Manulife Asset Management

Investment

Balanced Investing 2.0:

A New Option For Institutional Investors

BY: DARIO DI NAPOLI, CFA, CAIA

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Historically, the traditional balanced fund has served many institutional investors well. The secular drop in bond yields that started in the early 1980s introduced a multi-decade wave of unprecedented returns for bond investors. This proved to be a golden age for balanced investors, with the DEX Universe Bond (now FTSE TMX Universe Bond), S&P/TSX, and S&P 500 (in Canadian dollar terms) each providing returns of about 10 per cent annually.[1]

Fast forward to the post-Great Recession period (2008 onwards) and investors continued to experience strong returns from balanced funds, as yields compressed due mainly to global central bank intervention which kept interest rates low, coupled with a fairly lengthy bull market in equities over the same time period. Your traditional balanced fund asset allocation of roughly 30/40 per cent Canadian equity, 20/30 per centU.S./ foreign equity, and 30/40 per cent plain vanilla Canadian bonds would have earned

you about eight to 10 per cent in both the 3-year and 5-year categories, as presented in the 'Q4 2016 Mercer Pooled Balanced Fund Survey.'[2] I call this 'Balanced Investing 1.0.'

Given the current outlook for bond and equity markets, we believe, as do many academics and investment professionals, that 'Balanced Investing 1.0' will likely not get the returns of the past. There is a higher risk that actual returns could fall short of institutional investor objectives, such as a pension plan discount rate or a foundation or endowment spending target of CPI plus 3.5 per cent.

Subdued Outlook

After a 30-plus-year run, the outlook for bond returns has perhaps finally reached an inflection point. We recently experienced the effect of 'Trumphoria'[3] (as Megan Greene, Manulife Asset Management's chief economist calls it). Bond yields spiked 75 basis points in the weeks after last November's U.S. election[1] as investors felt (and continue to feel) a euphoric drive to sell bonds and buy equities. Most major bond indices declined at least two per cent or more during this period; the FTSE TMX Universe Bond fell 3.4 per cent in the fourth quarter.[1] Paul Schmelzing, of Harvard University and currently a visiting scholar at the Bank of England, concluded that, given likely prospects for a global rise in inflation, we could very well be facing "sustained double-digit losses on bond holdings."[4] Schmelzing quotes Paul Singer, a hedge fund manager and founder of the US$31 billion firm Elliot Management,[5] who said in a recent letter to investors that we are currently in "the biggest bond bubble in world history."[6] Many leading asset managers in the industry project that the forward looking returns for the broad fixed income markets are bleak. While it is unclear if yields will continue to rise or remain near these historic bottoms, it is clear that the current risk/reward environment for bonds is skewed to the negative and the compensation available may be insufficient given the level of risk assumed.

The story is similar within equity markets. Our team of global economists and portfolio managers believe that the low growth environment we are facing in the developed world is likely to persist for the next three to five years,[7] while risk levels stay the same. Investors are now confronted with getting half the returns they are accustomed to, without a commensurate drop in volatility. While there are a few industry outliers, many asset managers and market analysts do not believe we will continue to see the equity returns that we have been fortunate to achieve in the post-Great Recession period.

A New Approach

Balanced Investing 1.0 can still be a good solution for individual investors who don't have a specific, long-term stream of annual financial commitments where they rely on their investments to help them meet. However, it is coincidence – not investment due diligence – that has allowed balanced fund returns to meet the investment objectives of institutional investors like foundations and pension plans. There is no correlation between the two (other than with the benefit of hindsight).

With bond and equity markets both expected to see low returns and heightened volatility for the foreseeable future, more and more institutional investors are looking to measure investment portfolios in terms of how well they help them meet their financial obligations. A new 'version' of balanced fund investing for institutional investors is available to achieve this, a 'Balanced Investing 2.0.'

The starting point for this new approach is abandoning the typical balanced fund benchmark when it comes to measuring the performance of your investments. If such a benchmark loses 10 per cent, and your portfolio manager loses only five per cent, it's important to remember that you have still lost five per cent of your underlying capital. An absolute return approach can seek to preserve capital each year regardless of what's occurring in the market and, ideally, provide a return that covers either a payout ratio or a targeted discount rate. For example, a target of CPI+5 per cent over a rolling period would dovetail extremely well with the objectives of most institutional investors. Most foundations and endowments have objectives to:

- preserve existing capital
- meet payout targets mandated by regulators

Achieving CPI+5 per cent consistently would theoretically accomplish both of these objectives. Similarly, a pension plan with the objective of earning its discount rate each year, should be theoretically pleased to achieve a consistent return stream of five to seven per cent without major swings in volatility. For example, CalPERS,[8] the largest pension fund in North America, targets an annual return of seven per cent.

For institutional investors to meet a performance target regardless of what public bond and equity markets might do, balanced fund investors require more tools in which to seek out returns and the people they entrust to allocate their assets require more leeway to tactically adjust positions. These 'tools' include an expanded set of asset classes, as well as the ability to allocate at a more specific level within developed markets, such as market cap, investment style, or industry sector. It may include overlay techniques such as currency management as well. This can only be successful if coupled with expert asset allocators who are given the latitude to tactically adjust weights within this broad array of opportunities. These adjustments need to happen with speed and efficiency for the opportunity to generate incremental alpha.

This approach gives investors access to a broader set of markets with outlooks that are different than the traditional pieces of a balanced fund (i.e. the Canadian and U.S. equity markets and the Canadian bond market). This broader market set can include emerging market equities, global developed market investment grade and high yield bonds, emerging market government and corporate issued bonds, and both listed and private market alternatives. Furthermore, it advocates being able to meaningfully tilt to higher or lower weights in specific sectors of developed markets, such as small or mid-cap equities, growth or value style funds, and industry sectors like U.S. financials or information technology.

Of course, the most important re quirement to implement this approach is the skill and expertise of a robust portfolio management team. Having access to a global team of experienced investment professionals who have a long history of managing 'Balanced Investing 2.0' portfolios will determine whether this approach will be successful for an investor. These professionals must have the conviction to forecast an outlook over the long term in order to construct portfolios consisting of a number of different asset classes and tools noted above. They must also have the conviction to move quickly and efficiently when adjusting over and under-weight exposures to various asset classes and subsectors.

Taking The Next Step

In a nutshell, 'Balanced Investing 2.0' can be summarized as providing a trusted portfolio manager with the latitude to access new asset classes, as well as to allocate to more specific sub-sectors of the traditional pieces of a balanced fund, with the ability to make quick tactical shifts at the margins in response to incremental risk/reward opportunities.

Given the current return outlook for traditional public market asset classes, it may be time for many institutional investors to move beyond the idea that beating a benchmark is the best method to measure performance of a manager who you are paying to invest on your behalf. The likely first step required to implement a 2.0 approach is to amend the investment policy statement. We believe this document should be reviewed annually anyway, so investors should not shy away from making this change.

As almost everything on this planet evolves, so should one's approach to investing. Remaining static and looking backward to the returns you've achieved in the last five or 10 years provides no promise and should not provide any comfort on how to approach the next five. As asset managers have moved to taking a consultative approach to clients and prospects, asking them to assist you in delivering this message to your investment committee members can provide the impetus to taking the next step towards 'Balanced Investing 2.0. ' **BPM**

1. Bloomberg, as of February 28, 2017
2. Mercer: Investment Performance Survey of Canadian Institutional Pooled Funds, December 31, 2016
3. Manulife Asset Management: Global Intelligence: Outlook 2017 – Global Economic Outlook, December 22, 2016
4. Bank Underground: Venetians, Volcker, And Value-at-Risk: 8 Centuries Of Bond Market Reversals, January 4, 2017
5. Business Wire: Press Release, January 31, 2017
6. Financial Times: Paul Singer Says Bond Market Is 'Broken,' August 18, 2016
7. Manulife Asset Management: Economic Research Global Forecast, December 22, 2016
8. California Public Employees' Retirement System

Dario Di Napoli (CFA, CAIA) is a managing director of institutional investments at Manulife Asset Management, responsible for managing opportunities across Canada in the defined benefit pension, foundation, and endowment space.

Dario_dinapoli@manulifeam.com

www.manulifeam.com