AXA IM MARKETS NAVIGATOR

How to navigate the choppy investment waters expected in 2020

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Although it may seem on the surface as if 2020 will not offer institutional investors much to look forward to, those willing to engage in thoughtful strategies, keep an eye on megatrends and work with top managers can put themselves in a position to make the most of what could be a volatile year.

Surveying the globe, institutional investors are finding low or negative interest rates, relatively high stock prices and economies in various stages of modest growth to moderate slowdown. Not exactly the ideal picture for organizations such as pension funds seeking to drive strong investment returns to improve their funded status.

"I think the medium-term outlook for bond yields is that they stay very low, and it's not in our expectation to see a significant reversal in the trend of bond yields globally," said Chris Iggo, chief investment officer, core investments, at AXA Investment Managers. "So this is an issue for pension funds everywhere."

Many corporate pension funds in the U.S. have been moving aggressively to carve out all or parts of their pension liabilities via a pension risk transfer or launching a liability-driven investment strategy, and Iggo said the level of interest rates in the U.S. — even though low — should remain conducive to that activity in 2020.

But pension funds in Europe are in a tougher spot.

"It's been a few years since we've had negative rates in Europe, and one thing that has become clear, particularly this year, is that pension funds in Europe are all struggling," Iggo said. "There's a scarcity of very long-dated high-quality assets. And funding rates are falling to levels at which it could mean that pension benefits eventually get cut or sponsoring companies have to put up more money. So I think that's where low yields and negative rates start to have real social implications."

With interest rates where they are and not likely to move much in the coming year, the question becomes whether governments will use fiscal policy to drive or enhance economic growth. Iggo said that's possible, but not likely.

"If there is a change and it's fairly transparent, moving from [the] very cautious fiscal stance in Europe that we've seen for the last few years to something more expansionary, I think that would have an impact on bond yields," he said. "The problem with fiscal policy, as we saw in the U.S., is that it's transitory. The U.S. had the 2017 to 2018 tax cut, which did lead to the [yield] curve steepening and bond yields rising, but it didn't last that long. I think the influence of monetary policy is not pervasive over the long term, but if there is a shift in the stance of governments on the fiscal side, that will have an impact. I'm not sure we're going to see it, though. There's a lot of talk, but not much action."

Iggo added that while capital markets are not signaling recession, institutional investors need to keep an eye on geopolitical risks, from Brexit to the 2020 U.S. presidential election.

"There are no signs of any real stress in the credit market, and you would expect to see that if a recession was coming," he said. But "I think we shouldn't underestimate the fact that there are big geopolitical risks."

All that means is that institutional investors will have to be especially careful when looking at their fixed-income allocation, particularly if they invest in a passive index strategy that limits flexibility.

"I think there's been a general shift away from following market cap-weighted indices, and at AXA IM we've developed a buy-and-maintain strategy for institutional investors in which we optimize the allocation so it gets away from overweighting, for example, [General Electric] bonds because they're the biggest issuer in the index. It's much more equally weighted by sector and country and by maturity buckets, and it means that you can have very, very low turnover. It's very different from being dictated by a benchmark index."

FLEXIBILITY WILL BE KEY

In addition, the strategy allows allocations to be adjusted when conditions change, which is important, particularly in an environment such as the one that investors are facing in the year ahead.

"I think that's definitely the way to go, because bonds are not homogenous by any stretch of the imagination," Iggo said. "There are a lot of opportunities. You can craft good performance by allocating to credit, high yield, emerging market, distressed debt and some structured credit assets where the liquidity is acceptable. If you put them together in the right way and move them around as the cycle evolves, you can get a very good Sharpe ratio and very good risk-adjusted returns."

Turning to equities, long-term investors such as pension funds should be in a relatively good — if volatile and uncertain — place in 2020.

"The equity markets are becoming more of a difficult place, and I think ultimately more volatile as well, because they're relying on tech-heavy growth types of issuers, which can disappoint investors," Iggo said. "I think you might see more equity market volatility, or at least the kind of swings we saw in October between growth and value, when there was huge rotation within sectors."

But a pickup in volatility could be good for institutional investors that work with active managers.

"At some point, if we do get volatility, there could be a resurgence in good old-fashioned active approaches, particularly for those of us that have the luxury to take a longer-term view," Iggo said. "That said, there's nothing cheap at the moment, and being able to make those long-term, high-conviction choices is quite difficult. So it's about understanding risk premiums."

ESG GROWTH TO CONTINUE

One trend that proved strong in 2019 and is likely to remain throughout 2020 is the movement of institutional investors toward integrating environmental, social and governance factors into their overall investment strategy and looking for managers that have ESG built into their processes.

"The whole question of ESG and responsible investing has become central to all our conversations with institutional investors," Iggo said. "Every [request for proposal] that we respond to now has a huge section on ESG, and what we're doing with institutions is to integrate environmental and social governance issues into our investment process. It's become the biggest issue for most pension funds and insurance companies, and it's even spreading into the private-banking area. It's only going to get more and more important. We're seeing products launched that are addressing some of these issues."

Iggo said the evolution of ESG into investment strategies is slowly making its way into the fixed-income market after breaking in on the equity side of capital markets. For example, AXA IM's ESG-focused efforts on the fixed-income side include a green bond fund and impact funds.

"The approach that we see becoming most widespread is trying to look at ESG risks in the same way we look at credit risks, [then trying to] understand what that means for the performance of a portfolio going forward," he said. "If a company is a big polluter or a big producer of thermal coal, for example, they're going to attract fewer investors and therefore the cost of their capital will increase. As the cost of capital increases, the risk of default increases."

Iggo and his team analyze those factors to determine how they might impact the future credit worthiness of issuers "in the same way we would look at a balance sheet and a P&L [to] try to get clues about any changes in credit ratings.

"We're looking at these other factors now to see if they can provide any points about the future returns," he said, "as well as saving the world." •

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