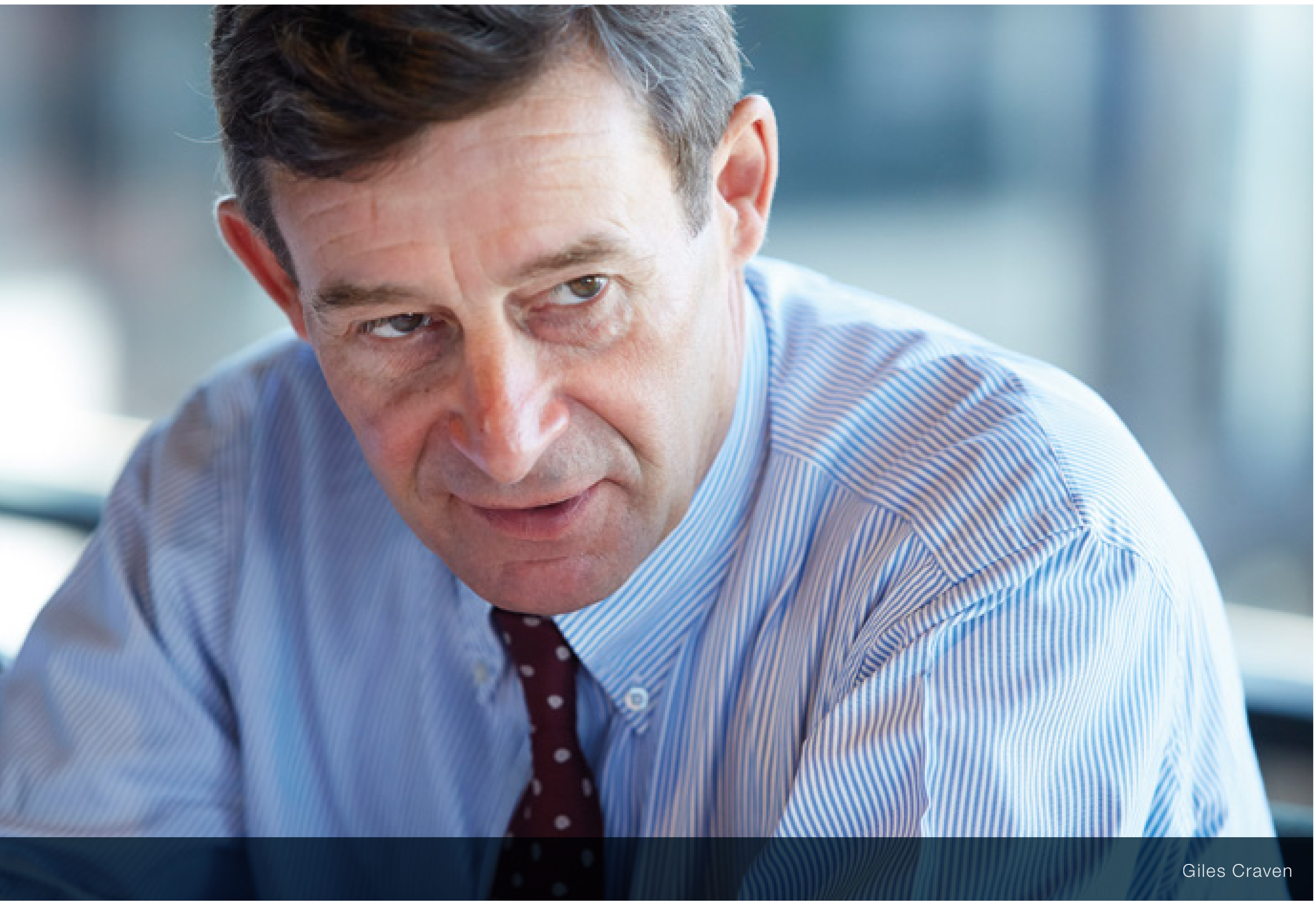
Dell: The most popular area we've seen has been the more defensive strategies, that will probably provide some protection in falling markets. They tend to have absolute return objectives, even though they're equity strategies and they're positioned as inflation-plus, or total return-style objective. This has been probably the most popular area of global equities we've seen in the last five years. At the other end, there's been a rise of the smart beta. It's hard to say exactly how much money has gone down that road, but some of the ETFs or pooled funds have got a lot of assets behind them.

This is drawing attention back to very low cost solutions, because many of these solutions are basic mechanical quant strategies. There's been a bit of a barbell – at the unconstrained expensive end, and the really low cost end.

Mason: We've seen most interest in emerging markets from the pension fund side. Emerging markets have under performed for the past five years, so it may be time to up weight. We've seen the most interest and inflows in this area over the last six months.

Dell: This year it feels like people have been slightly more concerned about some of the risks in emerging markets. With everything that happened in Russia last year, the valuation that took place in parts of the Chinese market, have cause people slight concerns, so I'm not sure how that's going to feed through into asset flows for the rest of the year.

Parry: I think a lot of the flows we've seen are going down the multi-asset route within emerging markets. I'd also echo Richard's views in terms of global equity mandates focusing more on smart beta, low vola-



Giles Craven

"There are tools for measuring equity risk, but for the other stuff that's in [multi-asset funds], the tools might not be quite as well developed. If you add up apples and pears you could end up with something very funny." Giles Craven

tility products. Generally speaking, as part of the focus on newer areas of exploration, pension scheme trustees and investment consultants are also very keen to engage fund managers on fees, as new areas for development often initially command higher fees due start-up research costs.

Dell: As we continue to move to DC, where fees become more important, low fees are more transparent. Both multi-asset solutions and the low cost equity solutions will have an increasing role to play in some of these DC solutions.

How well-diversified are these multi-asset funds when 80% of the risk is within equities?

Phillips: The ones we run are very bottom-up equities and bonds but others which are almost like macro hedge funds wouldn't be just equities. Ours are predominantly DC-orientated, as we think [equities and bonds] is likely to be where DC investors end up and, therefore, you do get a dominance of risk in equities.

Craven: There are some measurement issues on risk for the non-equity portion. You know there are tools for measuring equity risk, but for the other stuff that's in there, the tools may not be quite as well developed. So, if you add up apples and pears, in terms of risk measurement on the two asset classes, you could end up with something very funny.

Phillips: That's a good point. You have to start running against an outcome that is inflation-linked, rather than nominal, as you find that almost none of the risk systems work, because they think zero nominal risk

is zero risk, when it's not in a real context. We've had to completely re-write our risk systems, and it turns out that the nominal bonds represent quite a big risk, in the context of the goals that you're running after. So, be careful how you're measuring risk.

Mason: But is risk just volatility, or is it the risk of permanent capital loss? In the multi-asset space, this is much more our mindset. So how do you measure risk? How much is equities contributing to that?

Craven: So your 80% was possibly 80% of the volatility.

So how does the lay trustee make head or tail of that?

Phillips: The lay trustee will get some help, but it's the DC investor who doesn't.

Dell: That's the issue – DC investors are trying to do it largely on their own.

Is there consensus you need to be active in emerging market equities?

Mason: I think passive may struggle with governance in emerging markets. We believe investors need either active with a governance overlay, or passive with a governance overlay, but it's about someone assessing the governance of the stocks.

Dell: We've seen an increase in emerging market-focused products that are even more unconstrained than we've seen traditionally. They may focus on a particular area or target the emerging consumer, which is often the rationale for investing in emerging markets in the first place.

How would a rising rate environment affect global equities, and how should investors respond?

Mason: If it's an inflation shock, then it's a problem for global equities, but there are currently very few inflationary impulses in the world economy. Rates are more likely to rise because of economic growth picking up in the US and possibly feeding through into Europe and other parts, so the rate rise will be for a good reason. I think it will mean a bumpy ride for equities, but overall it must be largely discounted by now.

Dell: And you assume it won't be a sharp rise either, but a gentle, steady increase, which the market will

"An increasing number of trustees have triggers in place to increase hedging linked to rises in interest rates. You have to allocate from somewhere and a lot of the time equities are the obvious first port of call." William Parry

presumably absorb much more easily?

Mason: Yes. There is a risk of a 1994-type scenario, where there was initially a dip in the equity market, but then a stronger trend emerged for the next several years.

Phillips: From a stock picker's point of view, the answer is a case of some do well and some don't. We see that as one of the opportunities for the active investors. I would hesitate to look at them on average.

So that's a good selling point for active management then?

Phillips: Some of these macro things that may change offer an opportunity to active buyers, within a portfolio, that it would be harder to implement in passive.

Dell: One area where we have some concerns if rates increase is the low volatility equity space, where we've seen a number of managers invest in this systematic style, low volatility equities. A number of those tend to be sensitive to interest rate rises, particularly in the highly-geared space, of high yield or low volatility equities. You might see some of that kind of come off, if we have a rise in interest rates.

Parry: The other thing is the impact it could have on equity allocations. An increasing number of trustees have triggers in place to increase hedging allocations that are linked to rises in interest rates. If you're adding hedging you have to allocate from somewhere and a lot of the time equities are the obvious first port of call when de-risking.

Phillips: Right now, I'd be most fearful of the statements some people have come to rely on – that bonds perform pretty well, they tend to be uncorrelated with equities. That statement is behind lots of things having done quite well over the last few years, and I would worry that it doesn't hold true. If it doesn't hold true, then we've got a bit of a problem in some places.

Mason: Bonds have been in a bull market effectively, since the 1980s and it's a brave person who calls the end of a 35-year bull market. But with rates where they are now, it could be very different.

Phillips: It's not just the bull market, but the correlation as well.

Craven: I think an important issue on the question of rate rises is the amount of signalling that's going on. I think part of the 1994 problem was that the signalling system didn't work or was wrongly interpreted, and things happened that people didn't expect to happen. There's so much read in the tea leaves about what the Fed will do and I think they have perhaps got better at signalling.

Dell: Well, haven't they made a concerted commitment to be more transparent in signalling what they're going to do in the future, which is the idea, to make these issues less.

I do think Lance's point about active management being useful in these situations is very valid. In low vol, you don't necessarily have to forecast to add value through active management, but you can manage risk better through using it. If you're using straight passive, or even one of these smart beta style solutions, these risks are baked into the construct of the portfolio, and they're impossible to get rid of.

Craven: In our case, rising rates will be a trigger for looking at setting up hedging and while the scheme closed to new joiners, it's still accruing. That's what we've been training our trustees for – so when things change, we'll be in a position to do something without having to retrain them.

What might the effect of Greece's woes be on equity portfolios?

Phillips: If it is only domestic risk, it's not particularly important. The issue is whether it becomes non-domestic, but it doesn't look like it will have much contagion effect.

Dell: We see active managers trying make sure they manage the exposures in their portfolio, so that depending on a number of scenarios, their position to either benefit or not be too badly hit, and certainly not be caught off guard by an outcome that might impact their portfolio.

Mason: Our response to these situations is to remain bottom-up, putting it all together looking for cheap stocks, looking for alpha and controlling the risk. I wouldn't say regardless of the outcome, but you'd hope the alpha would come through.

Parry: When this story first flared up and people were getting quite concerned about the domino effect, there was real concern that it could have an impact on markets over the next one or two years. But the feeling is now that pretty much whatever happens in Greece is priced in – even the worst case scenario.

Giles Craven and Graham Mason

Mason: When the market focuses on these areas, it does provide opportunities to take advantage of market mispricing.

Which regions do you favour at the moment?

Phillips: We run a relatively concentrated 30-stock, bottom-up portfolios, and the geographies are secondary. The primary issue is where we see opportunities at individual company levels. Broadly, the geo-


Lance Phillips, Richard Dell and William Parry

"We see active managers allocating to Japan as the potential change in the governance mindset could create opportunities. The trouble is, there are risks with every opportunity so we have to wait and see." *Richard Dell*

graphic macro-economic issue of the EU is modest, rather than dominant in the portfolio. We're looking not to be dominated by how the macro works in various parts of the world, but be balanced across lots of moving things, lots of them company specific.

Mason: In our multi-asset funds we implement geographical overlays. We are overweight in Europe, given that on a cyclical basis the valuation is fair. North Asia's looking very interesting as well.

Dell: We see active managers allocating to Japan as the potential change in the governance mindset could create opportunities. The trouble is, there are risks with every opportunity. So we have to wait and see. Some active managers won't invest anything in Japan, because they see it as a bust economy, with huge levels of debt and fairly poor corporate governance.

Are you seeing any bubbles forming in equity markets?

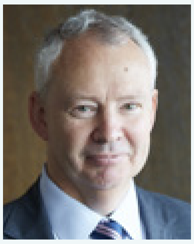
Phillips: I think valuations are high, but because of bonds as opposed to because of greater fool theory.

Mason: There are no obvious bubbles in equity.

Parry: The fact things are reaching very high levels doesn't necessarily make the market over-valued. The impetus put into the system, and the way that's materialising through strong underlying growth, particularly in America, seems to be what's supporting the increased level of the markets.

Why outcome-orientated investing matters for ‘real’ returns

By Lance Phillips, head of equities, Legal & General Investment Management



In the current market environment many asset allocators will be having lively discussions around where and whether to invest. Whilst much of the industry is structured in this way, first considering asset allocation and then selecting the manager or the index, the growth of outcome-oriented funds provide an alternative to conventional asset management which can enable greater speed and flexibility to optimise risk and return.

The choice of which assets to invest in is ultimately driven by the investment outcome you’re trying to achieve, which for most investors involves some prioritisation of capital preservation, capital growth, income generation and income growth. For those seeking capital growth, and / or income growth, equities almost certainly have to be a significant consideration. The question then becomes which equity indices or which managers, or stocks, to own. However, exposure to an equity fund benchmarked to an index provides the beta of that equity index, which may or may not help achieve the ultimate outcome you’re looking for. Indeed, in the current environment, where equity returns could arguably be lower than long-term averages and bond yields are already close to long-term lows, there is a higher risk that beta investments alone won’t be sufficient to deliver the required investment outcome.

Against this backdrop, the proposition of a growing number of outcome-oriented funds becomes more compelling: an explicit objective of delivering a real return over a specified (short-medium term) time horizon.

Tackling the ‘real’ challenge

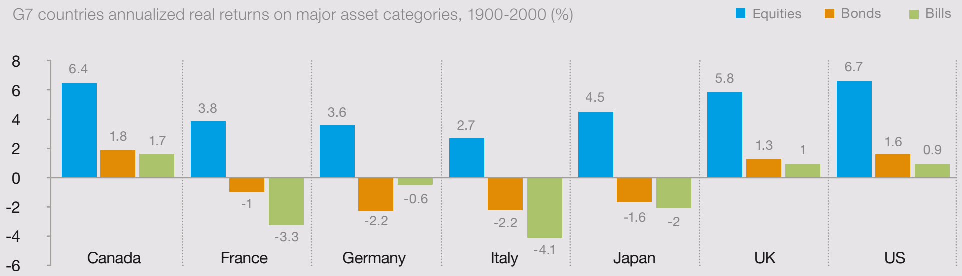
Whilst investment outcomes vary, the majority of investors aspire to real growth in their capital that can be used to either generate or fund income. This is most evident in pensions, but applies to many other institutional investors too, from charities and endowments to high net worth individuals and sovereign wealth funds; all of whom are looking to offset the harmful effect of inflation to maintain, and ideally grow, real spending power. This ‘real’ challenge seems particularly prescient today, given that real wages fell by 2.2% per annum between 2010 and 2013, the longest sustained period of falling real wages in the UK on record. For savers, and particularly retirees, historically low interest rates mean traditional forms of savings, like bank accounts and ISAs, struggle to generate enough interest to preserve real wealth.

How much is enough?

Back in 1970, £1 would have needed to earn 5.7% a year in nominal terms on average for the last 45 years to have the same buying power today. Looking back in time, the real returns from owning global equities averaged 5.8% through the 20th century (Dimson, Marsh, Staunton, 2011), whilst bonds averaged 1.2%. However, the recent track record of bonds has been stronger - real yields from government bonds have averaged 4.5% in the UK and 3.7% globally since 1980. Notably, bonds are unlikely to achieve such returns in the near term as real yields are currently zero for government bonds, while investment grade corporate bonds are returning around 1%. So what is a realistic return objective? Ultimately that depends upon the risk appetite, but assuming two thirds the risk of a typical equity index, we believe inflation plus 4% is realistic.

Taking a long term view, equities have consistently generated higher real returns than other asset classes.

G7 countries annualized real returns on major asset categories, 1900-2000 (%)



Source: Dimson, Marsh, Staunton, 2011

Taking this as a targeted outcome, three broad approaches are available: investing in a combination of single index or single benchmark funds, investing in a multi-index fund, or investing in an outcome-oriented fund. The immediate challenge with the first two options are that they'll deliver the returns of the index or the indices, which may or may not turn out to be a real return over a medium term time horizon (i.e. ~3 years). Even a high performing actively managed fund will only result in slightly more than the relative performance of the index, with no provisions made for a real return, as managers are incentivised on a relative rather than real basis. Furthermore, diversification of active managers may dilute any relative alpha, such that the aggregate returns remain close to the underlying beta of the index. All the more reason to consider an outcome-oriented approach.

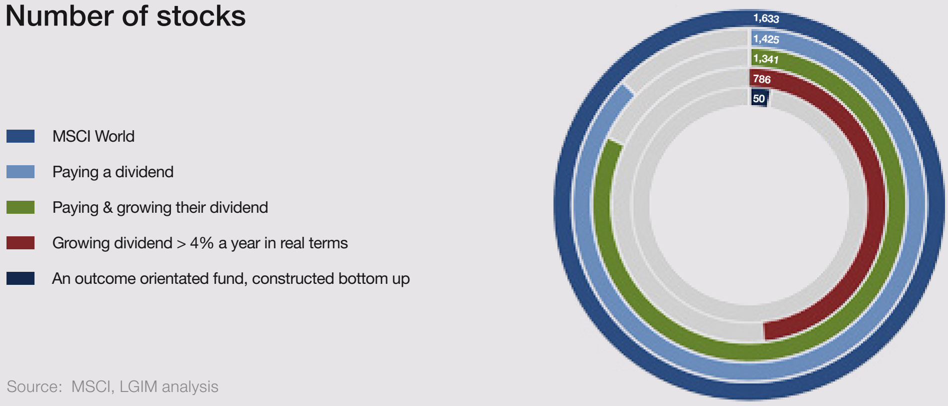
In its simplest form, the value of outcome orientation is being able to select the investments that are best able to deliver the result required (and explicitly not own investments that won't deliver the outcome required). To date, outcome-oriented funds have typically been associated with a top-down investment process. However, it is also possible to construct a diversified outcome-oriented fund using a bottom-up process. In this instance, we find it helpful to view equities as heterogeneous and adaptable to many different investment objectives, rather than as a homogenous asset class. Certain stocks are suited to capital preservation, others to income generation, others to income growth and many to supporting a capital goal. However, identifying the equities that best achieve the desired outcome requires active selection.

Outcome-orientated investing versus tradition

To take a simple example of an outcome of generating income with sustained annual growth of 4% above inflation, some exposure to equities are required to deliver income growth and support income generation. An index-based approach could hamper achieving this goal. For example, of 1,633 stocks in the MSCI World Index, almost half the index either pays no dividend at all or pays a dividend below

1.5%, rendering their income generation insufficient for the outcome required. Furthermore, only a third of the index has delivered real dividend growth of greater than 4% during the last three years. Accurately predicting which third of the index will do so over the next 3 years becomes harder still. An active approach that isolates individual stocks that generate sufficient yield and that have strong future prospects for growing both income and capital, is more likely to achieve the required outcome of real income growth.

Number of stocks



Source: MSCI, LGIM analysis

Importantly, the question the outcome-orientated fund manager is trying to answer is not do I own equities or bonds. Nor is it what proportion of equities and bonds should I own. Nor is it should I own European or North American equities, or be overweight banks or technology stocks, or tilt towards income, growth or value stocks. It is simply which equities and bonds should I own to deliver my targeted outcome.

This approach provides several specific advantages. First, and most importantly, it aligns the fund manager more directly with the objectives of the end investor, making investment decisions with a real return objective in mind. Second, it liberates the investment process from benchmark considerations, thereby concentrating resources on the investments that can best achieve the outcome. Third, it benefits from the flexibility of being able to adjust quickly to changing valuations to select whichever investments will best achieve the desired outcome. Instead of requiring a readjustment of the asset allocation mix, which may well involve a different decision maker and a longer decision making process, the manager can readjust rapidly. Such delegated decision making could also enable a more counter cyclical investment decision, further supporting the delivery of the required outcome.

The coming importance of active management

By Graham Mason, head of investment – equity, multi asset & retail fixed income, M&G

With hindsight March 2009 looks like it could have been a once in a lifetime chance to buy equities. Almost any equity. If you had bought US large cap quality dividend payers you'd be particularly happy but the reality for most DC and DB schemes is that most equity holdings have delivered pleasing absolute returns. Even with the impact of the Eurozone crisis, the Italian and French markets delivered excellent returns.

The reason for these stellar returns was twofold: valuation and regime. The deep pessimism which was the legacy of the financial crisis meant that you could pick up almost any growth asset with an almost unprecedented margin of safety. Where many had expected a low return world there has instead been a bonanza. Couple that with the ongoing structural decline in inflation and interest rates, it is easy to see why equities have delivered in excess of what pension funds should typically expect from their growth assets.

While choosing this period can rightly be called cherry picking, it is perhaps not entirely coincidental that the years since 2009 have also been associated with the rise in popularity of passive equity strategies, particularly for institutional investors.

Hindsight is a wonderful thing; it all seems so obvious now. But what about the prospects for equity returns from here? At least one of the forces behind the strong, and less differentiated, returns across equity markets is no longer so evident. Aggregate valuations today look far more in line with long term averages and, in the case of the US, are viewed by some as outright expensive. To identify genuine value therefore one has to be more selective.

More importantly, since the scope for a helpful valuation correction is reduced, earnings growth will have a far more important role to play in dictating equity returns. Identifying companies, sectors, or regions that can deliver increasing profits requires discretion and analysis, suggesting a greater role for the successful active manager.

As for the regime, there are two reasons to think that active management could mean the difference between ongoing capital growth and disappointment.

The first of these centres on the interest rate environment. Market commentary today reveals a disagreement between those who anticipate that interest rates in the Western world must revert to the levels that we experienced prior to the financial crisis and those who believe we have entered a new structural regime of low rates for the foreseeable future. Either of these scenarios suggests that understanding a company's earnings dynamic will be critical.

Should rates stay low, we may expect more defensive stocks to continue to outperform as they continue to be perceived as 'bond-proxies.' However, as we have seen in recent years this is predicated on these stocks continuing to deliver stable earnings streams. Any sign of disruption to this reliability in individual companies has been met harshly by the market, and with valuations on these types of company in particular looking stretched relative to history, there is arguably even less margin of error today.

On the other hand, in a 'rate normalisation' scenario it will be critical to identify those companies whose earnings delivery and valuations are resilient in the face of higher rates. This may be those 'unloved' areas of the market that simply haven't participated to the same extent in the re-rating that has come with ultra-low interest rates, or it could simply be those companies that are set to deliver the strongest earnings growth.

The second regime development to heighten the importance of active management is that of currencies. For the past twenty years or so, the world has enjoyed a period of general consensus in policy among major economies. The emphasis has been on inflation targeting and in the main this has meant that volatility in major currency pairs has been muted relative to what was seen in the 1970s and 80s. However, the signs are that this consensus is breaking in a meaningful way. As the US seemingly moves toward tighter policy, other areas of the world are trying far more unconventional policy measures to try to stimulate growth.

In Japan, this has been seen most clearly with Abenomics, causing the yen to devalue close to 40% versus the US dollar over the past four years. With signs that parts of Asia are slowing, and the ongoing attempts of the European Central Bank to aid European recovery, we could well be entering a period of large and rapid currency shifts far in excess of what many fund managers will have experienced in their working careers.

Such moves have complex effects on a company's earnings; profits can move, but so can costs; a weaker currency might stimulate an economy but could be inflationary, market share can change dramatically as can the cost of foreign financing. These forces will impact each individual company in an index differently, not to mention the influence on returns to a foreign investor (consider the hedged versus unhedged returns to UK investors in Japan for example). Active engagement at a company level is vital to understanding whether the market price is compensating you adequately for these risks and opportunities.

It would seem, therefore, that there are conditions in which active management is more important and some of those conditions may be coming to the fore in the period ahead. Unsurprisingly, a survey of the literature on the value of asset management in 2011 (*Active Management in Mostly Efficient Markets*, Jones and Wermers) suggested that the active asset manager was more likely to outperform the market in periods of uncertainty and greater return dispersion. However, it also revealed that it is vital to understand the characteristics of an active manager.

Active management is a zero sum game in aggregate, and selecting the winners remains a meaningful challenge for trustees. Knowing who will win this game is not easy, but the rewards for getting it right could well be significant enough to mean the difference between satisfactory and unsatisfactory outcomes. Most important is to have an understanding of whether the manager is equipped to deal with developments like those outlined above. Does the manager have a clear style bias or significant constraints? If so, one needs to understand under what conditions they will do well and not expect absolute return in all scenarios.

Similarly, the markets in which a manager operates can be critical. A common view is that Western developed markets tend to be more 'efficient' than their counterparts in the emerging world. The efficient markets hypothesis outlined a series of conditions for efficiency, such as a large number of investors or independent and universal news flow. However, these are issues of degree: we can say if a market is more or less efficient but cannot identify the point at which it is so efficient that active management is not worth the cost. The only way around this is to try to understand what the manager thinks their 'edge' is. What exactly is the inefficiency they believe that they can identify?

There will always be a role for active management in ensuring efficient and rational capital asset allocation by correcting mis-pricing, and as a result, add value to institutional investors' portfolios. Moreover, there will be periods when the gains from active management are more valuable than others. Identifying these periods ahead of time, and understanding which active managers will be able to successfully negotiate them remains an essential element of the trustees role.

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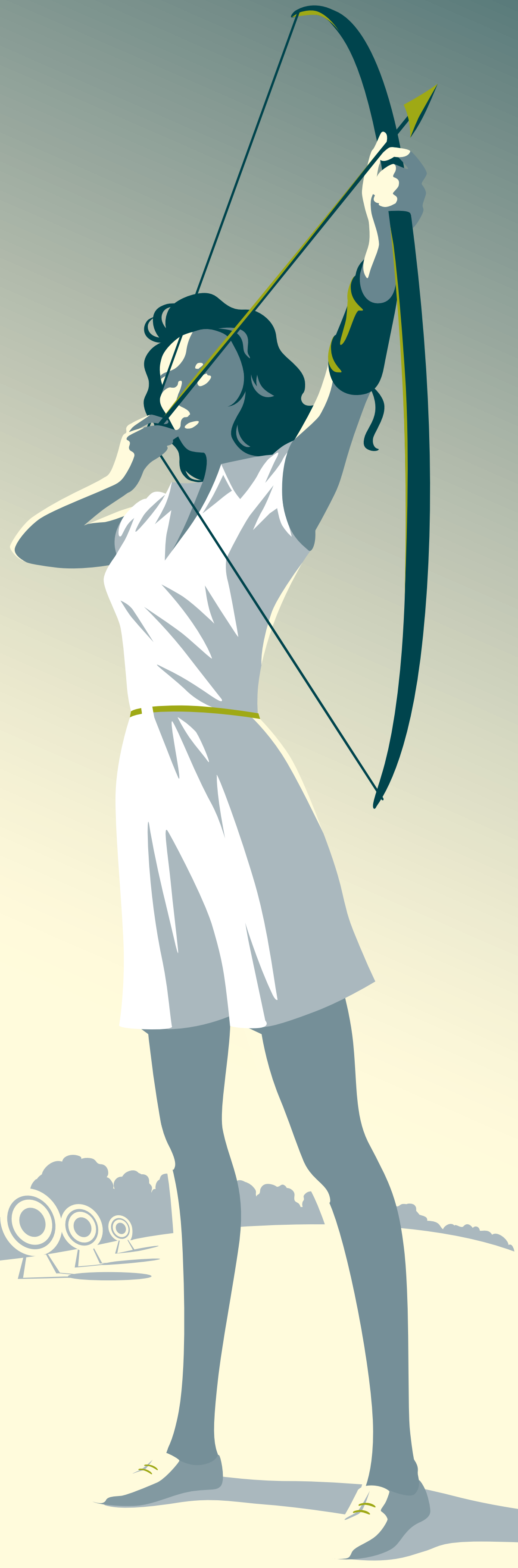

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Editor: Chris Panteli
Deputy editor: Sebastian Cheek
Contributing editor: Pádraig Floyd

Contact:
Sidra Sammi
Phone: +44 (0)20 7596 2875
E-mail: s.sammi@portfolio-verlag.com

Printer: Buxton Press
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Contact us to find out more:
Sidra Sammi
Phone: +44 (0)207 596 2875
E-mail: s.sammi@portfolio-verlag.com

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