

NAVIGATING THE NEW WORLD

Investment Strategies for the Low-Yield Environment

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RED PAPER

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QIC

Executive Summary

In the Old World, investors held on to the following as an absolute truth: that a model, balanced portfolio of 60 per cent equities and 40 per cent bonds would provide an attractive long-run equilibrium return above inflation. That was then. **This is now.**

Now is a New World.

COVID-19, demographic and digital disruptions are combining with geopolitical and economic trends to upend how and where returns are generated.

Making asset allocation decisions in liquid markets is now challenging, especially when trying to decipher recent movements: equity markets feel buoyant despite the long-term economic uncertainties; the ASX200 bounced almost two-thirds since its March lows with the S&P 500 and Nasdaq scaling record highs in August and September; bond yields driven by extreme policies, are low; and ICE Data Services² shows 86 per cent of the US\$60tn global bond market has a yield of less than two per cent.

This is raising questions as to the traditional defensive characteristics of a sovereign bond index. At the height of COVID-19 market stress during March 2020, when margin calls and redemptions drove the extreme requirement for liquidity, liquid assets were the first cab off the rank for monetisation. The Bloomberg Barclays Global Aggregate Index fell 7.8 per cent from 9 March, 2020 to 23 March, 2020 while the MSCI ACWI global equity index lost 19.7 per cent in the same period. The requisite offset from bonds was just not apparent through the stress period.

With volatility in bond markets subdued and rates being held low, investors are looking for new ways to build defensive characteristics into their portfolios.

Now is an Age of Discovery.

Modern investors are searching for yield in an environment where returns are going to be "Lower for Longer".

Yet there are opportunities arising out of these uncharted waters, ones that will require investors to think and act differently, and more quickly.

In this Red Paper, Navigating the New World: Investment Strategies for a Low-Yield Environment, we attempt to answer the question which is top of mind for institutional investors: How can I extract value and maximise portfolio defensiveness and liquidity in this New World?

We believe investors face several options. They can: accept a lower investment return; move up the risk curve in traditional approaches; or look for ways to enhance returns by taking non-traditional forms of risk or managing portfolios more efficiently.

This Red Paper tackles these opportunities under the guise of looking for risk adjusted returns **across, between** and **within** traditional asset classes and in doing so, present investors with our views on how to maximise value in a low-yield environment.

² Smith, C. (27 July, 2020) "Desperate hunt for yield forces investors to take 'extreme risk'" published in Financial Times: <https://www.ft.com/content/b44281c0-2ddb-46ae-83e2-150461faed65>

While our base case is that cash rates will eventually rise again, they will not return to historical long-run averages in the foreseeable future; a forecast which has long-run implications for returns. As such, we believe investors now need to consider their investment objectives and position their portfolios differently to extract value in the New World.

Across the asset classes:

Rethinking the levers at the top to enhance defensiveness and liquidity

Creating efficient defensiveness: Portfolio hedging

In the New World, investors are recasting for tools which can rally and protect portfolios as sovereign bonds near their lower bound. We see portfolio hedging emerging as a permanent tool to not only adjust asset allocation, but secure downside protection for the short and long-term and enhance portfolio diversity.

An evolving SAA: Creating liquidity with derivatives

Strategic Asset Allocation (SAA) is a long-standing and well-tested portfolio strategy. In a low-return environment such as the current COVID-19 reality investors now face, being able to control SAA deviation leakage is more important than ever before. We believe a considered rebalancing framework that utilises derivatives can be a cost-effective way to reduce risk and enhance portfolio liquidity.

Total Portfolio Approach (TPA): Greater flexibility to capture opportunities

While SAA will continue to play a major role in asset management, investors requiring even greater flexibility may consider tilting towards TPA which may offer a more streamlined approach for portfolio construction. While regulatory requirements may preclude full adoption of a TPA approach for Australian superannuation funds, we believe there is a spectrum of approaches between TPA and SAA that can be considered.

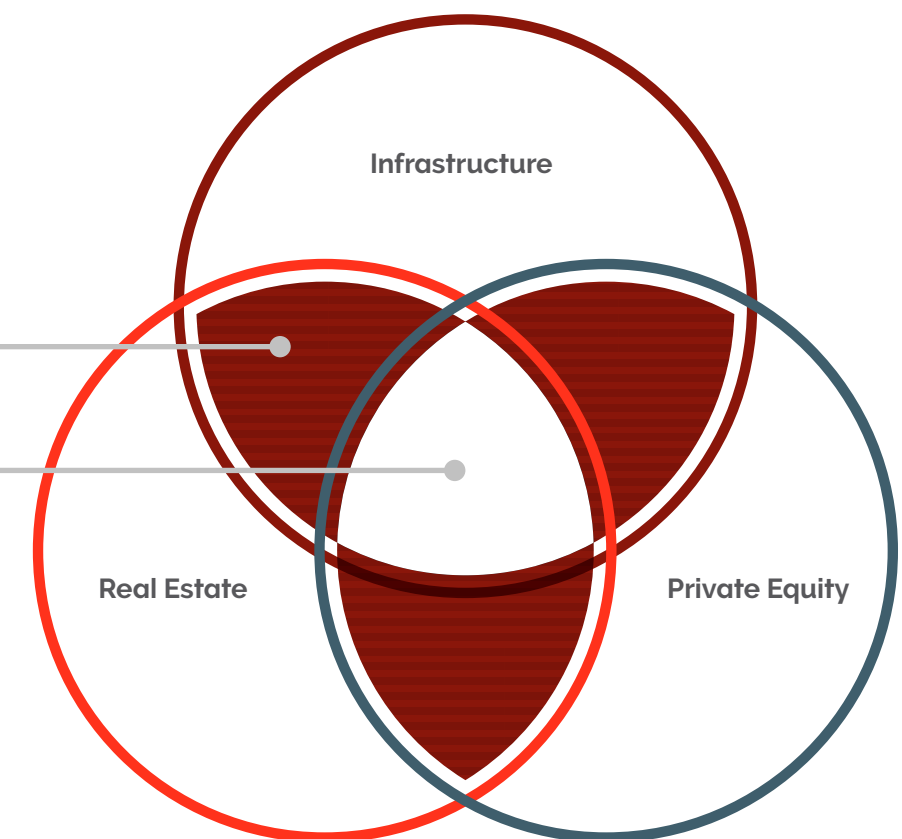
Between the asset classes:

Netting opportunities in the White Space

The boundaries between asset class definitions are becoming porous in the New World, creating opportunities between the silos which are worth exploring. These are opportunities that do not meet traditional asset class definitions, escaping the majority of institutional investors' searchlights to potentially offer attractive risk and return prospects for portfolios.

New assets may cross the boundaries of various traditional allocations

A pool of capital can be deployed to capture those opportunities falling between the three asset classes





The drive towards these hybrid assets – which live in the “White Space” – is not a cyclical phenomenon. It is structural; and is part of the future of the investment landscape. It will operate alongside traditional vertical asset allocations, all of which will continue to deliver value to institutional investors.

This White Space is highly customisable to create bespoke value matching individual investor needs. Within the White Space lie assets which disregard traditional definitions and customise new risk and return opportunities to generate cash flow or capital growth.

Figure 1: The risk-return spectrum can be enhanced with hybrid assets occupying the “White Space”. Source: QIC

This trend is prompting asset managers to infuse and leverage greater active management skills like never before to deliver additional value components alongside quality, long-term assets and with returns generated from strong cashflows.

By harnessing these opportunities – the ‘Efficient Frontier’ or return for given risk on the spectrum – can be extended.

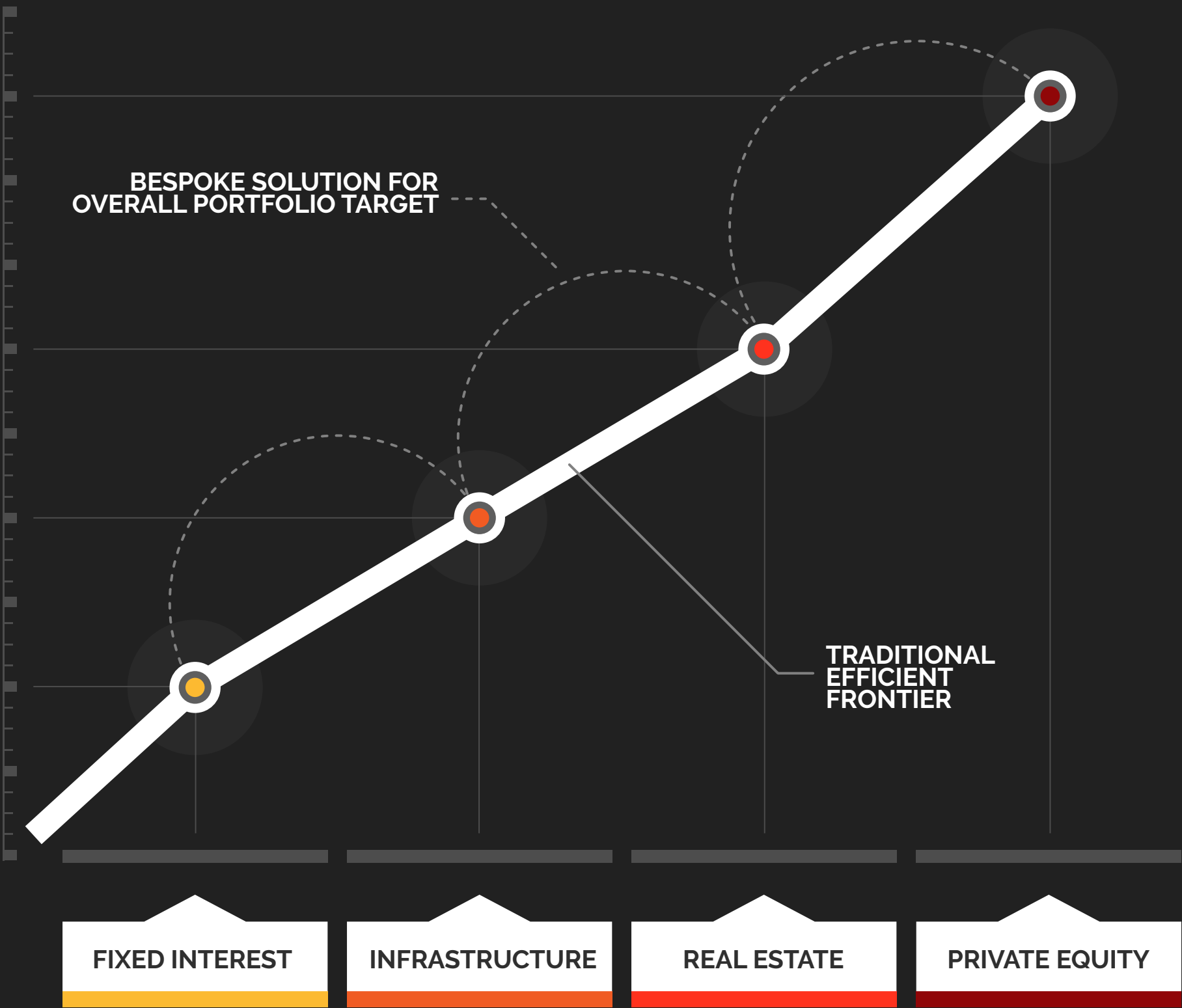


Figure 2: Extending the Efficient Frontier to capture new, untapped returns. Source: QIC

Within the asset classes:

Recasting nets to capture value

As long-term, active managers of alternative assets and fixed income, we remain strong advocates of their value for investors while also constantly innovating within these classes to increase risk adjusted returns for our clients.



Infrastructure: The rising importance of business planning

COVID-19 has ushered in a New World for infrastructure investors, with the pandemic acting as both the biggest disruptor, and generator of opportunities. We see the current raft of fiscal stimulus packages as a key influence in defining this sector's future.

Technology and the rising power of the consumer is also evolving the delivery of essential services, leading to increased risks for some traditional monopolistic utilities which are being replaced by decentralised customer-driven solutions.

The hunt for yield in the New World has also tipped the balance to favour the value being derived from growth-orientated infrastructure assets compared to yield-orientated ones.

And while we continue to believe in core infrastructure assets, we foresee an even greater role for active management to extract maximum value from an asset. In this way, stringent business planning for infrastructure has never been as important as it is in this low rate environment and post-COVID landscape, where the long-term impacts of the pandemic over a 30- to 50-year time horizon are still unknown.

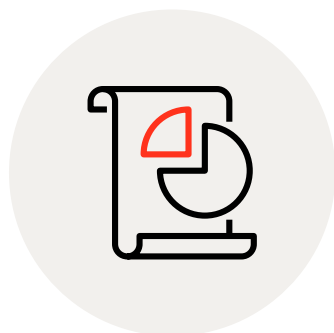


Real estate: Transforming the traditional

Even before the advent of COVID-19 reshaped a new socially-distanced reality, the following drivers were affecting structural changes in real estate: human behaviour and consumption patterns; changing business models; demographic trends; falling interest rates; and technology.

These structural changes have seen a growing prominence of alternative real estate assets with sub-categories including: student accommodation; residential; build-to-rent; industrial buildings; logistics centres; health-care facilities; and data centres. The common theme binding the growth of the alternative real estate sector is the focus on the customer.

As such, asset managers need to embrace a greater spectrum of specialisation to secure returns for clients, encompassing a broader range of risk. The core assets in real estate are also undergoing a transformation, with the retail sector the most visible.

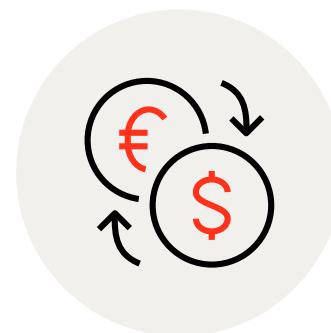


Private equity: A leader in constant motion

Superior private equity strategies focused on capturing value arising from consumer, enterprise and industrial trends – particularly in a post-COVID landscape – will benefit institutional investors. Private equity's focus on infusing strategic and operational improvements into investments also makes this asset class well-placed to harness the digital transformations global economies are undergoing.

Investors have the option to now increase their allocation to secondaries and co-investment opportunities in order to increase their pace to market, minimise the J-curve impact and lower their average fee burden.

We are also seeing some investor preference for pursuing longer time structures rather than the traditional three to seven-year hold period.



Fixed income: An alternative take for a traditional class

Traditional fixed income was typically regarded as a ballast in the late-cycle economy as it provided investors with defensive income. But as bonds come under scrutiny – with over 20 per cent now trading with a negative yield³ – new benchmarks are needed to keep pace with structural changes.

This change could take the form of strengthening the focus on income generation, the jettisoning of negative yield assets from traditional benchmarks or finding new markets such as the Chinese corporate bond market. As such, this traditional class is seeing a rise in alternative approaches to seek improved risk and return outcomes from the sector.

Read on

This paper will look at the opportunities which can be harvested by exploring overlays and options as whole of portfolio tools. It will then investigate the potential benefits available from broadening asset class definitions to encompass the “White Space”. Finally it will explore the ongoing opportunities floating to the top as alternative asset classes evolve in the New World where Lower for (Even) Longer is the norm.



3 Bloomberg Barclays Global Agg Index (27 July, 2020)

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The logo for QIC, consisting of the letters 'QIC' in a large, white, sans-serif font.