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Investing at a Crossroads

Disruptive Forces in Investing — **September 27, 2022**

Anu Rajakumar: They say the only constant in life is change. And when it comes to the market environment, it appears that we could be in for a significant one. For over four decades, the global economy and financial markets have benefited from moderate inflation, low-interest rates, globalization, and intensive growth fueled by cheap natural resources like oil. But as many of those tailwinds reverse, asset allocators need to assess the long-term portfolio implications of a market characterized by higher rates, higher inflation, deglobalization, decarbonization, and higher correlation between stocks and bonds. What lessons can we take from the past to guide us into the years ahead, or is this shift so monumental that the playbook needs to be rewritten entirely? My name is Anu Rajakumar, and today I'm delighted to be joined by my multi-asset colleagues, Erik Knutzen, the global CIO of multi-asset strategies, and Niall O'Sullivan, CIO of multi-asset strategies in EMEA, who'll be sharing their thoughts about investing at a crossroads. Erik, Niall, thanks for joining me.

Erik Knutzen: Great to be here, Anu.

Niall O'Sullivan: Thanks, Anu.

Anu: So let's get started, Erik, summarize some of the key elements driving the view that we're in for a significant shift in global markets.

Erik: Well, you highlighted them in your open. The-the global economy and financial markets have really been driven by some macro trends over the last 30 to 40 years that have really been amplified in the post- GFC, pre-COVID environment of, falling inflation, falling interest rates, cheap and-and readily available resources and energy, globalization, China coming onto the world stage and really in many ways, exporting disinflation through the world, declining relative power of labor versus capital.

And we think that we are at an important inflection point where many of these trends are not just, declining, but in fact changing direction. So as we look out, not just over next quarter, next year, but over the next number of years, we see an environment where, um, we do expect globalization to continue to wane. We likely have seen peak globalization for some period of time.

Energy is going to be more expensive as we go through a process of global, decarbonization. as China changes demographics and changes policies, you're going to see a different orientation of China in the rest of the world and less likely to be exporting deflation, different orientations of populism and policy, all of which will likely lead to a changing relationship between labor and capital. You put all of these things together, and it is more likely than not that we are going into an environment where inflation is higher than what we've seen certainly over the last 10 years and will be stickier and more problematic. That has broad implications in terms of thinking about the potential returns for fixed income, for headwinds, for economic growth that will affect equity markets and margins and valuations, the relationship or correlation between stocks and bonds. And these will present, in our view, challenges to investors who are working off the playbook that perhaps worked over the last 10 years.

Anu: Yeah. So, you know, I was talking to one of our colleagues who represents the LATAM region, just yesterday, who was pointing out that, you know, Americans really haven't seen these levels of inflation for decades. Unlike, you know, what he and others in that region have been familiar with. So, obviously some monumental shifts. Niall, why don't you run us through some of the investment implications of what Erik just described?

Niall: So I think there's the old adage that what got you here, won't get you there. And that in a nutshell is probably what we're facing into. If you think about adapt, so that idea of adapting to the changing conditions, the world is changing. Some tangible things to think about in that context, we were speaking to our equity team yesterday, and they-they made the context that a few years ago it was all about money tomorrow. Now people want money today. And that is pulling a lot of things forward and causing a lot of things that are based on future cash flows to become less valuable. And those trends tend to last for quite a while. So it's an interesting thing to think about your portfolio construction in that context.

When you think about mind the gap, when you look at a portfolio and the expected returns are lower, what do you do? You can either accept that, and that's one way to go. What a lot of people do is they do the same thing but just take more risks. So they dial it up to try and get to the same return, but eventually, that risk will bite.

Or the third thing you can think about is doing things differently. One of those, which is-- we're going to talk about later on, is trying to find new sources of return. But the other way is to diversify your portfolios a little bit differently. Something Erik said is crucial. The way that portfolios are diversified for the last number of years has been, you've had a lovely movement between typical growth assets like equities and typical defensive asset like bonds. And when equity is zigged, bond zags, you put the two together and they both went up.

You have an environment now where if inflation is the driver, then they're going to be driven by the same force. And they're going to move in the same direction and worse in-interest rates continue to rise, it's clearly bad for fixed income assets. So one of the key things to focus in on is how do you diversify those portfolios differently and to create the defensiveness and the robustness for your portfolios.

Anu: All right. Perfect. Thank you. So now let's dig in a bit on these three themes. adapt, mind the gap, and diversify differently. Uh, the first one is about adapting to today's new challenges. Erik, what does it mean in practice to have to adapt to these new challenges?

Erik: Well, the first thing we would start with is really reassess how investors think about the basics of strategic asset allocation, beginning with the assumptions and inputs into their strategic asset allocation process, challenge their expectation of returns for traditional equities and fixed income. If we are in a higher inflationary environment with headwinds to growth, it is reasonable to assume that there will be a higher equity risk premium. We compensated less for owning equities with more volatility. Margins will be under pressure. Risk premium associated with bond markets may go up. And that correlation that-that Niall also spoke about will be perhaps more positive. You add in potential impact of global decarbonization and other factors like that, and we're beginning to incorporate climate value at risk into a strategic asset allocation process to gain additional views about how you build a portfolio that can adapt to this new environment.

Niall: And if I could just add one point to that, because I think on that decarbonization, that trend, I think this transition, we have to think about the long-term implications across the peaks. One, we've all seen the numbers of the-the idea of the amount that'll have to be spent. I've seen 30 trillion. I saw Goldman estimate for 56 trillion recently. Think about that the-the market cap of the S&P 500 is 36 trillion. The market cap of the MSCI world is 59 trillion. Those numbers are of the same order of what is going to have to be spent. There are massive capital investments that will be made. This is going to create huge opportunities, but it also changes the investment landscape.

Secular stagnation was all about the fact that you were finding it hard to find capital heavy investment. This is going to be capital heavy investment. And so maybe it's returns to the relationships that used to exist in the '50s and '60s when we were doing heavy infrastructure and that's being factored into portfolio thinking all the time.

Erik: Yeah. To keep building on this, one of our themes around it, adapting to this new environment, is favoring the fittest. And that's going to be the companies that are positioned to thrive in this environment. They're necessarily the companies that did well over the last 10 or 20 years. As Niall said, investors are looking for money now and companies that are investing in tangible, in real initiatives that will address these current challenges. So that could lead to an orientation towards perhaps more value stocks, more high-quality stocks, more income orientation in equities. And then finally if we are in a more volatile environment, as we expect, and these trends begin to have an impact there, we think there will be opportunities to take advantage of that through more tactical and global macro type strategies that can recognize these opportunities and trends and seek to benefit from them.

Anu: It's always helpful to hear the portfolio implications and how we're thinking about this, where we're biasing our views. Let's turn to the second theme, mind the gap, you know, the three of us have been talking to clients for a while about resetting expectations when it comes to capital market assumptions and you kind of alluded to this in your answer before, Erik, you know, whether it's reviewing their strategic asset allocation, their investment policy statements, et cetera. Niall, why don't you give us a bit more color about why it's important for investors to be focused on how they close the return gap?

Niall: So I think if you're in a situation, I said that three options that were available, but let's say that you're going to go for the option of trying to do new things. So to make it really reductionist, you've got to try and find a way to make your portfolio work harder.

So, for example, if you have made a decision that you're going to allocate to asset classes, and you want to keep your capital in reserve, can you generate some return on that capital because every little bit will help as you do that.

If you've made the decision that you're going to wait, that you have a certain level that you want to buy the market back in at, can you be paid to wait? Can you be-- effectively say, "Well, I'll definitely buy there. That's actually expressing a premium or a-a point of view that can be rewarded in the marketplace." Can you use that as part of your portfolio construction? I think other thing you need to be thinking about is where are you going to get the analytic skills to adapt to what's going on?

So, as Erik said, we're going to get a little bit more tactical, but how do you find it? Well, have a think about what's happening at the moment. Things that are those money tomorrow have actually got a lot cheaper. Inside that, there are companies that are going to be the winners. They're going to be the category leaders that have now become a lot cheaper than they used to be. If you have the analytic frameworks to analyze that and the way to look through it, you can find some opportunities. And there's a lot of things that people were talking about a year ago that have got a hell of a lot cheaper, and people aren't talking about now. Whereas it actually should always be the other way around.

You should look at those opportunities after they've fallen, not after they've risen. I think some of the other things you need to think about is I know from a lot of investors that we would speak to; people have got their ideas going into private markets to generate those additional returns from various premiums that might be there from things being complex or things being-less liquid as the case may be. But it's also the case that people have not drawn down those programs the way that they would like to have drawn them down.

And that's because you're being very sensible about how you go in through various vintages over time. But one thing to think about is people who have old vintages for a variety of reason now need to get out. And if you have somebody who can effectively allow you to time travel by buying older vintages and can also have the informational advantage to find the good ones from the bad ones, that is a huge opportunity around now to, A, give you a good return and, B, speed up what would've been an investment program.

And the last thing I think is massively important is to ask yourself, are you using all of the natural advantages that you have? So before you might have done a piece of work to see how does your, you know, return compared to your risk, or how are you doing versus regulatory constraints that you might have, and you might have left yourself quite a large degree of comfort. Mightn't be the worst time to go back and have a look to see, can that portfolio be worked harder, to see if can you generate some additional returns around there?

Erik: And in that last context, we're spending a lot of time with clients who are engaging with us to find out, you know, how can we partner with them to uncover, unlock and help extend their resources to take advantage of their natural edges and build on their natural edges to be that force multiplier?

Anu: Yes, absolutely. It's been very important for us. Thank you very much both. The third theme is about the role of diversification, which I think is probably the single most discussed topic this year that we've had with clients and prospects. So—and Erik is nodding, you can't see him, but he is nodding there. Erik, walk us through this diversifying differently theme.

Erik: Yeah, it's really been that as, you know, clients are really grappling with the stock bond, correlation challenges, stock bond correlations have increased. How are they going to get the kind of diversification that they got quite naturally just from stocks and bonds historically? And we're really focusing on two broad categories. One is, the obvious one in this environment, which is inflation hedges and many investors squeezed inflation exposures out of their portfolio over the last number of years when they didn't help, they didn't return. They were frustrating and challenging and were helping them rebuild those exposures.

The other category is uncorrelated strategies. And those can be uncorrelated, risky assets that just are not moving with stocks and bonds or inflation-sensitive assets, but also uncorrelated active strategies. In the real assets category, we're very bullish on commodities. We've been overweight, and we think we are potentially at the cusp of a long cycle of commodities.

And, in fact, potentially a long cycle of real assets, outperforming financial assets for some extended period of time-related to these broad trends. And this gets to the notion of deglobalization, higher inflation, supply challenges, all the pressures around decarbonizing the economy needing to restructure supply chains, geopolitical segmentation. And we think that that will continue to play an important role in portfolios, as well as the broader set of real assets that can be infrastructure real estate, both in public and private markets.

In the uncorrelated set of categories, one thing we like, and it is quite obvious, and it gets to the money now is short duration fixed income. There are attractive yields now and you can be high quality and capture a very high yield. And that income is going to be increasingly important in our view, in this environment. And then finally uncorrelated betas and uncorrelated investments like insurance link securities, or cap bonds and uncorrelated strategies like global macro or trading strategies will play, we think, an increasingly important role in client portfolios.

And then finally, we are spending a lot of time with clients thinking about how to tail hedge, how to manage risks in a thoughtful way.

Niall: And I think the other thing to think about is this is complex and there's a lot of cross-currents going on. We were discussing earlier on this week with our fixed income colleagues the idea that on one side you have all of these trends that we talked about that support commodities, that support the, you know, the reshoring, they are going to require massive fiscal spend. But at exactly the same time, you have the monetary authorities who are trying to slow things down and they are going to meet each other in all sorts of ways. And that's going to cause the market to become much more volatile, much quicker-reacting. And that one of the big trends of the last four or five years is that everything is happening so much quicker. And so what you need in that sort of situation is the ability to have somebody to react quickly on your behalf, because there will be times to get in and there will be times to get out. And when you have everything going the same way, then you can ride a trend. You can take things along and various things do well. When you have waves meeting each other and you can see them bubbling up, that's when you need the ability to be able to see now is good, now is bad and take positions accordingly.

Anu: Right, right. To be able to be nimble and dynamic and then take advantage of the opportunities. Yeah, absolutely. Erik, you did just speak about the commodities view. I want to see if you could just touch on how that view sort of aligns with your thoughts on China as well, which is, you know, can be part of that commodities picture. How do you weigh up because China's kind of a wild card here?

Erik: Yeah. And that's been one of our biggest sources of debate right now. China's growth has slowed obviously challenged by their zero COVID policy, the challenges in their property sector. It is likely that China from a policy standpoint will resume an orientation towards growth.

Maybe not the 8% to 10% growth we saw historically, but certainly a reorientation towards growth perhaps after the party congress, perhaps next year when they're able to roll out some mRNA vaccines. And that should be a significant boost for the commodity complex. I think that the kind of the hedge against China going towards more of a growth policy is having some commodity exposure which will benefit.

Niall: And I think related to that, as we're talking about China now, but actually I think there is likely to be a little bit more regionalization coming into portfolios. So in a European context, for example, versus a US context. Yes, you're seeing inflation going up in both cases, but the proximate causes can be a little bit different. And so how those things will play out over time will be different probably in Europe than it will be in the US. So what was before big trends being driven by, you know, monetary policy all going the same way, now you need people who are able to take advantage of, well, is it Europe is the story? Is it the UK? Is it the US? And to be able to take advantage of those things. We're talking about China now, but it'll be other areas the whole time.

Anu: Absolutely. Well, gentlemen, as we wrap up this episode, I want to ask you to share some concluding remarks that you want our listeners to walk away with from today's important conversation.

Erik: Well, the title of our podcast is investing at a crossroads, you know, investing in a more challenging environment. And I--it always feels challenging. I don't remember-I don't remember an investment environment that didn't feel challenging, and we all, to a certain extent, suffer from recency bias. For many of us, the last 10 years is the normal. But when you look over a very broad sweep of economic history, the last 10 years is perhaps more the anomaly.

This secular stagnation, post-GFC environment that we experienced and much of the challenges that we've highlighted actually have historical analogs. We talked about the period of the '70s and Niall talked about kind of the infrastructure investments in the capital investment period of the '50s and '60s. And I think that investors need to kind of embrace these challenges, rise to these challenges and be ready to think about this new environment in a very proactive way.

Niall: I couldn't agree more on the point, but there's always something going on. I think what is probably different though, is that the things that are able to do "easily" are more fully valued now than the things that are hard. And for investors, that's tricky, right?

Because if you had a choice between a cheap beta that was easily available, you'd like to take advantage of that. But I think what you have to do now is ask yourself, how are you going to get those portfolios more complex? And who are you going to trust to enable you to do that? And that's going to be one of the key questions. Up until now, it has mattered what you did. I think it's going to increasingly matter who you do it with as well.

Anu: Absolutely. That's a great point. Well I know that the part of the conversation you both have been most looking forward to today has been the bonus question. So I'll get right to it. Today, we've been talking a lot about a potential huge inflection point in the market environment. And I happen to know that both of you share a passion for history, which of course is also full of important regime changes and inflection moments. So my question for each of you is, if you could be a fly on the wall at any moment in the history of civilization, which moment would you choose and why?

Erik: For our podcast audience, we are not given these questions in advance-

Anu: [chuckles]

Erik: -despite asking numerous times-

Anu: Begging.

Erik: -begging numerous times. Boy, um, I'll go first, Niall. Um, I would like to have been a fly on the wall in Philadelphia in 1776, when the founders of the United States made the fateful, brave, courageous, maybe crazy decision to declare independence, and in so many ways, change the course of events of the world. It was an act of passion, conviction, and it was a changing moment in history, and it would have been interesting to see how they took those steps.

Anu: Great thank you. Niall what about yourself?

Niall: God, this really is, yeah, I'm only here a few weeks. This is not what I was expecting when, uh-

Anu: [laughs]

Niall: -when I came in to-to do the podcast today. Um, people know that I'm actually of monetary history nut, I love the whole idea of why currency is a charter list, is at all these sort of things, what John Maynard Keynes called this Babylonian Madness when he was trying to figure it out. So how money came into being is something I'm fascinated in. So, I'd love to have been around when they were thinking about the Bank of England and what they were trying to do. But I suppose if I had to pick one, I wouldn't have minded being on Jekyll Island when they were figuring out how they were going to get the Federal Reserve set up, put it in place, how they'd learned the lessons from the previous central banks that had- that had failed, and how that has got through from here to today.

Anu: Excellent. Thank you very much. That's a great answer as well.

Erik: Well, Anu, because we work together, I'm gonna turn this around, because-

Anu: Oh no! [laughs].

Erik: -no one ever- no one ever asked, you the bonus question or anyone--

Anu: No, no one's ever allowed. [laughs]

Erik: Okay. All right, Anu-

Anu: Okay.

Erik: -one fact that our podcast audience doesn't know about you, one interesting factoid that they should really know about Anu Rajakumar?

Anu: Okay. All right. Um, uh, let's see. So I don't know if everyone knows this, but the first day of my career was the day after the Lehman Brothers' bankruptcy. So my first day of my career was September 16th, 2008, as a Lehman Brothers analyst. So I had joined Lehman Brothers asset management, the last class of analysts that Lehman Brothers had. Eager and excited to join a terrific firm. But, of course, history had a different approach for the day. But thankfully for me, Lehman Brothers asset management later evolved into Neuberger Berman, and I have been here ever since.

Erik: So you had nowhere to go but up from your first day.

Anu: [laughs] I'd like to think so. Yes, absolutely. All right. Well, I think that's a-a very good place for us to wrap this conversation. This topic, that we discussed today, Investing at a Crossroads, is something that our listeners will be hearing more about from Neuberger Berman in the coming weeks. So look out for a white paper and a series of webinars delving deeper into this important topic, but for now, let me finish this episode by reminding folks about the three themes we discussed today. Number one, adapt to today's new challenges, number two, mind the gap and number three, diversify differently. And let me also take a moment to thank both of you, Erik and Niall, for sharing your framework for how to think about asset allocation in this new regime.

Erik: It's been fun.

Niall: Thanks, Anu.

Anu: And to our listeners, if you've enjoyed what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple podcast, Google podcast, or Spotify, or you can visit our website www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.

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