

Willis Towers Watson PODfolio episode 3

Is it too late to diversify?

CRAIG BAKER: Humility from all of this in terms of how we reflect that in portfolios is probably a good starting point.

NARRATOR: Welcome to the PODfolio, Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolios.

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LOK MA: Hello, and welcome to the third episode of the PODfolio podcast. I'm your host Lok Ma. And with me, we've got Craig Baker, our chief investment officer. And we're going to be talking about the kind of things that asset owners should be doing or at least thinking about in the current environment. So let's start with a very quick look at the headlines around COVID-19.

I'll pick something from the more positive side. A number of treatments and vaccines showing some early signs of promise. And then maybe towards the more alarming side, there's also a story emerging about the possibility of being re-infected by the virus.

And against that kind of background, the equity markets showing some signs of coming back to life. So especially if you look at something like the S&P 500 index compared to the very bottom of that market, things have rebounded at a pretty incredible 25% or so, so that, compared to the end of last year, the levels are only down a little bit over 10%.

So let's bring Craig into the conversation. Now Craig you are our chief investment officer. And when I think about a CIO, I'm maybe more typically thinking about someone who's working for a big pension scheme, looking after their overall investment strategy. Given the nature of what we do, a combination of giving advice to our clients and managing portfolios on their behalf, I would imagine that your role as CIO is somewhat different to that. So before we start, can you just give us a very quick sense of what your role as the CIO involves?

CRAIG BAKER: Yeah, sure, I mean, I think the typical role that people sometimes have in their mind of what a CIO does and certainly was probably true 10 plus years ago in most asset management firms where they had a CIO was that they set the asset allocation view, the views positive or negative on various markets, and then set the various teams underlying that to go away and fill in the buckets essentially in each asset class based on the asset allocation and top down views that might permeate their way through the various views on each asset class beneath that.

We don't do things that way for a variety of reasons, not least because we think there are better ways of managing portfolios. And we follow the total portfolio approach. So this is a term that's being used quite a lot with large asset owners around the world, and we see ourselves as a \$100 billion plus asset owner because that's the kind of assets we're managing on a fiduciary basis.

And the total portfolio approach is really this view that, rather than following this strategic asset allocation and filling the buckets approach, it's much more bottom up competition for capital of ideas that could come from anywhere and then thinking about risk in terms of the real return drivers of each idea that you put into the portfolio.

And so my job as CIO in that is really around building out a diversified set of skills in each of the research teams that we've got, ensuring diversity of thoughts within that group, which includes the usual R&D things, but very much also trying to think about how we pull together and make that a cohesive, single team that's got one goal to get better outcomes at the total portfolio level.

And that's really what my role is, is pulling together the manager research operation or due diligence for asset research, our thinking ahead team, and our portfolio management team all into one cohesive unit.

LOK MA: And you mentioned diversity in two ways-- I think diversity in terms of the things we invest in and also diversity of thought in terms of who's coming up with those ideas. And to me those two things have rolled into one. And no doubt, we're going to come back to that in a second.

So our main topic of the day is around what actions should people be thinking or doing right now. And let's start I think at the obvious points, which is around the idea of inaction as an action.

So if I'm an asset owner with quite a lot of money in equities that have just taken a fall, possibly showing some signs of coming back up again, so should I as a long term investor actually just try to hold my nerve and wait for that bounceback to happen rather than maybe risk giving up some of that upside if I'm changing strategy at this point in time?

And related to that, Craig, I think, would you think about what's happened in the equity market so far. Do you think that that's a sign that things could actually be bouncing back to normal?

CRAIG BAKER: Yeah, OK, well, there's quite a lot to pick out of that question. I guess the first one is around, should a long term investor just be comfortable running with a significant equity allocation and ride out the peaks and troughs. I mean, I think a lot of that comes down to quite how long term and investor you are. And I think people sometimes forget how long you can have periods that equity markets produce poor returns.

And so you need to be thinking in multiple decades really to have no worries around dealing with the volatility that's inherent in the equity market over the long term. And there will be some very, very long term investors, sovereign wealth funds, and the like that maybe can think through the world that way.

But I think in reality, even long term investors on the institutional side, have typically got to worry to a certain extent about the volatility of the assets they're investing in. And so I think there is an argument for having a diversified portfolio purely from that perspective. But that's something we'll come back to.

The second piece is your question of, if you've already seen a fall in your assets from an equity drop, is it a bad move to then suddenly change direction in terms of what assets you're holding and effectively be diversifying at the bottom potentially. I think there the important thing is to avoid the behavioral trap that you can fall into with really not wanting to accept that things may have changed and hence your portfolio needs to change and being nervous about being seen to do something daft following a fall.

Clearly, just a knee jerk reaction to move out of an asset class that's underperformed-- offered underperformances on average a pretty bad thing to do. But if the world view has changed dramatically, which we can argue it has with what we've seen happening, then starting again from scratch and just saying, if I woke up today and was designing a portfolio from scratch, would I have the portfolio that I've got today. If the answer is no, then it does make sense to make a change in the portfolio.

And then I think the final part of the question was thoughts on equities. I mean, clearly we've seen a big bounce back from the initial fall in markets, which were extreme, if you look at the something like a 34% fall in the S&P. I think that over a one month period that was the sharpest fall we've ever seen in history from the S&P.

If you look at the last 27 bear markets over the last 125 years or so, that was by far the sharpest that we've seen. But it certainly wasn't the biggest fall. It was just the quickest that you'd seen anything bigger than a 20% drop. It was a big bounce back. I think I would probably question whether such a quick reversal made sense when there's still so many unknowns.

But as I'll talk about later, I think the honest truth is that no one can have a strong view as to whether things look attractive or unattractive. And so having some caution makes sense.

LOK MA: And I think if you look at the news that has come out in the last couple of weeks, the balance between good and bad news, you wouldn't necessarily intuitively think that would equate to a massive bounceback in the equity markets. So it doesn't surprise me, Craig, that you would say maybe the strategy that you held going into this is probably not identical to the strategy that you would hold now that the world is completely different. So I think we're now moving into the main part of our conversation to what are the things that you would recommend to our clients to at least think about right now.

CRAIG BAKER: Well, I think we would certainly be encouraging clients to have diversified portfolios. Now we would, in normal course of events, be arguing quite hard for diversity. We tend to run diversified portfolios. And there's a number of reasons for that, not least of which is the fact that we believe extreme events happen more often than are typically allowed for by market pricing. And they're happening more often these days than they did in the past because of things being so more interconnected, thanks to globalization, greater sharing of information, be it through academia, through the internet, and the like.

And so we've always been cautious about having all of your eggs in one basket even if that basket is a rather large so-called diversified equity portfolio. We've always been proponents of having diversified portfolios. But I think we would be even stronger proponents of that today than even we were about six months ago when we were strongly arguing for a diversified portfolios partly following a 330% return from the lows from equities or 500% on

the NASDAQ, to put this in perspective from the post GFC lows. We thought that justification made even more sense the normal then.

But if you look at where we are today, we've got a global pandemic the likes of which we haven't seen for over 100 years. We've seen greatest economic contraction since the Great Depression. We've got oil price declines that are bigger than we've seen before. We even had negative prices on oil futures yesterday. And we've seen to combat all that the greatest central bank and government interventions of all time.

So how anybody can easily with strong asset allocation views in this is quite difficult to understand. I think now is probably a time where we just have to accept that it is quite difficult to call what's going to happen. And so having a diversification of return drivers in your portfolio seems to make more sense today than in other areas where maybe some things were a bit more predictable, albeit that there's always these extreme risks that can come and hit the portfolio out of the blue.

LOK MA: So here's a challenge of sorts for you then, Craig, because earlier we were talking about the idea that the world is different now so you probably wouldn't necessarily stick to one strategy. But I think it's probably fair to say that we have always advocated diversification. And before we headed into this period, we're now advocating that diversification is probably, if anything, more important now than ever before.

Is it always just the same answer or can you actually imagine a different time or a different set of circumstances where you would say actually a diversified approach isn't the right way to go?

CRAIG BAKER: Yes, so I can't envision a time where we would say you don't want any diversity in your portfolio. I can't envision us ever saying you'd want 100% of your assets in or 100% of your growth assets, let's say, in one asset class. However, there would definitely be times where particular asset classes look a lot more attractive. And hence, you would end up with less diversity in total than we would be advocating for today.

But we would never be in a situation where we'd say, let's put 100% in equities or 100% in investment grade credit. That said, if we go back post GFC, once we'd seen quite significant falls, we actually had quite significant weightings to equities and investment grade credit and high yield at the time.

And I could envision that being the case at the point where we're starting to see all the bad news coming through markets could have fallen further from here. And with a medium to long term perspective, you start to see some real opportunities in not being quite so diversified in the portfolio and having a bit more in some risk on assets. But as I said, unlikely we'd ever be at the situation where you want almost no diversity.

LOK MA: So there is a scenario where we would say something quite substantially different, but we haven't got to that place yet. And that's all fine. And I mean, to be honest, if you think about the concept of diversification as a way of controlling the spread of the investment outcomes, I don't think there's actually anything controversial about that. It is long established economic investment theory, if you like.

What is actually surprising to me is, if I look at the portfolios of lots of, I guess, institutional investors how little diversification there actually is. I mean, that's a bit surprising to me. And do you have your take on that? Do you think there are any reasons driving why quite a few investors have deviated away from what I would describe as long established and not particularly controversial theory around diversifying?

CRAIG BAKER: Yeah, I mean, I think there's probably two main reasons, that the first is just, when you've got a 10-year bull run in equities-- and that's seen as the simple asset class to implement, as you can just buy passive equity funds. I mean, I might argue that equity is one of the most complex asset classes to truly understand what's in the pricing.

But nonetheless, it's generalist considered a simple thing to invest in. When you've got that asset class doing so well over such a long period and hence pretty much any kind of diversified portfolio that hasn't got as much in equities looks as though it's performing worse, yes, it's doing it on a lower volatility. But you start getting phrases like, well, you can't eat risk reduction. And it's all about return.

People forget about the fact that extreme events can happen. People will focus on what the outcomes only have been rather than the risk adjusted returns. And naturally, that leads people to just question what diversification is really needed if you're a long term investor. Of course, it's only when you start seeing something like we've just seen with a 34% fall in equity markets in a month that people remember the real advantages of diversification.

So that was probably the first point. The second point is just how complex and potentially, at first sight, expensive it can be to run a diversified portfolio. It is more difficult to run a hedge fund portfolio and a private markets portfolio than it is to run an equity portfolio, even if you're running that equity portfolio on an active basis. Having three or four or maybe even five or six equity managers is still relatively simple to control rather than hiring some macro managers on the hedge fund side, some insurance linked securities managers alongside some long short equity, long short credit managers, some infrastructure managers, some real estate managers, so on and so forth.

It's actually quite a lot of governance burden required. And so for those asset owners that have got relatively small specialist teams and aren't willing to outsource a lot of that, it's a very difficult portfolio to manage on diversification grounds. And so I think it's really for those two reasons that we've not seen it in particular over the last 10 years.

LOK MA: Thanks so much for that. So Craig, and as you mentioned, though, you as the CIO in a slightly different situation in the sense that you don't necessarily directly control the investment of the assets, whether that's through our advisory client or even on a delegated basis. You will have been subject to parameters set by our clients.

The question I've got is-- let's imagine your advisory client. What is the one kind of investment action that, if you could just impose on people's portfolios without necessarily needing to go through the recommendation process, if you could just impose one change that would have the biggest impact from your point of view, what kind of change would that be?

CRAIG BAKER: I think the key thing would be clients really trying to understand what risk budget they're prepared to take and how's the best way of splitting up that risk budget between the big picture questions. So for example, once they've decided how much risk in

absolute terms for a DC situation or relative to liabilities in a defined benefit situation, once they've decided what risk budget is, how much do they want to take starting from scratch in interest rate or inflation risk.

How much do they want to take in their asset pool? And then within their asset pool, how much from the various return drivers, be that equity risk premium, credit risk premium, illiquidity premium, skill premium, those kind of things? If every client came to a view on those things, first and foremost, the rest pretty much falls into place because, after that, you can decide, well, can we do all of that ourselves. Do we need to change our governance? And that could be building governance ourselves. It could be outsourcing certain things.

That should be the secondary consideration-- so not starting from the premise of, given the governance we've got, what should our portfolio look like. Instead, start from, what do we think our portfolio needs to be to deliver on the promises we've made. And then how do we flex our governance to suit that? I think that would be probably the biggest thing I would get clients to consider.

LOK MA: And so one final question then, Craig. We've talked about how you would like to invest in terms of diversification and also touching on things like hedging interest rates and inflation exposures. So with that kind of investment approach, which I would say is very well risk managed, is there anything that still keeps you up at night in a professional context. So is there any scenario you could think of that would hurt that particular way of investing?

CRAIG BAKER: Yeah, so I think that the obvious debate within the liability side of things for our defined benefit clients is around at what point yields look so low that you wouldn't want to have as high a hedge ratio as we've had historically and, within certain markets, like the US, how much of the liabilities do you want hedged by a treasury [AUDIO OUT] or other treasuries versus credit. So those are the big questions that we grapple with on the RBI side.

And then on the growth assets side, the most obvious ones are how much in equity, how much in credit, and how much in skill premium essentially, which could include the illiquidity premium when taking that out into the less liquid markets and private markets in particular.

And so when you then look at portfolios that clients have got on the private market side, it will be interesting to see how any mark-to-market losses, how many of those actually turn into real losses. And that's kind of the big question that everyone's got really in diversified portfolios.

It certainly looks as though they've held up a lot better than not having diversified portfolios to date. But you can never count your chickens at this stage of where we are in this cycle. And so those are the things that really keep me and others up at night.

LOK MA: Any other thing that you'd want to talk about in terms of what people should be thinking about in the current environment before we wrap up?

CRAIG BAKER: No, I think we've covered a lot of it. I think it's this key point that it's very difficult at the moment to have extremely strong views on which asset classes look particularly attractive or unattractive. There's just so many unknowns out there on things that

we haven't really seen historically. Certainly haven't seen all of these things happening at the same time historically.

And so I just think humility from all of us in terms of how we reflect that in portfolios is probably a good starting point.

LOK MA: Well, thank you very much, Craig, for your time. It's been an absolute pleasure talking to you. And I hope that the people listening at home enjoy this as well. Please do check back into future episodes of the PODfolio podcast. And in the meantime, do you take care of yourselves. Thank you very much.

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