Global Fiduciary Solutions

STATE STREET GLOBAL ADVISORS

2019 Market Outlook – 3Q Update

In July, our Head of Public Investments, Jeffrey Palma, published an outlook for markets for the second half of 2019 and in to 2020. Since then, much has changed, as the calm that prevailed in the first half of the year has been given way to higher volatility, increased trade tensions, growth worries, and increased uncertainty about the Fed and other central banks. I wanted to check in with Jeff to see how his views have evolved and to dig deeper in to some of his conclusions from that piece.

Natasha Dayaramani
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Natasha – In July, you stated that the '… risk-reward tradeoff for taking on incremental portfolio risk is less favorable now, compared to recent years.' Given recent market volatility, has your market outlook changed?

Jeff – In short, no. We believe the current environment is a challenging one for investors. While recession doesn't appear to be a high near-term probability, global growth has lost momentum and is slowing, earnings growth is decelerating, and policy uncertainty remains elevated. At the same time, valuations are not attractive and measures of market risk have remained fairly well contained. Despite some volatility and weakness in early August, equity markets – particularly in the US – remain near highs, and credit spreads are tight. Meanwhile, government bond yields have declined. This makes for difficult asset allocation; as a result, we have actually cut our allocation to risk assets over the last month.

Natasha – What approaches to portfolio management do you use for our clients help navigate this environment?

Jeff – In addition to tactical asset allocation moves to help navigate market moves, there are more strategic tools at our disposal related to portfolio construction. In particular, we believe that utilizing strategies that offer good downside protection characteristics is one approach. Moreover, building portfolios with strategies that exhibit low correlation is an additional effective portfolio management tool to help over strategic investment horizons, which is critical for our clients.

Natasha – Let's dig in to both of those approaches in a bit more detail. Starting with downside protection, how do you do this and what are the costs that might be incurred?

Jeff – First, I think it's worth considering why we believe this is important. For many of our clients, particularly pension funds, market downturns often coincide with economic challenges. As such, declines in asset values place downward pressure on funded status at the same time that cash flow growth is deteriorating. As a result, the ability and desire to contribute to a plan is more challenged at exactly the same time it may be necessary. Moreover, more muted downside in asset values requires less risk and upside to recover from downturns, keeping measures of funded status and plan performance more stable.

In terms of implementation, there are several ways that we can approach this objective. We often use strategies that explicitly target lower levels of volatility, particularly in equity markets, in our portfolios. This approach has a long track record of generating returns that are similar to that of traditional 'capitalization weighted' strategies but with lower volatility and less downside. We can also use strategies and investment managers that tend to fall less than the market during downturns. While there is no explicit cost to using these strategies compared to other investments at our disposal, it tends to be the case that these holdings will lag somewhat during periods of robust performance. Of course, we evaluate these investments over the course of a cycle, not just short-term periods, to ensure that the portfolio is generating the rates of return we expect during good and bad times.

Separately, we also use tools that allow us to manage risk, exposure and volatility more specifically. When appropriate and possible, using overlay strategies and derivatives offers the ability to target specific markets – often equities – when we believe risks are rising to hedge market exposure, while leaving our underlying investments in place. This implementation approach has the advantage of being able to be targeted and timed. However, these strategies can come with a cost that is either explicit (i.e., option premiums) or implicit (i.e., built in fees or a drag to portfolio performance). All told, having the ability to use a range of investment vehicles allows us flexibility when implementing strategic and tactical investment decisions for our clients.

Natasha – Regarding the use of assets with lower correlation, what does that mean and why does it help our clients?

Jeff – An important aspect of our strategic asset allocation and portfolio construction process is to utilize different sources of return and risk. Over time, we believe this allows plans to perform well in a range of economic and market environments. Over time, these benefits – driven by portfolio diversification – allow for a) higher expected return for a given level of risk, or b) lower risk for the same level of expected return.

In a portfolio, including assets with different liquidity, risk and return profiles is beneficial. For example, equities, high yield bonds, private equity, and real estate all have different return drivers, economic exposures, and liquidity. Using these assets as portfolio building blocks results in more robust strategic expectations than using only one of these investments. Meanwhile, hedge funds and other asset classes may exhibit lower correlation to equity and bond markets. That means that these holdings will improve diversification – the relationship between risk and return – in a portfolio.

Further, when we pair managers within an asset class as a part of our portfolio construction process, we look for complementary strategies. That is, we consider a range of issues when evaluating investments including the approach and philosophy of the investment managers, the risk profile of the portfolios, factor exposures and risk. It is also important to ensure that these managers perform well at different times. By also including measures of the correlation of manager returns, we can blend strategies to generate the right level of risk and return, but also improve the resilience of returns during periods of positive and negative returns.

Glossary

Correlation: a statistic that measures the degree to which two investments move in relation to each other.

Downside protection: investment techniques that are designed to prevent a decrease in the value of the investment.

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