Benefits and Pensions MONITOR VIRTUAL EVENT

PENSION INVESTMENT TRENDS

Markets are made up of people with different time horizons, preferences, and ways of processing information. This creates an opportunity for active management to exploit the inefficiencies that result, says Bryan Barrett, Senior Analyst, Brandes Investment Partners, L.P., Sustainable Investment Leader at Mercer.

However, a repeatable sound process is needed to identify those inefficiencies that add value, he said in his talk on 'Thinking Differently: The Benefits Of Active Small Cap Value Investing' in the *Benefits and Pensions Monitor* Meetings & Events 'Pension Investment Trends' session sponsored by Brandes on the Bridgehouse Independent Platform, CIBC Asset Management, and Invesco.

Brandes' process focuses on fundamentals and understanding businesses and how they create value over the long term, looking at both large and small companies, globally. The same analyst looking at a large bank may also present a small bank to the global small cap investment committee. "That gives us an opportunity to learn lessons in one geography that are going to be relevant in a different geography. It also allows us to cover and understand complexities of industries and then apply them to smaller pieces," says Barrett.

This process allows Brandes to identify inefficiencies, particularly in the small cap realm where there a significant number of opportunities.

"In the global small cap arena, we're only looking to populate a portfolio of 50 to 70 companies, and we have thousands upon thousands to choose from," he said. "Not only are there thousands of fish in the sea we're looking at, but there are few people who are looking in this corner of the market," he said.

Augmenting With Alternatives

Dr. Michael Sager, Executive Director, Multi-Asset & Currency, CIBC Asset Management; said, "improved expected performance can be achieved by augmenting portfolio performance with alternatives.'

The alternatives market has grown incredibly vigorously in the past decade and this is expected to continue for the foreseeable future.

However, it's not the choice of one alternative or another. It's about the whole portfolio, he said, as adding allocations to alternatives can offer different sources of risk and return that holistically improve the overall portfolio.

When investors are surveyed about their reasons for investing in alternatives, they'll often focus on diversification. However, they are also looking to enhance expected return or income, and hedge risks like inflation. "You can't do that so well with nominal bonds or equity as we've seen recently. But, you can with real assets, including sectors within real estate and infrastructure, and with commodities. These tend to keep up with inflation, to hedge against it," he said.

PERIODS OF INFLATION ULTIMATELY AFFECT PRICES OF FINANCIAL ASSETS AND THE CURRENT ENVIRONMENT SUGGESTS THE ROAD AHEAD WILL BE MORE CHALLENGING FOR THESE SOLUTIONS.

As well, another aspect of traditional equity centric pension plan portfolios is that they tend to be very beholden to the economic cycle. When growth is good and inflation is low, they do well.

"We are perhaps facing negative growth in the next couple of quarters in North America. The odds of recession are quite high. At the same time, inflation is high and sticky and that sounds like stagflation. We have high valuations. This is a difficult mix for traditional public market assets. We need to do something different – alternatives," he said.

Managing Through Volatility

The whole discussion around 'Managing Through Volatility' centres around diversification, said Max Widmer, Client Portfolio Manager for the Invesco Global Asset Allocation.

A traditional balanced portfolio usually means variance optimization tools are used to build exposures. The critical variable will be the allocation to different asset classes based on return estimates.

However, there are two caveats with using return estimates to build a portfolio, he said. First, any error in return estimates will have a meaningful impact on the actual allocation. Second, and this is a result of the first, is the portfolio will not be balanced at all.

Since risks drive returns, looking at a portfolio through the lens of risk and risk contribution means that a conventional balanced portfolio is dominated by equity risk. And investors have benefited from this over the last decade. Since the GFC (Great Financial Crisis), the environment has favoured equities. This saw investors abandon the notion of diversification in favour of equity centric portfolios.

Things have changed over the last couple of months. Periods of inflation ultimately affect prices of financial assets and the current environment suggests the road ahead will be more challenging for these solutions.

The cornerstone of its portfolio, the Balance Risk Allocation Strategy, is the diversification framework because iteration when building a portfolio is geared to provide diversification across the different phases in the economic cycle – growth, recession, and inflation.

"Essentially, what we're doing is identifying those phases in the economic cycle and determining the asset classes that best correspond to each. We look at the assets through their ability to capture positive risk premium over time, risk, and correlations but also liquidity," he said.

The resulting portfolio is embedded in liquid equity markets for their positive correlation to growth, high quality sovereign debt to provide a buffer in times of recession, and across the groups of commodity complexes – energy, industrial, and precious metals – during inflationary periods.

"We do not believe that it's possible to correctly forecast the market. Instead, we attempt to build a portfolio robust enough to navigate the entirety of the economic cycle coupled with an element of adaptability," said Widmer. **BPM**

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