

The PODfolio Podcast Episode 16: New Year, New You

MARTIN JECKS: If you are sort of used to thinking about the future, thinking probabilistically kind of accepting that you're going to be wrong, you're better able, I think, to take those difficult decisions in the teeth of a crisis. And keep the balancing going.

KATIE SIMS: 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.

LOK MA: Hello, and welcome to The PODfolio podcast with me your host, Lok Ma First of all, welcome to 2021. Now we've called this episode New Year, New You because this is, of course, the time of year to make some new resolutions for how we run our lives. But should we also take a moment to think about how we run our portfolios. And make some resolutions to do things better there. That's the theme for today. And I was three esteemed guests joining me. Martin Jecks, who leads on our macroeconomic views. And how these are then fed into investment portfolios. Welcome to the show, Martin.

MARTIN JECKS: Hello. Thank you very much. Nice to be here.

LOK MA: Tessa Mann, who is an equity portfolio strategist. So welcome, Tessa.

TESSA MANN: Thank you, Lok.

LOK MA: And we also welcome back Katie Sims, who is our head of multi-asset growth. And also of course the silky voice your hear at the beginning of each episode introducing our podcast.

KATIE: Great to be back. Thanks, Lok.

LOK MA: In this episode, we'll be taking a look ahead to the rest of 2021 and beyond. Think about the forces that would influence world markets. And how we can allow for these in our portfolios. Before we do that though, there is a tiny cynical voice in my head that says, why make these predictions when the world is just so inherently unpredictable? And I just want to address that first. So turning to you first, Katie. We've just come out of the year 2020. A year, that as we all know, brought incredible upheaval to the world. And not just the investment market. So I just want to quickly revisit the predictions and portfolio suggestions that we made this time last year. And then think about whether those turned out to be any use. What did that experience teach us about trying to second guess the future, if you'd like.

KATIE: Sure. Well, I think if anybody managed to predict 2020 with any accuracy then they won't need to be listening to this podcast and looking for recommendations from us. Yeah. I don't think anybody sort of went into the year expecting the roller coaster ride that we inevitably experienced with markets. But what we did get right in terms of our expectations was that there is scope for there to be significant market volatility. And that you should bear that in mind when you are considering the risks and opportunities when building a portfolio.

So a number of the things that we have been consistently advocating, such as having lots of diversity in portfolios and thinking about things that you might want to own in the event that markets do sell off, they really came good during the course of Q1. So hedge funds were by and large up across the board. Our portfolios were up between 8% and 17%. And we also had employed some explicit downside risk protection, which had generated fantastic outcomes. So again, between 50% and 150% returns on those things.

So I think having an eye on the potential risks and impact that they might have is important for any investor at any stage in their journey. And so that risk management process is well worth embedding in how you think about things.

LOK MA: So now let's look ahead to what's to come. So generally speaking, given where we are now, how optimistic are you guys feeling about the world economy in the coming months and years?

KATIE: Yeah, generally, we're relatively optimistic. So what we have learned is once public health related restrictions ease, and we can see that it's likely that the vaccine will allow for that then economic recovery can be pretty rapid. So it is obviously worth noting, as you say there's a lot of unpredictability here. And a lot of things that need to go right in order for that economic recovery to continue. But that's certainly where the evidence is pointed at this stage.

LOK MA: And so, Tessa, I mean what are for you the main forces that will be driving our markets in the future months?

TESSA MANN: So I think certainly at this crucial juncture that the economy is at now it really is policy mix to start with. So we need to have more accommodative policy. Again, as I said, the evidence is pointing that way with a lot of willingness and ability from central banks and governments to continue with that. Part of that is keeping bond yields low for example. And also continuing to provide that combined monetary and fiscal support we've begun to see.

I think for us as well China's financial opening is very important to investors. So I was living in Hong Kong until recently.

LOK MA: I didn't know that. I'm from Hong Kong.

TESSA MANN: Oh, OK.

LOK MA: Yeah. Cool. We need to swap notes.

TESSA MANN: Yeah. Late 2019. So I think from that vantage point you really can see just--well, firstly the rapid opening up of China. And really how much of that kind of gravity is in the kind of Asian center there. And how that can be also underestimated somewhat from the West. But yeah, that's kind of the scale that the banking assets of around \$40 trillion. Around double that in the US. So as this opens up, that's going to have big implications for investors.

And I think the final thing, Lok, would just the long term sustainability. So something that a lot of us are discussing now. Particularly how we transition to a lower carbon economy.

LOK MA: Yeah. So we've got these three broad themes. You've got the policy shift. You've got the rise of China as a kind of global power. And you've got the theme of sustainability. Let me now turn to you, Martin. Can you tell us a bit more about the process of translating these themes into kind of practical changes in how we actually invest? I mean these I guess new year portfolio resolutions that I described.

MARTIN JECKS: Yeah. I mean, I suppose the first thing to say is we're sort of constantly trying to do that real time portfolio management means that you need constantly to be reviewing what you've got. But more formally we go through your process of what's my resolutions for the next year every December. And as we were doing that last December, obviously, there's masses to talk about. But the big thing that struck us was that 2020 does seem to us to be a bit of a watershed year in the trends that were happening that were ongoing in kind of a slow burn sort of way pre 2020, some of those have just been accelerated by the COVID shock. And I think the ones that Tessa was talking about there are prime examples. And that's really what we're focusing on in the report we're just about to release. The outlook 2021. We're taking those key three themes that Tessa talked about, and figuring out what the big portfolio implications, what the big portfolio resolutions of those themes might be.

LOK MA: And if that's OK I'd like to just go through some of these actions just so we get a better feel for what we mean. Does it work if I take these themes kind of one at a time? As if we start thinking about that idea of a future policy shift. So this idea of governments around the world putting more money into the system trying to kick start our post COVID recovery. What might that mean for future returns first of all?

TESSA MANN: So in the near term it's likely will have a bit more of the same. So more of what we saw last year. And without going full geek on you, more of what we've seen since 2008. So quantitative easing. Keeping bond yields low. Pushing investors across the risk spectrum, and pushing up valuations. Longer term we can see it's very likely that valuation increases can pull down returns from the future. So you can almost imagine you're borrowing those returns from the future.

There is elements of devaluing currencies relative to financial assets. But even in spite of that, it's most likely that we'll see kind of stronger nearer term returns and over the longer term that pulls the return profile down a little bit.

LOK MA: So I may not be kind of putting in quite the right way, Tessa. It kind of seems to suggest an approach of make hay while the sun shines. It's not the kind of thing that I remember us saying very much in the past. So I just want to test how strong is your conviction about this idea of stronger near-term returns, lower longer term returns. That you would actually change the way you invest and maybe take a little more risk now.

TESSA MANN: Yes, I mean, I would say for the right investors a medium conviction. If that kind of clarifies somewhat. So yeah as we said earlier, or kind of mentioned this, this is our base case. But we do recognize there's quite a few things that do need to go right for this to happen. So it's dependent on policy stance. For example, which we're kind of listening to a forward guidance and looking at what's been happening. That's obviously a key risk for example. So yeah. We're fairly confident. Wouldn't bet the ranch as it were.

MARTIN JECKS: If I can just butt in, Lok. I think that the clear implication here is that if you've got the right level of governance and kind of execution ability to be dynamic and keep

that judgment under review, then I think medium conviction take a bit more risk. Don't bet the ranch as Tessa says on it. I think that's what we would suggest. But for many investors being dynamic just isn't there cup of tea. In which case I think this idea of dynamically taking a bit more risk just isn't for you.

LOK MA: So that's a kind of general, I think, directional view. In terms of benefiting from the stimulus money being thrown around, are there any specific sectors or asset classes that you're more confident will benefit from the policy shift?

TESSA MANN: Yeah. Always important question. I think we've seen in the first instance that treasury yields clearly come down. And they're directly bought by central banks. Then we see this go across the risk spectrum. As I mentioned credit spreads, liquid equity, and listed assets. But I mean, it's also really worth throwing out that there are some differences to the last regime as well. So whilst we will the combined impact of a continuation of investors going out along that risk curve I mentioned, and we're also looking at policy innovation here where we'll see combined fiscal and monetary policy, which is much more consistent with real economy investment by government agencies. And we think that can also-- the two of those together is likely to make illiquid assets attractive.

LOK MA: So illiquid assets being a good asset class to benefit from. Potentially there's going to be even in money. OK. So let's move on to the second of our three main themes then, which is the rise of China as a global force. Maybe potentially even the dominant force. Some of our listeners you would have tuned in to our previous episode on this topic. And you would have heard our experts arguing for an increase in exposure to Chinese assets. And turning to you now, Martin. Are you on the same page on that one?

MARTIN JECKS: Yeah, definitely. And that's why it features quite prominently in this report. And when we were reflecting on our resolutions in December, what we were looking for are things that we think are relatively significant. They're going to make a material impact on portfolios. And also quite certain I think policy shift in our view is both very significant and quite certain. China fits really easily into that those criteria as well. It is obviously just a very large thing. China, as Tessa talked about, the financial system is quite difficult to comprehend sometimes I think from a Western perspective. It is just really quite really quite massive. And that is a technical term.

And so as it opens up, that is likely to have very significant implications. Particularly in terms of the opportunity set that the non Chinese investors face. And the other point there is that policymakers have reiterated in 2020 their desire to open up the financial system. And policymakers sort of have a habit of achieving what they set out to in China. At least relative to other places in the Western world. And so we do think that financial opening up is also fairly certain. So that's why it deserves such prominence.

LOK MA: And is your-- yeah, go on. Katie.

KATIE: I was to offer a thought from an implementation perspective. So if we fully agree with Martin's view. And therefore we expect investors to allocate more capital to Chinese assets, so there's likely to be some price movement through that process. And it pays to be ahead of the curve in terms of anticipating that trend and being a first mover.

LOK MA: Get in early. Taking all of that into account, is your argument based more around the prospect for better returns or is it more about diversification and downside protection?

MARTIN JECKS: I think where we started from was very much sort of the latter two. So when we're looking at China it is very large and very different to the other markets that we have exposure to. And so it was primarily a diversification argument. Now with China bonds being increasingly accessible to us, there's also a downside hedging element to it. But primarily it did start out from a diversification perspective. But I don't think we can't forget about returns. And Tessa this is a point you've made to me quite emphatically in the past.

TESSA MANN: Yeah. That's right. I think, as you say, the diversification case is very clear. I find it quite hard to forget just how quickly China is evolving and the opportunity for a return there when the economy is growing so quickly it's definitely meaningful. So we've got the fastest rising middle class. For example, in China and that's radically reshaping of the economic model with things such as the area commitment by 2060.

MARTIN JECKS: And plus how volatile markets are just lends itself quite well to scale that to benefit as well.

LOK MA: And one of the things you talked about Martin, which I picked out was this reference to downside risk hedges. In other words, I think investments that pay out when the economy runs into difficulties as a kind of a way to protect the portfolio against downside risk. And again, I just I just want to do a quick look back if I may. So I know we've been talking about these kinds of downside protection strategies for a while now. Perhaps not China necessarily in the past. But can you just very quickly talk about the extent to which some of the previous hedges we considered whether they did what you expected when things actually got into difficulties last year?

MARTIN JECKS: Yes. So I mean I think the answer to your question is things did behave roughly as we expected. Albeit not at the precise time. So I think Katie talked about earlier the various strategies we've got to cope with downside risk. And prominent amongst those is maxing out diversity. And that's really the first lever we pulled because coming into 2020, we were a little bit concerned about risks to asset prices because we felt that the policy regime that we're enjoying at the moment, which is monetary policy being joined up with fiscal policy, that just wasn't present back then. And so we were facing a world where cash rates were very low. And therefore the ability of monetary policy to sort of absorb any downside shock was limited.

So for that reason, we were a little bit worried about that downside. Maxing out diversity was the first lever we pulled. And that worked. I think it wasn't an entirely comfortable journey. So particularly when equities and bonds are shooting through the roof as they were in 2019. It wasn't you know supremely comfortable always. But your portfolios did manage to keep pace. And so I think that's a really good thing. And obviously throughout the crisis that diversity works.

The second lever we pulled was holding more bonds. And in fact we held on a leveraged basis the idea being that when a shock hits bond yields fall. And you make a significant return on those investments. And again, that worked. Although bond yields actually fell earlier than we were expecting. So we had to be quite on our toes in terms of exiting those positions. And actually we largely exited those positions before the COVID shock happened.

And then the final lever we pulled was with options protection. And that was a little bit reluctant because we're certainly not permanent holders of options protection. But if you're worried about the downside and the cost that you're getting charged in holding an option is reasonable, then we think you should go for it. And back pre COVID, the cost, which is directly related to how volatile markets are, the cost was pretty low. So we were able to spend a relatively small amount of capital, and get quite a lot of protection.

And so we did that, and it worked pretty well actually. And we had to be again pretty quick to react during the crisis. But we did manage to trade out of those positions. Realize a bit of money. And then reinvest that in equities in the trough. So that felt pretty good.

LOK MA: So those were the kind of downside risk hedges we had pre COVID.

KATIE: Martin almost undersold the impact of some of those. They were better than pretty good in the majority of instances. But there's a more simple portfolio mechanism that I think often gets overlooked, which is re-balancing. I saw a lot of trustees suspending balancing through Q1 due to fears around market movements. But actually, that's exactly the time that you want to be selling assets that have just performed relatively well. And buying assets that have performed relatively poorly. And keeping a cool head, and buying back into equities when it turned out they're at the bottom of the market was an incredibly powerful portfolio management tool that we were also able to make use of.

MARTIN JECKS: Yeah. That's spot on. And I think that's really important. And it wasn't easy for anyone. And I think it sort of comes back to your point earlier around what's the point of predictions. If you are sort of used to thinking about the future, thinking probabilistically, kind of accepting that you're going to be wrong, you're better able, I think, to take those difficult decisions in the teeth of a crisis. And keep your re-balancing going and that sort of thing. So yeah. I completely agree with that Katie.

LOK MA: And I very agree. We're so violently agreeing with each other. But I mean what you said about being probabilistic about how we look ahead. I think that's really important. It's not about making the right call and what's going to happen. It's doing the right things based on the various probabilities of different scenarios come to pass. And so OK. So looking ahead again then to the future period. Martin, you've already mentioned exposure to China as perhaps a new form of downside protection. Can you just talk a little bit more about that one maybe. And also any others that are worth mentioning for our new year portfolio resolutions.

MARTIN JECKS: Yes I mean maybe kind of cycling back through these levers we talked about. So maxing out diversity. I think an implication of what Tessa is talking about is maybe if you're dynamic, taking a little bit more risk. You could maybe ease off on that lever a little bit. But fundamentally, we still think you should hold lots, and lots, and lots of diversity. As much as you can tolerate, because that is just the best thing to answer we have to the investment problem.

The bond side of things has become more problematic since-- US bond yields fell in particular because those assets just aren't offering the protection that they were. So we need to look elsewhere. And where we've been looking, amongst other places, is China. So US bond yields at the time I'm speaking or about sort of 1% at the 10 year point. China bond yields are significantly above that. And we're looking at the five year point. It's around 3%. There's enough depth to those yields to generate some downside protection if those yields fall

in a growth shock. And that's the key question. That's what we spent a fair bit of last year looking at. Do we expect Chinese bond yields to fall in a similar way to say US bond yield? And that's all related to how the policy reaction function. How we understand that. And the short answer is we do think that China bond yields will fall to a global growth shock.

So I think that's a really interesting and new area of downside protection. Then third lever we talked about with options. As I said, the cost of those is quite related to how volatile markets are. Obviously, markets have been quite volatile. Hence the cost has gone up. That doesn't mean that you should necessarily just disregard options. I think we are facing an uncertain world. It's right that those options should be more expensive. But they are going to be a less prominent part of kind of the downside hedging mix.

LOK MA: And finally then let's come to the third main theme we had, which is around sustainability. And within sustainability, I think, climate change is the thing that's really getting a lot of attention. Katie, are you are you happy to talk about the climate related investment opportunities definitely. But also the risks as well.

KATIE: Sure. Yeah. So I think in my previous podcast appearance, we spoke at length about climate. But I am happy to give a brief overview of some of the things that we're seeing. So I think everybody sort of fully bought into the rise of renewable energy. And therefore the opportunity that presents in terms of investment. So seen many institutional investors committing capital to buying solar farms, wind renewables, hydro renewables. And so I think that's a commonly accepted way of accessing the climate opportunity.

But there is a lot more beyond that. The scope for thinking more broadly about solutions that contribute to the problem. Whether that's making technology more efficient or even investing in solutions in the fossil fuel industry. If you can make those sorts of businesses behave and perform more efficiently, then there is scope to add value there. But some concrete examples of things that we've done recently include investing in forestry. So actually, directly into things that are capturing carbon from the atmosphere and locking it away. That's a very positive impactful thing to do.

And many governments have got objectives around trying to invest into those sorts of areas to bring down their carbon footprint. We've also invested in a charging infrastructure for electric vehicles. We've looked at investments in batteries. If you move more to a renewably generated energy grid, then storage becomes more of a problem. Because you can't just switch on a coal power station or ask the sun to shine. So there's a lot of ancillary solutions that need to be developed in order to help this climate transition. And so there's a lot of scope beyond the obvious things to do in order to invest in opportunities.

LOK MA: And what about some of the risks as well?

KATIE: Yeah. So I mean, I think that the risks are relatively well understood in terms of the overall themes where risks are exposed. So the idea of stranded assets the fossil fuel companies own. Or the concept of a carbon price coming in. And at what level that ends up being. And so how that impacts on different sectors like travel for example. But actually, there's even more nuance on that because within sectors and within industries, there are businesses that are sort of more focused on their transition and more progressed in doing so. And so it requires quite a granular assessment at a stock level to really understand how those risks are going to manifest for each individual business.

MARTIN JECKS: I think that's the crux of it. Isn't it? That's the main challenge we've got. And actually the entire investment industry has got. It's joining up that bottom up picture. And aggregating it up and figuring out what that means for the assets you hold. And that's a really big kind of data and analytics challenge. And actually, for that reason I'm really excited about a couple of developments that have happened kind of outside of the investment business at Willis Towers Watson.

We've taken on board a couple of analytical teams who to do just that. They try and marry those kind of idiosyncratic and bottom up factors, and aggregate them up. And try and get a picture of where those risks might emerge given current prices. So I think that's really quite exciting.

LOK MA: So we look forward to seeing the output from that. So that was climate change, which I presume will affect different sectors of the economy differently. And then on top of that, you've got the recovery from COVID, which again I think will be experienced differently in different places. Does that mean we're going to see more divergence going forwards across different markets and maybe even across investments within a single market?

KATIE: Yeah. I mean, we've already seen a huge amount of divergence in just the US stock market alone. I think it ended up in positive double digit territory for the year of 2020. But that was driven by a very small handful of very large tech stocks. And then vast parts of the US index are still very much struggle to recover from the sell off in March. So dispersion is already rife within markets. And very much expect that to be the case going forward. So I think that means the scope for active managers to add more value in the future. But also active management can help mitigate risks as well. So the stock market is incredibly concentrated at the moment. It's more concentrated in tech stocks now than it was before the dot com bubble.

So I think that thinking through your exposures and having an active manager to bear that in mind is a useful risk management tool. As well as the scope for adding value.

LOK MA: I know Katie always supportive of active management. But you're saying this is especially the time for it, which I get the point of. And finally on that sustainability front the other hot topic is of course inclusion and diversity. We did again talk about I and D in a previous episode. But I think it's an area where they can definitely be different perspectives. So I mean, Katie, how important is I and D to you?

KATIE: It's incredibly important to ensure that we're getting inputs into our investment portfolio from just the broadest range of spectrum of ideas that we can possible. Because it's very easy for things like groupthink, and confirmation bias, and all the terminology that you would have heard in relation to this subject. But it's very, very easy for you to get comfortable and ingrained in the way that you think about the world. And therefore, challenge is important. And having an I and D lens on how you organize yourself, how you facilitate discussions, and how you allocate capital is just incredibly important I think. And particularly as we see the pace of change accelerating in the world, you need to reflect that in your decision making processes. And the people you include in them.

LOK MA: So now's a good time for active management. But if you're going to do it, one of your New Year's resolutions should be to make sure that the people making decisions on your

behalf are getting all the kind of full range of viewpoints through designing that as well. So yeah. Very much get that.

So thank you very much I think to all three of you for taking us through these themes, and translating them into investment actions. And finally, let's say, yes, we will make our New Year's resolutions and adopt all this good thinking in our portfolios. How do we then monitor that against how the world actually plays out in practice and evolve what we do over time? Because we will turn out to be right and also not so right in different areas.

MARTIN JECKS: Yeah. Well, that's a very fortuitous question. And I thank you for it. Part of the outlook report is we've designed three dashboards to monitor these themes we've been talking about today. So how the policy shift is evolving, and the extent to which that creates more or less inflation risk. How China's opening up is progressing. And also in particular climate change. A dashboard for that. So I would commend them to the house.

LOK MA: And so, I think that is a good time to wrap up this episode. Thank you very much, guys, for your contributions.

KATIE: Thanks, Lok. It's been great.

MARTIN JECKS: Yeah. Thanks very much for having me, Lok.

TESSA MANN: Cheers, Lok. Hope you'll have me back again.

LOK MA: Yep. Certainly will. Don't worry about it. And the last thing for me to say to our listeners is please do look out for our paper, which goes into more detail on the various things that we talked about today. It's called the Outlook 2021. And until next time, please do take care.

KATIE SIMMS: You've been listening to a Willis Towers Watson podcast. For more information, visit willistowerswatson.com.