THE POWER OF DIVERSIFICATION

QUARTER 3, 2021

Monene Watson, Chief Investor Officer at Old Mutual Multi-Managers tackles some of the toughest investment questions of the moment.

IN YOUR OPINION, WHAT IS THE CURRENT STATE OF THE GLOBAL INVESTMENT LANDSCAPE?

Markets price in the future, not the present or past, and therefore started rallying well ahead of economic growth actually picking up. This is an important reminder that you can't wait for economic conditions to improve before you decide to invest.

In a nutshell, this is a reasonably good environment for investors. However, Covid has not gone away and the impact of the pandemic continues to linger. Global supply chains are disrupted, there are shortages of key items, and outbreaks are still wreaking havoc with production and logistics. All of this has contributed to elevated inflation rates across the world, which will be compounded by the recent surge in global energy prices.

ARE YOU CONCERNED ABOUT INFLATION?

Inflation, and how central banks respond, is probably the biggest risk facing investors. While we think the pre-existing disinflationary forces of technology, globalisation and demographics will more than likely reassert themselves over time, it is hard to say with certainty that inflation won't prove to be sticky in the next year or so. Inflation can remain uncomfortably high if Covid-distortions continue to impact prices. Markets might then question whether central banks are right in viewing it as a "transitory" phenomenon. In fact, central banks themselves might start to sing a different tune about how quickly interest rates are expected to rise. While we try and understand these risks, there is a high level of uncertainty regarding how this will play out. The best we can do is to construct portfolios that to our best knowledge can withstand shocks. We do this by buying asset classes that are cheaper and diversifying our risks.

THIS COMES AGAINST THE BACKDROP OF FAIRLY EXPENSIVE GLOBAL EQUITY MARKETS, DOESN'T IT?

Yes, looking at workhorse valuation metrics like forward price earnings ratios, global equities are on the pricey side. This is largely due to the US, which is expensive relative to its own history. The US constitutes around 60% of the main global equity benchmarks and has become more expensive than during any time since the dotcom bubble.

However, even more expensive than equities is global fixed income. Cash rates are zero across the developed world and deeply negative in real terms. Long-term government bond yields are so low - 1.3% in the US and 0.8% in the UK - that even modest inflation will wipe out real returns over the next decade.

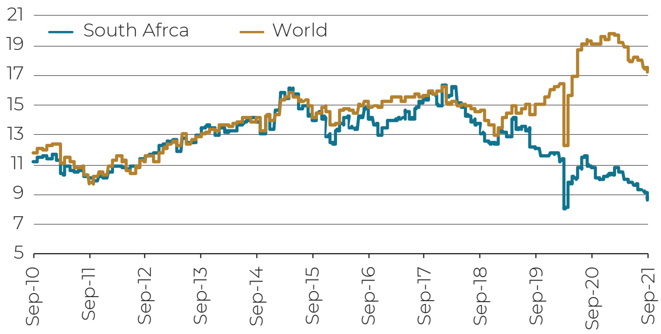
With historically low interest rates, equities might not be as expensive as they seem at face value. But if there is a proper inflation scare and rates rise, the picture changes. That is the risk.

WHAT IS YOUR VIEW ON THE DEBATE BETWEEN LOCAL VERSUS OFFSHORE?

Rather than an either-or-debate, it's about a combination, in my opinion. Investors should be diversifying across both, bearing their individual circumstance in mind. Local bonds and equities are cheap compared to global markets. While global equity valuations have increased over the past couple of years, local equity multiples declined.

Local government bond yields are high relative to where inflation is. Even among our emerging market peers, our yields stand out as offering attractive real returns. One thing we can be proud of is the South African Reserve Bank which has managed inflation expectations lower, with the current stable inflation outcome preventing an erosion of the real yield offered by government bonds.

Chart 1: SA vs Global total market equity valuations



Source: Refinitiv Datastream

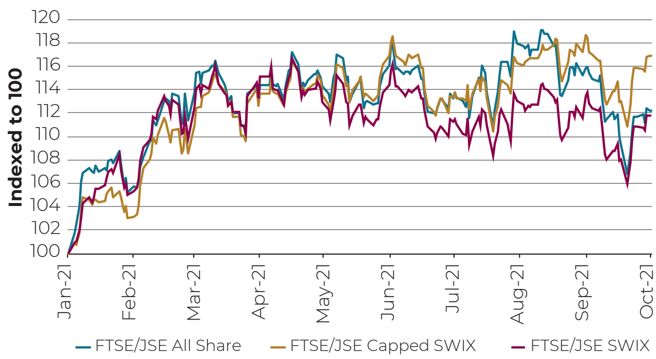
There are risks in SA. Bond yields are high because investors question government's creditworthiness. Equities remain cheap due to investor concerns that SA will never emerge from the slow economic growth path of recent years. Another risk is that the local market is top heavy with a handful of big shares disproportionately driving returns. Global equities, on the other hand, provide investors with much greater choice but are more expensive. Ultimately, it's about the price one pays for an asset and balancing risks to mitigate where we could be wrong and doing this calmly and rationally. Offshore assets provide diversification in important ways. They diversify away from the structural and growth risks in SA. Global stock markets also provide access to companies and sectors not available on our market. How does one bring this together? There are definitely opportunities in local assets which are priced more cheaply given the risks. Global equities are unlikely to repeat the stellar returns of the past decade because their starting point is so much higher. But in the end, it is about taking a long-term view and having a portfolio which is diversified with assets that can deliver returns while not betting the farm on one outcome.

HOW BIG A ROLE DOES HAVING THE RIGHT BENCHMARK PLAY?

The right benchmark is critically important. At Old Mutual Multi-Managers, we control the asset allocation for each of our funds, and use a number of external asset managers for each asset class. These managers are judged against a relevant benchmark in each instance, both when we do our up-front research, and also when monitoring ongoing performance.

The choice of benchmark is sometimes obvious. When the JSE introduced the Capped version of the SWIX, for example, we adopted it as our equity benchmark because it substantially reduced the weight of Naspers and was the most diversified SA equity benchmark available to us. For a time, the Capped SWIX underperformed because Naspers was flying. It also has a lower resources weight. Recently the situation reversed when the Chinese regulatory crackdown on technology shares hurt Naspers. The China Evergrande debacle also weighed on commodity prices in recent weeks. We can't predict which benchmark will outperform and our approach has been to invest with the most diversified benchmark, which we believe should do better on a risk-adjusted basis over time.

Chart 2: SA equity benchmarks in 2021



Source: Refinitiv Datastream

WHAT DOES THIS MEAN IN THE CONTEXT OF THE ACTIVE VS PASSIVE DEBATE?

There is no such thing as passive investing: you still need to make decisions, even if it's just which index you are going to track or how much equity exposure you are going to have. Having the appropriate equity allocation over time is probably the most consequential decision an investor can make.

Secondly, the evidence is clear that active managers struggle to outperform after fees. But the evidence is also clear that many managers do outperform after fees. The trick is finding them, and we believe we have the skills to do so. So it's not just about costs, but value for money – and we believe it's worth paying for outperformance.

If you don't want to spend the time looking for managers, a cheap index tracker that offers broad market exposure is fantastic. They are a bit scarce in the SA context but globally you can get tracker funds that only charge a few basis points.

Thirdly, even the best active managers won't consistently outperform their benchmark. Outperformance tends to be lumpy and you need to be patient and stay invested with the manger to benefit from those bursts of alpha. Too many people chase performance. They see a fund shooting the lights out and decide to invest in it after the fact. However, alpha is usually cyclical. There's a risk that you sell a manager just as their performance cycle is about to turn up and invest with one who has just peaked. This destroys value over time.

We avoid behaviour errors by being honest about managers. We work as a team, critically analysing whether we are letting our emotions get in the way, and build robust processes around this. Diversification goes a long way to avoiding these behavioural pitfalls.

The urge to "do something" is often an investor's worst enemy. By being appropriately diversified, investors can really save themselves from themselves. That is at the heart of what we do: build portfolios that are suitably diversified across regions, across asset classes and across the best fund managers.