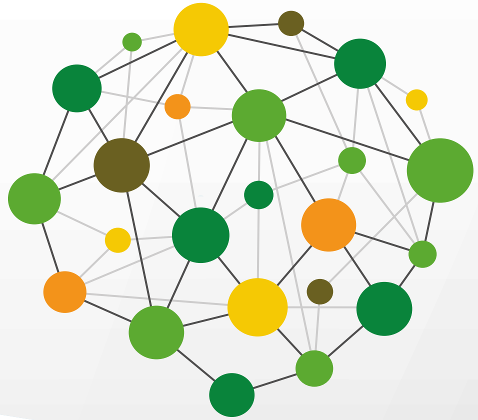

Solutions in 2021: adapting to a new normal

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- In unprecedented times, clients are struggling to build well-diversified portfolios, as well as grappling with the rising cost of guarantees and management of very expensive liabilities. After depending on fixed income diversification for decades, they must find new ways to hedge their exposures while growing assets.

- Asset classes such as infrastructure, private equity and real estate deliver the required combination of diversification and yield. But they bring challenges of their own because they are illiquid, with lock-up periods, so do lend themselves less than other asset classes to dynamic asset allocation. It is an interesting conundrum and one we have to be mindful of when building long-term investment portfolios.

- Clients are seeking high-quality credit portfolios that are less likely to experience defaults in next year's economic fallout. Our research-intensive approach is at the centre of doing this and allows us to build portfolios with quality bias and only intended exposures.

- Ageing and increased longevity of populations are also putting retirement planning under the spotlight. In 2018, for the first time in history the number of people over the age of 65 outnumbered children under five, according to the United Nations. By 2050 there will be twice as many over-65s as under-fives.

What kind of customised solutions are our institutional and sub-advisory clients looking for in today's yield-starved, default-conscious and ageing world? With developed world government bond yields as low as ever before seen, the traditional diversification into fixed income duration and credit is no longer so effective.

In our experience there is a growing appetite for alternative approaches in building long-term investment portfolios including dynamic strategic asset allocation, which is actively adjusted to a range of market states and searching for further diversification in portfolios by using alternative asset classes. Spurred by a sharp rise in government and corporate borrowing as the Covid-19 pandemic wears on, the global debt load stands at a record high,[1] even greater than in the 2009 aftermath of the global financial crisis. When the pandemic is finally over, we appear likely to emerge into a world of low inflation and low growth, where interest rates remain lower for even longer than was previously expected, and corporate defaults could rise.

The need for well-diversified strategic portfolios

In these unprecedented times, clients are struggling to build well-diversified portfolios, as well as grappling with the rising cost of guarantees and management of very expensive liabilities. After depending on fixed income diversification for decades, they must find new ways to hedge their exposures while growing assets. How can we create strategic portfolios that replicate the diversification historically provided by fixed income when yields were higher?

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As previously mentioned, taking a dynamic approach to asset allocation is an increasingly popular approach. This involves using signals to identify a range of market states – for instance, bearish, neutral, bullish and highly bullish – and actively dialling risk in a strategic portfolio up or down. Portfolios can be quickly switched to pre-determined allocations designed for each of these states using liquid instruments.

The need for customised quality credit

A lot of our clients are wary that 2020's severe recessions will translate into credit defaults in 2021/22 when government support for the economy is withdrawn. China is already feeling the credit consequences of Covid-19. As its government has withdrawn the support it provided to state-owned entities, so there has been a wave of bond defaults. Europe and the US are later in the Covid-19 cycle than Asia, and there is a danger they may face similar credit risks at some point.

[1] Global debt increased by US$15 trillion in the first three quarters of 2020 and now stands above US$272 trillion; Attack of the Debt Tsunami; Global Debt Monitor; Institute of International Finance.

Those of our clients investing in multi-asset or credit portfolios are keenly aware of such risk. Consequently, they are seeking high-quality credit portfolios that are less likely to experience defaults in next year's economic fallout. Our research-intensive approach is at the centre of these portfolios and allows us to build portfolios with quality bias and only intended exposures.

Demographics and regulatory pressures

Beyond these immediate issues, ageing and increased longevity of populations are putting retirement planning under the spotlight. In 2018, for the first time in history the number of people over the age of 65 outnumbered children under five, according to the United Nations.[2] By 2050 there will be twice as many over-65s as under-fives.

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Insurers and advisory clients face this issue when delivering investment or guarantee solutions to their clients. This, together with the emerging challenge of growing regulations as well as the introduction of two new accounting standards (IFRS 9, financial instruments; and IFRS 17, insurance contracts), forces firms to rethink how they match assets and liabilities and approach product development in 2021, and therefore how they construct well-diversified and capital-aware portfolios.

Conclusion

In 2021 and beyond, investors will react to the challenges they are facing by taking new approaches to managing investments and liabilities. Many will worry about growing regulatory pressures, ageing clients or the lack of diversification in investment portfolios. Either way, building diversified, informed and well-scaled dynamic strategic portfolios is a must in 2021 due to the inability to rely on fixed income to diversify risk in portfolios, the growing risks of defaults and the low interest rates environment. Our clients will also build portfolios which include responsible investment considerations, reflecting their beliefs as well as the broader trend in the industry. Doing so will allow them to adapt to an exceptionally challenging world of low fixed income yields, mounting regulation and lack of diversification.

[2] United Nations. World Population Prospects 2019. https://population.un.org/wpp/Publications/Files/WPP2019_Highlights.pdf

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