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PRIVATE WEALTH

the tortoise & the hare

Insights from the first 'Research Exchange'

In December, a group of investment experts who have all kindly agreed to participate in what we call the 'Research Exchange' came together for the first time. The aim is to meet twice a year and in every meeting two experts share some of their latest research findings. This provides them with valuable feedback and the other members of the group the opportunity to gain new insights.

The experts are a diverse mix of professionals from across the investment industry, featuring heads of departments and lecturers from USS Investment Management, Willis Towers Watson, Bankhaus Lampe, Imperial College Business School and TIAA Asset Management.

Long term expected returns

The first topic we discussed was long term expected returns. The central scenario is a world of steady economic growth with no crisis like in 2008. Inflation pressures are assumed to be limited with the Bank of England achieving its inflation target of 2%. Interest rates are expected to slowly converge to match inflation, or in simple terms real interest rates will be zero. Such an assumption is more optimistic than the consensus in the UK, which is for real 30 year yields to still be negative in ten years' time. The current high equity valuation multiples and tight credit spreads are expected to gently moderate. Current sterling undervaluation should revert to fair levels based on the assumption of purchasing power parity.

If this scenario were to play out, such a world would look very different in terms of long term expected returns compared to what most of us have previously experienced. Even being invested in low risk assets like UK government debt or global investment grade credit would not produce returns that beat inflation. To do so, one would have to take more risk and be invested in high yield or emerging market bonds. Returns from equities are still expected to be above inflation, but deliver only roughly half of the good fortunes of the last ten years.

Risks in this scenario are plentiful. We could have another taper tantrum in 2018 or 2019 or economic growth might slow in China. Furthermore, concern was raised that the current high level of profitability at American companies might not be sustainable. Of course, there is also the possibility that Brexit might turn out to have a negative impact on the UK economy.

Everyone acknowledged that the scenario described by the presenter is a realistic possibility. However, everyone including the presenter also acknowledged that predicting long term asset returns is flawed with uncertainty and that other future states of the world also deserve close attention and monitoring.

Working out alternative scenarios and their impact is therefore a good risk management exercise. These scenarios range from ones that result in higher economic growth with low inflation, to low or negative growth and high inflation. I pick out a scenario of populism and protectionism. In this scenario, central bank independence is expected to be undermined, trade wars are to hamper economic growth and the UK may pursue a radical left wing agenda. In this alternative state of the world, inflation is expected to rise to levels of around 4% in developed markets and higher still in selected emerging markets. Growth, on the other hand, could be non-existent and even a recession might be on the cards in the Eurozone. Under this scenario, ten year real returns are expected to be negative across the board, except for inflation linked bonds in some markets. UK credit would fare the worst, impacted by both widening credit spreads, as well as rising interest rates.

Sustainable investing

The other topic we had the benefit to hear about was sustainability and ESG.

As a little reminder, ESG stands for Environmental, Social and Governance. ESG criteria enables values and beliefs to be actionable. Sustainability has increased in popularity for over a decade now. More and more investors believe that their money can and should achieve more than plain investment returns. As a large Dutch pension fund puts it: "The benefits we pay are worth more in a world worth living in".

Still, sustainability is early in its change trajectory. Catalysts that might accelerate the pace of change are improved data coverage, accuracy and analysis. Large and sophisticated asset owners, like pension funds, will first need to improve their understanding of the topic. That will allow them to develop their belief systems and in turn create policies to improve their orientation towards being a stakeholder.

Such development will turn out to be a catalyst on its own for more widespread adaptation across smaller institutional and retail investors. The CFA Institute believes that over the next decade the investment management industry will also raise its game, with many organizations becoming more professional and ethical, because sustainability is viewed as business critical.

Large providers of ESG data, research and indices, like MSCI, FTSE, S&P Dow Jones and Sustainalytics, have a significant role to play in determining the future of sustainable investing. Will companies who take sustainability considerations into account provide higher cash flows than their peers who do not? Will the risk of a rare, negative business event be reduced? So far, the investment-driven case for factoring ESG into portfolios is generally made from a risk perspective. Although an increasing amount of research is being carried out in this field, it takes considerable time to collate viable data sources and generate statistically relevant conclusions.

Currently, there is no clear indication of a particular family of ESG indices becoming the preferred benchmark. Reasons can probably be found both on the supply as well as demand side. Providers so far offer a wide breadth of index methodologies that to the naked eye seem to address identical objectives. Investor beliefs also vary widely on the connection between sustainability and security mispricing degrees, the importance of different aspects of suitability as well as the preferred investment approaches to pursue stated sustainability goals.

Encouragingly, some investors have already made significant progress. One example is the New Zealand Superannuation Fund, which invests in a passive, low-carbon global equity portfolio based on their belief that "Climate change presents a risk for which we believe we will not be rewarded – an undue risk over the long-term – and it is good practice to try to hedge this risk." However, many investors remain on the side lines watching closely for new data, new research and new solutions to evaluate and frame their own investment approach to sustainability.