HEALTH WEALTH CAREER

2017 INVESTMENT THEMES AND OPPORTUNITIES

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1 FRAGMENTATION

If 2016 reminded us of anything, it's that forecasting, and especially political forecasting, is challenging. With very few pollsters or commentators having accurately predicted the outcome of either the EU referendum in the UK or the US election, it would be wise to keep an open mind in relation to elections taking place in the Netherlands, France and Germany in 2017. Growing nationalism, fragmentation and what some have dubbed "the death of liberal politics" are likely to remain prominent influences on the political landscape for some time. Indeed, it may be that large parts of the developed world are undergoing a political regime shift on a similar scale to the one ushered in by Margaret Thatcher and Ronald Reagan in the early 1980s.

2 SHIFT FROM MONETARY TO FISCAL STIMULUS

2016 may have witnessed the high point of monetary stimulation, with policymakers increasingly recognizing its limits and unintended consequences. At the same time, increasing calls for fiscal stimulus have been supported by both mainstream economic voices as well as populist politicians. The speed and magnitude of any shift from monetary to fiscal stimulus could have important implications for investors in the years ahead, not least in relation to the potential build-up of inflationary pressures.

3 CAPITAL ABUNDANCE

The sustained period of monetary stimulation by central banks — now entering its ninth year — has created what might euphemistically be described as "a challenging environment" for investors. With real yields below zero in much of the developed world and most asset classes having experienced significant price inflation, generating annual real returns as high as 3%-4% is likely to be difficult over the next 3-5 years. Many investors will therefore need to consider less familiar asset classes and more flexible strategies in order to meet return objectives in the coming years.

4 UNDERSTANDING STRUCTURAL CHANGE

Amid the shorter-term discussion of politics and economics, longer-term structural forces, such as demographic trends, climate change and technological disruption, could also have far-reaching, if less obvious, implications for investors. Identifying some of the broad market outcomes that these structural forces could create will help investors manage risk and return over the long term.

In the sections that follow, we delve into each of the four themes above and consider some of the specific actions that investors can take in response to the evolving economic and market environment.

1 FRAGMENTATION

Taken together, Brexit, the election of Donald Trump, the rise of populism across Europe, and the increasingly nationalist tone of Vladimir Putin and Xi Jinping, suggest a possible fragmentation of the prevailing global political order.[1] These political developments come at a time when global trade and cross-border capital flows (both taken as a proportion of global gross domestic product (GDP)) have been flatlining since the financial crisis. The risk is that isolationism and the introduction of protectionist trade policies send the globalization trend of recent decades into reverse — what has been described as "deglobalization."

While populism and nationalism have been on the rise for some time across Europe, elections in France and Germany in 2017 have the potential to ignite a fundamental crisis within the eurozone given their size and centrality to the European project. Marine Le Pen, leader of the National Front, has already stated that as President she would seek to take France out of the euro and hold a referendum on France's membership of the EU. In Germany, the AfD (Alternative for Germany) has been extremely critical of the eurozone bailouts and has suggested that it would hold a referendum on German membership of the single currency.

The potential implications of political fragmentation and the possibility of deglobalization are far from obvious, not least because there remain many uncertainties around the economic policies that will be pursued by President-elect Trump. In the face of this uncertainty, we would highlight the following actions for investors:

- Given the heightened political risks in this environment (such as trade and currency wars), stress-testing portfolios against large equity, bond and currency movements will be important in assessing portfolio risk exposures. Volatility-sensitive investors may wish to consider approaches to managing their downside risk exposure via "hard" or "soft" hedges.[2]

- Reduced levels of liquidity in markets (driven to a large extent by banking regulations) may exacerbate the magnitude of any sell-off in markets, especially given the increasing volume of assets that respond to spikes in volatility by reducing risk asset exposure (such as risk parity strategies). Periods of market stress may therefore create opportunities for investors who are willing and able to behave in a contrarian manner. This supports the case for flexible and dynamic strategies (and processes) able to capitalize on those opportunities.

- As illustrated by the performance of sterling following the Brexit vote, political surprises create the potential for large currency moves. Protectionism and trade tensions could also lead to currency volatility. This increases the importance of a clear policy on hedging currency risk and may also create opportunities for active currency or global macro managers.

[1] Ian Bremmer, President of Eurasia Group (a geopolitical research firm), has suggested that the world is "at the bottom of a longer-term geopolitical cycle … characterized by a growing vacuum in global governance." *After the G-Zero: Overcoming Fragmentation* (Fall 2016).

[2] "Hard" hedges would include explicit forms of downside protection such as equity options. "Soft" hedges would include a range of strategies that might be expected to reduce the impact of a painful scenario either because of their inherent defensiveness (such as low-volatility equity) or typical performance characteristics in an equity sell-off (for example, trend-following strategies or flight to safety currencies such as the US dollar, Swiss franc or Japanese yen).

2 SHIFT FROM MONETARY TO FISCAL STIMULUS

Over the course of 2016, an increasing number of policymakers and market participants expressed concern about the diminishing effectiveness of monetary policy. Particular attention was focused on the unintended consequences and the detrimental impact on the financial sector of negative interest rates. In response to such considerations, policy discussions have shifted toward the merits of fiscal stimulus, in marked contrast to the insistence on fiscal austerity for much of the post-crisis period. Japan has already taken some tentative steps toward fiscal stimulus, and President-elect Trump is widely expected to propose a fiscal expansion via some combination of tax cuts and infrastructure spending.

The path of inflation over the next few years will be driven, at least to some extent, by the scale and pace of any fiscal stimulus (and the extent to which it is a global phenomenon) as well as actions taken by central banks. As the magnitude of any tilt toward fiscal stimulus becomes clear, we believe the following actions warrant discussion:

- Investors should be clear about the extent to which inflation might pose a risk to the achievement of their objectives. Where inflation is seen as a material risk, investors should consider which parts of their existing portfolio might be exposed and which parts might provide some protection from inflationary scenarios. For portfolios lacking in inflation protection, investors may wish to consider direct inflation hedges or assets providing some inflation sensitivity (such as real assets). Such considerations will necessarily be region and investor-specific.

- A more aggressive shift toward fiscal stimulus will increase upside risk to bond yields (already evident in bond market moves following the US election). Floating rate or short duration credit exposures may therefore be preferable to strategies that are tied to a benchmark that brings structural duration exposure (unless this duration exposure is specifically desired for risk management reasons). It is worth noting in this context that the duration of many fixed income indices will have increased materially as yields have fallen in recent years.[3]

- Regardless of the direction of yields, an increase in bond market volatility due to an increase in uncertainty around monetary and fiscal policy (following a period in which policy has been one-directional) should create a more fertile opportunity set for global macro, absolute return bond and unconstrained fixed income strategies.

- If the monetary policy punchbowl is removed faster than expected and bond yields rise materially, companies that have been supported by ultra-loose policy may face challenges in refinancing their debt. A rise in default rates, while painful for existing credit portfolios, could create opportunities for strategies that are positioned to allocate capital to distressed assets. Long/short credit strategies or more adventurous multi-asset credit strategies may provide some exposure to such assets.

[3] For example, the duration of the Barclays Capital Global Aggregate Index has increased by almost 20% over the past 5 years (from 5.8 years as of November 30, 2011, to 6.9 years as of November 30, 2016).

3 CAPITAL ABUNDANCE

Following 8 years of central bank largesse and low levels of business investment, the world is awash with financial capital seeking yield. The exceptional returns of the past eight years will not be repeated and there is a scarcity of "easy beta" to be harvested. We believe that portfolios dominated by traditional beta (that is, equities, credit and government bonds) offer a relatively unattractive risk/return trade-off on a forward-looking basis. Investors will therefore need to prepare for lower returns or consider less familiar asset classes and more flexible strategies in order to deliver on their return objectives.

An abundance of capital has enabled companies to take on additional leverage and to extend the maturity of their borrowings, and encouraged investors to move up the risk spectrum in search of yield. This clearly brings additional risk and creates the possibility of a reversal of fund flows in stressed markets. In this environment of low yields and low to moderate risk premia, we believe that investors should place a greater emphasis on diversification of return sources and might consider the following areas:

- Continue to seek a contribution to returns from a diversified mix of alpha sources. This can include systematic factor exposures (or "smart beta") and idiosyncratic alpha (a function of a manager skill) across a range of liquid markets. The search for alpha need not be constrained to hedge funds or traditional long-only active strategies. Indeed, niche strategies in traditional asset classes where much of the return is likely to be driven by manager skill may be attractive diversifiers in the current environment — opportunistic/value-added real estate and activist/engagement strategies in listed equity are two examples.
- While many private markets have seen significant inflows in recent years, opportunities remain for high-quality managers to extract returns from a combination of illiquidity and complexity premia and direct asset management (or "hands-on value creation"). This is especially true for areas of the private markets opportunity set where there continues to be a structural imbalance between the demand and supply of capital — most notably private debt finance for smaller companies that have limited access to the capital markets.
- Less familiar segments of the credit markets (such as asset-backed securities, private lending, trade finance and receivables) offer investors the potential to generate a premium to cash of 2%-4% per annum as compensation for complexity and illiquidity risk. Secured finance strategies provide one potential access route to such assets.

As an aside on capital flows, it is worth noting the significant growth in exchange-traded funds (ETFs) in recent years. This shift has been supported by a gradual but steady multi-year trend from active to passive management (most ETFs provide a passive exposure to some underlying market). We have long argued that market cap-weighted indices are an inefficient means of allocating capital on the grounds that they are biased to past success and often embed unintended risks. An environment of cheap and abundant capital is only likely to have amplified the unintended risks inherent in market cap indices (especially in bond indices). We are wary of these difficult-to-quantify risks and believe this strengthens the case for genuinely unconstrained active management (approaches that are not tied to a benchmark index) from both a risk and return perspective.

4 UNDERSTANDING STRUCTURAL CHANGE

Most economic and market commentary focuses on relatively short-term questions — when the Fed is expected to implement the next rate hike, what the latest employment figures tell us about GDP growth or how China will manage its currency over the next 6 months. As a result, longer-term structural changes are often ignored, despite the fact that they may have important implications for long-term investors.

Three areas of structural change that we believe merit greater attention from investors are climate change, demographic trends and technological developments. As we have discussed frequently in recent years, climate change remains an important issue, both as a physical risk to real assets and as a policy risk to a wide range of carbon-sensitive assets. Demographic trends and technological advance are two of the key drivers of long-term economic growth, affecting the size of the working age population and the rate of productivity growth. Beyond this high-level macroeconomic significance, we believe that a deeper understanding of these trends can provide useful insights to help inform asset allocation decisions.

There is clearly some uncertainty around the future direction of US climate change policy under President-elect Trump. However, climate change remains an issue of global importance, and we continue to believe that investors should review the extent to which portfolios are exposed to carbon-intensive assets as a way of assessing the impact that policy developments (such as carbon pricing or a carbon tax) could have on portfolios. Carbon footprint analysis on listed equity portfolios and recent developments in low-carbon indices can be valuable tools in addressing this source of risk.

The overriding demographic trend is global aging. Fertility rates have fallen across much of the world (especially in Japan and continental Europe), reducing population growth, while advances in health care have led to increases in longevity. As a result, large parts of the world are moving through an inflection point in their dependency ratios — where the ratio of the dependent population (essentially children and retirees) to the working age population is moving from a downward trend over recent decades into an upward trend for the decades ahead.

The investment implications of this shift are far from clear, not least because changes in working patterns (e.g., working long past traditional retirement ages) could mitigate the impact of aging populations thereby halting or reversing any rise in dependency ratios. However, we might venture the following observations:

- While it is not clear what impact an aging population will have on economic growth and corporate profits at an aggregate level, it is clear that some countries will be more challenged by these trends than others (either because their demographic trends are further advanced or because cultural factors mean that they are less likely to be able to adapt in time). This will likely create material divergences in economic outcomes at a regional level.

- As the baby boomers in much of the developed world move into retirement over the coming decades, they are likely to gradually draw down their pools of savings. This is likely to act as an upward force on real yields, albeit one that will play out over a multi-decade horizon.

Technological trends are perhaps even harder

to predict than demographic trends given the somewhat random nature of innovation. However, it is possible to suggest a few of the potential implications for investors.

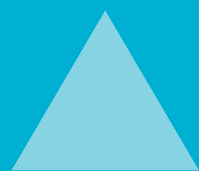
- Technological disruption clearly creates winners and losers at a corporate level. This should create opportunities for long/short equity investors, perhaps particularly in relation to opportunities on the short side of the book (identifying the losers from technological change may be easier than picking the winners).

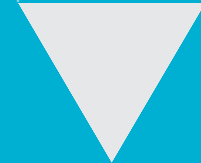
- An extension of the point above is that market cap indices may be at particular risk of technological disruption given that these indices hold large weights in the existing incumbents across all sectors.

- The rapid rise in the number of "unicorns" (privately owned companies with a valuation of more than $1 billion) is at least in part driven by the fact that private companies are choosing to stay private longer than they have done in the past. This suggests that investors may need to be willing to allocate to early stage private equity in order to access these sources of future growth. Indeed, some large listed equity managers have started to invest in unlisted securities (where mandate guidelines allow) for precisely this reason.

TAKING ACTION

The ideas outlined in this paper represent our observations on the challenges and opportunities present in the current investment environment. We provide these ideas with the aim of provoking useful discussion, but the appropriate response at an investor-level will be heavily influenced by the specific beliefs, objectives, and constraints of each investor. We look forward to helping investors adapt their strategies as new risks and opportunities arise over the course of 2017.





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