Managing volatility

Riders on the storm

Femi Bart-Williams | Rob Booth | Tapan Datta
Pete Drewienkiewicz | Andy Scott

APRIL 2019 | PORTFOLIO INSTITUTIONAL ROUNDTABLE


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Managing volatility: Riders on the storm

Investors are on the verge of taking a step back in time.
After almost a decade of asset prices seeming to do little else but rise and the value of equity markets breaking and re-breaking records, volatility is expected to return and it could be here to stay.
The bouts of turbulence recorded last year are set to become a regular feature of the investment landscape, just like in the days before the financial crisis forced some central banks to start buying bonds.
The end of quantitative easing is just one catalyst behind why some commentators believe that the prolonged period of calmness about to end. Slower global growth, rising political risk and, according to some analysts, corporate profit margins in the US starting to shrink are other factors.
This could be just what some institutions need. Volatility is a long-term investor's friend thanks to the attractive entry prices it could create, especially after valuations have been considered a little overheated for some time.
Yet final salary schemes are on a de-risking journey and the growth assets held by those close to their endgame, which could mean handing the scheme over to an insurer, could be sensitive to any turbulence.
And dips are not always followed by recoveries, as those invested in Japan's stock market over the past 30 years will testify.
Defined benefit (DB) schemes that are close to their end game should have sold many, if not all, of their equity holdings by now, but those who are years' away will still own growth assets, especially if they have funding gaps to close. The question is, will they be ready to change their mindset and ride out the storms that lie ahead after becoming accustomed to markets typically going up for so long?
Although the first quarter of the year was quiet, the professionals that we sat down with in March expect markets to get a little choppier in the next year or two. You can read their views on how investors should tackle the oncoming storms from page 4.

Mark Dunne

Editor, *portfolio institutional*

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Tapan Datta

"Across the spectrum there is less tolerance and less of an ability to withstand sustained market volatility than there ought to be."

Tapan Datta, Aon

Portfolio Institutional: Is volatility on the way as many commentators predict that it is?

Pete Drewienkiewicz: We have had a reasonably smooth ride and therefore it is sensible to predict that we will have more volatile times in the future. Do I have any sense of when that might come or what will cause it? Making predictions like that would be like throwing darts at a dartboard.

We should take into account that the past 10 years have been abnormal. Therefore, if there is a concern it is complacency. The central bank activity that came into support the markets has almost conditioned people to invest in a certain way.

Tapan Datta: We are likely to see volatility at higher underlying levels, but today's levels are nothing to get over-excited about. Markets have been calm this year.

That may be due to central banks providing reassurance to markets, but we would expect, on an underlying basis, that volatility is likely to move up in the next few years.

Femi Bart-Williams: If you plotted the "spike" volatility that we have seen over the past 12 months on a long-term chart you would barely see it.

There is an argument that such a low volatility environment cannot continue. So preparing for the eventual increase in volatility will be key.

Rob Booth: If we held this roundtable two years ago would the conversation have been similar. It feels like we've been hearing for a while that: "Returns are going to be low and volatility will return, so it's going to be a bumpy ride. Let's start preparing for it."

In the defined contribution (DC) environment, if members read that in the press they might sit in cash. 2018 would have been a nice year to be sitting in cash, but that corrected itself earlier this year.

The world seems to be controlled by central bankers, so it depends on what happens in that environment to determine the sort of volatility that could hit the markets.

Andy Scott: In DC volatility is very much around investments, what's happening to assets. On the defined benefit (DB) side, it is about your definition of volatility. Is it assets going up and down, or assets changing compared with the cost of your pension? So the funding level, effectively. If your assets are going up 10% but the cost of a pension is going up 20%, you are in a bad position.

So for DB schemes, volatility is more about how the assets vary compared with the liabilities. That sometimes is quite difficult for trustees to understand or to get across.

Drewienkiewicz: The time horizon for a lot of DB schemes is getting pulled in and with volatility what's important is your time horizon.

It is different for the DC scheme that Rob's looking after where it is potentially dangerous for people to have too many levers that they can pull because they don't want to worry about it too much. But for DB schemes where the time horizon's coming in, people are starting to think about buyout.

Obviously, you can be more sensitive to a bit of volatility and it might make a difference between being able to buyout now or pushing it out for 18 months.

Booth: In DC, we might have a long-term horizon but if a member looks at their benefit statement and the £1,000 they have put in over the past 12 months is now worth £800, they start thinking: "I'm not sure about this pension thing."

So it is getting the right balance as trustees. You have got to have your foot on the pedal but without scaring the horses.

Scott: The financial education of the members is a big part of them not getting scared by that £1,000 becoming £800, especially when they are 25 and have 40 years until it all comes back to them.

PI: Have trustees been focusing on financial education in recent years?

Booth: Yes, but, from an auto-enrolment perspective, when you have all these new savers you must be careful what you wish for. Only a small proportion of members open their benefit statements or register online to see what their pension is worth. The whole idea of auto-enrolment works because of inertia, people weren't engaging. The more they engage, the more they understand, the more scared they could potentially become.

So in a way it is great if they are not looking at the valuations, especially if markets are going to drop. If they start understanding a little bit then that knowledge can be dangerous. They could start thinking: "I didn't want to be here… I'm out."

Bart-Williams: The clarity of the objective is crucial here. It is one thing to measure the value of the assets versus the value of the

Andy Scott

"Because the markets have gone up in the past seven or eight years, people have almost forgotten that growth assets can go down as well as up."
Andy Scott, Dalriada Trustees

liabilities, but if you are looking at a scheme in run-off then, arguably, if you hold a corporate bond portfolio for the resulting cash-flows and don't intend to sell those assets then you can look at how much of your benefits could you pay. That measure of volatility gives you quite a different answer to: "What's my corporate bond worth?"

Whether it's DB or DC, having that objective crystal clear in your mind, and then managing and measuring volatility and risk relative to that, is key to making good investment decisions.

Drewienkiewicz: Exactly. We have seen clients coming up to buyout thinking about having a measure of the corporate bond spread baked into the liability discount rate. They are mechanistically starting to reduce the volatility that they observe on the funding level, which is appropriate because you have a closer and closer match for the assets that the buyout provider is looking at to derive their price. So it's context led.

Datta: There's a paradox here. For the DC investor the standard adage is that you need to take a long-term view, take the bumps and ride the volatility out because these are short-term market moves. If you try to be too clever with the time you have you are going to lose a lot of your wealth.

That message doesn't seem to get across terribly well. When individuals look at their pension statements and see that their £1,000 is now worth £800 they could disinvest at the wrong time.

Institutional investors are supposed to be better informed but their ability to ride out funding level volatility


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has declined. Across the spectrum there is less tolerance and less of an ability to withstand sustained market volatility than there ought to be. That is becoming a problem.

Scott: There are several ways pension schemes are trying to tackle volatility. Liability driven investing (LDI) has been trying to remove interest rate and inflation risks.

Everyone is still looking for that extra return from equities to get them through. If you are underfunded it's a different situation. If you are not ready to buyout you have to take more risk and be subject to volatility. Structured equity can help ride out the bad times but not take so much advantage of the good times.

These are the ideas that schemes are going through to cope with the fluctuations that are happening but a lot of it is education. The hardest thing about LDI was getting trustees to understand it. It was the same with structured equity. It is a good idea, but it might take a year or two to come in because people don't understand it or don't feel comfortable with it.

PI: How are you positioning your scheme to face any volatility that may lie ahead?

Scott: It depends on where you are. If you are at maturity and almost at the buyout stage, then you are structuring it so that you can hand it over to an insurer. If you are about 95% there you don't want to risk your funding level falling.

Drewienkiewicz: It is an interesting challenge because as you get closer to buyout you sell more and more risk assets. An insurer is not going to want to take all your assets, particularly the higher risk and non-investment grade corporate ones, so you start to take them all down.

It is like pushing out from the edge of a swimming pool. If you make it far enough to get to buyout, great, but if you don't make it then you haven't got any of your risk assets left.

Scott: When a scheme has almost got to the end it doesn't want to go back to 90% funded. Schemes have been closed to new members and winding down for 10 to 15 years, when deficits started coming in. So when you get within one length of the swimming pool left, people will sell on the understanding that it might cost them, but they cannot afford to go back a length.

Femi Bart-Williams

"Journey planning is important. It is true it might not get you to the end of the swimming pool, but it can minimise the distance by which you might be short."

Femi Bart-Williams, Legal & General Investment Management

Bart-Williams: Investors get more risk averse as they get closer to their end goal, whether that's buyout or self-sufficiency. Even if you don't end up buying out there's a great synergy between what a buyout-ready investment strategy looks like and what it looks like if you are paying the pensions yourself.

After all there is some logic as to why insurers invest the way they do. It is not as binary as buyout or nothing; there are shades of grey in between. A sensible strategy towards the endgame will probably involve a lot of interest rate and inflation risk being hedged, a significant amount of corporate bonds and a little bit of extra return-seeking assets.

PI: What about schemes that are 10 years away from buyout?

Bart-Williams: You can probably distinguish between those who are close to an endgame, whatever that might be, and those who are significantly far away.

If you are significantly far away that just necessitates taking some risk to plug the funding gap. The key thing you can do to manage that growth risk in the short term is to diversify your assets. So it's not just equities but corporate bonds, emerging market debt and private equity, etc.

We see draw-downs of about half on a diversified portfolio compared to equities. So you can manage risk in that way. LDI can help mitigate short-term volatility, so can equity protection. For instance, if markets are relatively high and your funding level has benefited from that, it may be the time to buy some


Rob Booth

"The world seems to be controlled by central bankers, so it depends on what happens in that environment to determine the sort of volatility that could hit the markets."

Rob Booth, NOW:Pensions

protection against a market correction or a downturn. So there are different tools that you can use if you are further away from your endgame.

Scott: On the DC side, if the £1,000 rises to £1,200 then it's a bonus. If you build in equity protection so it only goes up to £1,100 your members would still be happy if it stops it going below £1,000.

Booth: Because of the charge gap investment management budgets are tight, so you need to think about the cost of buying protection.

I see protection as a bit like motor insurance. If you are driving along and you have a little prang, are you going to claim against it while your car's still drivable, because you can only claim once, or wait for a complete write-off and then claim?

There are other ways you can take risk out of the portfolio when markets drop by a certain percentage, but the trouble is when do you put risk back on again, which is the hardest thing by far. It is quite easy to work out when to take it off. All those things combined, particularly the cost angle, make it a nice-to-have. It could probably work in the flexible income draw-down space even more than the accumulation space.

Drewienkiewicz: That's the difficulty with a lot of these protection strategies. It is easy to put things on and envisage how it can help you, but unless you have a clear game plan for how long you are going to roll it out for and what would make you take it off, it can be a governance drain.

Scott: In DB you leave it with the managers as much as possible and give them the parameters in which they can work. For DC, it is the member who sees the £1,000 going down to £800.

Someone I know who is in an equity fund told me: "The manager is useless. Previously it was always going up, now it's going down." That is level of understanding.

Booth: People tend to blame that on the pension rather than the fact that if you are going to get a decent return for your retirement you need to take some risk.

Some research that was done six or seven years ago said that people want to be savers, not investors. Investing means stock market, stock market means gambling, gambling means losing money. It begs the question, what do they think saving is? How do they protect their money against inflation?"

Bart-Williams: What's ironic about staying in cash is that it pretty much guarantees you a loss in real terms, i.e. inflation will likely erode the future purchasing power of that cash.

Datta: It is difficult to grasp the risk you take by sitting in cash in that returns are concentrated in quite a short period of time. The best of the gains can come in quite short periods, as little as 10 days of the year, so if you are out of the market you have missed out. A lot of investors fail to appreciate just how much risk they are carrying in being out of the market.

PI: So selling all your risk assets is not a good strategy?

Datta: It is bad for your long-term wealth and financial health. That said, there is also a sense that some of the conventional wisdom over-eggs it by saying: "Ignore the volatility, ignore the downside. The market dips will be followed by recoveries."

Drewienkiewicz: In some markets that's not happened. People are good at focusing on markets where you get V-shaped bounces but talk to people who have been invested in Japan's equity market for 30 years. They have been waiting forever for that to happen.

Datta: There's no single solution to managing volatility. One must appreciate the risk of being wrong in terms of market timing, but also what a broad valuation means for implied expected returns.

You still have to make a judgment on whether over the next three to five years the risk you are taking is worth the likely returns, and if it isn't then potentially there should be an encouragement to de-risk but not to sit in cash. Just take a bit less risk because that risk is not being well rewarded.

You have to make that judgment without going to the other extreme of piling into cash, because that doesn't make any sense at all.

Drewienkiewicz: The challenge is that on the flipside of the volatility coin there should be opportunities, but equity markets are difficult to call. You can obviously use valuation as a type of compass but it's still not a perfect guide. There are other asset classes, credit springs to mind where the mean reversion is much stronger, where volatility should allow you to take advantage of the opportunities. So if you have a portfolio that has spare cash we like to see volatility, particularly in credit markets, as an opportunity to buy, depending on a client's risk preferences. I feel much more comfortable doing that in credit than in equity markets where that mean reversion is much weaker.

Scott: A big factor for DB schemes is the covenant, the strength of the employer. If the employer wants you to invest in a group of risky assets because they want the upside then that's helpful for me as a trustee so long as the employer understands that risk. Because the markets have gone up in the past seven or eight years, people have almost forgotten that growth assets can go down as well as up. Investing in equities is seen as an automatic way of getting an extra return, but it is potentially a way of losing that extra return.

Datta: One of the challenges is that understanding how much risk you need to take to earn a return is a tricky concept to grasp.

Various trustees have said to me when I talk about risk-adjusted returns: "Ah but, you see, risk-adjusted returns do not buy you lunch; only returns do."

This is the difficulty. They want the risk when they know they can get the upside but they want none of the downside risk. There is no investment on earth that can do that. That is the aspect that is difficult to grasp for a lot of people.

Scott: It's the proportion that you put into the risky assets. Asset allocation is the main driver of what your returns are going to be. Being in the right place or the wrong place doesn't really matter.

Booth: What strikes me is that bit about understanding how wrong it can go. Instead of looking at the funding level, a sponsor needs to understand what the contributions at risk are and make a calculated

view around what they would be on the hook for if it goes wrong.

Where you have a weak covenant it might make sense to take more risk while you know that the employer's still around rather than sit out a long recovery plan. It is the combination of trying to close a big funding gap with a weak sponsor covenant that makes the volatility greater.

Bart-Williams: I would go one step further. Ideally it would not just be a statistical measure of covenant risk. The correlation of that with pension scheme risk is useful to understand, e.g. the economic scenario that might cause your sponsor stress and hopefully making sure that that is not the same economic scenario that is causing pension scheme stress.

Drewienkiewicz: That's easy to say. In practice you are going to be investing in a lot of corporate businesses, via equity or debt, and in all likelihood your sponsor is a corporate business.

Bart-Williams: Yes, it is a corporate so general corporate risk is important, but there are also sector-specific risks. So you can't do it with forensic accuracy but you can do a pragmatic approach and ask: "Is it oil prices that are going to cause my sponsor stress? How might that impact my pension scheme investments?"

It is one of a number of measures that you should probably look at but it's not a silver bullet.

Scott: If a scheme has a risky covenant, the regulator is taking a much closer look at the investment strategy or the funding strategy because they don't want the scheme going into the Pension Protection Fund.

Whereas it was the case in previous years that your best chance of trying to make up for any shortfall was to take a bit of investment risk, that strategy would come under quite a lot of scrutiny by the regulator and they would probably stop it.

Bart-Williams: Scenario testing and statistical stress analyses are important. Sometimes you get consequential risk. For example, if you use derivatives to hedge some of your risk then there might be a collateral call on that.

Having a plan for collateral and not parking that in assets that are volatile and market-sensitive is a sensible thing to do to diversify that risk, otherwise your collateral pool is getting depleted at precisely the time you need it.

Drewienkiewicz: This is about holistic risk management. That is what the regulator's been pushing hard on.

Bart-Williams: It is certainly something that they should plan for. I'm not saying sit in cash, but it's useful to have a waterfall so if you need collateral you can get it. Then you make sure that those assets in which you park your collateral are ideally market neutral, certainly close to duration neutral, so you don't have significant interest rate and inflation sensitivity in those assets.

Typically, it is your interest rate and inflation hedges that might need collateral at a certain point in time. So it is important to have a plan for collateral.

PI: Could volatility force a move back to active management?

Booth: Over the past year or so there's been a lot of commentary suggesting that we are heading towards an environment where active management will come into its own.

I don't know whether that's right and only time will tell. Intuitively, it feels like there could be opportunities to identify some underappreciated value, but the pressure on active managers will only increase if that doesn't turn out to be true.

Drewienkiewicz: I have seen studies that support this thesis and studies that debunk it, so I'm not convinced there's any significantly clear evidence that active managers do better in more volatile times.


Pete Drewienkiewicz

“The time horizon for a lot of DB schemes is getting pulled in and with volatility what’s important is your time horizon.”
Pete Drewienkiewicz, Redington

There are investing styles that many managers follow, particularly quality and defensive, that tend to underperform in the market in big rallies but perform when we have volatility.

To say broadly that active management has a better time when volatility hits…to be honest, some people are guilty of a bit of wishful thinking there.

Datta: The issue is if markets lose their thrall to central bank policies then internally there’s more diversity in the markets, the interim market correlations will fall and that will help active managers.

We have seen false dawns on this over a number of years, so I’m not holding out any hopes that active management is making a big comeback. The other point is that almost 50% of US assets are passively managed. There is some academic work suggesting that there is a point at which active managers are advantaged, but volatility per se is not going to rescue active management.

Bart-Williams: Volatility returning to the market can be anyone’s friend. If you are a passive investor, for example, and you imagine that volatility is doing an oscillation around a fundamental true value, perhaps due to sentiment say, if you average in over time volatility can be your friend. So volatility is not only your friend when you are active.

Volatility per se does not necessarily mean active managers are going to outperform. However, if increased volatility were due to a lack of support from central banks, which was previously making it

difficult to distinguish between good and bad valued corporate bonds, then intra, and inter, market volatility could return and that could be advantageous to active managers.

I'm not sure that it will necessarily play out that way because philosophically active management is skill-driven and, arguably, that should be evident whether it's in volatile or less volatile markets.

Scott: From a trustee point of view, I wouldn't just switch to active management because volatility can also be your enemy.

One of the ways to reduce volatility is through journey plans. By that I mean banking your gains when you are ahead of your target and also taking harder, riskier decisions when you are below it. This will keep the scheme within pre-agreed boundaries on its journey to its target position and whilst it might mean missing out on some of the good times, the scheme will not be over exposed to the bad times.

It must be frustrating, however, for active managers who have done a great job only to be told to sell their good-performing investments because they are ahead of the game and transfer them elsewhere to safer corporate bonds or gilts.

Drewienkiewicz: These marginally de-risking plans don't make sense. There's that final length of the swimming pool risk. If you are swimming slower every second and you don't get it absolutely perfectly right then you get stuck and have no risk assets to get home.

They need to be run with substantial buffers and a lot of caution around that. Maybe you can start with more risk than you would run if you just ran a lower level of risk for a longer period of time.

Scott: If you know you are going to keep looking at it and adjust it appropriately. It's not so much in the final length; in the final length you are pretty well de-risked and the employer is prepared to pay the 2% if it doesn't get to the end. But when you are 10 or 15 years away you have to take risks to take advantage of the good times.

Datta: Yields are low so the expected returns in fixed income are low, while risky asset valuations are generally on the high side. The return profile doesn't look brilliant, so we need manager skill to add alpha. The question is, are we going to get it? It is more urgent than ever that we get that but it is still a challenge in these markets. As we saw last year with active management, it's a big challenge to get that excess return from skill.

Bart-Williams: Active management is more suited to particular strategies, so a high-yield bond strategy, for example. One should not necessarily go hunting for alpha everywhere.

Journey planning is important. It is true it might not get you to the end of the swimming pool, but it can minimise the distance by which you might be short. For most corporates there is a distance within which it's tolerable, and it makes sense to manage your risk as you get closer to that endgame. It is consistent with the concept of being more risk averse as you have more to lose.

Scott: Regulators are going to be asking about dividends in the future whereas they may not have done so in the past. That is going to be an interesting.

Bart-Williams: We get interesting reactions when we speak to clients about their value at risk. If you start from a place where you put your biggest bets on the views that you hold strongest then it should follow that the value at risk, however measured – whether it's funding level, etc – when decomposed should show where you have your strongest views.

It is rarely the case that trustees have the strongest views on long term interest rates or inflation. They inherited these risks, yet they tend to be the dominant risks of many pensions schemes. It is back to that point about being aware of where your risks are coming from and sizing them accordingly, not unwittingly betting the whole house on long-term rates going up or inflation coming down.

Scott: On the DC side, is being active or passive something that you look at?

Booth: It's mostly underlying passive. It is all about working out where the risk is going to be allocated rather than where the assets are going to be allocated, then trying to allocate the risk in a diversified way that has the right level of portfolio risk and using the underlying instruments, which will be fundamentally index tracking.

There may be some individual corporate bonds, for instance, but it's a minority. In equities we will go for indices but trying to find indices that work for what we are trying to achieve can sometimes be a little bit tricky.

PI: Where have you allocated your equity portfolio?

Booth: We don't like taking positions. If you tried to call the market two to five years ago you would probably have called it wrong. So our equity allocations are typically around a third UK, a third US, a third Europe and we might put some in the Far East.

PI: So how do you hedge currency risk?

Booth: We hedge currencies, but we use quite a lot of futures. So we have currency hedging built in.

Scott: From the DB side, we were talking about less about equities full-stop. As the time horizons get pulled in schemes are investing less in the growth assets.

Drewienkiewicz: Equities are down to under 20% in a typical UK DB scheme. Almost everyone is global. Someone said to me it had been two years since they saw a big consultant search for a UK equity mandate. We did one at the end of last year but there hasn't been a huge amount of activity in domestic equities.

Bart-Williams: The name of the game over the last maybe 10 to 15 years has been diversification. Out of listed equities and into other asset classes, for example private equities or infrastructure debt. The equity allocations that we see now are typically much lower compared to 10 years ago.

If you look at the diversified strategy compared to equities you can have broadly the same expected return when you allow for diversification bonus, etc, but maybe two thirds of the risk, and as a trade from a risk-efficient return perspective, that makes sense to a lot of investors. You would probably find more diversified strategies than you would find equities these days.

Scott: Where they are expanding is in credit. It's something that regulators are trying to get what they call "efficient capital" for DC schemes. It's trying to get DC investors into these, so its infrastructure, private lending and so on.

Datta: If time horizons are shrinking, then the capacity and the ability to withstand illiquidity have also reduced. That is not a logical fit if you are going towards buyout. That is the big problem behind increasing illiquid asset exposure.

Bart-Williams: In our experience, clients are clear on what they are using strategies for. Typically, illiquid assets are used for their cash-flow. You take income from them and they are typically distinct from the assets that you would sell if you need liquidity.

So there's a liquidity ladder in our clients' minds as to where illiquids sit, whether it is a buy and maintain corporate bond portfolio or emerging market debt. They sit at different rungs of that liquidity ladder.

Booth: It still gets difficult on the DC side. You have purchases and redemptions going all the time and so you need a daily valuation. We have just hit £1bn under-management, which is actually quite low to have meaningful illiquid assets in it because you need such a diversity of those liquids to stagger the valuations to make it fair.

PI: How do illiquids fit in with the charge cap?

Booth: The charge cap is a big issue. At the moment in DC, in everything you look at that's illiquid there is a bit of a fudge to make it work. For DC members, for instance, it's lovely to think: "Okay, I am investing in that new hospital in Manchester," but at the moment it's just about getting those valuations right.

Drewienkiewicz: To come back to the core point, what you can invest in to make you much more relaxed about volatility is high-quality cash-flows that you know are going to get paid, it doesn't matter where they are from. If you buy attractively-priced cash-flows then everyone's happy.

The problem is that at the moment all the cash-flows that are in the public market are quite expensive. The cash-flows that for a little while we thought were a bit cheaper have been in the illiquid market, and it is difficult for DC investors to access those.

I would agree that if you are not careful there's definitely an element of fudge that goes on, particularly in DC where the fee cap is even more of an issue.

PI: What impact will geopolitical risks have on the markets?

Scott: The uncertainty in the markets just now is making it difficult. What's going on in the Commons, what's happening with the US and China, all that stuff makes it difficult to know where to invest.

Drewienkiewicz: The smaller holdings in equities have helped that a lot. We obviously saw rates fall to the asset liability point, so funding levels, particularly where people aren't fully hedged, will have been a little bit more challenging. Overall, people have weathered this reasonably well so far.

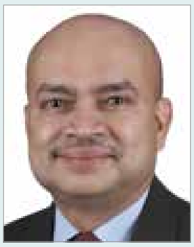
Bart-Williams: Volatility and uncertainty are almost existential. Today it's the Commons, a couple of years ago it was Trump and before that it was the French elections.

There will always be a story that makes the world an uncertain place. If one accepts that, then doing a lot of the stuff that we talked about today – diversifying, being clear on what your endgame is and that your strategies align with that – will continue to be broadly the right thing to do.

Preparing for volatile times is something that we are just going to have to do forever.

What is a transition environment?

Tapan Datta, global head of asset allocation



For some time now, we have regarded market conditions to signal a 'transition' environment. Our timing indicators suggested that we moved into a transition phase sometime in the first half of 2018, taking us from a long period of risky asset strength towards an eventual market downturn phase when bonds will be the only performing asset.

A question we are often asked given the length of the current bull market[1] is when will the ultimate market downturn arrive. A large market downturn still does not appear imminent but sometime within the next year or at most two, looks a reasonable expectation for such an event – by the summer/autumn of 2020 we estimate we'll have been in a transition environment for some two-and-a-half years.

In this environment, markets will go through several mini-cycles. Volatility will go higher in a jumpy, discrete process that essentially reflects the higher level of economic and market uncertainty.

It is not necessarily the case that these asset moves are synchronised in the transition phase; only in the final market large draw-down phase are there sympathetic moves in risky assets across the board.

Market leadership at sector and stock level can change drastically, though this is not a given. Three main factors will determine the likelihood and scale of such shifts: Valuation anomalies, economic conditions and policy reactions.

Market phasing

Market cycle measurement typically focuses only on rising and falling risky asset performance centred on equities. This does not recognise the intermediate or transition phase we are referring to here when risky assets start to perform less well.

Typically, transition markets see a tussle between factors pushing markets higher, and those which are pulling markets lower. Down markets should be seen as the end of a process which is set in motion in transition environments. It is what happens in the transition phase that ushers in the final market phase of sharp falls in risky asset prices and outperformance of defensive assets.

Triggers for the beginning of the transition

We are in an environment where the longevity of the global business expansion that began 2009 is now looking suspect. US policy interest rates have risen, broad financial conditions are tightening, and expansionary fiscal policy is likely to create added strain at a time when US labour markets are tight and expansion capacity is limited.

At the same time, global threats to the economic expansion are rising, given more trade protectionism and growing economic divergence between the US and other regions. The economic risks from this are seen in a flattening US yield curve.

Notwithstanding their setback through the end of 2018, equity markets and risky assets in general remain on rougher ground given the change in monetary conditions and narrow risk premiums. Low long duration bond yields still provide some support to equities, but high valuations look less sustainable given the broader economic message from low bond yields and poor economic data.

Triggers for the end of the transition

The transition phase ends as a logical culmination of the changes that are occurring through time. However, a 'shock' of some kind is probably needed. This shock could come from some economic development – a significant rise in inflation which brings concerns of faster-than-expected monetary tightening, or a major economic growth slowdown that comes from either the lagged effect of higher interest rates or the creeping effects of trade protectionism.

1) The current period of rising markets has now caught up with the previous longest, the decade long 1990s rise in markets.

Alternatively, a shock can come from seemingly nowhere, such as a more pronounced challenge to the Eurozone from Italy or a large devaluation in the Chinese currency.

Portfolio challenges in a transition environment

Staying the course with risk asset markets appears a gamble given the likelihood of the ultimate large reversal. However, anticipating the downturn by selling risky assets is also a problem since the transition phase can still see the market gain significantly over its duration.

Neither is diversification into assets with intermediate risk-return characteristics that easy a compromise. The diversification promise may not materialise one way or other as made clear by the experience of the financial crisis and the very low return profiles in some cases thereafter (as with most hedge fund strategies).

What should be done?

It appears to us that the better course is portfolio adjustments that incrementally move towards lower risk-taking. Ultimately, making some moves, even if early, will be better than taking no action at all.

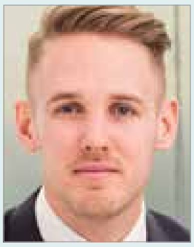
Here are some actions to consider, most of which are standard risk mitigation measures:

- Looking at more defensive approaches within asset classes as well as across the broader mix of assets.
- Using diversifiers where not currently much used or raising exposures in this area – intermediate risk-return assets are the opportunity set here.
- Using any weakness in bonds to build or increase positions. Clearly the higher yields are, the more it pays to build positions, but it is time in these conditions to not be too greedy on yield levels.
- Considering portfolio overlay-type protection strategies. With the timing of market downturns uncertain, open-ended protection strategies would seem best, if available and affordable.

Ultimately, it must be appreciated that in dealing with a transition environment, some risk will have to be taken. Either it will be a case of being too early and foregoing gains directly or costs incurred from purchasing insurance; or in the case of not doing anything or not doing enough, of being too late to protect capital adequately.

It is weighing up these opposing risks for portfolio moves that make the transition environment so challenging. It should hopefully also be clear that this challenge cannot be avoided. Market cycles are like that.

Managing risk in turbulent times

Jonathan Joiner, senior solutions strategy manager,
and Peter Boakes, solutions strategy manager,
Legal & General Investment Management (LGIM)

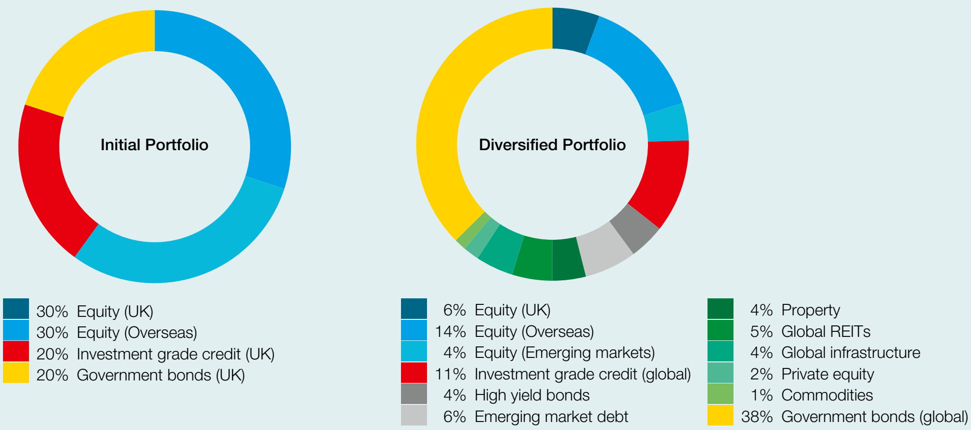
2018 will probably be remembered as the year volatility returned to the market. As highlighted in our CIO's investment outlook, there are a number of tail risks on the horizon that could cause this to continue. While there is no panacea for market volatility, these four simple steps can help reduce the impact.

1. Diversify by geography and asset class

In figure 1 we introduce an example pension scheme and show the effect of diversification on risk.
The scheme's current portfolio is a classic 60:40 split of equity and bonds which has an expected return of 2.7% over gilts but is exposed to significant downside risk, with a one-year funding level at risk (FLaR) of 13.8%.
This means that over a one-year period, in a 1-in-20 event, the funding level is expected to drop by 13.8%. In the right hand portfolio, we have diversified the asset allocation. The expected rate of return is unchanged but the risk (measured by FLaR) has been reduced by c.25%.

Diversification is not a new concept and UK pension schemes have certainly made improvements in this area. However, we believe there is still room for further improvement. For example, schemes with less that £10m of assets under management still have, on average, 40% of their equity exposure in UK equities.
This compares to just 15% for schemes that are over £1bn. This leaves smaller schemes in a higher risk position where they are more susceptible to UK-centric shocks.

Figure 1: Risk reduced while maintaining expected return



	Initial Portfolio	Diversified Portfolio
Expected rate of return over gilts (% p.a)	2.7%	2.7%
1 year 95th percentile FLaR	13.8%	10.3%

Initial funding level is assumed to be 80% on a gilts flat discounting basis

Source: LGIM

2. Target an appropriate liability hedging level

Trustees face the challenge of balancing required exposure to growth assets with allocating to government bonds to reduce liability risk. This is where incorporating leverage, through swaps or synthetic bonds, can be a vital risk reduction tool.

Returning to the example scheme, the diversified portfolio only hedges 35% of the scheme's liability risk owing to the low government bond allocation. However, the liability hedge ratio could be increased to 80% by using leverage. This would reduce the FLaR by a further 10%, whilst still maintaining a similar expected return.

3. Collateral and cash-flow management

The drawback of leverage is it requires the scheme to maintain sufficient collateral. This requirement for cash has been exacerbated by more and more pension schemes becoming cash-flow negative. It goes without saying that ensuring efficient collateral management is a key part of the solution.

Additionally, employing a cash-flow aware approach can help schemes mitigate this risk. Cash-flow negative schemes can be adversely affected during periods of heightened volatility where they need to liquidate assets to pay pensions. This can be at prices that may have strayed significantly from "fair value" and so losses are crystallised. Moving towards a cash-flow matched portfolio not only reduces this early sale risk but also reduces re-investment risk.

4. Currency exposure can mitigate risk

A bonus of diversifying assets globally is this leads to foreign currency exposure. Choosing a currency hedge ratio is not an exact science but we believe maintaining some exposure to foreign currency is an important risk mitigation tool. This is because of the exposure to safe-haven currencies such as the US dollar, Japanese yen and Swiss franc, which have historically been known for rallying when there are market downturns.

Currency risk: Friend or foe?

As investors' portfolios stretch evermore global, currency has become a bigger issue. So is it time to consider active currency funds or could such risk be used to boost portfolio returns? *Elizabeth Pfeuti* takes a look.

Currency markets are the largest in the financial world. Every day, some $5trn is transacted, according to Nasdaq, equal to 25 times the volume traded on every stock market around the globe combined.

However, despite the size of this vast ocean of money that ebbs and flows in markets that never close, just the smallest movement can upturn an entire investment portfolio – and often these movements come out of the blue.

While most securities move on the back of something physical – a fall in sales or potential M&A activity, for example – currency markets take their lead from sentiment and the actions of others, making their direction much harder to predict.

An unexpected referendum result or an early morning tweet can send a major currency soaring or falling, while volatility in a seemingly distantly connected sector or land, can have a massive influence on how a euro, pound, dollar or peso moves against its peers.

A slide in the value of a home currency can hurt a pension fund portfolio – on a paper basis – in a matter of hours if the investor has not made provision to try and hedge out the risk, but as markets regain some of their usual pre-crisis choppiness, could shrewd investors be using the volatility to their advantage?

> "Currency risk is going to be a central theme in the next few years as volatility across asset classes in general and FX in particular becomes prevalent in portfolios."
>
> Thanos Papasavvas, ABP Invest

THIS TIME IT'S DIFFERENT

After almost a decade of markets being soothed by quantitative easing, volatility has come back to the fore.

This volatility has spread into currency markets, providing peaks and troughs for traders to exploit. In the first three months of 2018, CLS, a US-based settlement house specialising in currencies, said its volumes had hit a post-crisis high.

Elsewhere, Thomson Reuters said a spike in volatility in March 2018 had seen currency trading volumes on its platforms rise 28% in 12 months, just narrowly missing the previous month's total, which was its best ever month. The last time pension fund investors saw such volatility, their portfolios looked very different. A distinct home bias could be detected in portfolios until the 2008 crisis made many change their minds.

According to the Pension and Lifetime Savings Association, UK pension funds with less than £100m in assets held 30% of their portfolios in UK equities in 2008. Funds with £2bn or more were only slightly behind with 20%.

By 2012, however, when stock markets had fallen around the world, both ends of the scale had shifted at least 10 percentage points out of London-listed companies, while retaining a consistent level of international equity holdings.

By 2018, Mercer's annual survey of all sizes of UK pension investors found that just 7% of portfolios were held in domestic equities.

But while the message of diversification has been understood and implemented by trustees and pension investment committees, this geographical dispersion has brought currency risk into play. In the 12 months to the end of November, the pound jumped up to $1.43 and down to $1.26 against the dollar and between €1.15 and €1.10 against the euro.

When amplified by a portfolio worth millions, if not billions, of pounds a move that might make a foreign holiday seem expensive – or cheap – could mean the difference between solvency and insolvency for a pension scheme.

Alan Pickering, chair of BESTrustees, who advises UK pensions on their investment strategy, says that as defined benefit (DB) schemes work towards self-sufficiency all risks are being reduced wherever possible. Just 14% of UK DB schemes were open to new members and future accrual in 2018, according to The Pensions Regulator (TPR). Furthermore, some 40% are closed to future accrual, a number that has doubled from the 20% recorded by TPR in 2010.

This means many pension schemes now have an approximate wind-up or end date it can work towards. Unlike open schemes, which can take on risks that may level out in the future, for these closed schemes any risks that are not rewarded, or will not have the time to play out in order to be so, are being taken off the table – and currency is seen in that category by most.

"For those schemes that have very long time horizons, the ebb and flow of the currency markets may ultimately have no effect – it might all level out – but this is not the case for the shorter term investors," Pickering says.

Chetan Ghosh, chief investment officer of the £8.5bn Centrica Pension Schemes, says his team sees currency risk as an opportunity to defend their capital.

"In evaluating our currency risk, we look at how risky the underlying asset is, to see if we should hedge it," he says. "If the underlying asset has low volatility, we will hedge 100% of the currency risk as we do not want the asset to become a currency play."

Assets that are more volatile and have higher expected risk premia, such as equities, generally require a less precise currency hedge to capture their risk premia return. The return from fixed income risk premia can be dominated by the currency impact, hence why investors hedge 100% of the currency exposure to protect the fixed income risk premia from its impact.

Pickering at BESTrustees says that many investors hedge between half to all of their assets, with a preference around the start of the scale to get the best value for money. However, Ghosh says his investment team have decided to remove their hedge on equities, believing they can take advantage of currency movements – they have spotted the potential to make additional returns.

"We were 65% hedged for a long time, now we can take advantage of currency movements to defend our capital," he adds. "We look at the strength of sterling and when it is at what we deem to be a fair rate, we do not hedge. When it is weak, we use a hedge to defend our capital."

The Centrica team monitors the purchasing power parity (PPP) measurement and looks at currency spot values daily.

"It is a question that is at front and centre of our investment outlook," Ghosh says. "We consider $1.40 to be fair value currently under the PPP measure – but it would have to get to $1.26 before we would hedge."

PROTECTION STRATEGIES

Pickering at BESTrustees says that uncertainties about Brexit had brought currency risk into focus for trustees.

"Many may have made a one-off gain with the fall in the pound after the UK's vote to leave the European Union, but it has also spurred trustees to look into how they need to be protected for further currency moves."

This is a sensible default approach, according to Ghosh, who thinks more pension schemes should be encouraged to think about it. Even funds without the sophisticated team at Centrica should be hedging, he says.

"It is not a particularly difficult thing to think about," Ghosh adds. "Consultants should be advising their clients to do it all the time. Looking historically, there are oscillations and mean reversions that can be captured."

Hedging contracts usually cover between three and nine-month exposure to diversify the roll risk, according to experts. At some points, a fund may need to finance these contracts so may have to divest some assets to do so, according to its strategic asset allocation.

"On the operational side, it is not straight forward," Ghosh says. "You have to ensure you are hedging the right exposures and there are calls for capital to oversee, which can come at the same time at equity market falls. So, there are operational challenges, but there are practical solutions for them, too."

In the Netherlands, the €1.5bn (£1.29bn) Nedlloyd Pensioenfonds (NPF) has taken a different approach.

Randy Caenen, NPF's head of finance, control and risk, says that the fund hedges its currency risk for developed and emerging market fixed income holdings through mandates with its investment managers.

"We approach currency risk on a strategic level and monitor it on an ongoing basis," Caenen says.

"NPF does not engage in tactical asset allocation, meaning that there is no explicit view on currency movements or action taken in the short term to gain from currency movements."

The Rotterdam-based pension fund holds around 30% of its assets in non-euro-denominated currency, with the US dollar making up around 15%.

"Regarding geopolitics, it is hard to predict what will happen," Caenen says. "Is a potential trade war going to have the biggest impact or a shift in currency, or both at the same time? We do use stress tests with severe but realistic scenarios to assess the vulnerability of our total portfolio to shocks."

He adds that as the pension fund itself was not taking decisions at a security-selection level, but rather uses multiple investment managers to do so.

Caenen believes that implementing a hedge would be operationally difficult and expensive for something that might not be that effective in the end. "Strategic asset allocation decisions are made on how to diversify across regions," he says.

"Times are changing, and monitoring of assumptions is needed. We believe that taking a well-priced risk will lead to a higher (expected) return."

A GATHERING STORM

This theme of change was echoed by Thanos Papasavvas, founder of consultancy ABP Invest.

"Currency risk is going to be a central theme in the next few years as volatility across asset classes in general and FX in particular becomes prevalent in portfolios."

This pick up in risk will be driven by several factors, including a divergence in policy between central banks around the world and these players making mistakes in tightening up too quickly – or slowly.

In turn, market participants' reactions to these events will – as they have done in the past – add to the impact of any policy change or misstep, with a backdrop of geopolitical uncertainty adding to the mix.

Technical and regulatory changes too, have led to banks' trading desks becoming much more active in search of better price and liquidity in currency markets, too, says Papasavvas. "They have been upgrading their skill-set and knowledge in technology."

With all this in mind, is now the time to reconsider an active currency fund to boost returns?

One London-based pension investor says she was looking to get out of a sequence of rolling contracts and take active exposures "on extremes" but remained skeptical of the efficacy of straight currency investment funds.

For Pickering's clients, there is not much interest. "Active currency management was once seen as an opportunity, now it is seen as happenstance – it is a risk too far for most trustees when other asset classes have come along," he says.

Ghosh is unconvinced, too. "We have and have found it to have mediocre results. The objective starts out sound, but as the assets pile into the industry, its ability to profit seems to go away. It is disappointing that more consultants are not aware of the potential for failure of these funds as the money gathers in them."

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