

# MyConsultant

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Steven heads Asset Consulting for Implemented Consulting clients, joining JANA from MLC Implemented Consulting in March 2012. Steven and his team are responsible for advising a range of institutional clients including insurance companies, endowments, not-for-profits and corporate superannuation funds with both defined benefit and accumulation components.

Steven is a qualified actuary and has 20 years' experience in the industry across asset consulting, multi-manager funds management and investment research. Steven commenced his career in South Africa where he was Director of Investment Consulting at Fifth Quadrant Actuaries & Consultants. He has held several senior positions in the investment industry in Australia including Head of Investment Solutions at St George Bank with responsibility for oversight of multi-manager portfolios with \$7bn in assets under management, Senior Consultant at Intech Asset Consulting, and Senior Portfolio Specialist at MIR Investment Management.

Steven has a MBusSc majoring in Economics and Statistics and is a Fellow of the Faculty of Actuaries.



## Is it time to consider de-risking?

Many Investment Committee meetings have lately turned their attention to the question of whether now is an opportune time to be de-risking investment portfolios. We recently addressed this question at our Collaborate Research Luncheons in Sydney and Melbourne, and in this article we provide a summary of our views on this question. We also provide some thoughts on how to navigate portfolios through this challenging market environment.

In the September 2013 edition of MyConsultant, we highlighted that forward-looking return prospects across most asset classes were materially lower than long-term historical levels and that the current low real interest rate environment was presenting a challenging environment for asset allocation decisions, a challenge we likened to "investing in the desert". The horizon now looks more like one of "storm clouds brewing", with increased risks and some ominous signs emerging, yet at the same time, some positive signs or "rays of sunlight" can also be seen on the distant horizon, much like the image below.

### Arguments for and against de-risking

It has been well documented that the recent unprecedented monetary accommodation by central banks across the US, UK, Japan, and Europe has supported a strong rally across most 'risk' assets such as equities, sub-investment grade credit and increasingly, property and infrastructure. With short term interest rates reduced to close to zero across many developed markets and yields on longer dated bonds suppressed to historic lows by central bank bond purchases, investors have been coerced into higher yielding, riskier assets.



Source: Asia Travel Stories

This has manifested in some interesting and in some cases worrying outcomes across equity and bond markets:

- The US equity market (S&P500) has reached record highs and is up over 190% since March 2009;
- Credit spreads on investment grade credit have narrowed from over 2.5% in 2012 to 1.1% currently, levels last seen prior to the Global Financial Crisis;
- Credit spreads on high yield bonds have also narrowed to levels last seen prior to the Global Financial Crisis, and have moved from over 7% in 2012 to 3.9% currently;
- Yields on 'peripheral' European Government bonds have fallen to historic lows - Spanish 10 year Government bonds are now trading at 2.4%, well below those of AAA rated Australian Government bonds;
- Yields on German Government bonds have recently fallen below 1% for the first time ever.

At the same time, volatility has fallen to very low levels, as highlighted in the chart below showing implied volatility on the S&P500 Index (as measured by the VIX). Interestingly, this decline in volatility has not been confined to equity markets, but has been evident across equity, fixed interest and currency markets. The recent small spike in volatility following escalated geopolitical tensions has so far been only a minor blip on this low volatility backdrop. While low levels of volatility are not predictive of market corrections, it does suggest that there are likely to be increasing levels of complacency creeping into investor behaviour.

Some signs of investor complacency and potential warning signs of heightened risks have been emerging of late, including:

- Issuance of 'covenant light' loans (with easier lending terms for borrowers) has risen to record highs;
- Margin debt levels have risen to record highs in the US;
- Dispersion of analysts' earnings forecasts has narrowed to very low levels, reflecting high levels of crowding of views;
- Merger & acquisition activity has very recently increased to levels typical of a late stage in the market cycle.

Much of this behaviour in markets is being fuelled by ultra-low cash rates engineered by ultra-loose central bank monetary policy. As we approach the end of the US Federal Reserve's quantitative easing programme, attention is increasingly turning to the timing and magnitude of likely US interest rate hikes and what impact the normalisation of monetary policy is likely to have on markets. It is difficult to predict how markets will respond to such normalisation as members of the US Federal Reserve have themselves admitted that "no central bank - not, at least, the Federal Reserve - has ever been on this cruise before", and "We are sailing deeper into uncharted waters" (Richard Fisher, Chair of the Federal Reserve Bank of Dallas, September 2012). In these unprecedented and uncertain policy driven environments, having a firm eye on valuations provides an important ballast in making asset allocation decisions.

## So, what do valuations say? Are markets expensive?

The answer to this question depends on which measures of valuation you choose to look at. Measures of Cyclically Adjusted Price-Earnings multiples, known as "CAPE", show the US market to be expensive when compared to long term historic averages, as highlighted in the chart on the following page. In addition, US corporate profit margins are close to record highs, and some of the cyclical factors that have led to such high profit margins are likely to recede over the next decade which will put further pressure on valuations.

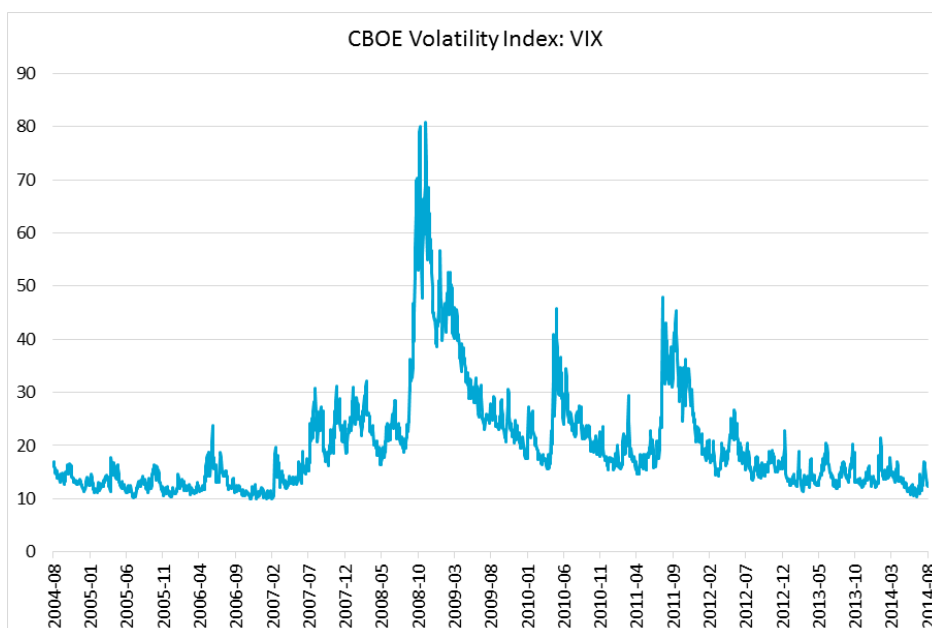
Nevertheless, there are some who believe that equity markets are not overvalued. US Federal Reserve Chair, Janet Yellen, recently commented that, "in general price equity ratios and other measures are not outside of historical norms"; however, she did later go on to say that, "valuation metrics in some sectors do appear substantially stretched, particularly those for smaller firms in the social media and biotechnology industries". When looking at valuations through the lens of one year forward Price-Earnings multiples, markets do not look expensive.

In addition, markets are being supported by improving economic fundamentals. Economic recovery is gaining traction, particularly in the US, UK and to some extent in Europe and Japan. The corporate sector generally is in a strong financial condition with low leverage and high cash balances on balance sheets, while manufacturing activity is gradually improving in a co-ordinated fashion across major developed economies. Furthermore, any weakness in growth is likely to be supported by continued central bank intervention, which will likely provide further support for equity markets.

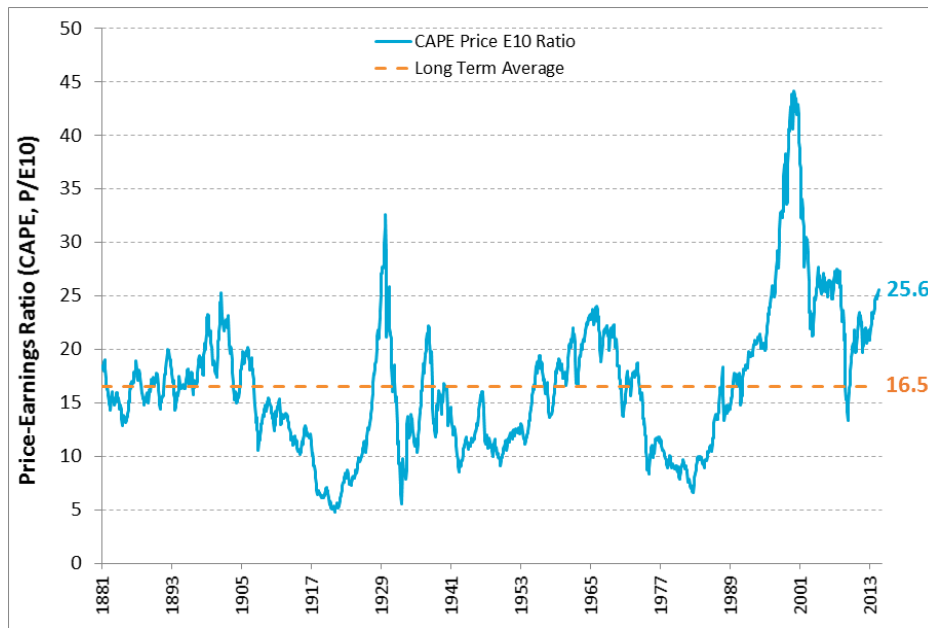
There are thus strong arguments that this rally might continue for some time, and many believe that we are only in the early stages of a speculative boom and that conditions today are more akin to 2005 rather than to 2007.

## So, what to do?

On balance, we believe that a slight reduction in risk may be warranted for some client portfolios. Our clients' portfolios have benefited from being at full weight in 'risk' assets over the past few years. Over the recent past, we have recommended that clients begin to gradually reduce the extent of the weighting to 'risk' assets and believe that now is an opportune time to move to a slight underweight in equities, while at the same time maintaining full weightings to other 'growth' assets such as property and infrastructure.



Source: Federal Reserve Bank of St Louis



Source: [www.econ.yale.edu](http://www.econ.yale.edu)

However, the decision on whether or not to de-risk, and if so how to de-risk, will be dependent upon each investor's particular and unique circumstances, investment objectives, risk appetite and where each investor is in their investment journey.

In assessing and determining how to respond to the current environment we would proffer the following guiding principles:

## 1. Be clear on your investment objectives

How important is peer group performance to you? How sensitive are you to short term negative returns? Do you have annual investment earnings needs? Do you have specific liability, regulatory or funding requirements?

As a general rule, the more sensitive you are to short term negative returns, the stronger the case is to de-risk.

## 2. Be clear on what stage of your journey you are on

What is your current 'growth' asset exposure and how has this changed over the recent years? Is your portfolio on a particular path of increasing or reducing the level of risk?

Some investors with low current exposures to 'growth' assets might consider themselves already de-risked, but it is still important to check what your expectations are with regards to investment returns and whether you can tolerate the range of possible downside outcomes that is inherent in having some, albeit small, allocations to 'growth' assets.

## 3. Understand the strengths and limitations of your decision making process

How quickly can you respond to changing conditions?

For some investors, annual or bi-annual meetings might make it difficult to implement asset allocation decisions quickly. Hanging on for further gains in markets in the hope that you can de-risk later could be a dangerous game and leave one exposed should markets fall prior to the next investment committee or board meeting.

## Conclusion

Higher risk assets have enjoyed a strong run over the past five years and investors have enjoyed healthy positive returns from their diversified portfolios. The arguments for "locking in gains" and de-risking portfolios are appealing, however, there are strong reasons why this rally in risk assets might continue for some time, not least of which is the continued support of central bank intervention and improving global economic fundamentals. While equity markets do not appear to be in "bubble" territory, we do believe that valuations have moved somewhat ahead of fundamentals and as such the margin for safety in equities is now much lower, and the potential downside risks are now higher.

The decision to de-risk needs to be considered in the context of each investor's unique circumstances, risk appetite and investment objectives. For investors with greater sensitivity to short term negative returns we would suggest consideration be given to some level of de-risking. In addition, for many liability driven portfolios, improved solvency levels provide a further strong argument for de-risking.

We would caution that it is at times when markets are buoyant and complacency high that markets are often most vulnerable, and it is timely to remember the wise words of Warren Buffet, "Be fearful when others are greedy and greedy when others are fearful".

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