HYMANS ROBERTSON

Investment Perspectives

Autumn 2019

In this issue:

Welcome

Welcome to our 2019 Autumn edition of Investment Perspectives

Halloween may have come and gone, but the ever present nightmare of an unresolved Brexit continues. In our most recent Brexit commentary, we highlighted the drag on UK investment and consumer confidence of the protracted uncertainty surrounding Brexit. While 12 December is now firmly stamped in the calendar for a UK election, there is no guarantee that this will lead to an outcome that will quickly resolve the current Brexit impasse one way or the other.

Meanwhile, dark clouds continue to persist in global markets, with key economic themes lingering on. In his latest capital markets update, Chris Arcari explores some of these themes and what they mean for asset classes.

To help avoid the never ending feeling of Groundhog Day associated with UK politics and the global economy, in this edition we also explore some broader key investment themes:

- William Chan explores what it means to be a responsible investor amid a sharp increase in the responsibilities that pension schemes now carry;
- With sustainability being a key topic at the moment, Simon Jones and Caoimhe Bain explore what sustainability within equities as an asset class means; and
- The sharp drop in traditional bond yields over the past decade or so has driven many investors to diversify their bond portfolios into less traditional areas. Allison Galbraith explores two popular parts of the market: absolute return bonds and multi-asset credit.

Andy Green

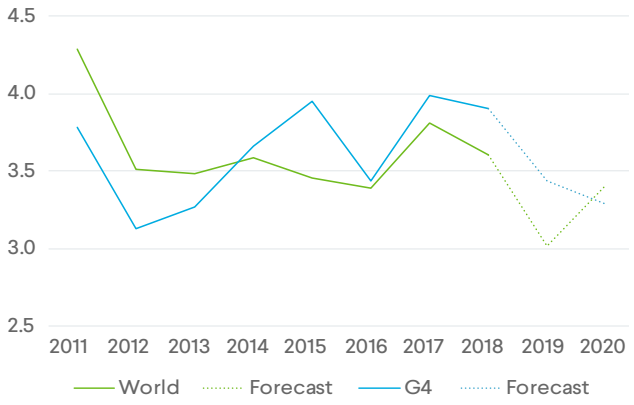
Chief Investment Officer
andy.green@hymans.co.uk
0131 656 5151

Capital markets update

The ongoing trade dispute between the US and China, and its disruption to global supply chains, continues to impact both realised and forecast global growth. GDP growth for many countries has slowed, although consensus forecasts still suggest most major economies will avoid recession next year. The IMF this month forecast global growth falling to 3.0% in 2019, its lowest level since 2009 and a 0.9% downgrade from the same forecast last summer (Chart 1). In 2020, growth is expected to moderate further in the world's biggest economies, although global growth is forecast to rebound slightly as emerging economies outside China accelerate.

The US economy has outperformed developed market peers but, here too, growth has slowed on 2018's robust pace as tariffs raise costs for domestic producers and consumers. Disruption has been particularly notable in large open and export-orientated economies – in Germany, last year's fall in industrial production has worsened in 2019 on the back of trade uncertainty. Though the UK returned to growth in Q3, following contraction in Q2, forecasts for 2019 and 2020 have fallen, reflecting acute Brexit uncertainty and increasing evidence of its negative impact on business investment.

Chart 1: Realised and IMF forecast growth for the World and G4 (China, Euro Area, Japan, US)



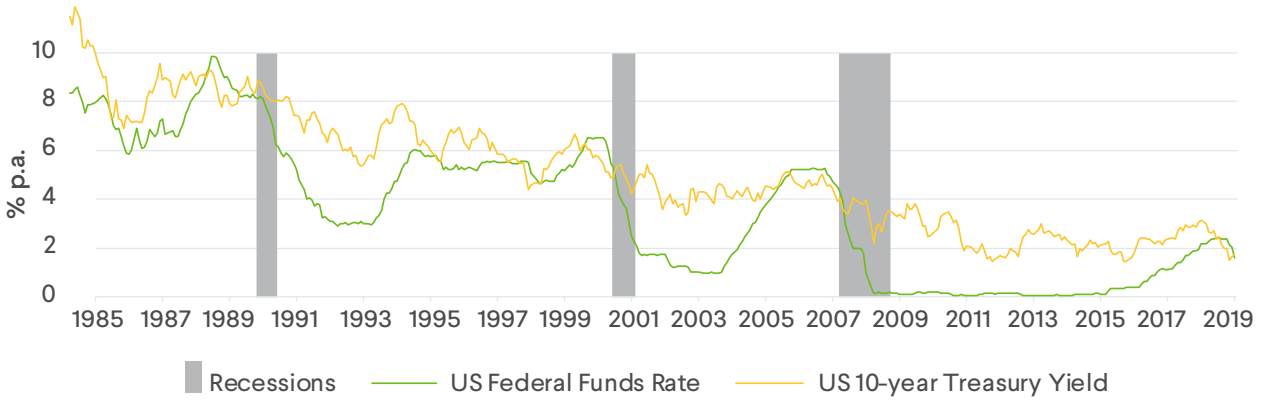
Source: Datastream

Reflecting the weakness in investment and trade, the Global Manufacturing PMI has continued to drift lower and is now below 50 (typically consistent with contraction in the manufacturing sector). Notably, equivalent indices in the US and Germany have fallen to their lowest levels in a decade in Q3. The effects of manufacturing weakness have so far been cushioned in broad economic output, as a more resilient services sector – larger in most advanced economies – has supported labour markets, helping to underpin wages and consumer spending. Unemployment is at multi-decade lows in the US and UK (despite an unexpected 0.1% rise in August) and is at its lowest level since the financial crisis in Europe. However, there are signs of economic weakness spreading beyond manufacturing. Service sector PMIs in the US, UK and Germany disappointed expectations in September, with the latter two falling below 50.

Against this backdrop and with inflationary pressures still largely absent, a shift towards more accommodative monetary policy is now well established. Despite a tight labour market and still robust growth, the Fed cut rates for the third time in three months, while the ECB cut rates further into negative territory and announced it would resume quantitative easing in November. The direction of UK monetary policy will likely depend on the Bank of England's assessment of whether lower growth or higher inflation is the bigger post-Brexit threat.

Monetary policy is once again bearing the burden of alleviating the slowdown but many question how effective further easing may be. Even in the US, where rates are comparatively high, there is scant headroom to deliver the level of monetary stimulus seen in previous downturns (Chart 2). October's IMF World Economic Outlook argues that monetary policy should increasingly be coupled with fiscal policy to counter any prolonged slowdown. But it's not obvious to what extent more expansionary fiscal policy will be adopted. The US deficit is already swollen by 2018 tax cuts and record high military spending; pre-election spending wish-lists in the UK may be trimmed by Brexit disruption; Germany is likely to shrug off another rebuke on its fiscal caution in the IMF report. Slowing growth at a time when monetary policy is already easy, and support from fiscal policy far from certain, suggests a cautious outlook is warranted.

Chart 2: US Fed Funds rate and US 10-year Treasury yield since 1985

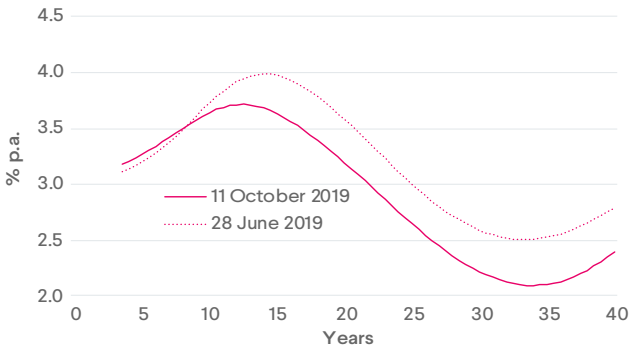


Source: Datastream, Hymans Robertson

Government bonds

Against this economic backdrop, global sovereign bond yields continued their slide. Gilts followed the global trend and nominal yields touched record low levels in August: prospective returns from current levels look derisory. Implied inflation (Chart 3), as measured by the difference between conventional and index-linked gilt yields, has fallen at longer terms. The potential replacement or changes to the calculation of RPI following the government's response to a House of Lords report on the subject, is likely to have been a factor here, with little change at the short end. Whatever the reasons for the recent moves, the variation in inflation pricing by term remains a notable feature of UK gilt markets.

Chart 3: UK forward gilt-implied inflation

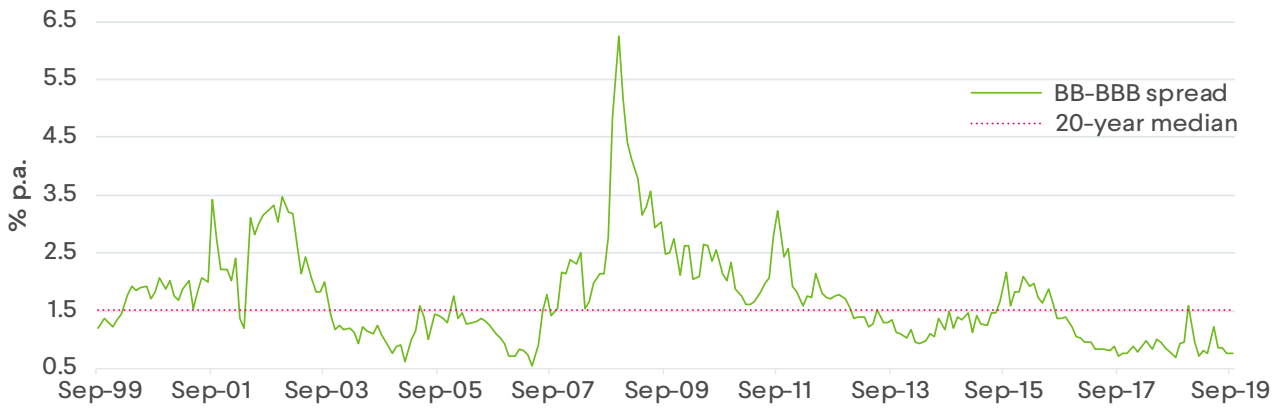


Source: Bank of England

Other bonds

Valuations in global credit markets seem driven more by monetary support than the fundamental backdrop, which is deteriorating. Investment-grade credit spreads are a little below long-term medians on a ratings adjusted basis, while speculative-grade valuations look demanding – at the end of September, BB-rated US high yield spreads were touching a level they have only ventured below 10% of the time over the last 20 years. But conditions are getting tougher – earnings growth of US high-yield borrowers was negative year-on-year in Q2 and debt affordability, as measured by the number of times earnings cover interest expenses, has fallen in 2019. Despite monetary support, these factors are likely to be of material detriment to the credit quality of more highly leveraged borrowers – Moody's forecast the 12-month trailing high-yield default rate to rise from August 2019's actual 2.9% to 3.9% by August 2020. Yet, although risks are rising, the extra yield on speculative-grade debt remains historically low (Chart 4). We are inclined to take a more conservative approach in credit portfolios, both through diversification and even an increased exposure to investment-grade.

Chart 4: US corporate credit yield spread on BB-rated speculative-grade over BBB-rated investment-grade

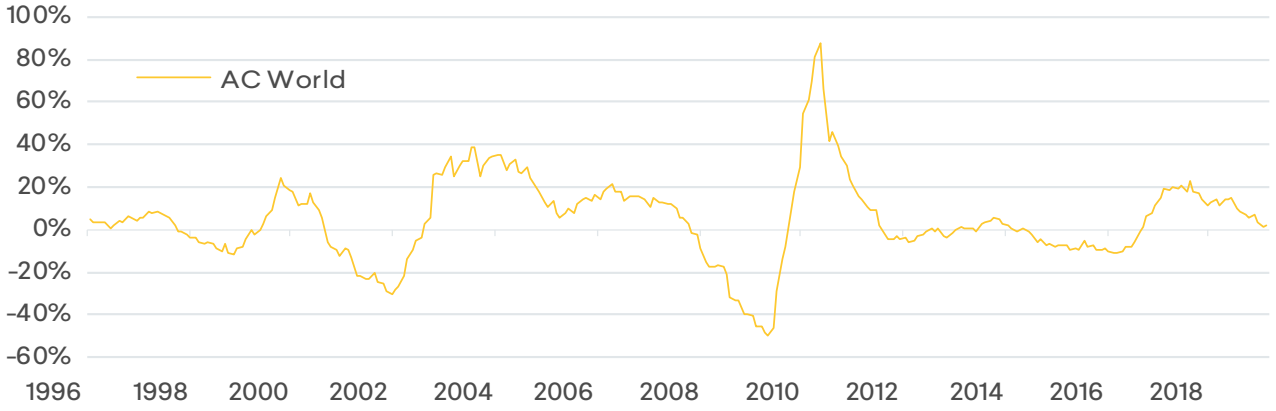


Source: ICE Index Platform

Equities

Despite recent concerns about trade and an ongoing industrial slowdown, global equity indices edged higher in Q3. These concerns had resulted in significant cuts to Q2 earnings forecasts and the fact that the outturn was not as bad as feared paradoxically provided markets with some support. Nevertheless, slowing economic momentum is prolonging the deceleration in earnings growth that has been in place for over a year now (Chart 5).

Chart 5: MSCI All-Country World year-on-year earnings growth in $ deflated by US CPI



Source:Datastream, Hymans Robertson

Consensus expectations still point to a rebound in earnings growth to around 10% for global equities in 2020. Realising these forecasts would require more positive news on the macroeconomic front than currently looks likely. While falling short of an ambitious forecast need not be calamitous for equity markets, it will make it harder to wring out further gains, when key valuation measures are already slightly above long-term median levels.

Property

In aggregate capital values have continued this year's steady fall, although annual rental growth has arrested its downward slide in recent months, remaining marginally positive, but well below CPI inflation. These figures continue to mask stark divergence within core property markets. While 12-month rental growth remains positive for industrials and offices, even rising in the latter case, retail rents continue to fall, albeit at a declining pace. Office capital values have been flat year-to-date and industrial values marginally positive, but retail capital values have fallen over 8% in 2019.

Perhaps of more significance than rental growth, the latest survey evidence from the Royal Institution of Chartered Surveyors points to a difficult fundamental backdrop – overall occupier demand remains weak, while available space has increased; not surprisingly, inducements offered by landlords (such as rent-free periods on new leases) are increasing. Despite this, property yields remain low relative to history, both in absolute terms and relative to equity dividend yields. A comparison with gilt yields is more forgiving, though this may not be considered a high bar in the current environment.

Conclusions

A slowdown in global growth is well established and broad-based, as the trade conflict between America and China takes its toll on the world economy. Global central banks are trying to help, but traditional, and even not-so-traditional, monetary policy toolkits are looking increasingly bare. Until now, manufacturing has borne the brunt of the slowdown, but there are signs the contagion is spreading to the services sector. This, in turn, could quickly deflate the current buoyancy in labour markets, impacting consumer confidence and spending and leading to a more protracted slowdown.

While sovereign bond yields were marked significantly lower reflecting the gloomier outlook, valuations on risk assets, in general, have not. But the deterioration in economic conditions is beginning to impact credit and equity market fundamentals. Our view is that valuations here reflect economic outcomes that may be plausible, but as an upside surprise rather than a reasonable base case. We are growing more cautious here as a result, and so we would continue to advocate holding a little more cash than usual. We continue to prefer equities to property in growth-orientated portfolios and would advocate diversifying credit portfolios, potentially by trimming speculative-grade exposures.

Chris Arcari
Investment Research Consultant
chris.arcari@hymans.co.uk
0141 566 7986

Responsible Investment: Moving beyond core

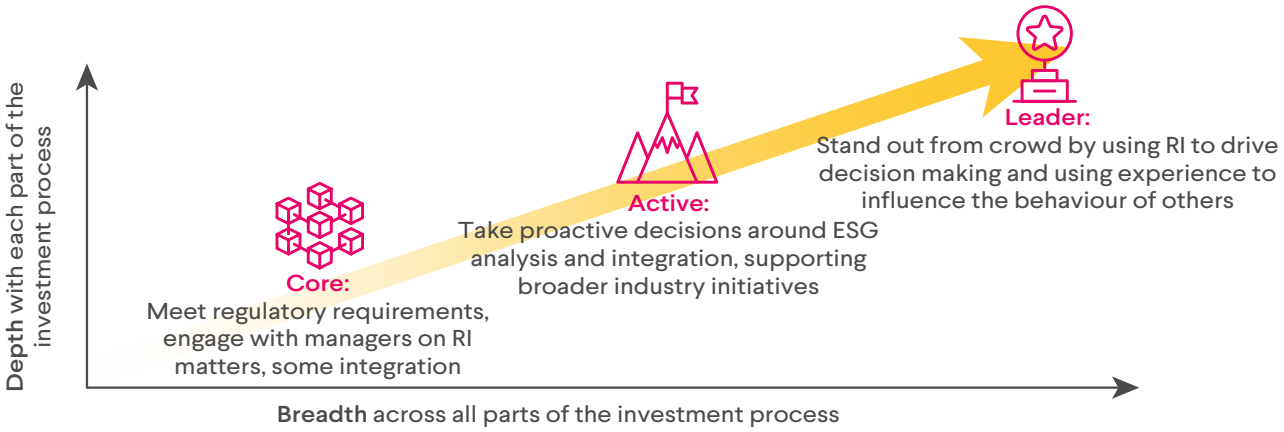
For UK pension schemes, 1 October 2019 was a milestone date for pension regulation. Readers will be aware that the trustees of both defined benefit and defined contribution schemes are now required to produce a Statement of Investment Principles which sets out both how they take account of financially material considerations and their policies in relation to the stewardship of investments, including specific reference to climate risk.

For many the looming deadline may have meant treating the change as a tick box exercise, doing what was necessary to meet regulatory requirements. Some may be happy with meeting the initial hurdle, but for many this will be seen as a starting point for reconsidering their behaviours with regard to responsible investment ('RI') practices. The challenge is how best to move forward from here.

Our starting point when talking to clients is to ask the question: "what sort of responsible investor and how active a responsible investor do you want to be?".

On the spectrum of different behaviours, those who wish to treat the changes as a compliance activity sit firmly in the bottom-left of what we refer to as our core-active-leader framework while others wish to be more active or even industry leaders.

Diagram 1: Core-Active-Leader framework



The challenge is then if you want to move from having met the minimum requirements to something more active, how do you go about it. In this article we present three live case studies that demonstrate different activities across a range of client types, illustrating both that there is always something more that investors can do, and that no two investors have the same priorities.

Before illustrating these case studies we note that minimum requirements and obligations are both subject to increased scrutiny and upward pressure on what may or may not be acceptable practices. For DC schemes, policy scrutiny will come from the requirement to publish SIPs online, a requirement DB schemes will face from 1 October 2020. Such scrutiny is inevitably going to place trustees under pressure to do more.

But it's not just minimum standards that are being pushed upwards, best practice is also being pulled progressively higher. Revisions to the FRC Stewardship Code and the efforts of the Principles for Responsible Investment are continuing to raise the requirements for signatories who, by definition, seek to exemplify high standards. This upward trend means that what may be considered the active responsible investor of today may become the core level of compliance tomorrow.

Case Study 1: Pooled fund investors can be active

This DB scheme is a small, quasi-public sector scheme with assets invested in pooled funds. Equity allocations are in passive tracker funds and active management is used within the property, multi-asset and infrastructure allocations. There has been growing trustee and member interest in responsible investment issues, particularly climate change, and the trustees have progressively sought to do more.

Over an 18-month period, the trustees have embedded responsible investment considerations into much of their work. This has included the following initiatives:

- **Developing and documenting RI beliefs:** The trustees have reviewed and documented their investment beliefs including a specific focus on RI considerations, acknowledging that climate change presents a financial risk to long-term investment outcomes.
- **Taking a first step to reduce climate risk in their strategy:** The trustees reviewed a number of alternative index strategies from their passive provider's product range. As a result, the trustees reallocated 25% of their passive equity portfolio into a climate-aware equity strategy.
- **Requiring the consideration of ESG integration in manager selection:** The trustees have selected managers for infrastructure and real estate mandates, ensuring they understood prospective managers' approaches to the integration of ESG factors and giving weight to this factor in their decision making.
- **Enhancing the monitoring of ESG issues:** The trustees regularly meet with their managers and have sought to boost their scrutiny from an ESG perspective, with the subject now a standing agenda item. More formalised ESG reporting and disclosures are being developed.

Although a relatively small scheme, this group of trustees have been active in their willingness to embrace responsible investment considerations, demonstrating that size and investment though pooled funds are not barriers.

Case Study 2: Integrating ESG into a DC default arrangement

Our second case study relates to the DC scheme of a large company. Over the past couple of years, both the company and the trustees have worked with us to be at the forefront of ESG integration for their DC default arrangements.

2017: Investigating member views

Over 1,000 members responded to a questionnaire which sought to ascertain views on responsible investment issues. The results demonstrated that over three-quarters of members expected the default investment strategy to be invested in funds that considered ESG issues, although not to the detriment of returns.

This expectation was far removed from the existing default investment strategy – the growth phase is invested in a market-cap weighted passive equity strategy which transitions into two multi-asset funds that are held until members retire.

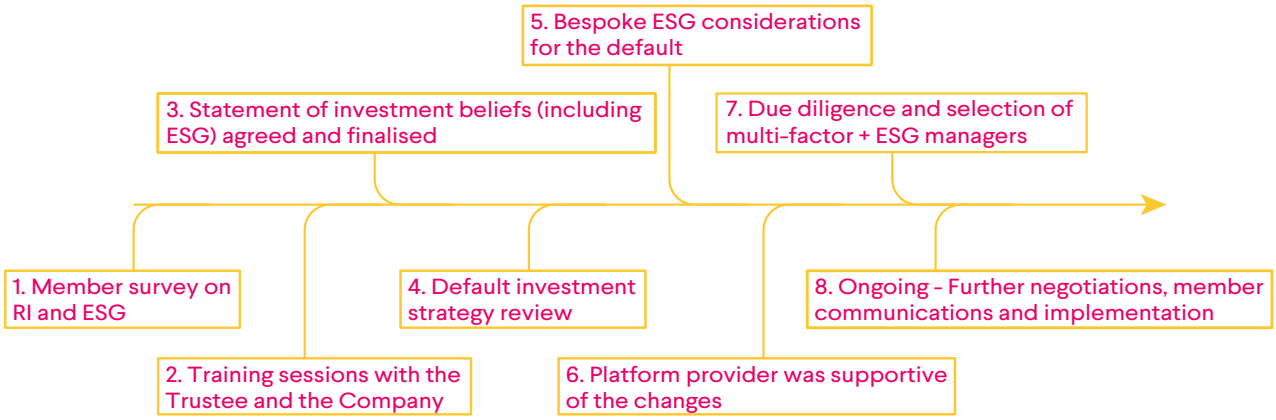
2018: Knowledge building and solution design

Over the course of 2018, we worked with the trustees to develop a deeper understanding of responsible investment issues and subsequently reviewed the default and self-select fund ranges.

Through this engagement, we established the trustees' specific requirements for a solution, but also allowed them to gain comfort that any change to integrate ESG considerations would leave members "no worse off".

We subsequently helped develop a bespoke solution which fitted the needs of the trustees. The diagram below shows the timeline of events:

Diagram 2: ESG integration timeline



2019: Implementation

The trustees reached the position where they could implement a bespoke default investment strategy, seeding two new equity mandates that incorporate a factor-based approach that tilts allocations away from lower ESG-rated companies.

Case Study 3: Reducing exposure to climate-related risks

LGPS funds are subject to increasing public scrutiny of their actions on responsible investment, particularly with regard to climate change. One of the first actions we took with our client following appointment was to help them develop an ESG policy and to document the Fund's approach in a number of areas.

Building knowledge was critical and we arranged training from multiple parties to help develop the committee's understanding. We particularly focused on climate risk and the committee commissioned a carbon footprinting exercise on its listed equity exposure. A recent Greenwich Associates survey suggested that only 5% of UK pension funds had even considered such an exercise.

Using this exercise as a benchmark, the committee made a commitment to reduce carbon exposure within its listed equity portfolio. The committee set an explicit target of reducing carbon exposure by 50% when compared to the global equity market over the period to 2022. We have since helped the committee take steps to implement this strategy through the introduction of a low carbon equity strategy.

Action has not been explicitly focused on climate risk, with the committee also developing a set of investment beliefs and continuing to seek opportunities to collaborate with others.

Conclusion

What does an active responsible investor look like? We believe all three case studies illustrate different ways in which trustees can look beyond compliance and achieve a more active position. There is always something more that can be done.

Moving beyond core requires a commitment on the part of trustees and pension committees to begin a journey. For many, this journey began on 1 October 2019 when the new investment regulations became effective. We look forward to working with many of our clients in the pursuit of being more active.

William Chan
Senior Investment Research Consultant
william.chan@hymans.co.uk
0207 082 6357

Understanding sustainable equity

Sustainability is increasingly being discussed within the institutional investment community but, in spite of the widespread use of the word, is there a clear understanding amongst asset managers and investors as to what "sustainable investment" actually looks like?

There is clearly a wide spectrum of possible strategies that could be considered to fit the definition of "sustainable" – those that invest in companies that are able to demonstrate sustained earnings growth; those that invest in companies which are aligned to a theme of sustainability; or strategies which invest in companies which are directly aligned to the Sustainable Development Goals (SDGs), see below. All fit the definition – the devil, as they say, is in the detail.

The 17 Sustainable Development Goals (and 169 underlying targets) are a global agenda, adopted by countries in 2015, with a vision of ending poverty, protecting the planet and ensuring that all people enjoy peace and prosperity. The goals and targets are universal, meaning they apply to all countries around the world, not just poor countries.
International Institute for Sustainable Development

Paraphrasing the United Nations definition of sustainable growth, sustainable investment could and perhaps should be considered as investment in assets to generate returns sufficient to meet the needs of the present generation without comprising the ability of future generations to invest so as to generate returns sufficient to meet their own needs. In this context, a company which irreparably diminishes its underlying resource base may not be regarded as sustainable. However, it also means that a company does not necessarily have to contribute to the advancement of society to be considered to be sustainable.

Putting 'sustainable' into an investment context

What then does the universe of sustainable equity funds look like? To inform the discussion, we took a closer look at a sample of funds that fall within the sustainable equity universe. Of the 14 funds we considered, most incorporate the term "sustainable" in their name, although others include terms such as "impact", "ESG" or "responsible". This lack of consistency in terminology highlights a challenge for investors who need to be sure that what they are investing in is aligned with their goals.

Exploring the stated objectives of these 14 funds, we found differing interpretations of sustainable: references are made to "earnings sustainability" and "sustainability scores" while several directly align themselves to the SDGs. In practice, the funds can be categorised as:

1 'ESG-integrated' funds where sustainability considerations tend to rely on the evaluation of ESG risks and opportunities within companies and the direct integration of these considerations into an investment process – 10 of the 14 funds fit this broad definition;

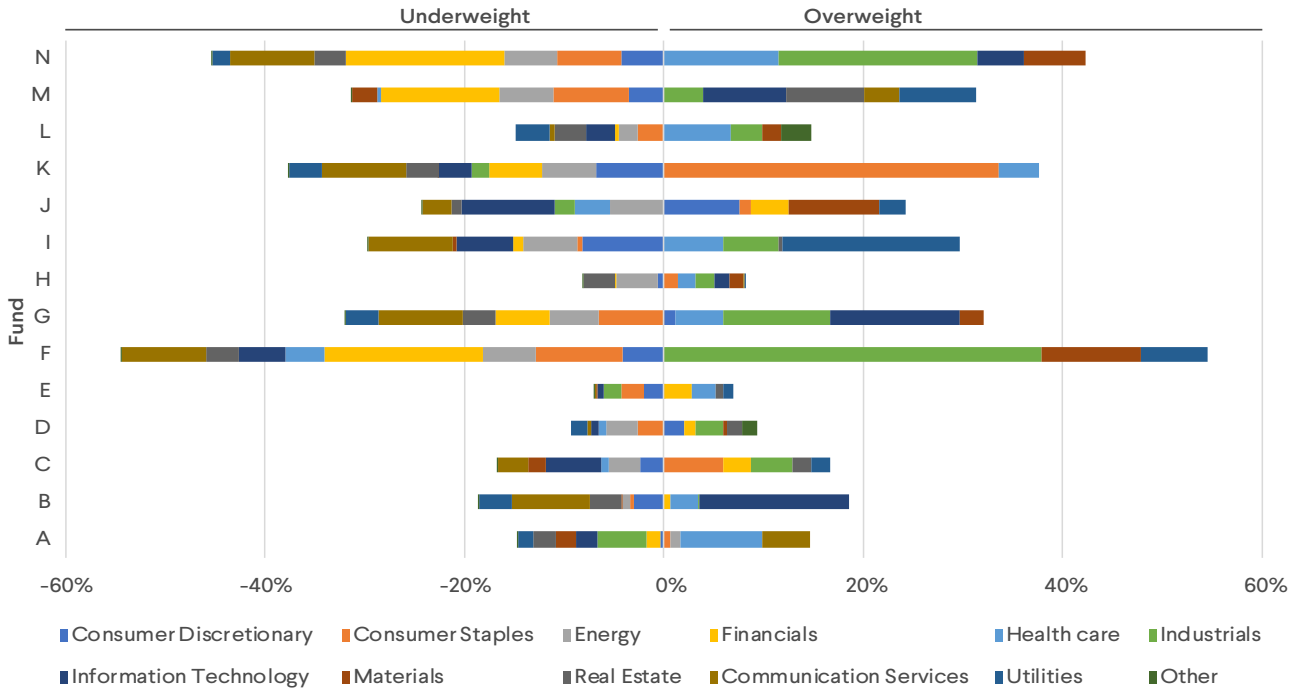
2 'Impact' funds which aim to achieve long-term returns on capital, but have a specific further aim to create a measurable social or environmental impact through their investments. The remaining four funds fit this definition.

Getting beneath the skin

In considering the merits of different approaches to equity investment, prospective investors should consider whether sustainable equity strategies deliver anything materially different to other equity strategies and whether capital is being directed towards companies that are consistent with their own expectations of what "sustainable" looks like.

To explore this, we can consider attributes such as regional and sector allocations across different funds; Chart 6 below taking the latter of these, comparing the difference in sector allocation for each of our 14 sample sustainable funds to that of the MSCI World Index.

Chart 6: Comparison of relative sector positions as at 30 June 2019



The chart reveals the extent to which these funds differ in their sector allocation compared to the MSCI World Index. Key observations include:

- The sector positioning trends are similar, but the scale of variation differs materially; funds demonstrate relatively small levels of variation (+/-10% in aggregate) up to sector variations of +/-50% or more.
- Energy is a consistent underweight across all the sustainable equity funds we looked at, perhaps reflecting concerns over future carbon emissions and the still considerable weight of the fossil fuels industry within this sector, as well as communication services, where there have been concerns over data privacy in some high profile stocks, and financials.
- Those with the greatest variation in sector allocation lie towards the "impact" end of the spectrum. While our sample size is small, the impact funds we looked at had a greater allocation to industrials and/or utilities, reflecting that one central interpretation of impact investing may be to invest in companies that create "solutions" to global challenges. The average sector relative exposure across the impact funds we looked at relative to the MSCI World Index, is industrials (+17%), utilities (+8%) and financials (-11%).

At a stock specific level, several companies are common across the different sustainable equity funds within our sample. The most prevalent is Microsoft which, as an IT firm, has limited ESG risk exposures, but also demonstrates strong ESG policies relative to its sector. For example, the firm has been carbon neutral since 2012 and is aiming to cut its emissions by 75% by 2030.

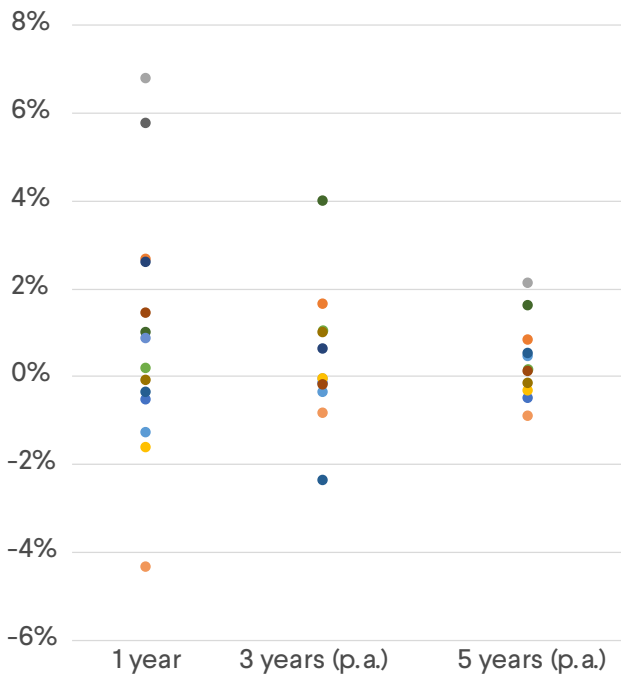
Walt Disney is another company common across several funds. This firm also has strong carbon risk management policies and objectives whilst also placing considerable emphasis on social issues, for example, using the appeal of its characters to promote healthy eating to children. However, Walt Disney has seen scrutiny from shareholders and others on issues such as executive pay and wage inequality. These examples illustrate the problem of understanding what "sustainable" actually looks like when investing in equity. They also demonstrate that companies that meet certain definitions are not necessarily free from ESG risks.

While both companies have the potential to exist sustainably and are taking steps to ensure this is the case, can either be said to create a meaningful positive environmental or social impact? Indeed, we can contrast these examples with Xylem, a water technology company which seeks to provide technology solutions to the provision of clean water and management of waste. This company features in the impact funds within our sample, clearly having a societal objective and thereby meeting a stronger definition of "sustainable".

Does sustainable equity deliver return?

One of the most common questions posed of sustainable or ESG related strategies is that of return; arguments are made both for expectations of underperformance and of outperformance. Yet, as we have illustrated above, sustainable equity strategies are simply a subset of other active equity strategies and returns can therefore be considered in a similar manner. Chart 7 below compares the relative returns against their global equity benchmarks from our sample set across different time periods.

Chart 7: Relative return: Periods to 30 June 2019



The outcome is not very different from what we may expect from a sample of active equity strategies; broad dispersion of returns over a shorter time-period with some funds delivering material outperformance, others underperforming relative to their global equity benchmarks. Longer term outcomes are more clustered with relative performance from our sample set of between -1% p.a. and +2% p.a.; this is still a very short-time period, and coincides with a growing drive towards investing in sustainable companies. We would therefore be wary of taking this as evidence of future performance, but it does support the hypothesis that investing in sustainable equity strategies need not lead to lower returns.

Should investors allocate to sustainable equity?

Our study suggests that the investment industry has not yet reached a definition of the term 'sustainable' which is universally recognised. This is logical – investors will have different views about what sustainable means, and so too will asset managers. If the definition was universal, it would essentially become "tick-box".

However, from our high-level analysis, there does appear to be a distinction between the goals of those funds which are labelled as "impact", compared to other funds within the sustainable equity universe. This offers some ability to differentiate between approach; trustees who wish to explore investment in sustainable equity strategies should therefore be clear on how the strategy aligns with their beliefs and investment objectives.

Sustainable equity strategies ultimately seek to play on a theme that, over the long-term, if companies do not ensure that they have the ability to survive through the careful management of their underlying natural and human resource base, then they are unlikely to be attractive investments. Within this lies a subset of companies that are actively looking to develop and implement solutions for the environmental and social issues facing the world as it grapples with the transition to a low-carbon, more sustainable economy. As we have seen, different funds will look at different aspects of sustainability meaning that prospective investors in sustainable equity strategies should ensure they fully understand the nature of the investment strategy and carry out due diligence on the approach.

Simon Jones
Head of Responsible Investment
simon.jones@hymans.co.uk
0131 656 5141

Caoimhe Bain
Associate Investment Consultant
caoimhe.bain@hymans.co.uk
0207 082 6028

Diversifying your bond portfolio

In recent years there has been an increased exposure in pension funds to credit markets. This increased exposure comes as a result of the improved funding levels of many defined benefit pension schemes as strong equity market performance has allowed schemes to de-risk by reducing their allocations to equity markets. Fixed income assets have been the natural home for the proceeds of the de-risking process. However, as allocations to credit have grown, schemes have been looking to diversify their overall allocation to a wider range of credit asset classes.

As developed market sovereign bond yields have fallen close to or even below zero over the past 10 years, many investors, including pension schemes, have been on the 'search for yield' and exposure to higher yielding 'multi-credit' strategies, where managers are not constrained to one underlying asset class as defined by credit quality, geography or credit type, has increased. There is a wide variety of multi-credit products available but arguably for pension schemes the two most common strategy types within this category have been Multi-Asset Credit ('MAC') and Absolute Return Bond ('ARB') strategies. It is these two strategy types that we focus on in this article.

Our description of MAC and ARB

Providers and advisers within the industry may mean different things when using similar terms. This can lead to uncertainty as to what a product is actually trying to achieve, and how it is trying to achieve it. Fixed income is no exception and ARB funds can be confused with MAC funds. We set out below our description of each strategy.

Multi Asset Credit (MAC) Strategies

Our description of a MAC fund is one which allows investors to access a range of geographically diversified credit assets within a single investment fund. The focus is typically on sub-investment grade, with the asset classes most commonly included in a MAC fund being high yield bonds, senior secured syndicated loans and collateralised loan obligations (CLOs*). Some managers will include Emerging Market Debt, asset backed securities and investment grade bonds.

*CLOs are a specific type of asset backed security where the underlying pool of collateral is an actively managed pool of senior secured syndicated loans issued to corporate sub-investment grade borrowers.

MAC funds seek to provide a credit risk premium over traditional investment grade corporate bond markets and offer an alternative growth-like return to equities. As this additional premium represents compensation to the investor for the increased default risk, it is essential any MAC manager can perform detailed credit risk analysis to protect against the risk of default. Over time returns will be driven by the yield available on underlying credit assets.

Most MAC managers employ a long-only global approach and seek to generate returns through a visible stream of income. Many specialist credit managers adopt a bottom up stock picking approach to portfolios, limiting allocations to high yield bonds and loans. However, top down MAC approaches involve more actively traded strategies across both investment and sub-investment grade credit sectors and returns are more heavily reliant on getting the dynamic asset allocation across credit markets correct.

Absolute Return Bond (ARB) Strategies

ARB funds have the common objective of delivering a positive return above cash in all market conditions, regardless of whether interest rates are rising or falling.

The approach will therefore differ from that of MAC strategies. Most ARB investing could best be described as 'diversified long/short fixed income'. Key to the success of diversified long/short credit strategies is the preservation of capital, and the strategy will often rely extensively on derivatives to hedge market exposures. Multiple long and short positions are taken in the strategy, potentially across numerous global bond asset classes at any one time, including sovereign bonds and credit, hedging out a significant element of credit market risk.

Returns are much more dependent upon manager skill, with less directional credit market exposure.

Table 1: Key characteristics of MAC and ARB strategies

	Multi-Asset Credit	Absolute Return Bond
Objective	Outperform conventional credit	Capital preservation: positive returns in all market environments
Credit Quality	Sub-investment grade focus, but some use investment grade too	Typically investment grade
Investment style	Long only	Long/short positions with use of derivatives
Currency	Any currency exposure hedged	Will often take active currency positions
Liquidity	Should maintain liquidity but some liquidity risk in extreme market conditions	Aims to maintain liquidity in all market conditions
Typical Expected Return	Libor+400-500bps p.a. over a market cycle; some target +300bps, especially if including investment grade	Libor+200-250bps p.a. over a market cycle, but some may use more leverage and target up to Libor+400bps
Manager skill	Detailed bottom up credit analysis to ensure additional credit premium realised	Heavily reliant on skill of manager to identify relative value opportunities and market timing decisions.

Allocation to MAC or ARB?

Through a full economic cycle, an allocation to a MAC strategy offers an alternative return to that available from equity markets, but with more predictability. MAC strategies generate their returns through a structural exposure to sub-investment grade sectors. Consequently, when credit spreads are below average there is less relative upside potential and when credit markets experience periods of stress, MAC strategies may suffer periods of negative returns over shorter time periods. Top down MAC strategies aim to offer greater protection in these environments, however there is little evidence they achieve this. We illustrate in Table 2 below performance from our universe of MAC strategies during two recent noteable periods of credit market stress, Q1 2016 and Q4 2018.

Table 2: Average MAC returns under credit market stress

	Q1 2016 (%)	Q4 2018 (%)
Bottom up MAC* strategies	1.5	-2.2
Top down MAC** strategies	0.5	-2.8

* Hymans universe of bottom up MAC strategies ** Hymans universe of top down MAC strategies. Source: Hymans Robertson/Managers

As Table 2 shows, in periods of credit market stress, returns from top down MAC strategies which are reliant on getting dynamic asset allocation correct have struggled to outperform bottom up MAC strategies.

ARB funds generally have lower correlation of returns with other asset classes, including conventional fixed income; there is less directional market exposure than in a MAC strategy. An allocation to an ARB fund can therefore be a useful diversifier in a scheme's overall fixed income allocation, especially when credit looks expensive or starts to experience higher defaults; ARBs aim to generate a positive return in all market environments and can bring an element of defensiveness to an overall fixed income allocation. However, as with the top down MAC strategies, this assumes a reliance on managers to deliver consistent returns through market timing decisions. While over longer time periods most ARB strategies have met their key objective of capital preservation, many have struggled to meet their performance target. Over recent years, central bank monetary policy and the after- effects of QE have caused markets to become increasingly correlated which has proved challenging for ARB managers.

Given their lower risk/lower return characteristics and higher liquidity, ARBs can also play a role in providing an enhancement to returns for schemes holding material levels of cash.

Our view

We have long been supporters of MAC strategies, and bottom up stock pickers in particular, for the focus on delivering more predictable returns than many growth assets. However, we do also recognise that current market conditions, with lower yields and tighter credit spreads, act to constrain the potential upside. Top down MAC strategies have scope to mitigate some of these challenges by accessing multiple markets, albeit the focus remains credit based.

ARB strategies, with their lower net market exposure, should provide a natural complement to MAC strategies at this point in the cycle. However, their much greater reliance on active management does not provide the same level of predictability. Therefore taking care over the choice of ARB manager is key.

The alternative may be to sit on the MAC sidelines temporarily, or at least be content to run a modest underweight position, and wait for more attractive entry levels, which will happen, even if we cannot predict when.

Allison Galbraith
Investment Research Consultant
allison.galbraith@hymans.co.uk
0141 566 7618

Market returns to 30 September 2019

	Yield % p.a.		Returns to 30 September 2019 (sterling, % p.a.)		
	30-Jun 19	30-Sept 19	1 year	3 years	5 years
Equities					
Global	2.5	2.5	7.8	12.2	13.3
UK	4.1	4.2	2.7	6.8	6.8
Developed markets ex UK	2.3	2.3	8.2	13.1	14.3
Emerging markets	2.9	3.0	7.1	8.4	8.7
Bonds					
Conventional gilts	1.3	0.8	13.4	3.2	6.0
Index-linked gilts	-1.9	-2.2	18.4	4.9	9.6
Sterling corporate bonds	2.6	2.3	11.0	3.6	6.0
High yield (US) *	6.4	6.4	6.3	6.1	5.4
Emerging market debt	5.9	5.5	17.1	5.4	6.1
UK Property	-	-	2.9	7.7	8.2
Hedge Funds *	-	-	2.1	3.8	2.3
Commodities *	-	-	-2.8	4.5	0.9

* Return in $

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

If you would like to find out more about any of the topics discussed in this publication, please contact your usual Hymans Robertson consultant or:

Andy Green
andy.green@hymans.co.uk
0131 656 5151

Mark Baker
mark.baker@hymans.co.uk
0207 082 6340

William Chan
william.chan@hymans.co.uk
0207 082 6357

HYMANS ROBERTSON
CLUB VITA

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk