Client considerations for 2020

Addressing the returns and income dilemma

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Following the Market GPS: Investment Outlook 2020 provided by our heads of Equities, Fixed Income and Alternatives, Norbert Fullerton, Head of Institutional Client Strategy, EMEA, explores what the key considerations should be for clients in 2020.

In 2007, when Steve Jobs disrupted the telecommunications industry with a revolutionary touch-screen smartphone, not many people thought he would be successful. Most of the existing mobile phone providers were sceptical of the iPhone. And only companies like Apple and, two years later, Samsung, decided to adapt and think differently in order to bring change to the mobile phone world.

Smartphones have now radically transformed our lives. And they typically have more than 100,000 times the processing power of the computer that landed man on the moon 50 years ago.

As we start this new year, we look ahead at four key considerations for institutional investors in Europe, the Middle East and Africa (EMEA):

1. Where next for global interest rates
2. The need for income
3. The impact of geopolitical tensions, and
4. Sustainable and responsible investing.

The most successful investors will be the ones who, like Jobs, choose to think differently and, where necessary, adapt their investment strategies to the changing economic, market and regulatory environments.

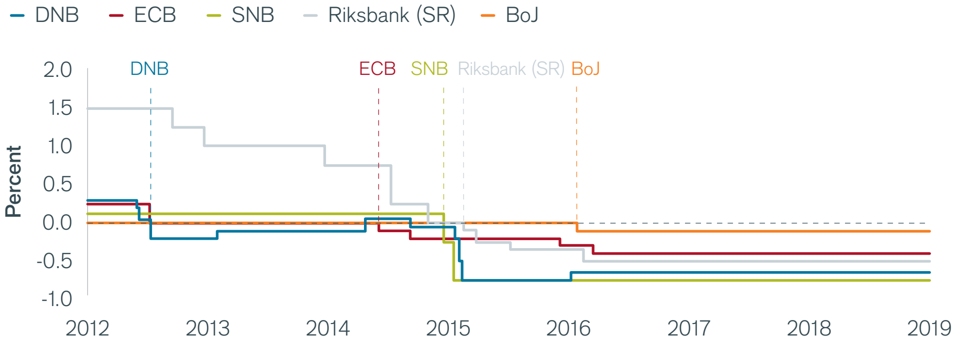
1. Where next for global interest rates?

A possible Japanification of developed Europe and the US

For the past 30 years, Japanese equities, as proxied by the local currency MSCI Japan Index, failed to surpass the high watermark reached at the end of 1989. To put it more bluntly, local investors who bought and held Japanese equities have made no money for the past three decades.

Separately, the paths of short-term policy rates shown in Exhibit 1 below illustrate how the European Central Bank (ECB), the Swiss National Bank (SNB), Sweden's Riksbank and the Danmarks Nationalbank (DNB) have followed the Bank of Japan (BOJ) to the zero and negative interest rate environment since 2015. This refelects the poor economic growth over recent years, and dismal future outlook for interest rates in Japan, the eurozone and the UK.

Exhibit 1: paths of policy rates



Source: Christensen, Jens HE "Yield Curve Responses to Introducing Negative Policy Rates." FRBSF Economic Letter 2019-79, 15 October 2019.

MARKET GPS

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Larry Summers, the former US Treasury secretary, noted in a series of tweets last July:

- "Black-hole monetary economics — interest rates stuck at zero with no real prospect of escape — is now the confident market expectation in Europe and Japan, with essentially zero or negative yields over a generation,"
- "The United States is only one recession away from joining them."

Also, the ECB interest rate policy guidance from September 2019 stated, "The Governing Council now expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converse... close to, but below, 2%."

Given the above two statements, as long as the ECB remains steadfast to the foregoing policy statement and, the inflation outlook fails to converge to 2.0%, interest rates in the eurozone may remain stuck in the nether region of zero to negative for the foreseeable future.

The harsh implication for long-term institutional investors is clear. For pension funds, sovereign wealth funds and insurers that depend on a certain return from fixed income assets, low bond yields present a whole host of challenges. It is especially difficult for defined benefit (DB) pension funds, most of whom calculate the value of their liabilities using government bond yields. When nominal and/or real yields fall by more than expected, their liability values rise (all else being equal), which leads to a deterioration in their funding levels.

No one knows whether Europe and the US will repeat the low yield and low growth Japanese experience of the past three decades. However, despite strong global equity market performance over the last decade, it behoves us all to set our long term return expectations lower, meaningfully lower, than those realised since the nadir of the Global Financial Crisis in February 2009.

2. The need for income

Show me the money

According to most pension surveys, the majority of private sector DB pension funds in the UK and Europe are maturing rapidly. With increasing cash-flow demands from members, many of these pension funds need a lot more income.

Trustees and sponsors are, therefore, increasingly shifting their focus towards income-generating strategies. In the UK, the make-up of these assets varies depending on the target end-game, such as self-sufficiency (where there is low dependency on the sponsor to support the pension fund), buyout with an insurer, or the transfer of assets and liabilities to a commercial DB consolidator.

Coupled with the above backdrop for low interest rates, strategies focused on generating income need to be a key feature for DB pension funds in 2020 and beyond. These strategies should help to increase the certainty of returns, reduce funding level volatility and meet cash-flow needs as DB pension funds near their end-game. Ultimately, they should provide a clearer path for meeting the desired long-term objectives.

For DC pension funds, as the focus shifts from accumulation to decumulation over time, income-focused strategies will become increasingly important – especially to cater for members who don't want to purchase an annuity.

3. The impact of geopolitical uncertainties

War, what is it good for?

Had the US-China trade war been fully implemented, about $550 billion worth of Chinese imports would have been subject to US tariffs. Given the vast size of the US and Chinese economies, it is not necessarily the magnitude of the Chinese imports that investors are concerned about but, rather, the associated negative externalities and the pall it casts over investor and business sentiment.

As shown in Exhibit 2 (on page 3), the average return around both positive and negative news surrounding the trade war has been 0.25% between June 2016 and January 2020 – meaning, investors were better off ignoring the news surrounding the US-China trade war. Sure, one could have generated meaningful alpha by timing the news, but that alpha would have accrued only to the prophetic investors with perfect foresight.

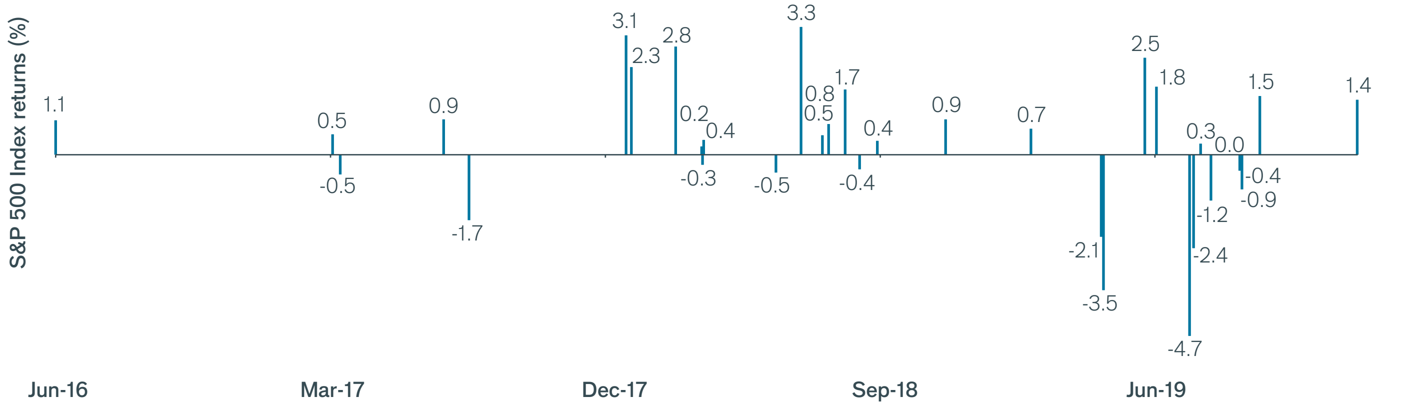
A very similar conclusion arises from analysing the market effects of the news and sentiment surrounding previous Brexit negotiations or the current US-Iran tensions.

On 15 January 2020, the US and China signed a breakthrough "Phase One" deal to halt the trade war, equity markets had started to react positively to that news. Although we expect US-China tensions to moderate over the next few months as the US presidential elections get closer, no one really knows how the trade war will evolve from here.

Similarly, now that the Brexit deal has been voted through the UK Parliament, the wheels are now in motion for the UK's departure from the EU. However, no one knows how the Brexit trade deal negotiations will proceed during the transition period, which culminates at the end of 2020.

The key to success in any investment strategy is relating how macro uncertainties will impact the fundamentals of individual companies and business confidence. Institutional investors with budgets for tactical and dynamic asset allocation activity may be able to take advantage of any market dislocations. However, most other investors should stick to their journey plan for evolving their investment strategy over the medium- to long-term.

Exhibit 2: timeline of the US-China trade war



The average S&P 500 Index return over the time period shown: 0.25%. Periodic returns shown represent cumulative returns 3 business days prior to and 3 after the news announcements.

Key Announcements Examples

28 Jun 2016	3 April 2018	10 July 2018	18 June 2019	1 Aug 2019	5 Aug 2019	23 Aug 2019	15 Jan 2020
1.1% return	-0.3% return	3.3% return	2.5% return	-4.7% return	-2.4% return	-1.2% return	1.4% return
Trump lays out plans to counter unfair trade practices from China at a campaign rally in Pennsylvania.	Trump unveils plans for 25% tariffs on ~$50B of Chinese imports.	US unveils plans for 10% tariffs on $200B of Chinese imports.	Trump and Xi agree to rekindle trade talks prior to G20 summit in Japan.	After two days of failed negotiations, Trump announces additional tariffs.	China halts purchases of US agricultural products in response to US tariffs; yuan weakens beyond the key seven per dollar level.	China announces retaliatory tariffs.	US and China sign “Phase One” deal to halt the trade war.

Source: Reuters. “Timeline: Key dates in the US-China trade war.” January 2020 Janus Henderson Investors.

4. Sustainable and responsible investing

Time for action

There continues to be increased prominence of environmental, social and governance (ESG) considerations and sustainable investing. This has been driven in EMEA by regulatory pressure, risk management and, more generally, client demand for improved investment outcomes and a desire to have a more positive impact on society and the wider world.

While sustainable investing has come a long way in recent years, there is still much more to do. Recently, Mark Carney, the outgoing governor of the Bank of England, said that according to leading pension fund analysis, the policies of companies were “consistent with warming of something in the order of 3.7 degrees to 3.8 degrees” Celsius. This was far above the “1.5 degrees that people say they want and governments are demanding”.

Mr Carney said companies were not reporting in “any consistent way” on how they are managing their transition to a net-zero carbon emissions target. He threw down the gauntlet to institutional investors by saying, “A question for every company, every financial institution, every asset manager, pension fund or insurer: what’s your plan?”

The majority of institutional investors in EMEA also agree that the pace of investor action on sustainability is relatively slow. The main findings from a joint report on ESG integration in EMEA[1] by the CFA Institute and the United Nations-supported Principles for Responsible Investment (PRI) cited that, “governance is the ESG factor most investors are integrating into their process”, while “environmental and social factors are gaining acceptance, but from a low base.”

The message is clear: the decade for institutional investors to start delivering to the UN PRI’s sustainable development goals is upon us. 2020 is the year to really focus on these issues and ensure that there is consistency in investing in a sustainable manner, and reporting accordingly.

What does it all mean for 2020?

Valuations across both risk reducing and return-enhancing assets appear stretched and there are macro risks, as explained earlier. Therefore, the dearth of assets or investment strategies (both at strategic and tactical levels) that can generate high returns and income to meet the spending needs represents the biggest challenge facing all investors.

[1] ESG Integration: Europe, the Middle East and Africa: Markets, Practices and Data (CFA Institute & PRI, 2019)

Client considerations for 2020

Investors should, therefore, think differently and adapt their strategies to the changing markets and their evolving needs. We suggest the following actions for our current and prospective clients:

a. Focus on income

We expect the current low yields to continue for the foreseeable future – especially for UK and European nominal and inflation-linked government bonds. The asymmetry in the range of outcomes – lower expected returns and elevated risk of loss – means, in our view, the approach for investors in 2020 should be one of caution, selectivity and patience.

The increased demand for income from pension funds should help shift the focus from mark-to-market volatility, to increasing allocations to positive-yielding income-generating assets (such as buy and maintain fixed income and equity income) to help meet cash-flow requirements and end-game objectives. We outline further thoughts in our paper 'Cash is king for DB pensions' and our latest long-term study into global dividend trends.

b. Think medium to long-term

Macro and geopolitical uncertainties abound. We caution against making knee-jerk investment decisions in reaction to potential events with binary outcomes, such as the current US-Iran tensions, the Brexit trade negotiations, or the US-China trade war. Their impact on asset prices tends to be ephemeral and soon forgotten after their eventual resolution.

c. Add diversifying sources of return

There is long-term merit in adding genuine diversifying sources of returns, especially in a world where traditional portfolio diversification may no longer work, as witnessed in 2018 and 2019. Especially for insurers and mature pension funds that are increasing their payments to beneficiaries, reducing risk via true diversification across a range of risk premia could prove beneficial. This includes well-diversified alternative strategies.

d. Integrate ESG risks and opportunities

Successful investment strategies reflect better returns, lower risk and are more-aligned to client-specific objectives. We believe these strategies should have ESG factors and effective stewardship at the core of their investment processes.

About the author

Norbert Fullerton

Norbert is Head of Institutional Client Strategy, EMEA, for Janus Henderson. He is responsible for the thought leadership and strategic investment solutions for institutional clients in EMEA. Norbert has over 20 years' industry experience as a business leader, lead investment consultant and solutions provider at firms such as Mercer, Russell Investments and Willis Towers Watson.

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