REAL RETURN AND THE INVESTMENT CHALLENGE OF 2020

PERPETUAL INVESTMENTS
14/10/2020

Everyone is running out of adjectives to describe the year 2020. Weird, crazy and unprecedented are some of the most overused words this year. Financial markets have also been ‘crazy’ this year with a violent sell-off in equity markets in late February and March followed by an explosive rally, particularly in technology and other growth stocks.

But we should not let the global pandemic obscure some pressing challenges for investors. These challenges have been building for some time and after this year’s moves in equity and bond markets it is becoming urgent to address them.

How did we get here?

The past four decades have been incredibly good for investing. There has been a stunning bull market in just about everything led by fantastic returns in equities, fixed income and property. The technology revolution, the re-emergence of China as a major global economy and falling inflation have all played a role. In particular, falling inflation has underpinned a structural trend toward much lower interest rates. As a result, even government guaranteed defensive investments, like Australian 10-year bonds, have generated double digit returns over the past four decades.

Moreover, those lower interest rates have in turn been capitalised into higher prices for growth assets like equities, property and infrastructure. In the US, the S&P 500 index is dominated by growth stocks (in the technology and health care sector in particular) which have been massively re-rated driving stellar returns in US equities of over 11% per annum over the past 40 years. Meanwhile, Australian equities have returned over 9% per annum in the 28 years since the last recession helped by a massive re-rating of the resources sector owing to the China boom. And the property sector (residential and commercial) has been underpinned by the combination of dramatically lower interest rates and very high migration driving strong population growth.

Against this backdrop, it is unsurprising that it has also been a wonderful time for multi-asset investing. Traditional multi-asset funds have fixed strategic allocations to equities, fixed income and cash together with some limited exposure to other investments like property, infrastructure and alternative investments. Investment managers typically try to add value to this baseline investment through stock selection and some tactical asset allocation, but managers stick pretty close to the strategic allocation to growth assets (around 70%) and defensive assets (around 30%). As a result, the 'strategic asset allocation' drives most of the return.

Not only have the returns been stellar, but the diversification within this strategy has worked very well as the periods of strongest bond market performance coincided with cyclical bear markets in equities.

Starting point valuations were crucial

The key to the success of recent decades was the extremely low valuation starting points for both equities and bonds in the early 1980s. In the early 1980s, the PE ratio for the US stock market was in single digits and 10-year bonds were also extremely cheap with yields of almost 16%.

In stark contrast, now the valuation starting points are very high. Equity valuations are in rare air (only in the late 1920s and late 1990s has the US PE (cyclically adjusted) been higher). Of course, one reason for these high equity valuations is that interest rates have NEVER been lower. Cash rates are around zero in most developed economies and 10-year government bonds in Australia, the US, Japan and most of Europe are less than 1% and in some cases are negative. Effectively, the so-called 'risk free rate' is zero and there is no hurdle rate for equity investors!

This carries huge implications for future returns from equities and government bonds:

- Investors in government bonds need to be aware of the dramatic change in the landscape for their investments. There are few certainties in life and financial markets but one is that if you buy an Australian 10-year government bond at a yield of 1% and hold it for 10 years your return will be 1% per annum[1]. Of course, this compares very unfavorably with the historical return generated over the past 40 years.
- Similarly, the prospective 10-year return from equities, from this valuation starting point, is likely to be lower than historic returns as there is a lot of good news already in the price, including a discount rate that has NEVER been lower.

What does this mean for investors?

The implications for investors include:

- Equities will have less support in a recession as the cushion of falling bond yields (ie the discount rate falling) comes into question.
- Central banks have less ammunition. The so-called 'Greenspan put' of 20 years ago has morphed into the 'Powell put' of today, but there is not much more central banks can do. This means that fiscal policy will be much more pivotal in the next decade, just as it has been in 2020. Of course, fiscal policy is subject to the vicissitudes of the political process in each country.
- 'Traditional' portfolios (ie 70% growth assets, 30% defensive assets) now have less diversification so clients who need equities have less downside protection.
- Sell-offs in equities could be brutal as the role of equities in portfolios changes from growth, to yield of last resort and ultra-stimulative monetary policy potentially drives speculative bubbles.

To sum up, there has been a profound shift in the investment landscape. Approaches that have worked for decades now face enormous challenges.

Perpetual's Diversified Real Return Fund (DRRF) responds to these challenges in a number of ways:

- by keeping our eye on the investment objective of CPI plus 5% in considering all investments;
- a totally flexible asset allocation;
- greater diversification; and
- an expanded defensive tool kit.

Since its inception ten years ago, the Fund has delivered returns similar to Australian equities with about one-quarter of the risk. To highlight the point, earlier this year the peak to trough fall in Australian equities was 37% while in Perpetual's DRRF it was 7%. At the time of writing, Australian equities are still 17% from their peak whereas DRRF is back close to its peak.

It is understandable that the global pandemic and all that it implies for our health and the economy is occupying just about all of our thoughts right now. But the changes to the investment landscape are profound and they suggest a different approach to investing may be warranted in the decade ahead.

A CASE STUDY

The 2020 Bear Market

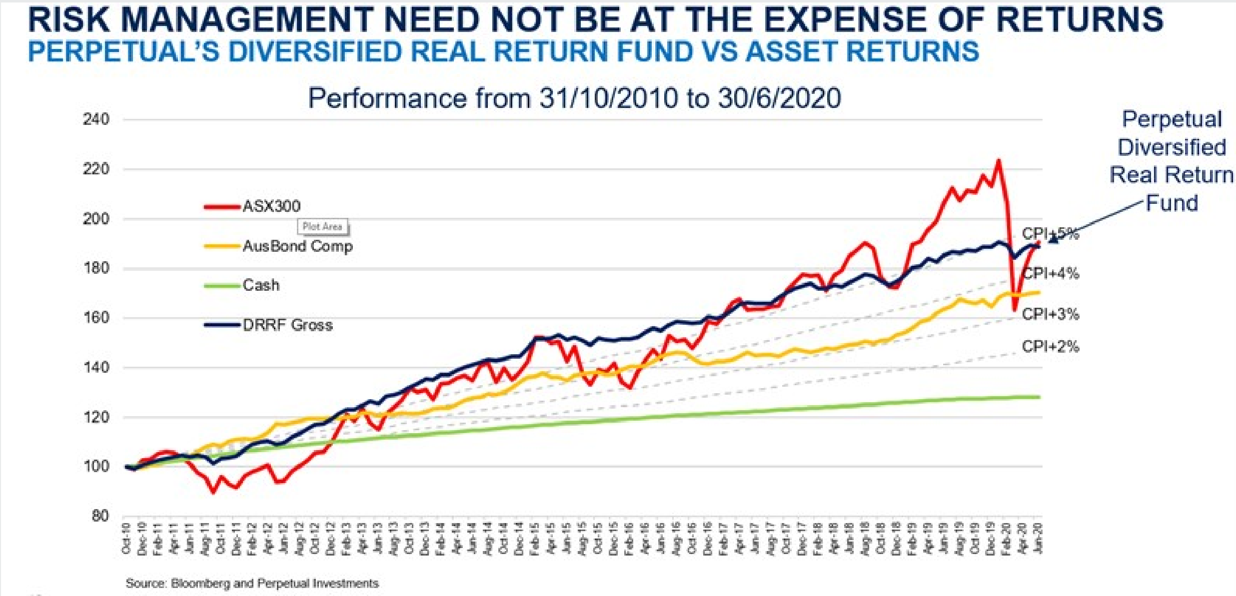
The commentary on Perpetual's Diversified Real Return Fund positioning at the end of January highlights many key features of the Fund which allowed it cushion the blow from the subsequent bear market and, in the process, significantly to out-perform other multi asset strategies.

'We have been mindful for some time that we are likely in the late stages of this economic and market cycle, with little traditional central bank ammunition left to utilise. While central banks are now easing monetary policy, the slowdown in economic growth, the trade war and more recently the novel coronavirus are creating valid concerns about a global economic recession.

Accordingly, the Fund is positioned to maintain participation in any rally in equities and credit markets. However, the portfolio retains strong defensive qualities to mitigate against various risks including:

- Value and quality bias in the equity allocations; a position in Australian sovereign credit default swap; some exposure to Australian bonds; and a long dated Australian dollar put option (versus the US dollar) which should add to performance in the event of an Australian recession.
- Optionality in Australian and US equities will lower the weight to equities in the event of a sell-off. Added to this, the Fund has a position which would benefit from a steepening of the US yield curve and an increase in fixed income volatility – both of which usually occurs during recessions.
- Finally, the Fund has a significant cash position and substantial foreign exchange exposure (in addition to the currency option positions cited above) with a position in the US dollar, core emerging market currencies (such as the Chinese Yuan, Korean Won and Taiwanese dollar) and the Japanese Yen.

These and other portfolio hedges have been selected based on a combination of their intrinsic investment merit as well as consideration of the cost of carrying them to help to protect the portfolio in the event of a hard landing.



Find out more about the performance, strategy and holdings of Perpetual's Diversified Real Return Fund.

1. The return cannot be higher than 1% and there is an extremely remote possibility that the return is lower in the event of a default.