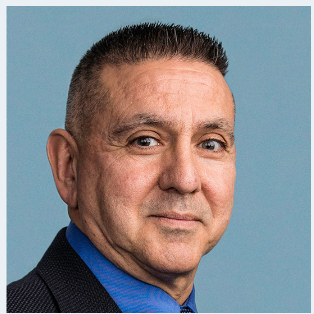
INVESTMENT INSIGHTS



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Multi-Asset Class Investing in a Low-Return World

Institutional investors' search for return never ends, but in today's environment, with questions about economic growth, interest rates and stock prices, not to mention the impact of macro issues such as trade tensions and a U.S. presidential election in 2020, that search has become harder than ever. So what to do? Biagio Manieri, managing director and chief multi-asset class strategist at PFM Asset Management, says when done right, investing in alternatives and using active management combined with some passive strategies, can get the job done.

Pensions & Investments: Do investors face a more challenging market environment today?

Biagio Manieri: We think the answer is yes, with the higher political risk and oversized influence of monetary policy today. In addition, in the past investors could simply stay close to strategic long-term asset allocation and expect a good return over time.

For example, if we take the 10-year period ended Dec. 31, 2005 — which included a three-year bear market in U.S. equities, a 60/40 balanced portfolio of broad U.S. and non-U.S. equities and fixed income — it delivered an annualized total return of 8.3%, which met the needs of most institutional investors. Based on our 2019 capital market assumptions, a balanced portfolio, including broad-based U.S. and non-U.S. equities and fixed income, can expect to achieve a total return of 5.1% over the intermediate period and 6.7% over the longer term. Some other capital market assumptions predict much lower returns than ours. We also need to consider that the funded status of the typical pension plan has deteriorated since the 1990s.

P&I: How are institutional investors responding to the current market environment?

Manieri: According to a recent P&I article, large investors are planning to increase allocations to alternatives and active management. But according to data from NACUBO [the National Association of College and University Business Officers], endowments, which are big users of alternatives and active management, have failed to outperform a simple portfolio of index funds over both the short and long term. Over time, the relative performance of alternatives, such as private equity, has deteriorated. Given the growth in the number of firms that offer alternatives and the growing amount of dollars allocated to these strategies, it is reasonable to believe that the relative performance of alternatives is unlikely to improve or benefit plan performance.

Other institutional investors pin their hopes on the use of active management, with the expectation that managers who pick the right securities can deliver above-market returns. But according to another recent P&I article, even in a year such as 2018, when volatility increased, 69% of active managers underperformed their benchmark. And according to S&P Dow Jones Indices, over the 15-year period ended Dec. 31, 2018, 89% of U.S. equity funds underperformed their benchmark.

P&I: If the use of active managers and alternatives does not consistently add to relative performance, what are other ways institutional investors can reach their investment goals?

Manieri: We believe that the use of active managers and alternatives — if done right — can add value. But we place significant emphasis on tactical or dynamic asset allocation as a way to add to relative performance.

By tactical or dynamic asset allocation, I mean overweighting or underweighting the various asset classes and strategies that we include in client portfolios. We base our tactical asset allocation decisions on relative valuations and trends in fundamentals. For example, are fundamentals stable or improving, or are they peaking or deteriorating? Studies have shown that low valuations lead to higher future returns and vice versa. But how does an investor avoid so-called "value traps"? That is where fundamental analysis comes in.

It is not enough to overweight assets that appear cheap based on traditional valuation metrics. For example, we have been overweight U.S. equities and underweight emerging market equities for an extended period, despite the valuation difference, because we believe the fundamentals and outlook are better in the U.S.

With respect to the use of actively managed funds, we use a combination of low-cost index funds when and where we believe active management would struggle to outperform, and combine that with actively managed funds during times when we believe the strategy and manager that we selected face a favorable market environment. Combining low-cost index funds with carefully selected actively managed funds not only leads to better relative performance, but also reduces costs, which benefit clients.

And with respect to alternatives, we use these strategies in a careful and highly selective manner. Rather than taking the typical endowment-model approach, where the portfolio always has a large allocation to alternatives, we allocate to alternative strategies based on economic and market conditions as opportunities present themselves. We also look for niche strategies that have not attracted significant assets and where competition is low.

P&I: What other strategies or asset classes should institutional investors think about in today's low-return world?

Manieri: We have found that factor-based exchange-traded funds such as low volatility, quality and other factors, can be valuable in market environments that we believe are favorable for those specific factors. Research and analysis of the relative performance of active managers shows that a major driver of relative performance is the factor exposure embedded into portfolios. For example, the relative outperformance of a U.S. large-cap manager may disappear when measured against the S&P 500 Equal Weight index or a composite index made up of both large caps and small- and mid-cap [SMID] stocks. Rather than hiring higher-fee active managers that are simply giving us exposure to the size factor, we would construct a portfolio using a combination of index funds where we overweight or underweight SMID stocks based on our view of relative value.

We believe that a combination of tactical asset allocation — including attractive assets that are overweighted relative to less attractive assets; the use of low-cost index funds with carefully selected actively managed funds; a thoughtful approach to incorporating alternative strategies; and greater use of factor-based investing — can help institutional clients improve their expected returns. •

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