Asset allocation challenges: 5 questions to ask in 2021

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1. Is there a point to owning bonds or cash anymore?

The role of defensive assets in a broader portfolio is probably the number one question on investors' minds at the moment. With cash rates around zero and longer term bond yields not much higher (and in some markets negative), it does beg the question: are bonds and cash helping achieve our objectives?

Some investors simply do not want to hold such low-yielding assets and others are fundamentally questioning if they will play the same 'defensive' role we have seen historically.

Our view is that cash is still king, as it relates to liquidity. There will always be a need for cash for the purposes of funding transactions and keeping powder dry in more volatile times, to deploy in riskier asset classes down the track.

Importantly cash should NOT drift in style into a riskier bucket such as credit, because this defeats its primary purpose of being accessible at a moment's notice.

Fixed income is more nuanced. Holding a long-term bond that offers a near-guaranteed low return in the period ahead will, on its own, fail to deliver on most portfolio return objectives. However, high quality government bonds are one of the only true 'safe havens' that investors can flock to during times of crisis.

Most traditional asset allocation analysis involves determining expected returns across asset classes and optimising their weights based on assumptions around how assets move relative to each other – i.e. correlation. One of the foundations within investments is that stocks and bonds move in opposite directions, particularly during periods of more extreme volatility. In other words, they have a negative correlation.

This relationship has been particularly helpful over the past three decades or so, for those invested in a simple balanced portfolio (e.g. 60% stocks, 40% bonds). Over this period, bonds provided ongoing and consistent income and typically performed well during equity market crashes such as the Tech Wreck in the early 2000s or the Global Financial Crisis in 2008. However, we are carefully watching this relationship in the period ahead, as there have been many examples over longer periods of time where stocks and bonds actually moved in concert with each other. This would be problematic when the chief premise of holding a mix of assets is to provide diversification and a smoother journey, allowing investors to avoid making the cardinal sin of investing: panic selling at the bottom.

So far, we continue to see diversification benefits from high quality fixed income assets and expect a low or negative correlation to hold, especially in periods of extreme volatility. Even in markets with negative yields such as Germany, Switzerland, and Japan, we have seen yields fall (and prices rise) for bonds during recent sharp equity sell-offs, such as in March 2020.

However, this relationship is something we are carefully focused on as we could easily see an environment where both fixed income and equities fall in tandem – in fact one may cause the other. For example, if yields suddenly rose or central banks had to aggressively hike interest rates to curb inflation, then this would likely hurt equities as well.

Unfortunately, there is very little 'income' in fixed income at the moment to compensate for the volatility in capital value. To retain the desirable defensive characteristics of high quality government bonds and generate some income, we favour a 'barbell' approach by owning longer dated government bond exposures (but less of it), and other higher yielding areas of fixed income such as corporate credit or emerging markets debt.

2. Will high liquidity continue to shape the markets?

The price of money, set by central banks around the world, is at an all-time low. Further, with 'conventional' monetary policy being more-or-less exhausted, many central banks including the RBA have embarked on 'unconventional' policy to ensure easy conditions, such as quantitative easing (i.e. asset purchases).

These efforts combined have made the system awash with liquidity – banks can lend huge amounts of money to corporates and individuals, at record low rates. Quality borrowers generally have little problem gaining access to credit. Further, this has crowded savers out of bank accounts and pushed investors into riskier and potentially higher yielding assets.

We would argue that central bank activity has been the single biggest driver of asset performance over the past decade – both due to the enormous amount of liquidity that has been generated and the potential for that liquidity to be taken away.

Since the COVID-19 crisis unfolded and central banks responded, we are now in an environment where central bankers have stated that easy monetary policy is here to stay for an extended period of time. Many investors are behaving as if this liquidity will last forever.

Although we will not underestimate the willingness and ability of central banks to creatively 'do more', we think they may be running out of monetary policy ammunition. While 2021 is unlikely to see a pullback in central bank interventions or a rise in cash rates, the pace of the global recovery may see markets rethink the 'liquidity forever' theme – and this in itself may spark investors to pause and revisit their assumptions regarding the high performing asset classes of 2020.

3. Can the good times in equities continue?

While it seems like equities have been on a raging bull run for a long time, let's not forget how much they dropped as the COVID crisis unfolded. At its low on 23 March 2020, the ASX 200 had fallen more than 36% from its peak on 20 Feb – an astounding move that was similar to other markets.

The recovery in equity markets has been highly uneven, with US tech companies leading the charge: over the past 12 months, the NASDAQ is up by nearly 46%; the ASX 200 slightly down (-2%), the European bourses marginally up by 1%, and the UK down by almost 7% (as at 24 Feb 2021)[1].

Further, there has been a large bifurcation between the winners and losers – both at the sector level and individual company level. While it's hard to avoid the constant 'equities reach all-time highs' headlines, it's important to note that it hasn't universally been 'good times' for equities.

In times like this, it's useful to remember the fundamentals of investing. Stocks should converge on their intrinsic value – in other words, they are only worth the present value of future earnings. The key variables then are:

1. future earnings or earnings growth, and
2. the discount rate.

The price paid for a stock really should be anchored to the intrinsic value of a company, however, equity markets value companies based on multiples of current earnings. Multiples for equities ebb and flow depending on a wide range of factors. Generally speaking, though, when multiples are higher than average, stocks are seen to be 'overvalued' and when lower than average are seen to be 'undervalued'.

The key point here, however, is that we don't know for sure, in advance, whether a single stock or a broad market index is cheap or expensive, because we don't know for sure what earnings are going to do. If earnings growth increases more than expectations, then a high multiple should normalise (the 'E' in a Price/Earnings ratio increases).

In the absence of strong earnings growth to justify high multiples, the current high equity returns may become lacklustre in the period ahead.

As it relates to the discount rate, it's clear that the risk-free rate in most developed markets has fallen to all-time or near all-time lows, which means that future earnings and dividends for companies can be discounted at lower rates, thereby boosting the current value. Further, this low rate has made it easier for companies to issue and refinance debt, often with all-time low interest payments.

In other words, companies can fund their operations and longer term projects very cheaply and increase leverage, while retaining their ability to pay off debt. So, as it relates to the falling and low discount rate, this has been a strong positive driver of valuations and justifies some of the multiple expansion. However, given the rock-bottom level of cash rates and bond yields, we don't anticipate this trend to continue.

In fact, any future increase in these rates should have the opposite effect, which could correct equity prices rapidly if the market begins pricing in this outcome.

One of the most influential investors of all time, Ben Graham, famously said, "In the short run, the market is a voting machine but in the long run it is a weighing machine"[2]. There are many equity market participants out there focused on short term profits and others simply don't know what else to do with their money. The shenanigans seen recently in Gamestop and other Reddit-fuelled retail darlings certainly feels like late-cycle bubbly market behaviour.

So, there is no doubt the technical trend is strongly in favour of equity markets – there's more voting than weighing going on at the moment, in our view. Ultimately, we think fundamentals and valuations matter and that is the basis on which we are positioning portfolios.

4. Is inflation off the agenda for the foreseeable future?

If there is a near-unanimous consensus macro view out there, it would be that inflation will be low for an extended period of time. Given the conditions for high inflation don't currently appear to be present, we would agree.

Central banks kept monetary policy extraordinarily loose over the past decade and have printed money at a record pace, but were still unable to generate much, if any, inflation in developed markets. The current global recession makes the prospect of inflation less likely than deflation at the moment.

However, this is precisely the sort of asymmetric risk that we look out for when managing a multi-asset portfolio, particular to a 'real' objective. A sudden and unexpected inflation shock would likely be painful for both fixed income and risk assets, simultaneously.

While predicting future inflation has always been extremely difficult, a couple of changes have occurred recently that further complicate things. First, one of the staples of modern economic theory – and a key page out of a central banker's playbook - has been the concept of the "Phillips curve".

In essence, this captures the trade-off between inflation and unemployment. Logically, when an economy reaches capacity and has low unemployment, that typically leads to higher inflation. Conversely, when unemployment falls and extra slack builds up in an economy, then that leads to lower inflation.

However, in recent years, unemployment rates have continued to fall around the developed world, particularly in the US, while inflation has hardly budged. It seems like the Phillips Curve is broken. There are many theories why this is the case but it means that one of the more reliable indicators of future inflation (i.e. low unemployment) may not be particularly useful for predicting inflation going forward.

The other big change relates to central bank activity and how responsive they may (or may not) be to a pick-up in inflation. Again, typically central bankers are obsessed with fostering price stability – it's usually the main aspect of their mandate. Therefore, at the first sign of a potential rise in inflation above target, we have historically seen monetary policy tighten to keep a lid on things – this has been the playbook since inflation got somewhat out of control in the late 1970s and early 1980s.

However, recent guidance from the world's central bankers – including the RBA – has been that cash rates will remain anchored at or near zero for an extended period of time. Importantly, central bankers at the Federal Reserve in the US have indicated that they don't plan on responding to inflation for some time once it hits their 2% target in an attempt to offset periods of low inflation.

This fairly material shift in approach means central banks are likely to let economies run a bit hot before tightening policy through traditional (rate rises) or unconventional (quantitative easing) means. Similarly, in Australia, the central bank has said that wages growth would need to reach mining-boom-era levels to give a serious push to inflation, and that seems unlikely based on recent years' growth.

We are cautious on this approach as it is unclear if a policy mistake can be rectified fast enough, should we enter a period of higher and potentially out-of-control inflation.

5. Will active management come to the fore?

The active vs. passive management debate has been raging for decades and often elicits an emotional response amongst each camp's evangelists. Most research referenced on this topic focuses on highly efficient and heavily researched or traded segments such as US large cap equities, with other areas like frontier market equities or high yield corporate credit largely ignored.

Further, like many things in investing, there is typically a cycle within active management when more active managers outperform for longer periods of time – this has often been seen in periods of higher volatility and extended bear markets. This makes sense, because dispersion between companies, sectors, countries, and asset classes increases during those times. Picking winners and losers is easier when there are more winners and losers!

Dogma aside, our Multi-Asset Solutions team has several principles with respect to active management, which are used in the management of portfolios and may be useful for investors who operate within shades of grey.

First, we like to point out that even if an investor uses all passively managed building blocks, their overall asset allocation decision is very much an active one. And the research is clear on this point: asset allocation is the dominant driver of overall portfolio outcomes. Therefore, getting your asset allocation right is of critical importance. So, why is so much time spent on picking individual stocks or individual fund managers?

One pejorative label put on active managers is that of a 'closet indexer', meaning that a manager claims to be active but the data indicates very little volatility (or tracking error) relative to the overall market. You are paying for active management but are essentially getting passive returns.

While this may be true in some areas, we think about an alternative concept of a 'closet active manager', which is an investor who believes they are investing passively, but completely ignore the significant active asset allocation calls constantly being made. Many are accidental active fund managers!

We believe you can have both active and passive approaches in a broader portfolio. When building an objective-based multi-asset portfolio, our team typically passively replicates most of the large market exposures in a portfolio. This keeps down transaction costs, especially when dynamically increasing or decreasing exposures. These exposures focus on the largest and most liquid markets such as global developed market equities or global government bonds.

Then, this passive exposure is buttressed with selective active sleeves in areas that have historically been much less efficient, like small cap Australian equities or areas where it is impractical to fully replicate a market, and high levels of diversification are desired, such as global investment grade credit.

Finally, costs matter - which is why we build custom baskets of exposures instead of constantly trading in and out of pooled vehicles, which carry fairly large bid-offer costs on entry and exit.

In Summary

As it relates to building a multi-asset portfolio, it is highly unlikely that a static approach – particularly in the defensive side of the portfolio – will deliver on many investors' long term return objectives. For example, if you hold a traditional balanced portfolio with 40% or 50% allocated to bonds and cash, this defensive component will unlikely keep up with inflation in the period ahead based on the yields on offer. And to deliver on an objective such as CPI +3%, 4%, 5% over longer timeframes, this means that growth asset returns will need to far exceed historical averages in an environment where many (including us) believe valuations are already somewhat stretched. Taking the average market return will only get you so far. Therefore, we believe the only way to deliver on many portfolio objectives is to 1) be dynamic in your asset allocation; and 2) add uncorrelated non-market directional strategies to a portfolio (i.e. alpha).

1. Source: Bloomberg, Feb 2021

2. Ben Graham, Security Analysis, 1934