INVESTMENT INSIGHTS

Is a dynamic absolute-return approach a viable alternative for pension plans?

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Capital markets have been experiencing an historic run, accompanied by significant bouts of volatility. But the investment backdrop is growing more uncertain and distorted.

In this context, many investors, while still wishing to deliver against their risk and return objectives, are seeking to diversify and derisk their exposure. Some may find the answer in alternatives and more illiquid investments, including private equity, private debt and hedge funds. However, many asset owners, remembering the global financial crisis, are likely to be concerned about excessive leverage and the opacity of certain more esoteric investments.

"U.S. equities, as represented by the S&P 500 index, have posted annualized returns of around 15% over the last decade, while valuations have become ever more elevated," said Suzanne Hutchins, investment leader of Newton Investment Management's Global Real Return team. "The cyclically adjusted price-to-earnings ratio has been above 30 for much of the last two years, a level not seen since the dot-com bubble in the late 1990s to early 2000s. Such asset-price inflation has not been limited to equities, with corporate bonds and high-yield credit among other asset classes that have experienced similarly robust returns over the same period."

In addition, she said, the global economy is highly indebted and the productivity of new debt (measured by the amount of economic growth generated by each incremental increase in borrowing) is falling as capital is increasingly misallocated. Further, major economies around the globe are cyclically challenged, particularly in the area of global trade, with frictions and pressure on supply chains intensifying.

FUNDAMENTALS, WITH FLEXIBILITY

A growing number of investors are therefore seeking tools that place an emphasis on fundamentals while having the capability to allocate not only to equities and bonds, but also to underrepresented and potentially undervalued asset classes. In seeking to navigate today's uncertain environment, it will also be important for asset owners to maintain the flexibility to take advantage of opportunities in a timely manner, while protecting against market falls.

One means of achieving these objectives could be through an actively managed, absolute-return investment approach, with a mandate to deliver returns significantly ahead of cash. Such a strategy can be designed to respond nimbly to capital-market opportunities and gain a degree of diversification beyond what is otherwise practical, while seeking to deliver consistent returns and provide downside protection.

An unconstrained multi-asset, global and highly active strategy has the ability to be tactically flexible and opportunistic in a way that strategies that rely mainly on passive diversification cannot.

"It's important to distinguish flexibility from simple trading," said Aron Pataki, a portfolio manager on the Global Real Return team at Newton. "For example, although flexibility can be tactical, at Newton we derive perspective from a framework of investment themes — a dynamic view of the world that attempts to tease out important trends, such as the buildup of global debt — that drive change and create both opportunity and risk."

SETTING A BALANCE

Pataki said that maintaining transparency on positioning, avoiding complexity and investing in liquid assets that can provide clients with the freedom to transact on their terms, should the need arise, are key to such an investment approach.

"Structuring a portfolio around a stable core of predominantly traditional return-seeking assets and an insulating layer of 'stabilizing' assets can help to set a balance between participation and capital preservation, with the aim of maximizing the upside potential when markets rise and limiting the downside risks when they fall," he said.

"To us, stock selection and fundamental analysis form a critical part of the investment process and should lead to long-term investments in individual securities," added Andrew Warwick, a portfolio manager on the Newton Global Real Return team. "We believe it is important to look at how each security contributes to a portfolio in terms of risk and return expectation, considering the diversification benefits and the correlations between asset classes.

In addition to global equities, a dynamic absolute-return strategy can be exposed to a broad range of assets in the 'risk space,' including corporate credit and emerging market sovereigns. Alternative investments such as infrastructure, renewables, real estate investment trusts and aircraft leasing can provide uncorrelated return streams.

Following a holistically constructed single-portfolio approach that's based primarily on holdings of individual securities means there is no obligation to invest in all asset classes at all times. Instead, investors can take a selective and specific approach to investing in different asset classes on the basis of their underlying investment characteristics. It is possible to alter the style and characteristics of positions in an asset class as the backdrop changes, rather than just the weights.

'STABILIZING ASSETS'

"The stabilizing assets in a portfolio can then be used either to dampen or increase the volatility and equity-risk beta, based on the stage of the market cycle," Warwick said. "Derivatives can be used as a direct hedge and can be accretive to returns in periods of market stress. Government bonds can be positioned as an indirect hedge against falling equity markets while precious metals, such as gold, could provide a safe haven during tough economic times, as well as having the appeal of being real assets that cannot be manipulated by changes in central-bank policy."

Against a financial backdrop that remains highly distorted, "we would contend that volatility has the potential to be heightened for the foreseeable future, as a combination of deteriorating fundamentals and lofty valuations threatens asset prices," Hutchins said. "In this context, a straightforward global multi-asset strategy could be valuable for portfolios, as it seeks both to capture some upside and dampen the drawdowns that are so damaging to long-term returns. Such a strategy could be used as both an insurance policy and a diversifier, and could also have a role tactically, as part of an overall portfolio allocation to adjust risk levels, without giving up the optionality on sizeable capital growth through the cycle."

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