TAKING STOCK: NEPC ASSET ALLOCATION ROUNDTABLE: THE COVID-19 EDITION

BLOG POST

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Asset allocation is integral to the success of any investment strategy and it is among the most important decisions an investor will make. In this discussion, we lift the curtain to offer you a behind-the-scenes glimpse of the issues and themes at the forefront of the meetings of the NEPC Asset Allocation Committee.

The participants:
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Robert Goldthorpe, ASA, Research Consultant
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Aparajita Bubna, Senior Finance Writer, facilitated this roundtable

How are you thinking about the uncertainties around the timeline of the pandemic and the economic recovery?

Jenn: I would have had a different answer from when the pandemic started, to three months ago or even a month ago. I think back to what Phill said in March and he had a different perspective. He said we wouldn't be back in the office for the rest of the year and I didn't believe that. Now I agree with that completely. I believe things are still evolving. I keep pushing out the time when things go back to normal. I think of this from an economic perspective too. It will take a while for unemployment and growth to get back to even remotely normal levels.

Eumene: I agree with Jenn. Talking to my family in Korea and seeing first hand when I was in China, I'm more pessimistic seeing how the US has handled things so far. We are ways away from returning to normal; I think that will be more likely at the end of 2021 and 2022. It will be a hard road to recovery.

Lynda: I agree with what has been said. I was also in Jenn's camp earlier. I thought by September, we'd be back in the office. Now, the first wave is still rolling through the country and there's still the fear of the second wave when winter comes. As far as the economy goes, the airlines and other industries could see massive layoffs and some of these jobs just aren't coming back. I see another wave of unemployment happening. That said, the government is doing what it can to prop up the economy.

Phill: What I think about around the timeline of the pandemic relative to economic dislocation and recovery is how do you factor in the extreme uncertainty around a vaccine? There are so many variables that go into it. In a way, the markets have made some rosy assumptions about what a vaccine would look like, but when you dig into it and look at the vaccines that are in Phase 3 trials, they are unprecedented in terms of new technology. It's important to realize how long it can take going from that, to ensuring it's safe, and then mass-producing it such that you can provide coverage for any general population.

Chris: I'm not disagreeing with Phill, but let's do a counter factual. There's a reasonable chance that within the next six-to-12 months we have an effective treatment or vaccine; it has some probability greater than zero and less than 100. Even in that world, how much air travel is happening? How much has fundamentally changed in terms of people going to an office or wanting to live in cities? We saw an increase in people moving back to the cities once they have raised their kids. That could fundamentally change. Industries are changing.

But I don't expect we are going to see airlines or major industries failing in a world with *permanent interventions*. We will have consolidation, but I don't think any big names will go out of business. There is a massive desire to not lose jobs. So, we are not going to have a major restructuring of the economy. There have been fundamental changes that the market is ignoring by going straight up, with the expectation that no one is going to be a loser in this scenario.

Phill: Building off Chris's point, we could see businesses not fail despite extreme economic dislocation. This references the thematic things we talk about, for instance, the unprecedented support from central banks that we roll into our market theme of *permanent interventions*. But what happens if you don't get a continuous stream of stimulus? What happens if you have a hiccup in central bank support? How fragile is the system, even if it's a couple of months where there is a lack of support? How much damage can that do to the economy? Companies say that they can go a month or two with little or no revenue; you can't survive quarters and quarters. I think that's the uncertain dynamic at play here.

What are the challenges around predicting earnings and price-to-earnings multiples in this environment?

Jack: There is a lot of focus on the near term. Instead, we should concentrate on the long-term impact to earnings. Using discounted cashflow models, with yields so low, the intrinsic value of companies is little changed if they take an additional year or two to reach some sort of steady state of earnings. I think that explains the dislocation in the market right now, with prices going up while earnings are not. This also explains why markets aren't really reacting to COVID-19, and why large caps have outperformed small caps since they have lower bankruptcy risk and their earnings are less likely to be impaired.

Similarly, I think this is why growth has been outperforming value. A decrease in the cost of capital for companies lowers the discount rate and increases the value of future growth. So, I expect growth to continue outperforming.

Phill: That's an interesting thought. In many ways, we're struggling with how we can have higher unemployment (which typically comes with falling earnings), but then see equity markets in the U.S. start to move back towards all-time highs. How do you reconcile these contrary facts?

But clearly there's something to what Jack is saying. Investors are not looking at now, but out into the future and, then the question is, is there anything in the near term that is disruptive that distracts them from that long-term view?

Chris also talked about the support for companies and unlikelihood of seeing major bankruptcies. So, it's just an odd narrative. In some ways, you could say there's a rational aspect of the market, which is looking beyond the present uncertainty to when earnings will be more normal, and pricing off that. We haven't encountered this type of valuation view in our careers so far.

Rob: If investors are looking farther out, isn't that a rational investor? We like to say that the markets are not rational right now, but if they're looking towards the long term, it seems like a rational investor to me.

Jack: It's a rational market. May be using valuation metrics like trailing PEs is not the right way to view it.

Rob: Right. So, current valuations make sense if you assume investors are rational right now.

What are your views on the Federal Reserve?

Lynda: I would say our theme of *permanent interventions* is of critical importance and the central bank is going to continue to be accommodative.

Jenn: I was thinking back to when the Fed tried to normalize rates at the end of 2018 and the market reaction was so negative, it had to back off from that. So, a big component of the *permanent interventions* theme is that the Fed managing market sentiment is so important now. A continuing concern is what happens when the Fed can no longer manage sentiment and if the market stops caring about the amount of stimulus being pumped out? That's a risk, but it's hard to know what that tipping point is going to be and when it's going to happen.

What are the most important factors to consider in asset allocation?

Eumene: There are a lot of broad answers to this. From my perspective, my first exposure to this was in the corporate pensions space, so I look at it from the aspect of diversification, that is, using diversification to get optimal returns and lower risk to a portfolio. I think that's standard; but this is all very situational. It all depends on the financial situation of each individual or company and their starting point. I'm more inclined to look at asset allocation as dynamic and tactical as opposed to static.

Jenn: Discipline is incredibly important. We work with clients with unique constraints and situations. We set the strategic asset allocation based on those details. So, when the market becomes volatile, it is vital not to touch your strategic allocation because that was done knowing your constraints. Certainly, things can be adjusted on a tactical basis, but the strategic allocation gives you a lane to operate in.

Chris: We have some long-held house views that we always need to challenge, and guard against group think. That's why it's so important to have new people joining the team who bring in different experiences, backgrounds and viewpoints.

We present asset allocation as a mosaic with multiple tools. I feel strongly about this because I dislike approaches with one model that claim to have all the answers. It's also lazy because what investment consultants did for a long time is they ran an efficient frontier, they added a new asset class to the frontier, and, magically, the frontier expanded, and they told the client, "We can improve your risk-reward by putting 5% in international or small-cap equities." There are people still doing that. We tend not to do efficient frontiers as the end-all and be-all.

And, like Eumene said, we are also dynamic. And you've heard me say this often and I also say this to our clients: Our assumptions are wrong in the sense that nothing is going to land exactly on what we say and there's a reasonable chance it's going to be a standard deviation outside of what we have said, and that is within the bounds of what we expect. What you can do as an investor is target the level of risk you're comfortable with. I think figuring out risk tolerance is an iterative process of looking at outcomes. At the end of the day, this is people-based, and we can't forget committees are often made up of people who we need to equip with the right information to make an informed decision; that's not models, that's dealing with people.

Jack: I do think efficient frontiers are useful. To be sure, most people running efficient frontiers are using historical data and history may not repeat itself in the future. Our efficient frontiers are more powerful because we are modeling forward-looking asset classes. I agree our assumptions may be wrong, but I think on a relative basis they make sense, and if you add the correct constraints to them, I think they are a lot more powerful than most people think.

Chris: Actually, I agree with Jack.

James: This is something Chris has always said. The more granular we get, it almost convolutes the situation when the asset allocation discussion should be about how much to put into stocks, bonds and diversifiers, and have just three or four asset classes and call it a day.

I would suggest starting with a very top-down view of the main risks you are trying to capture in those asset classes, and then having a second-level discussion about how to optimize within the asset classes. People often forget that implementation of manager strategies can sometimes obscure your asset allocation work. What I mean by that is asset allocation is a strategic exercise, but part of it should involve discussion around tracking error risk you're comfortable taking versus that asset-class-level target you set. This ties implementation back to tracking error versus the strategic asset allocation.

What fundamental asset allocation assumptions have withstood the test of time and economic cycles?

Phill: A fundamental assumption we have is the need to have some level of safe-haven fixed-income exposure. How you size it is going to be different according to the needs of investors. It's important to have some level of Treasuries for liquidity and TIPs to provide a balance between real and nominal rates. This is tried and true, and we generally don't comprise on this point.

What are your views on inflation?

Eumene: We're seeing historically low inflation rates and our outlook is for low inflation. It's still hard to think of scenarios for when we have high or medium inflation.

Also, I don't know if CPI is always the best gauge to look at inflation. Globally, we're looking

at the CPI forecast to be lower from 2019 to 2020, except maybe for China.

Jenn: It's odd to me that you can reasonably get to two very different scenarios. There's one where we see higher inflation because of stimulus, the movement in supply chains and the current environment. Then, there's the other side where you could also easily make a case for deflation. There's a lot of uncertainty with a big question mark on oil prices, which is a major component of inflation.

Chris: The low inflation and this disinflationary environment are very much tied to Fed policy. So, it's either a misstep or some other exogenous event that gets inflation to go up. To be clear, I would expect that people on a fixed income right now would tell you that their cost of living has gone up, and that's getting back to Eumene's point about CPI. Prices have gone up this year for fundamental things like food and household goods because of the supply chains and the pandemic. I think the presumption is that it will resolve itself, but global supply chains are going to change because of COVID-19, pushing consumer prices higher.

Phill: I'd be curious to know what everyone's definition of high inflation is today. If we think back to the last 40 years, high inflation would get you something closer to double-digits. But what is considered high inflation in this day and age when you think about demographics, technology change and these other factors? Is it something very different and much lower? If I told you there's going to be high inflation in the next 10 years, would that be 5%?

Chris: I think CPI over four is a key signal because that's what the Fed has addressed several times; it has also said that it is okay with that if it's only for a short period of time. But if CPI was at four, you're going to see pockets in the economy that have double-digit inflation and it's going to be very disruptive.

Phill: I would agree with you on that. The CPI level at four is a major macroeconomic risk. Think of how much of the market pricing we need to change. To Jack's point, the future value of equities and where interest-rate levels are with a CPI number in the threes or fours are materially different.

Chris: Looking at history, when we've had major productivity gains—for instance, in the late 1800s in the U.S. with industrialization and railroads—many industries went under, but they had knock-on effects that fundamentally lowered prices for everyone. We're experiencing that still in technology and it hasn't disrupted everything. We have the potential that AI (artificial intelligence) could eventually do the same thing in which case we expect prices to go down over time.

And we don't have to worry about prices going down 2% because the technology industry has been seeing that for 30 years and it's obviously extremely successful. So, deflation, if it's led by innovation, is not the boogeyman it's thought to be.

What do you think about emerging market equities?

Jenn: Let me get on my soapbox! I understand the fatigue with emerging markets that's going on now. Looking back at the inception of the emerging markets index, there are long drawn-out periods where it has under- or over-performed and these tend to happen in 10-year increments. Right now, we're in the long-end of an underperformance relative to the U.S. That said, nothing could compete with the dominance that we've seen in the U.S., specifically

in large-cap technology names. Looking at some other indexes, emerging markets don't look so bad. From a strategic standpoint, I'm still excited about emerging markets. We talk about growth and demographics, but I think the big story still is the emergence of China and how important emerging Asia is going to become.

Last, I get a little bit angry with the index construction because everyone talks about the MSCI Emerging Markets Index and one data point that I have frequently looked to is the calendar year returns by countries in that index. And if you look at the best- and worst-performing country in the index, the dispersion, since inception, has been over 100% on average. So, to me, that is really telling: there is alpha potential if you can find good active managers.

Has your view of risk changed?

Rob: There are different ways to view risk. One is volatility; our assumptions haven't changed quarter-over-quarter. There is also liquidity risk. After what happened in March, we stressed in our first-quarter outlook that clients hold two quarters of benefit payments and expenses in cash or some liquid short-term fixed income.

Now the dislocation has calmed down, but uncertainty is still high. So, we've urged clients to carve out that Treasury allocation to manage liquidity in addition to serving as a safe haven.

How does climate change influence your views and potentially change strategic allocations in the future?

Lynda: There is growing demand from our clients to analyze their portfolios for climate risk. We look at asset classes, for instance, private-real asset markets, coastal real estate and commodities, which will be hit harder by floods and droughts. We also look at certain geographies that will be likely affected and are most vulnerable to climate change and least likely to adapt. This can inform our outlook for global equities and debt and GDP growth. COVID-19 will add another layer to our analysis. The pandemic offers an insight into governments' potential responses to global climate events and their ability to adapt.

Are you incorporating the U.S. presidential elections in your outlook?

Chris: I am nervous that this is an extremely contentious election, and I'm not convinced that whatever the results, things are going to be clear in December.

Phill: It injects another aspect of uncertainty, which we already have enough of with COVID-19. In some ways, we are trained to try to look beyond that, and hope the market can look beyond a month or two of political rhetoric and volatility. But big changes can happen, especially if one party assumes full control, winning the presidency and the Senate. If you said eight years ago, worries of a trade war with China would be at the forefront of investors' thoughts, it's not something we would have thought about.

James: With the increased uncertainty, the focus is more on liquidity, and that ties back to some of our earlier discussions on Treasuries. We can then look past this shuttering of our economy and prolonged lower demand, no matter what comes through the political sphere. As long as the Fed remains easy, investors will continue to look past the uncertainty. So, it might not be all that valuable incorporating the elections into the outlook, especially because we're ready for it, given the fact that we have moved to more liquid, more Treasury exposure in our portfolios.

What asset class—conventional or not—do you think will be the best performer for the remainder of the year?

Jack: U.S. small-cap growth.

Lynda: The S&P 500, so large cap.

Rob: Baseball trading cards and 20+ STRIPS (zero-coupon Treasuries).

Chris: Bitcoin.

James: Gold.

Phill: China equities, specifically the technology sector.

Jenn: U.S. large cap.

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