Investec
Asset Management

2016 Investment Views

These are the views of our Multi-Asset team. Investec Asset Management is a multi-specialist house and the views expressed may or may not be held by our other specialist investment teams.

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The need for portfolio resilience

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Now, more than ever, investors are confronted by a world that appears full of potential pitfalls. Consequently, investors are increasingly demanding robust portfolios that can outperform the market in challenging environments and are resilient in the face of unforeseen events. But building this type of portfolio is not easy.

It requires a strong understanding of investment risks, beyond just estimates of volatility. Portfolio construction needs to balance the trade-offs between potential returns and individual assets' contribution to overall risk exposure, and ensure a level of diversification that is robust and appropriately adaptable to an unpredictable backdrop. A vital consideration is the durability of the underlying cashflow generation of company business models, and avoiding areas at risk of disruptive change is key.

Finally, portfolios have to limit exposure to the least liquid parts of the market and have strategies to deal with bouts of market stress.

Where did returns go?

Potential growth rates across the developing world have been trending downwards for many years, but the after effects of the global financial crisis have added to the headwinds facing the global economy and raised the prospect of a long period of insufficient demand and low consumer spending. Many hoped that growing emerging markets, particularly in Asia, would provide enough demand to drive the global economy, but this has been dashed by the imperative for China to rebalance its economy to a slower growth model and a rapid build-up of debt in the developing world. It is now unclear what the new drivers of company profit growth and investment returns will be.

In an effort to revive investors' animal spirits central banks have depressed the yields – and thus prospective returns – offered by defensive fixed-income assets down to very unattractive levels. Low yields have caused something of an investor stampede into higher-return assets and inflated valuations, further reducing their future performance potential. Additionally, with little prospect of a material rise in real global interest rates for the foreseeable future, asset markets are susceptible to periodic asset bubbles, as investors chase returns.

If these concerns were not enough, investors also need to contend with the possibility that the current global economic expansion and equity bull market, after almost seven years, are already mature.

Greying populations

The globe's ageing populations exacerbate these forces: as the proportion of working-age people shrinks, both productivity and economic growth are depressed. Moreover, older populations mean a larger number of risk-averse retirees who are looking for higher yields on their savings to provide for ever-longer retirements.

As a result, markets are likely to continue to place a premium on defensive investments, higher-income-paying securities, and assets capable of generating sustainable real growth. In some cases, however, these characteristics do not naturally go together. For example, the search for income in a low-yielding world necessarily requires a willingness to take more risk.

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Structural changes

Portfolio resilience is further challenged by five structural changes which have increased financial market turnover but have reduced depth and liquidity.

These trends have reinforced one another and led to an increase in so-called flash crashes in both bond and equity markets.

Five structural changes challenging portfolio resilience

The growth of exchange-traded funds and high-frequency trading, both of which are short-term, momentum investors.

Regulation has reduced the market-making capacity of investment banks and limited an important source of liquidity.

Quantitative easing has decreased the availability of high-quality collateral used to fund much of the world's trading activity.

Systemic option selling and portfolio insurance tend to increase selling pressure in falling markets.

Investors' desire for daily fund liquidity has created an implicit liquidity mismatch between fund assets and investor needs.

Historic disruption

It also seems to be becoming harder for markets to revert to their historical mean measures of fair value. This trend is partly retirees' preference for certain asset characteristics, but also the effect of disruptive technologies, such as genomics, energy storage and robotics, on some sectors and businesses, which can turn apparently cheap investments into obsolete value traps. Consequently, companies with more durable franchises and established drivers of growth will garner higher credit ratings.

Our models suggest that a meaningful recession is unlikely to occur in major economies in the next year, but we believe portfolios need to be able to cope with unforeseen events and be flexible enough to adapt to changing probabilities of growth and recession.

How to build resilience

Building portfolios that can prove sufficiently resilient to meet the needs of investors, despite these many impediments, requires a strong understanding of investment risks, beyond just estimates of volatility. Portfolio construction will need to balance the trade-offs between potential returns and individual assets' contribution to risk, and ensure a level of diversification that is robust to events. Portfolios will have to be flexible and able to adapt exposure to suit the changing investment backdrop.

Ensure a level of diversification that is robust to events

Investors need to consider the durability underlying cashflow generation of their investments' business models and avoid areas at risk of disruptive change. Portfolios will also have to limit exposure to the least liquid parts of the market and have strategies to deal with bouts of market stress. On top of all of this, however, they will need a disciplined framework for identifying attractive investment opportunities and those to avoid.

Avoid areas at risk of disruptive change

Related views:

- Multi-Asset Growth
- Multi-Asset Income
- Global Quality
- UK Quality

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Diverging monetary policies

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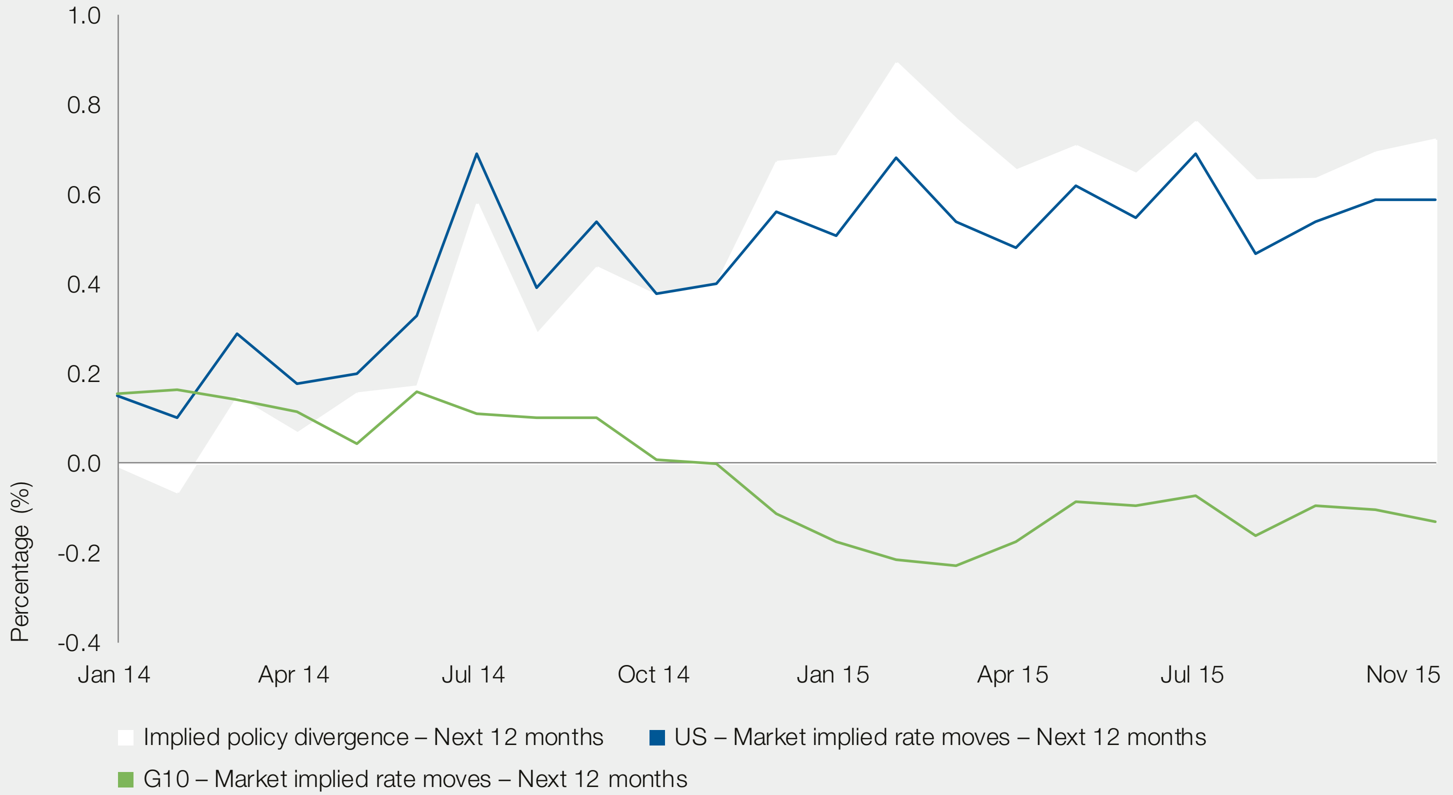
US dollar consensus, driven by divergence

Despite being an increasingly consensus trade, we believe the US dollar will continue to be well supported and reach new cyclical highs as US monetary policy normalises slowly but surely. Having delivered an economic recovery, the US is in a position to raise the cost of money. Europe, however, remains at least three years behind this stage, having only just started to run down private-sector debt. Asia, and China in particular, are nowhere near this stage and their debt to gross domestic product ratio is still high, suggesting monetary policy will need to be easy for several years to come.

We first turned positive on the US dollar in 2012 when it became clear that the economy had already made progress on deleveraging, American banks had improved their capital ratios and the shale revolution in energy extraction was starting.

Figure 1: Monetary divergence: the US vs G10 (2014-2015)



Source: Bloomberg, November 2015.

The currency was then extremely cheap and under-owned. Fast forward three years and we have experienced a substantial re-evaluation of the US dollar against a wide range of both advanced economy and emerging-market currencies. Much of this rally has been driven by divergent monetary policy, with the Federal Reserve (Fed) indicating for several months that 2015 would be the year that their target for Fed Funds is finally raised. In contrast, the European Central Bank (ECB) managed to clear enough hurdles to enable them to launch their own version of quantitative easing and the Bank of Japan took forceful steps to boost the money supply significantly.

Changing behaviour of currency dynamics

One interesting aspect of recent price action has been the changing behaviour of currency dynamics. Traditionally, the US dollar has been defensive, rallying when markets are nervous and falling when markets are upbeat. However, the euro has also begun to exhibit defensive behaviour.

We believe there are two factors behind this change. First, with negative interest rates, the euro is a funding currency for higher-risk currencies and second, the euro zone has accumulated a substantial current account surplus and the excess savings from this flow out to investments beyond its borders.

> The euro has also begun to exhibit defensive behaviour

When markets are calm this situation presents few problems, but as soon as volatility rises or participants become nervous, these flows reverse rapidly as higher beta currency trades are unwound and capital flows back into the euro zone, boosting the single currency. This, of course, is exactly the market price behaviour traditionally displayed by the yen.

This situation raises a possible risk to a further US dollar rally, but there are others. In particular, the future trajectory of the US economy is crucial to our narrative, and whilst the labour market has largely healed, inflation remains well below the Federal Open Market Committee's (FOMC) desired level and so the FOMC needs to be confident that its forecasts are robust enough to ensure that inflation rises back towards the target level.

Looking forwards

Given the likelihood of a further rate rise in 2016, we expect that the US dollar will remain well supported by investors. The greenback's continued strength will, therefore, keep pressure on those emerging market borrowers who have hard-currency debts. The countries most affected will be those whose income depends on natural resource revenues, which will likely remain subdued.

> We need to dynamically manage our currency exposure

What are the investment implications of this theme? Foremost is an increasing awareness of the need to dynamically manage our currency exposure to manage down-side volatility and capture opportunities when presented.

> The greenback's continued strength will, therefore, keep pressure on those emerging-market borrowers who have hard-currency debts

Related views

- Multi-Asset Growth
- Multi-Asset Income

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Selectivity needed in emerging markets

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The emerging-market universe is a disparate one offering a wide range of investment opportunities. While there are some unifying factors, the year ahead is likely to continue to be characterised by continuing divergence between markets. This will present us with some fundamental challenges, but also some pockets of value that is better than we have seen for some time.

A tale of two powerhouses

At a high level, emerging markets are caught between the twin economic powerhouses of the US and China. While it has been this way for many years, the exact nature of those influences has changed through time. Many emerging markets, particularly commodity exporters, have been hit by the sharp fall in demand for basic materials and commodities from China. As the People's Republic rebalances its economy to favour services over heavy industry and infrastructure, fixed-asset investment and property have slowed from 25% year-on-year growth to 15% today. We consider that these rates are likely to slow gradually over the medium term, rather than declining precipitously, as China works through capacity overhangs in many industries. Nonetheless, for countries that relied on extracting natural resources and selling them to China for their economic growth, this slowdown has come as a distinct economic shock and continues to hold back growth.

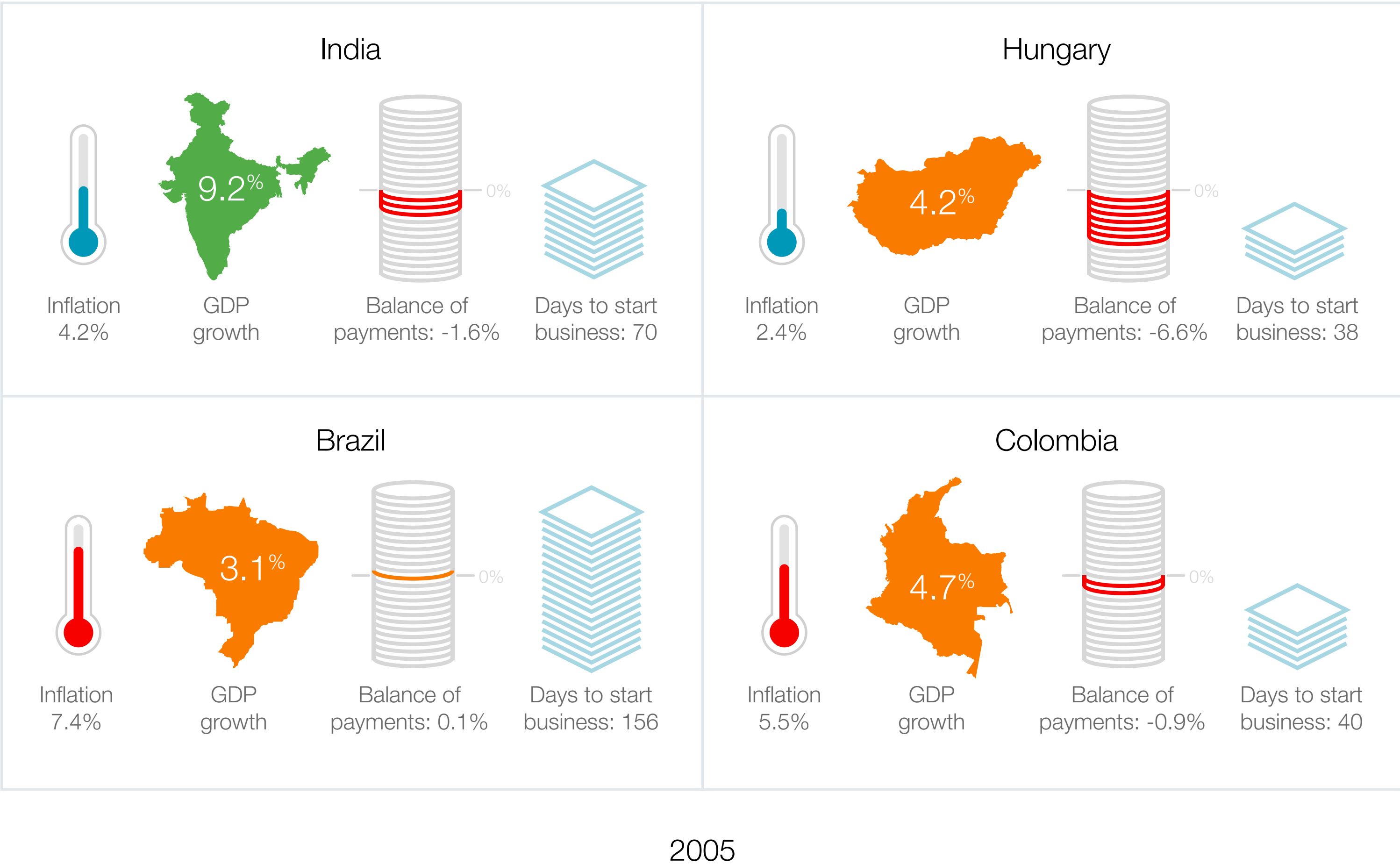
For many emerging markets, the US has shifted from being a strong demand and export driver through its consumption of their products, to a monetary driver as they import its ultra-low, quantitative-easing driven interest-rate policy. In some cases, notably in Asia, this cheap money-fuelled excess credit growth has allowed companies much freer access to global capital markets. If, as we expect, interest rates begin to rise in the US, those economies with high debt loads will be vulnerable over the coming year. To combat the impact of the US rate rise and maintain competitiveness, these countries are likely to let their currency weaken against the US dollar and cut interest rates.

Different pressures

However, not all countries face the same pressures. Countries that have substantial current account deficits such as, Brazil and Colombia, and which were the primary beneficiaries of quantitative easing between 2009 and 2013 are the most exposed to the impact of rising interest rates. Banking systems with high loan-to-deposit ratios and open capital accounts will also likely come under strain. The key risk for 2016 is, therefore, related to the financial cycle, particularly in Asia, where debt build-up is leading to the instability of the financial system and its attendant risks, even though the risk of global recession remains very low.

Our favoured markets are those of countries that continue to adopt market-friendly growth strategies

Our favoured markets are those of countries that continue to adopt market-friendly growth strategies, remove obstacles to doing business effectively, tame inflation and gain credibility.

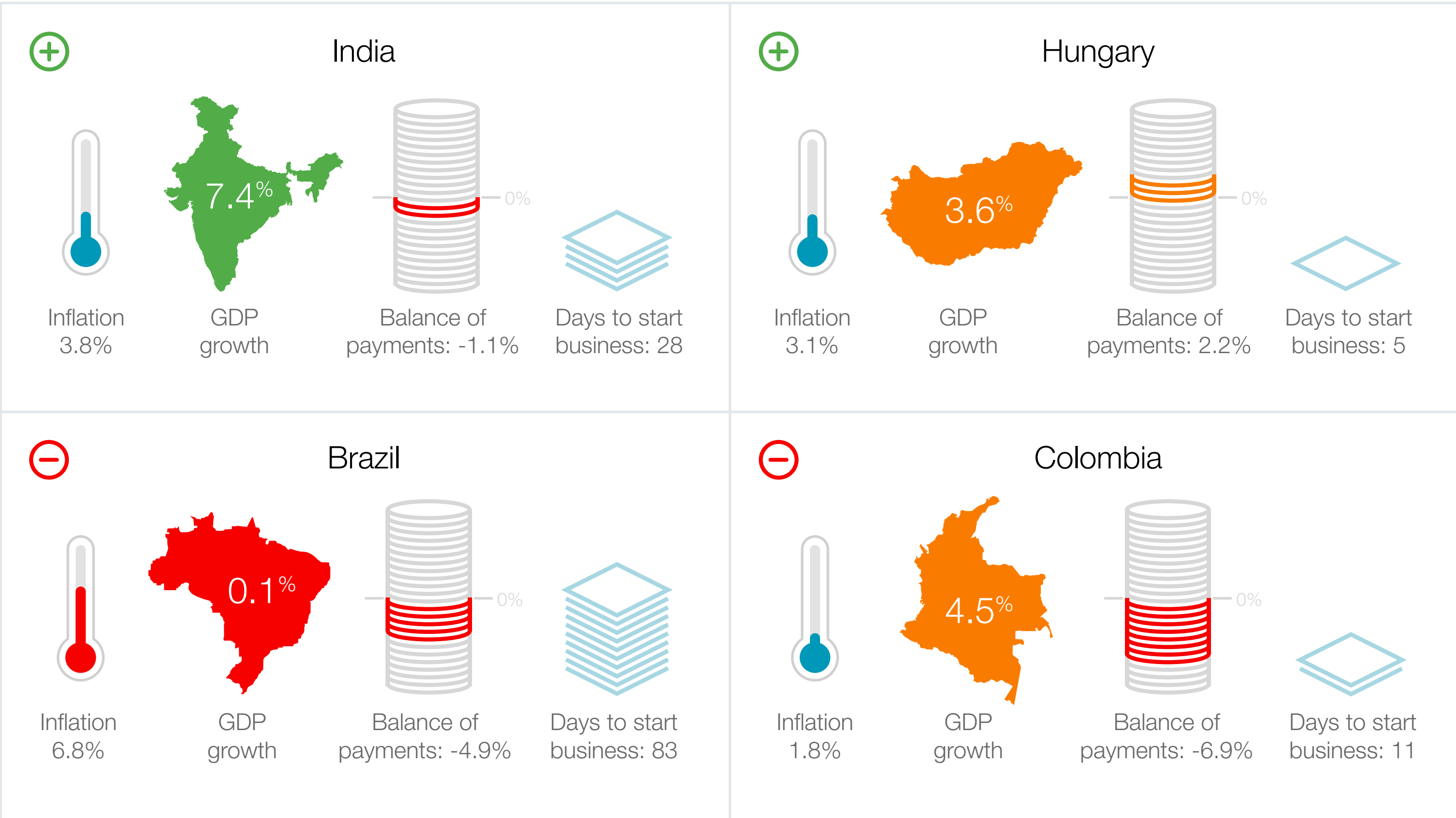


Source: World Bank and IMF.

Natural extensions

We also favour economies that are natural extensions of developed markets, such as Mexico of the US and Hungary of the EU. Both of these countries benefit from their neighbours' recovery in growth and activity. The relatively robust US economy, propelled by an increasingly confident consumer, provides a potential broader benefit to Mexico. The previous stage of US growth, powered by manufacturing and the shale oil boom, by its very nature did not pass through demand to emerging markets. However, a more typical recovery with consumers assisted by easier lending standards and a buoyant housing market could see a stronger source of demand.

We also favour economies that are natural extensions of developed markets



2014

Source: World Bank and IMF.

Fundamentally, however, those countries that were reliant on natural resource revenues, which couldn't mine it fast enough, and then couldn't stop mining it fast enough, are distinctly out of favour with investors. Some of these commodity producers may now be fair to good value. However, even then we have to differentiate between those economies that have exhibited the deep political problems associated with a struggling economy, Brazil for example, and those that are simply adjusting to a slower growth path.

Divergence brings back value

It is easy to be pessimistic about this challenging macro scenario – indeed our central case remains another year of growth disappointments – but value has come back as relative and absolute valuations now more accurately reflect growth prospects. With 150 countries, US$7 trillion in market capitalisation for the MSCI Emerging Market Index and $3.25 trillion of investible debt, according to JP Morgan in March 2015, the emerging market universe is significant and its divergence, in terms of what is on offer, is huge.

> The investor's challenge is to discriminate between the value and the value traps

Assets invested in emerging markets have proved sticky as institutional investors continue to make strategic allocations and to rebalance fixed-income mandates. The breadth of opportunities offered by the divergent bottom-up trends offers great scope to look for attractive returns and for value among the still fundamental challenges. The investor's challenge is to discriminate between the value and the value traps.

Related views:

- Emerging Market Equity
- Asian Equity
- Emerging Market Fixed Income
- Emerging Market Corporate Debt

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Finding bottom-up opportunities

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In 2016, we believe the investment environment will provide a more supportive backdrop for truly active, bottom-up, skilled stock-picking compared to that of recent years. There are five reasons why we think that this is the case.

The return of stock-specific risk

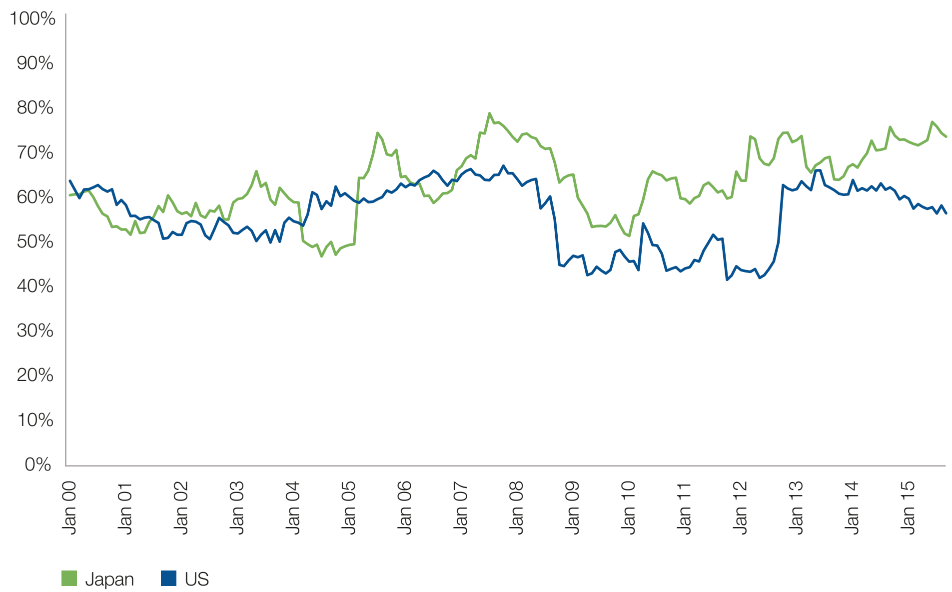
Figure 1 shows the proportion of equity market performance in the US and Japan accounted for by stock-specific factors. At 74%, it is clear that Japan is currently more of a stock-picker's market than the US, and Japanese equity is one of our favoured themes across portfolios. Another reason why we find a bottom-up approach rewarded in Japan is that the average return dispersion is high creating more opportunities for a focused approach. But even in the US, 57% of stock market performance is due to stock-specific factors and not accounted for by sector or style exposures.

Stock picking is particularly important in emerging markets and Japan

Falling correlations

The correlation between stocks is higher than normal, a sign that macroeconomic variables, such as central bank policy, have been the dominant drivers of stock market movements. We believe however in the coming year that correlations should mean-revert to a lower level, providing richer opportunity for stock picking.

Figure 1: Stock-specific factors as a percentage of overall performance



Source: Deutsche Bank, as at 30.09.15.

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Interest rates

We also believe that an environment in which US interests rates are not falling, and are likely to rise, (albeit gradually), should be more supportive for active equity managers. For example, long-term research by the Centre for Research in Security Prices (CRSP) shows that between 1962 to 2014 US active funds have seen their outperformance suffer during periods of falling rates.

> 'Macro noise' is probably one of the greatest sources of wealth destruction

Passive inflows

We also believe that the debate on the effectiveness of active versus passive is changing in favour of active. The meteoric rise in passive inflows relative to flows into truly active funds has acted as a drag on an alpha environment as people question the ability of active funds to outperform the market consistently.

However, recent empirical evidence favours active and if that starts to turn the tide in terms of passive versus active fund flow, the stock selection opportunity could become richer again. However, the major risk for stock pickers is that passive and exchange-traded fund usage does not abate and continues to act as a drag on those looking for alpha.

Seeing through the macro-noise

Finally, we believe that taking a bottom-up approach (not just to equity investing) is vital to counteract the short-term macroeconomic noise and commentary that can cloud investor judgement. We consider that 'macro noise' is probably one of the greatest sources of wealth destruction in investing.

We think the market correction in August 2015 was a perfect example of the tendency to overreact to macro news. The apparent trigger for the sell-off was the People's Bank of China's sudden announcement of the widening of the renminbi's trading band. This move raised fears that China was competitively devaluing its currency and led to speculation about the extent of the weakness of the Chinese economy and the threat to global growth it represented.

Contemporaneous top-down macroeconomic data seemingly confirmed this state of affairs, but the more micro bottom-up data told a rather different story.

Although China's old industrial economy was clearly suffering from a severe cyclical downswing – something that has been apparent for a number of years – measures of New China, albeit often anecdotal, in the form of consumption and services-related business growth, provided a significant counterbalance to the top-down narrative of a hard landing. The epicentre of China's problems was generally considered to be property – chronic overbuilding leading to ghost cities – yet mainland property stocks listed on Hong Kong's H-share market had been outperforming their wider index since May 2015 and continued to do so throughout the sell-off.

The clear lesson, therefore, is that overall asset allocation is a much more bottom-up discipline than most suspect, and while frequent data can hold valuable information it is important to set this in the context of well-developed medium-term views.

> Overall asset allocation is a much more bottom-up discipline than most suspect

Related views:

- Global Equity
- Global Quality
- UK Quality
- UK Value
- Global Endurance Equity
- European Equity
- Asian Equity

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ESG going mainstream

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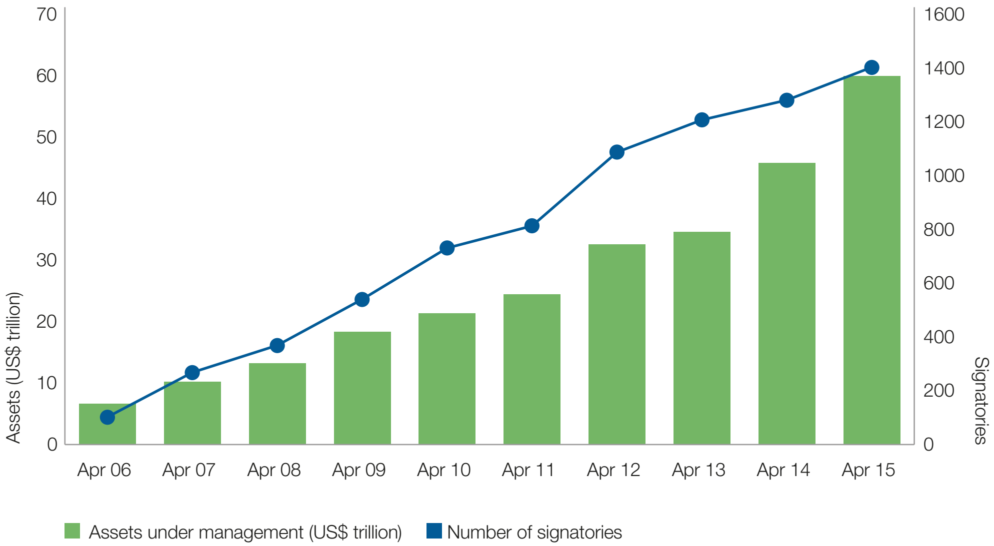
We believe that 2016 will be the year that environmental, social and governance (ESG) factors will move centre stage for many investors and be seen as a driver for long-term value creation. Of course, attention to ESG is not new and many investors, especially those in Europe, will claim to integrate ESG considerations into their investment processes.

Figure 1, shows the growth in signatories to the UN Principles of Responsible Investment (UN PRI), where the first principle to which members sign up to is, "incorporate ESG issues into investment analysis and decision making processes". However, in reality, ESG efforts are seen by many as a box-ticking exercise, or at best a moral obligation, but not as a way to improve investment returns.

The link between governance and shareholder, is clear

For most investors, the link between governance and shareholder returns, at least, is clear. As summed up by the UK's 2009 Walker Review of Corporate Governance, its role is "to protect and advance the interests of shareholders through setting the strategic direction of a company and appointing and monitoring capable management".

Figure 1: Growth of UN PRI Signatories (UN PRI)



Source: UN PRI, April 2015.

Japan: a shining light

Japan is an example of a country that is going through a programme of governance reforms that is helping to send encouraging signals to shareholders. Japan has traditionally had a challenging corporate governance culture characterised by closed boards, anti-takeover measures, worrying related party transactions and capital management strategies. But over the last two years, measures to promote greater transparency have included the launch of the JPX-Nikkei 400 index that included capital efficiency as a criterion for stock weightings.

Japan has also introduced a Stewardship Code and a Corporate Governance Code. In July 2014 ISS Japan, a corporate governance and socially responsible investment solutions provider, recommended that shareholders vote against proposals to elect directors where a company's ROE has remained below 5% for five years or more. From February 2016 they will also oppose top management at companies that do not have at least two outside directors.

Japan's focus on governance has also led to more tangible benefits, such as share buybacks at levels not seen since 2008, a gradual elimination of cross shareholdings, a rolling back of takeover defences and ROEs that are close to 10% (albeit other factors have played a role).

Volkswagen: a game changer?

Providing a nexus between both governance and environmental concerns is Volkswagen (VW). In mid-September 2015, the company admitted to using a cheat device in many brands of their cars that turned on full pollution controls only when the cars were being tested. Once news of this deception emerged, the company's shares fell almost 40%. Although some see this as part of the uncertainty inherent in investing, attention has frequently been drawn to the poor governance of VW in terms of its voting structure and, more importantly, its board composition.

> Attention has frequently been drawn to the poor governance of Volkswagen

In March 2013, Olaf Storbeck wrote for the news service Reuters that VW's supervisory board was highly politicised and lacked real external control consisting as it did of local politicians, trade unionists and two related, but often warring, families. He finished by observing that "Management theory and the history of other companies show that this structure is a recipe for disaster".

It may be too early to tell exactly how significant a role the corporate structure played in the lack of oversight and protection. However, it may hold valuable lessons on clearing up some of the more opaque structures used by VW, such as cross shareholdings and dual share classes. The effects from the VW case on the company and the industry are likely to be far-reaching with new value chains emerging within the transport industry if the move away from diesel is accelerated in city centres.

Centre stage for climate change

Moreover, the VW scandal occurred at a critical point for the global response to climate change: the UN Climate Change Conference in Paris (COP 21) that took place in December 2015. The gathering aims to achieve a binding and universal agreement on climate from all the nations of the world, which has never been achieved in over 20 years of negotiations.

Although global warming has been widely recognised as one of the world's most critical challenges, the effect of feedback loops is extremely complex, making it difficult to assess the timing and severity of the threat. A response to this threat requires global coordination and, given the vested interests, it is inevitable that any response will initially be inadequate and delayed. However, if the state is likely to disappoint, non-state actors can and, increasingly, will play a role. The idea that sustainability should be a pillar of sound investing is not new but as the German economist Professor Rudi Dornbusch wrote "things take longer to happen than you think they will, and then they happen faster than you thought they could".

> If the state is likely to disappoint, non-state actors can and, increasingly, will play a role

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