TAKING STOCK:

NEPC ASSET ALLOCATION ROUNDTABLE – THE 2021 EDITION

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Asset allocation is integral to the success of any investment portfolio 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 Team.

THE PARTICIPANTS:
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Aparajita Bubna, Senior Finance Writer, facilitated this roundtable

What are your thoughts on the current economy?

Jenn: It's weird.

Chris: It's always weird.

Jenn: What is clear is that the headlines are not giving the full story. I think that's true in many facets of the economy right now. You can say this for other periods too, but it's one of those where certain groups of people are doing really well…they are making more money and they are spending a lot of money. Then, there's the other side, where you hear about businesses, for example, having issues finding workers and facing inflationary pressures. It feels like the K-shape recovery is still around, but it's in many different parts of the economy now. You can craft this great story that we have a really positive economy underpinning all of this, or you can craft one where it's not so great and we're in the late cycle.

Chris: Fundamentally, I think this economy is about whether it's a late cycle with a recession coming soon, or if the party keeps going and the Federal Reserve does a smooth landing.

Phill: If you take the headlines Jenn talked about and throw out how people feel, I wonder if there is actually an incredibly robust, strong and growing economy under all those layers. That would explain some of the data: maybe it is the start of a multi-year economic growth explosion…a cycle we haven't seen in 20-30 years because we are so used to the economic recovery that followed the financial crisis.

Jenn: But outside of of spending data, how do you see that we have this really robust economy?

Lynda: Yes, and what's driving that?

Phill: Wages are growing, spending is improving, productivity and capital expenditures are up, labor mobility is up…these are all the classic signs of a really strong economy. Those are all the origins of a multi-year dynamic economy that is growing at a rate we haven't seen in a really long time. It doesn't feel that way, but the data suggests that could be one of the answers.

Chris: Now which of those factors are also a sign of an over-stimulated economy?

Jenn: That's exactly what I was thinking. How much of that is propped up by the Fed and fiscal stimulus?

Lynda: The economy is propped up, but I don't know what the impetus will be for the bubble to pop. It would be a Fed misstep or an inflation surprise that would spook the market. So, it would be behavioral in terms of all those factors that Phill mentioned. I don't see any of those necessarily changing unless people start losing their job or companies start laying people off.

Robert: I mostly agree with Phill; a lot of the data underscores a healthy rocket ship economy. The market believes it. I guess the pundits, Twitter and the news don't because they keep questioning why equity markets continue to run but then the data points are saying we're in this rocket ship-type economy, so I tend to believe what the market says.

Chris: I know we've got inflation later on here, but that's what the market is trying to figure out. In our view, if we are going to see the continuation of the higher inflation prints, equities are not a bad place to protect from that relative to TIPs or commodities. That's the conversation that's going on. It's driving all-time highs in equities. What else is there? It's the only game in town. It is a stimulated market.

Jenn: That is what's going on! There is no alternative investment other than equities even if you think inflation is coming. Are you going to take the volatility and, probably, a bad roll yield of commodities? And real assets as a whole haven't been great.

Lynda: Continuing Jenn's point, this reminds me of 2007 when fixed-income managers had nowhere to go to get yield. So, they stretched for yield. Everybody was invested in the only place where they believed there were returns and that fueled the crash. So, I just caution that if people are stretching for return somewhere, that can create a bubble.

How do potentially higher levels of inflation impact asset allocation?

Jenn: We've talked about this as a group, but for every inflation-focused discussion, I feel like we have to figure out what the actual inflation sensitivity of a client is. For the people who have inflation-sensitive liabilities or spending, that is a different conversation. But many of our conversations have really just been focused on how inflation is flowing through to capital-markets pricing. I think delineating those two, you'll get two different answers on how you should structure asset allocation.

Chris: To me, asset allocation is about figuring out your risk level. For clients, inflation is one of the many risks they need to manage. My observation would be it's a huge risk for some pools of assets, and it's actually not a risk at all for many other pools of assets. We have a lot of commitments—whether we are talking pension plans or other pools of assets—that are nominal commitments. So, even in an era of higher inflation, this is not a bad time to be a lender or to have a nominal commitment.

Phill: I think the other consideration is if inflation rises to a more normalized level like we've seen over the last 40 years. Rising inflation does not have to mean price destruction. It can be really supportive for equities and I think it's just another different lens to view equities as a really important component in a portfolio.

Chris: This is when I have to do the counter! The question right now is are we going to get inflation with really good growth or is it going to be inflation with bad growth? Of course, we could be in a late cycle and have a recession in the next few years.

Jack: It's hard to not see higher growth rates. We have other statistics, for instance, revolving consumer credit which is very low relatively. I think spending is going to increase and growth is going to kick in. So, I think the stagflation scenario is still a low probability event in my opinion.

Chris: But what is the catalyst for workforce participation to go up?

Robert: Higher wages.

Phill: The workforce participation number may be the wrong question to ask. If productivity goes up and there are fewer workers in the economy, that can still benefit macroeconomic growth and markets. But it emphasizes a lot of the bifurcation that's going on in wealth, and it further deepens income inequality.

Chris: It is shocking to see how many people are seriously considering not re-entering the workforce and it is disproportionately women.

Lynda: I think the pandemic really changed people's perspective on childcare and it disproportionately impacted woman in the workforce.

What are your views on inflation?

Robert: I still think it's transitory. Many components of inflation are experiencing this bullwhip effect, with retailers becoming highly reactive to demand and magnifying their expectations, which leads to distortions up the supply chain to the wholesaler, the manufacturer and the supplier. I believe we will see some of the headline inflation start to roll over post-Christmas.

Jenn: I agree with your comments about the goods-side being transitory. I cannot turn a blind eye to the shelter side. Chris said earlier that the markets are trying to figure out inflation. What do you think the catalyst is for the market to start believing that maybe inflation is not transitory?

Phill: I agree that shelter is the number one piece to focus on. I'd almost say I'm not concerned about inflation because a lot of the inflationary conditions are reflective of an underlying strong economy and that, by definition, is cyclical and transitory. As you move away from the base effect and other issues from the pandemic, the 6% year-over-year inflation that we've had in 2021 is likely transitory, but rising shelter costs could allow inflation to remain above 3% for a prolonged period of time, especially if you get greater housing demand and household formation.

Robert: Is there a high correlation between shelter inflation and overall economic growth? If shelter costs are rising along with economic growth, shelter inflation becomes more transitory.

Phill: There's certainly a link. The supply and demand drivers are probably the biggest component that influence shelter. And economic cycles obviously influence the demand component. But there's an acknowledgement that if shelter costs increase persistently, inflation will be higher than people expect.

Chris: I wanted to raise one other thing on inflation: during the depths of the pandemic, we actually had better supply chains in many areas than we do now because we had a state of emergency. We have reinstated the regulatory structure around supply chains that we had in 2019, which is not where we need to be right now.

We need to figure out what things are stopping the natural correction mechanism that happens during periods of inflation. When energy prices go up, look 18 months out, they are probably down because of the economic incentives created to boost supply. When you look at other bottle necks in the economy, like offloading container ships, we are not back to normal yet. But our regulatory infrastructure thinks that we are.

What are your views on the Fed?

Lynda: I feel like the Fed did what it needed to do in order to have the economy recover. It stepped in and used all the tools in its toolbox. But it needs to get interest rates back up and it needs to start tapering in order to refill its toolbox in case of another downturn. Has it overstepped its bounds? I don't think so right now, but if easy policies remain permanent, possibly. But I do think the Fed is currently propping up the economy.

Robert: Isn't that the role to prop up the economy?

Chris: Managing sentiment is not one of the Fed's dual mandates.

Phill: Officially.

Chris: I think it is all about inflation. I think the Fed does look towards popular opinion. Let's say gas is at $8 a gallon and there are broadly higher prices and people are just really upset, then whether or not the CPI or the PPI prints are high or not, the Fed will respond to public opinion on inflation.

How high can the S&P 500 Index go?

Jack: Higher.

Phill: I would say there is a path that it can go much higher than people expect. I think people could be surprised at how much the S&P keeps rising despite how well it's done over the last 10 years.

Jack: Looking at profit margins, they have been significantly higher than they have in the past. If we see margins improve, we could see equities keep rallying.

Chris: Jack, do you think the sea change companies have seen with remote work is making them more productive?

Jack: There's definitely an increase in productivity, but I also feel like technology has a more dominant role for companies in the S&P. So, the composition has slowly changed causing profit margins to be higher, which is a structural change.

Jenn: Yes, I would agree with all of that and my answer to this question would just be higher than our capital market assumptions.

Phill: When you look at our capital market assumptions, we assume there's a normalized path to valuations: they start to mean-revert over 10 years and profit margins start to mean-revert over 10 years. But I think we'd all agree that we can see a very real scenario where valuations get more expensive, profit margins go higher which, under certain conditions, could send the S&P much higher from where it is today. I think it's important to remember our capital market assumptions are an average expectation and, within that average expectation, there's a range of scenarios. If you poll us and our biases, it could very well be higher for the next several years relative to what return expectations would indicate.

Chris: I completely agree. The balance to that is that U.S. stocks are such a crowded trade that whenever the Fed takes the punch bowl away, this could be a really bad bear market.

Robert: Speaking of tech, I'm less concerned with the concentration risk in the S&P because of some of the big names, like Microsoft, Meta, Apple, Amazon and Netflix. These companies have diverse revenue streams and they're not just a one-trick pony like a simple dot.com tech company. They are obviously well-run companies, so if they are dominating the market, I'm not too concerned with that and I'd want to stay in that market.

Chris: In the past, when we've had market concentration, there's certainly been a market response. But the key question is regulatory capture because if there's true competition to one of these big tech firms, they're just going to buy them.

What is the biggest tail risk? And separately, the source of greatest returns in the market?

Robert: The tail risk is deflation brought on by automation and artificial intelligence. Also, the greatest potential for returns is automation and artificial intelligence.

Phill: Which I think disproportionately benefits U.S. equities.

Lynda: I feel a tail risk could be geopolitical risk because if there is a war of any kind in Asia, then that could really affect both the China-U.S. relationship, and also the global economy in general.

Chris: It's not a great stat and it's a long-term stat but the amount of conflict post-pandemics in history is very high.

Phill: Just to offer a counter, I would say the global economy is so integrated that it is economic suicide for any major economy to contemplate a military conflict. In many ways, we're in a post-conflict type of world where conflicts get expressed differently. Maybe it's cyber, maybe it's other areas, but I think the idea of two opposing tanks on a plain in Eastern Europe or even a China-Taiwan conflict is antiquated, one that gets over overestimated in markets but it's not a tail risk in my mind.

Robert: I agree with Phill. There's this dynamic where everyone is making money and you're not going to be the only one trying to disrupt that.

Phill: It's like in the Cold War era where everyone was playing the board game Risk and now the world is playing Monopoly and the goal is to own everything.

How does the prospect of higher inflation change your views on portfolio diversification?

Jack: All else equal, higher inflation equates to less portfolio diversification and that may fundamentally change some investment goals.

What is your most important recommendation to investors?

Phill: Don't be afraid of equities.

Jenn: I feel like we say this a lot, but don't get caught up in the market movement of the day. It's a timeless thing but markets have gone up historically and we expect that they're going to continue to do so over the long term.

Chris: Don't place your main emphasis on what you think will happen but invest for all the things that can happen. An evergreen message of diversification and rebalancing.

Jack: Have a dedicated liquid bucket.

Do you own any digital currencies?

Phill: Yes.

Jack: Yes.

Robert: Yes.

Jenn: No.

Jack: Let me ask you what role does it serve in your portfolio?

Phill: Pure entertainment.

Robert: FOMO. (Fear of missing out.)

Chris: Yes, it started out as an interest in a disruptive technology that was just cool. And then it was a 1% hedge to the concerns over the dollar. But I'm not actively investing, I'm just holding.

Robert: I think a high number of wallets are holders and not traders.

Phill: Do you see a framework that allows for crypto to be part of an institutional investors' portfolio?

Chris: I do. It's pretty out there for public funds and ERISA, but we know that large endowments have done it and many things they have done over the years have come to mainstream portfolios.

Robert: As a 30-year investment, I think it could be a part of an institutional investors' portfolio, especially if you believe in the digital age. There are literally digital real estate companies. Digital ownership doesn't make sense to us now but in the future, when everything is digital, the metaverse could be your life in the digital world.

Chris: You might call it a second life.

Robert: Yes, now you have got one of the largest companies in the world, Facebook, going in that direction.

What's your best performing asset class for 2022?

Jack: Small-cap equities in the U.S. I would pick the value side where you have attractive valuations. And on the growth side, you have a selection of interesting companies.

Jenn: I like China small-cap A shares.

Chris: Yes, I pick small cap.

Robert: Give me 3X levered S&P 500.

Lynda: I'm picking a longer-term theme of private equity and venture capital.

Phill: U.S. large caps.

Chris: When I think about 2022, I do think about the politics. I expect to see some sort of red wave in the mid-terms, which means that the second two years of the Biden administration are not going to be muscular. Usually a divided government is very strong for markets. I do think it's a risk-on year even though I think we're in a late cycle.

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