DISEASE OF DOUBT

Investors Must Combat Doubt and Confirm Convictions with Portfolio Positionings

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Doubt can be a pesky thing. Once you’re infected, it’s hard to shake off. It makes you second guess what you thought you were sure of, it’s contagious, and there’s no vaccine for it.

In investing, doubt takes hold whenever a portfolio position has not played out as expected. For investors, the past few years have naturally allowed some doubt to creep in. After watching U.S. equities repeatedly outshine global markets and witnessing the losses racked up by emerging markets and real assets, it is not surprising that investors are questioning their allocations and philosophies.

Over the past several years, progressive investors embraced approaches that departed from average allocations. These range from a risk-balanced structure with lower allocations to traditional long-only equity (generally globalized), a belief in emerging markets, exposure to real assets for long-term inflation protection, and unconstrained strategies.

This collective approach strongly outperformed ahead of the financial crisis and during the early years of the recovery. But recently it has fallen short. Central bank policy shifted investors out on the risk curve, leading to outperformance in higher-risk assets (equities) and assets domiciled in countries most proactive in monetary stimulation (United States). Concentration, not diversification, has been more favorable. Emerging markets have disappointed, unconstrained strategies have posted lackluster results, and inflation remains subdued. Faced with these disappointments, it is natural for investors to become doubtful about the validity of these approaches.

To be sure, this skepticism is appropriate. In fact, such doubt is helpful because it promotes learning. Learning fuels growth and through growth, horizons expand and new opportunities arise, which leads to better investment decisions.

In many ways, such doubt must be managed every day and with each market or geopolitical event. Certainly, recent election results in the United States, riding the crest of the past summer’s Brexit vote and the global wave of populism, sent a new tremor of doubt through diversified investors’ dispositions. A new U.S. president will bring policy changes with global implications, but investors would do well to dig deeper than the headlines to understand the implications for global portfolios.

In fact, globally diversified portfolios should continue to be well-positioned to capitalize on opportunities. Certain emerging markets may suffer with a shift in global trade, but policies targeting more-developed growth (and the potential for resulting inflation) would benefit many emerging markets as well as real assets. Further, managers of unconstrained strategies can combine scrupulous interpretation of these policies and their global implications, and weave them together with comprehension of global political, fiscal, and monetary trends, to skillfully navigate an increasingly complex investment landscape.

This article encourages investors to combat the disease of doubt and confirm their convictions with their portfolio positionings.

Better Balance: A Structural Advantage

A risk-based allocation, including comprehensive definitions of risk and recognition that different assets respond differently to core economic drivers, is critical to constructing long-term portfolios. The fact that the recent market environment has not validated exposure to most assets other than U.S. equities does not diminish this conviction.

Despite a tendency to extrapolate recent performance into the future, periods of significant outperformance weaken the probability of a rally continuing because fundamentals may not keep pace with expectations. These periods—where only a narrow sliver of assets outperform—may disappoint diversified investors. But they also pave the way for future benefits of diversification. To this end, it is vital that investors today maintain, rather than abandon, diversification.

Investors should employ a framework focused on long-term perspectives, recognizing there will be periods of underperformance and outperformance. Periods of underperformance will occur but long-term superior results are likely over time (see figure 1).

A more risk-balanced and diversified portfolio using risk parity shows fairly modest annual outperformance, edging out a
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Although recent currency depreciation has been painful for investors, lower currency values set the stage for improved competitiveness in manufacturing and exports. Emerging currencies have moved from being modestly overvalued to undervalued in the past four years. Undervalued currencies provide a potential double tailwind: Unhedged investors may benefit directly through appreciation and indirectly through better economic growth dynamics, which may lead to renewed capital inflows.

Currency appreciation is helpful, but core economic building blocks are the underpinnings of asset class returns over the long term. All asset class returns are driven by income and change in price. For equity investors, income is dividend yield. Change in price will occur due to earnings growth and changes in valuation. For emerging equities, recent performance has been driven by earnings contraction. This compression sets a strong foundation for forward returns.

Figure 2 compares forward five-year performance with trailing five-year earnings growth. Historical periods of earnings contraction have set the stage for future earnings growth and, thus, strong returns. A fundamentals-based building-block approach to setting forward-looking expectations would suggest a high single-digit return expectation for emerging market equities (3-percent dividend yield + 5–7-percent nominal earnings growth) without any adjustment for valuations. This relationship between trailing earnings growth and future returns—though less reliable and economically sound—might suggest even further upside. Although patience is required and periods of volatility are expected, future earnings growth is a primary driver of strong long-term returns.

Do Real Assets Still Have a Role in Portfolios?
Investors facing the horizon-management conundrum in emerging markets—

60/40 portfolio 55 percent of the time on a rolling annual basis. Yet, over time, the regular accrual of more-efficient performance piles up, leading to capital accumulation that exceeds the 60/40 model by 1.7 times during the 45-year simulation. A risk-balanced strategy can withstand various economic environments, and it also trumps more concentrated approaches to earn the same or higher returns per unit of risk.

Will Emerging Markets Ever Emerge?
Despite the promise that developing economies hold as the engines of future global economic growth, and despite the appeal of their strong consumer and sovereign balance sheets, investors have been largely disappointed. Depreciating currencies, plunging commodity prices, and structural shifts have eroded initial post-crisis gains. Recent market results, notably higher commodity prices, have helped some troubled countries, for instance, Brazil and Russia, but a further continuation of a significant energy rally seems unlikely given global supply levels and muted demand. The uncertainty around China’s growth also injects doubt. Yet, looking beyond 2017, emerging markets likely will normalize,
structurally beneficial in the long term but challenging in the short term—will detect a similar theme in real assets. With high commodity production, tepid global growth, and spending constrained by debt levels, deflationary pressures recently have outweighed inflationary concerns.

That said, inflation can rear its head with a change in policy, amid a strong spurt of global growth, or with unforeseen commodity supply shocks. Recent events underscore how quickly the inflation outlook can shift. The U.S. election results have tilted expectations toward a reflationary environment. Actual policy implementation will determine the magnitude of any potential increase in inflation, but suggested policies, if fully implemented, likely would push inflation and interest rates higher. In most cases, a portfolio of growth-centric assets (even if balanced with nominal bonds) would suffer meaningfully if inflation appeared.

The critical strategic decision for inflation protection is whether program objectives have an inflationary component. If they do, exposure to real assets should be considered a strategic imperative, even when suffering through losses.

Implementation considerations are critical. Given the low-rate environment, and continued negative commodity roll yield, there is prevailing concern about dedicated long-only commodity futures exposure. There may be further upside to commodity prices given the depth of the drawdown, but an uptick in spot prices is not expected to meaningfully offset the drag of rolling futures contracts. Instead, there will be opportunities for patient investors to provide capital to parts of the commodity market, particularly energy, experiencing low prices. These opportunities likely will be best accessed in private vehicles with long lock-ups. It is appropriate for managers to allow distress to play out and then benefit from providing capital and facilitating recoveries for quality businesses.

In particular, a specter of higher inflation may emerge in the near term based on the calculus of the Consumer Price Index (CPI). Over the second half of 2014 and in 2015, energy dragged down rolling two-month CPI by 1–1.5 percent each month. Inflation likely will calculate higher for several reasons: The base effect, i.e., current and future energy prices will be compared to a much lower number as one year ago sits fully in the energy downturn; a smaller net contribution from energy given falling prices; and the second-order effect of relative increases in energy flowing through to non-energy sectors. Although inflation pressures may remain subdued, some portfolio protection from inflation, either through Treasury inflation-protected securities, which would benefit directly from changes in CPI, or broader inflation-hedging exposure remains a critical part of managing risk.

**Will Unconstrained Approaches Deliver on Their Promise?**

A key tenet of effectively harvesting alpha is to grant skilled managers appropriate flexibility to implement their approaches to generate the highest information ratios they can deliver. That conviction likely will lead to investment strategies not constrained by traditional benchmarks or style boxes. These include global asset allocation, unconstrained fixed income, and, more broadly defined, even hedge funds with their flexibility to go long or short or employ leverage. Generally, these approaches have delivered relatively disappointing results over the past several years.

One reason for the recent underperformance is that many of these strategies are valuation-oriented. A valuation-based approach can be a sound investment philosophy capable of delivering excess returns over time. It can require a long-term horizon as value-oriented assets can become more attractive as they fall in price. Tactical trading with a value or mean-reversion foundation has not worked recently because asset classes exhibiting value characteristics generally fell further (developed non-U.S. equities, emerging markets equity/debt/currencies, and energy-related assets). Although it’s still early, it’s encouraging to see signs of a turnaround in these markets and these types of strategies likely will benefit.

Another cause of disappointment stems from the structure of these strategies and requires setting appropriate expectations. These strategies are designed to be more diversified than traditional allocations, whether it is a global asset allocation (GAA) manager relative to a balanced (60/40) allocation or an unconstrained fixed-income strategy relative to the Barclays Aggregate Bond Index. This structural diversification is expected to lead to stronger returns over the long term. Unfortunately, when certain asset classes, such as U.S. equities, outperform almost all other categories over a multi-year period, a more diversified strategy is expected to lag.

Investors should focus on strategic exposure to unconstrained strategies to capitalize on manager skill. The present market environment is defined by divergences across geographies and asset classes, providing attractive opportunities for skilled GAA and unconstrained managers to exploit. Despite recent challenges, these managers should be well-positioned to capture alpha in this changing landscape.

**What Have We Learned?**

It is rational and healthful for investors to doubt their investment philosophies after periods of underperformance. It would be irrational, however, to skip the critical next step of evaluating investment positioning through each forward-looking investment thesis and prematurely reach the conclusion of abandoning positions that didn’t work. If the original thesis still compels, investors must resist the temptation to conform to convention.

**Lessons learned so far:**

1. Unconventional and unprecedented monetary policy can have a dominating (if uncertain in the moment) influence on capital markets. In particular, relative monetary conditions can lead to a wide dispersion in

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capital market outcomes. A continued period of negative rates and reliance on central banks make it critical to interpret future policies and their effectiveness across regions.

2. Asset classes can experience extended periods of unexpectedly high correlations with each other. Standard allocation analysis may suggest adding or increasing several asset class allocations on their own merits. Yet, the layering of several of these positions can contain embedded themes, such as the close tie between real asset prices and conditions in emerging markets. A factor-based approach or thematic understanding of the portfolio can serve as an important lens to help understand risks.

3. Unconstrained strategies operate independently, but falling prices make some assets attractive to many different types of unconstrained investors. This

reinforcement of views should result in outsized returns for all strategies over time, but the imprecise timing of “buying low” means that it can often result in reinforced losses and overlapping positions across strategies and at the portfolio level. A look-through analysis of all exposures can reveal linkages across a portfolio. Investors need to either accept that aligned views increase short-term risk or limit their exposure to tactical mandates.

It is a time for investors to recognize and confront their doubts on current portfolio positions. It is a time to reflect on the decisions that led to that positioning, and to learn and grow through that reflection. But it is not a time for capitulation in the face of doubt. Instead, it is a time for resilience. Progressive investors will be able to battle through the disease of doubt and maintain or even add to themes such as risk balance, emerging markets, and high-conviction tactical strategies that are poised to outperform traditional allocations. ⚠️