Pragmatism in Asset Management

Is your manager a pragmatist and if not should they be?

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Pragmatism:

A method of understanding facts and events in terms of cause and effect, and of inferring practical lessons or conclusions from this process.

Nikko Global Equity – Pragmatism:

Ability to adapt an investment strategy to the implications of quantitative easing and the effects it has on investment opportunities.

In Brief

Many investment strategies are anchored around history repeating itself.

An ending of quantitative easing (QE) and the likely impact on markets will result in various strategies delivering poorer returns and greater volatility than suggested by the risk models that investors rely upon.

As a result, pragmatism which has always been relevant will become more important as a factor for investing in the coming years.

We believe a pragmatic approach to asset allocation, investment style and the use of risk models will lead to better outcomes for investors in all market environments.

"In the long history of humankind (and animal kind, too) those who learned to collaborate and improvise most effectively have prevailed."

Charles Darwin

Investment managers often justify their decisions by relying on historical precedent. While the constant and universal principles of greed and fear inevitably dictate market cycles, are today's stewards of capital very reliant on historical relationships which may not hold true in the economic climate of tomorrow?

This question could of course have been postulated at any time over the last few decades, but its relevancy today would appear much greater. We base this view on the observation that the pace of change in the information society of today and the degree to which the monetary goalposts are being shifted, are creating a 'normal' that is shifting faster than many investors recognise.

In the 1980s, speaking into a mobile telephone the size of a brick was almost an invite for derogatory comments from the vast majority of the population who perceived this as pretentious activity of the super rich. Instead, if you stand in the queue at the coffee shop today, conversation is often minimal, as individuals peruse their powerful smart-phones, viewing pictures from their children that self-destruct and competing for 'friends' on social media sites.

Whilst the way humans embrace technology may have annoying behaviours, it is clear that the exploding ability for efficient communication is impacting all our lives. The degree to which this trend also crosses cultures and physical borders, suggests to us that a more connected and urbanised world may be changing more rapidly. The degree of market capitalisation that has quickly been established for internet companies such as Google and Tencent is testament to this phenomenon.

In financial markets a similar evolution to more rapid change would appear to be happening. The willingness of the world's key central banks to embrace new forms of monetary stimulus, affectionately known as QE, is introducing a new parameter for the pricing behaviour of financial assets that has limited historical precedent in modern times.

As a result we believe that investing clients' assets based on theories that are solely anchored on historical precedent that occurred prior to QE have a much lower probability of success than many investors believe. Pragmatism in seeking out better investment opportunities is becoming even more important, and being a slave to previous asset allocations, investment styles or the guaranteed mediocrity of benchmark investing, is the likely road to underperformance.

We would focus on the following topics in particular when embracing pragmatism, as there is a range of observed behaviours within the markets today that would suggest things may be somewhat different this time. Our focus is on global equities as an asset class, but the principles can likely be applied to many other asset classes.

1. **Asset allocation and a shift from convergence to divergence**
2. **Investment styles as a driver of returns**
3. **Efficacy of risk models**

1. Asset Allocation

For a large cohort of investors within the financial world, the "years of experience" lauded within marketing literature have been garnered in a world that has seen an escalation in the degree of cross border trade and a proliferation of cheaper traded goods. The payment and investment flows that have been associated with this trend of globalisation have in fact driven the growth rates in many key locations. China is a standout example, and for much of the last three decades oscillations in the above trend has been a key factor in defining equity market returns.

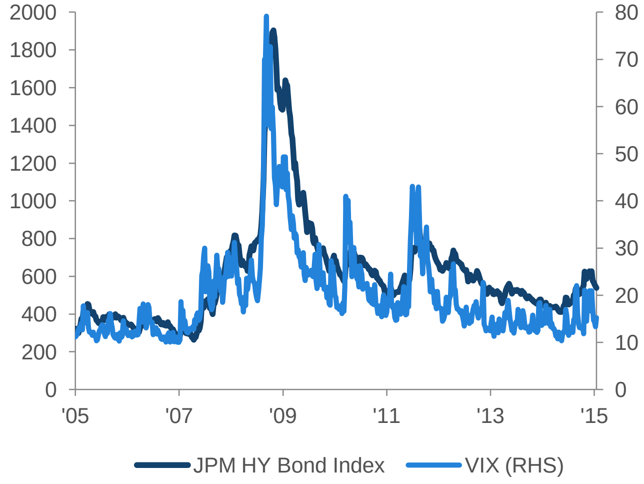
However, the global financial crisis has led to the introduction of QE, and an explosion in the monetary base of global central banks to try and counter the deleveraging that has been occurring within the private sector.

One of the explicit goals for QE has been to encourage an increased appetite for risk in financial assets, with ballooning central bank balance sheets being the source of "liquidity" for achieving this aim. In this regard, they have been highly successful, with increased valuations across all financial assets, and indeed across almost all geographies for much of the period since 2008.

The outcome of the above is that capital flows have become dominated by the scale and timing of QE rather than the more predictable ebb and flow of net external trade, the rate of growth in the real economy and the resulting monetary settings of the respective central banks.

With capital markets being highly global in nature, the actions of the Federal Reserve (FED), Bank of Japan (BOJ), Bank of England (BOE) or European Central Bank (ECB) have had clear and immediate implications for all financial assets, wherever they are located. This new "norm" is of course widely accepted, and when we consider the dispersion of risk spreads (see charts) or dispersion of valuations within sectors, it is clear that QE has already had a profound impact on available investment opportunities.

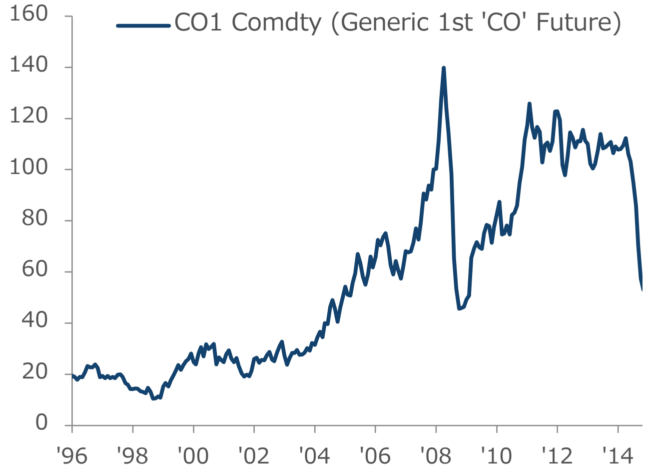
Lower Yields and Volatility



Source: Bloomberg as at 06/03/2015

This great convergence could run further and reach new levels of risk compression, but even if it does, the degree of impact of relative returns will likely be modest versus the last few years. On the other hand, if the scale of QE changes, or its efficacy over the long term is debated, there is significant scope for a reversal in current trends, with an increasing dispersion of valuations and returns. When looking for signals that a new paradigm may be emerging, it is difficult to ignore that the world's reserve currency, the US dollar has commenced a trend of notable appreciation.

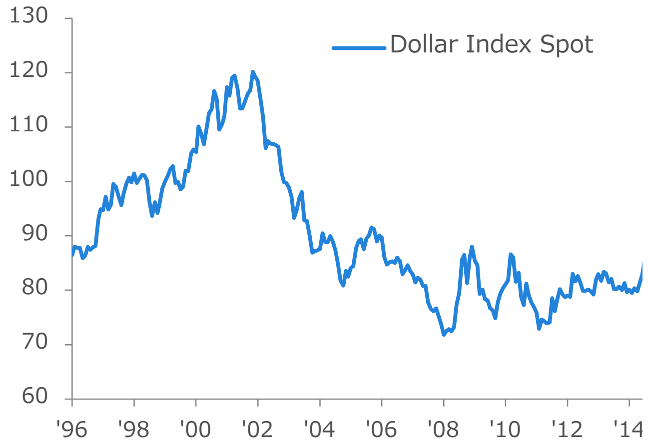
Collapse in Oil Prices



Source: Bloomberg as at 09/03/2015

A similar change is that oil prices and commodities in general have entered clear or continuing bear trends.

Rapid Rise in the US Dollar



Source: Bloomberg 09/03/2015

The purpose of this paper is not to discuss these macro trends in deep detail, other than to observe that key financial indicators such as the US dollar or oil, both of which are not artificially supported by targeted actions of the key central banks, are signalling an inflexion point has been reached in the global economy. The path ahead is far from predictable, with geopolitics, varying desires to implement further QE and competitive devaluation pressures, all being factors for the future. Hence we believe that pragmatism should be applied to the following key questions we ask ourselves:

What is the impact of portfolio capital flows on domestic monetary policy settings?

What is the probability of being coerced into joining competitive devaluations and the implications for corporations that have been using un-hedged foreign debt?

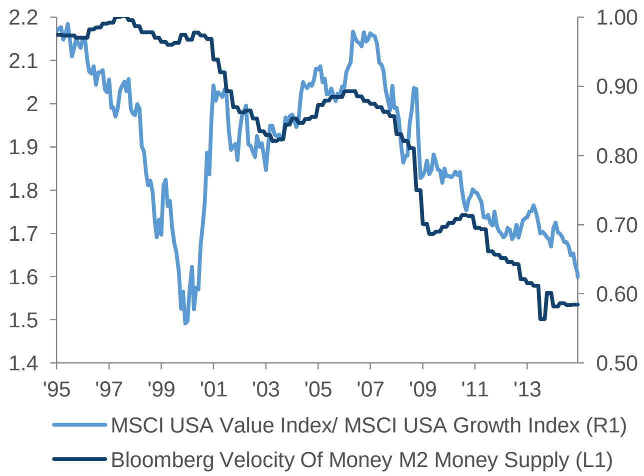
What are the implications from a declining US energy deficit on oil prices and as a result for exporting petro economies and other energy importers?

Will capital controls be used to alleviate pressures associated with currency pegs or volatility?

2. Investment Styles

Investment style is a topic that elicits notable debate, particularly amongst growth and value protagonists. We raise this issue, as many investors deploy capital on the assumption that portfolios skewed to particular factors will achieve higher returns. This is of particular note as "smart" beta has become a particular fashion for investors, with the resulting capital trying to exploit certain factor skews as a source of alpha. We would observe that the track records and the back testing thesis that are used to support these strategies were typically measured during long periods when credit velocity was higher and QE did not exist, as shown in the following chart:

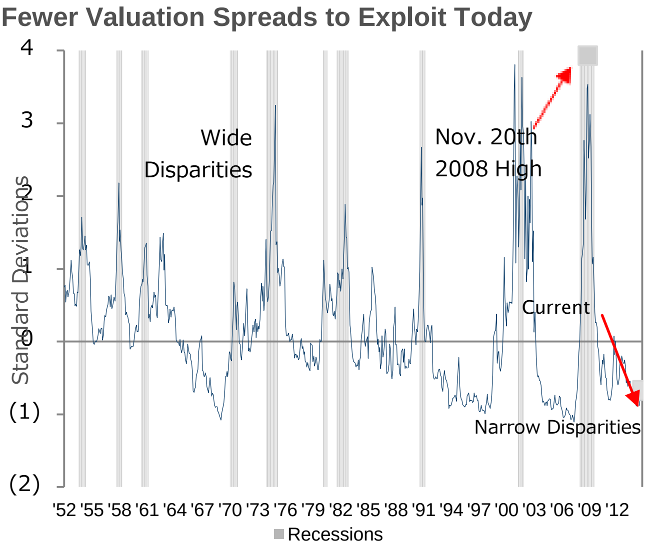
Value Investing Dependent on Credit?



Source: Bloomberg as at 06/03/2015

In addition, the abundance of cheap computing power has made technology a debateable advantage for asset managers as the importance of interpretation usurps data availability.

Valuation Spreads USA
The Top Quintile Compared to the Market Average
1952 Through October 2014



Source: Empirical Research Partners Analysis, National Bureau of Economic Research.

We accept that quantitative analysis and its application is not as simple as the above summation, and indeed there are clear variances between geographies. However, we would also observe that many factor strategies rely heavily on mean reversion as a driver of alpha, and as the dispersion of such factors is narrow by historical standards, the alpha opportunity would appear meagre at best from current levels.

In essence we are seeing an increasing deployment of investor capital in smart beta and fundamental strategies that all rely on the same benchmark defined companies, similar data series, similar beliefs on favouring certain factor skews....and are doing so at the same time.....and when the scale of such skews is modest at best. This brings to mind the old adage, that the more obvious and easy to believe an investment idea is, the less likely it is to be rewarding.

Instead we would suggest that one should be open- minded around what defines value, and be aware of the mis-pricings created by investors who worship data religiously and deploy capital solely at the behest of what MSCI and other index providers define as appropriate. Indeed we would suggest that the great convergence associated with QE has run its course, and as it becomes clearer that low nominal growth globally will prevail for some time, valuation spreads will actually start to diverge again. The axis around which this will take place is a key question. Quality may be a likely answer. We would define this as companies that can sustain compound profit growth in an environment of increased currency volatility, disinflation in traded goods and a rising wave of technology led automation. Return on capital, strength of balance sheet and geographical location may all be contributing factors, but we would suggest that experience and analytical insight will be better filters than a prescriptive computer model.

3. Efficacy of Risk Models

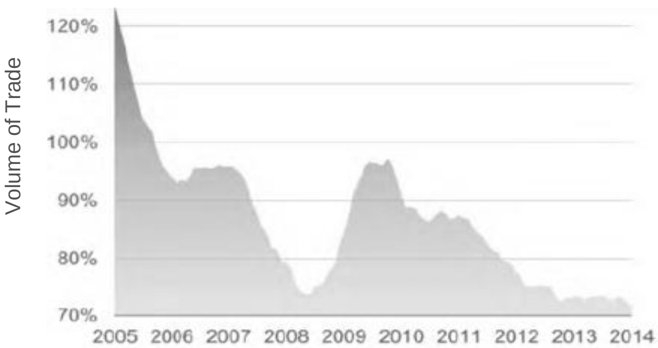
Our final topic is the utility of risk models. The Global Financial Crisis scarred many investors, and quite correctly has raised awareness of risk in both asset management firms and the overall financial sector. This desire to control risk is understandable, and we would suggest has become an increasing part of the DNA of most investment processes as expanding risk teams have carved out their position in the food chain. However, the unintended consequence of this trend is that investor risk positioning is becoming determined by a range of very similar risk models that exist in the market place. Volatility, correlation and other stock behaviours over the last few years (typically about three years) have therefore become the basis on which the future is predicted.

Prolonged Period of Low Volatility

Source Bloomberg as at 09/03/2015

This concerns us for a few reasons. Firstly, this period is one in which QE-led behaviours have dominated and the impact that financial risk taking has had on dampening volatility has become the new norm. Secondly, increases in volatility have become somewhat episodic in nature with the resulting trading decisions from shorter term investors, based on the output of such risk models, likely to be similarly variable over time. Thirdly, the assumption of liquidity by investors, allocating large amounts of capital to ETFs, is not matched by the willingness of dealers to enable these transactions, most notably in the fixed income markets.

Investment Grade Bond Volume



Source: MarketAxess, Blackrock

We would suggest therefore that investors should consider the outputs from risk models with a healthy degree of scepticism at this moment in time for the following key reasons:

Most risk models do not specifically list behaviours related to QE (eg desperation for yield) as a risk factor. Most approach risk through the same lens they have always done.

Now that periods of volatility associated with prior crisis have dropped out of the history of inputs, the default measure of risk is for volatility to remain at the levels that have prevailed more recently.

QE is an experiment, and therefore its unwind has no historical precedent on which to accurately assess risks, particularly if an unwind is disorderly in nature when compared with the systematic accumulation of current positions by the financial community.

Summary

The prevailing wisdom of many investors today that capital should be deployed using investment structures (ETFs etc) and factor-based index portfolios (smart beta) in risk-controlled asset allocations based on the playbook of the last few years, is something that sits uncomfortably with us. We would suggest that pragmatism, which is always a healthy tenet to incorporate in any investment process, has moved near to the top of the agenda in investment priorities. The unwinding of QE is likely to be varied across geographies and the impact this will have on behaviours within markets will be less predictable than most investors and risk models suggest.

With volatility only likely to surprise on the upside, we would suggest that investors should be open-minded about how this will be reflected in the dispersion of valuations within and across risk asset classes. Pragmatism in this regard will become a big factor in determining the delivery of alpha to clients.

Pragmatism – How is it incorporated into the Nikko AM Global Equity process?

Pragmatism in stock picking: We believe that each analyst is accountable for identifying alpha opportunities within the respective global sectors they are responsible for. There is no script for what defines alpha, but there is peer debate around the rationale for each company proposed as a global best idea. The common characteristic is that each investment idea will deliver superior returns over the longer term due to the share price underestimating the scope for growth and shareholder returns compared with the universe overall. Pragmatism in stock screening: With alpha drivers generally varying between sectors, and indeed also across geographies, we rely on the experience of our analysts to use the screening tools available for their use in a pragmatic rather than predefined manner.

Pragmatism in asset allocation: The team undertakes a quarterly global strategy review, with the sole purpose of identifying the key drivers for equity markets over the longer term. These drivers are not prescriptive and will vary over time as the investment backdrop evolves.

Pragmatism in using risk models: Risk models are an output for our review, to ensure that we understand our estimated risks, avoid notable unintended risks and meet all client mandate requirements. However, we are pragmatic in our interpretation, as one month’s hard statistic over risk exposures can become something very different a year down the line as models evolve with variances in market volatility and correlations.

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