Investment Insights Series

Janus Henderson
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Cautious – Patient – Selective

A New Mindset for a Shifting Risk and Low Expected Return Environment

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Despite concerns about the direction of central bank monetary policies, flattening of the U.S. yield curve, duration of the current equity bull market and the trade standoff between the U.S. and China, most investors do not appear to be doing anything different than at the beginning of 2018, when the consensus view in financial markets centered on coordinated global growth. One should not, however, infer a lack of thoughtful analyses from their inaction or maintaining the status quo. In fact, one should infer the opposite: beneath the surface, there is a debate raging among institutional investors on what to make of financial markets' behavior in 2018 – especially in February and during the fourth quarter. For our part, the changes taking place in the financial markets appear more fundamentally driven and detrimental to investors' capital for years to come.

In what follows, we address commonly asked questions and offer descriptive views of the material events afoot in financial markets to compel institutional investors to approach their strategic asset allocation with caution, patience and selectivity.

Key Takeaways

- Despite notable warning signs on the horizon, many investors are uncertain about what to make of financial markets' recent behavior.
- We believe the changes taking place in financial markets are fundamentally driven and potentially detrimental to investors' capital for years to come.
- Given lower expected returns, shifting monetary policy and resurgent market volatility, we outline how investors can pull different levers of active management to help close the return gap.

Dick Bove, a veteran banking analyst, remarked at the beginning of 2018:

“To argue that a shift in money availability; a shift in real interest rates; and a shift in the value of the dollar have no fundamental impact is simply folly.”[1]

It is difficult to argue against this tautology, especially since major shifts in global monetary and fiscal policies in 2008 and thereafter are the reason why asset prices are where they are today compared with March 2009.

As shown in Exhibit 1, U.S. equities (as proxied by the S&P 500® Index) stopped falling and reversed course when the Federal Reserve (Fed) lowered the fed funds rate to zero, launched large quantitative easing programs and the Secretary of the Treasury unequivocally assured investors that:

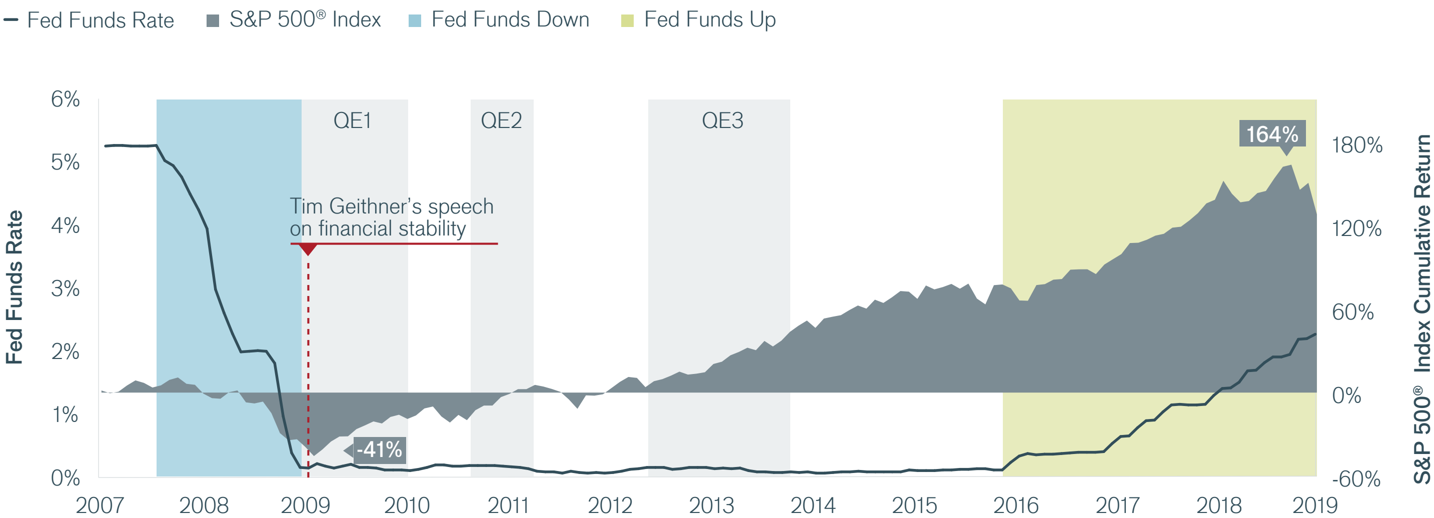
“The Department of the Treasury, the Federal Reserve, the FDIC, and all the financial agencies ... will bring the full force of the United States Government to bear to strengthen our financial system ...”[2]

Likewise, in the eurozone, as shown in Exhibit 2, European equities began rising when European Central Bank (ECB) President Mario Draghi assured the financial markets on July 26, 2012:

“The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”

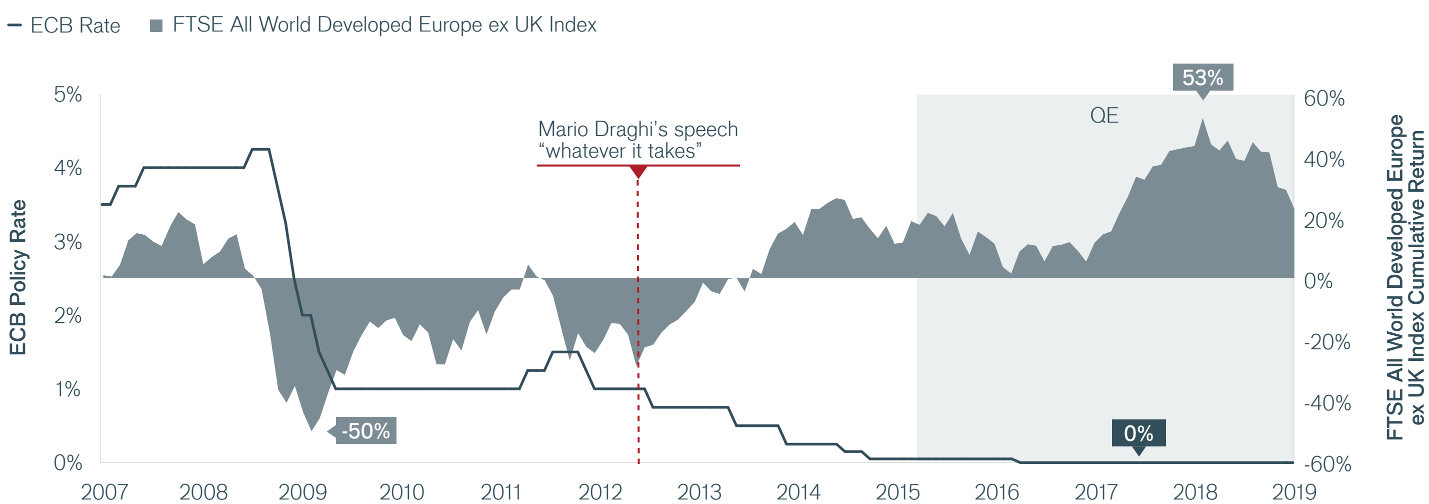
Debates aside, what matters most is how investors position their portfolios to respond to fundamental changes taking place as a result of monetary policy reversals in major economies.

Exhibit 1: The Impact of Stimulative Monetary Policies in the U.S.



Source: Bloomberg

Exhibit 2: The Impact of Stimulative Monetary Policies in Europe



Source: Bloomberg

[1] Dick Bove. cnbc.com: “A fundamental change is underway in the financial markets, and it will not be pleasant.” February 2018.

[2] Remarks by Treasury Secretary Timothy Geithner. U.S. Department of the Treasury. February 10, 2009.

Is the Eurozone the Next Japan?

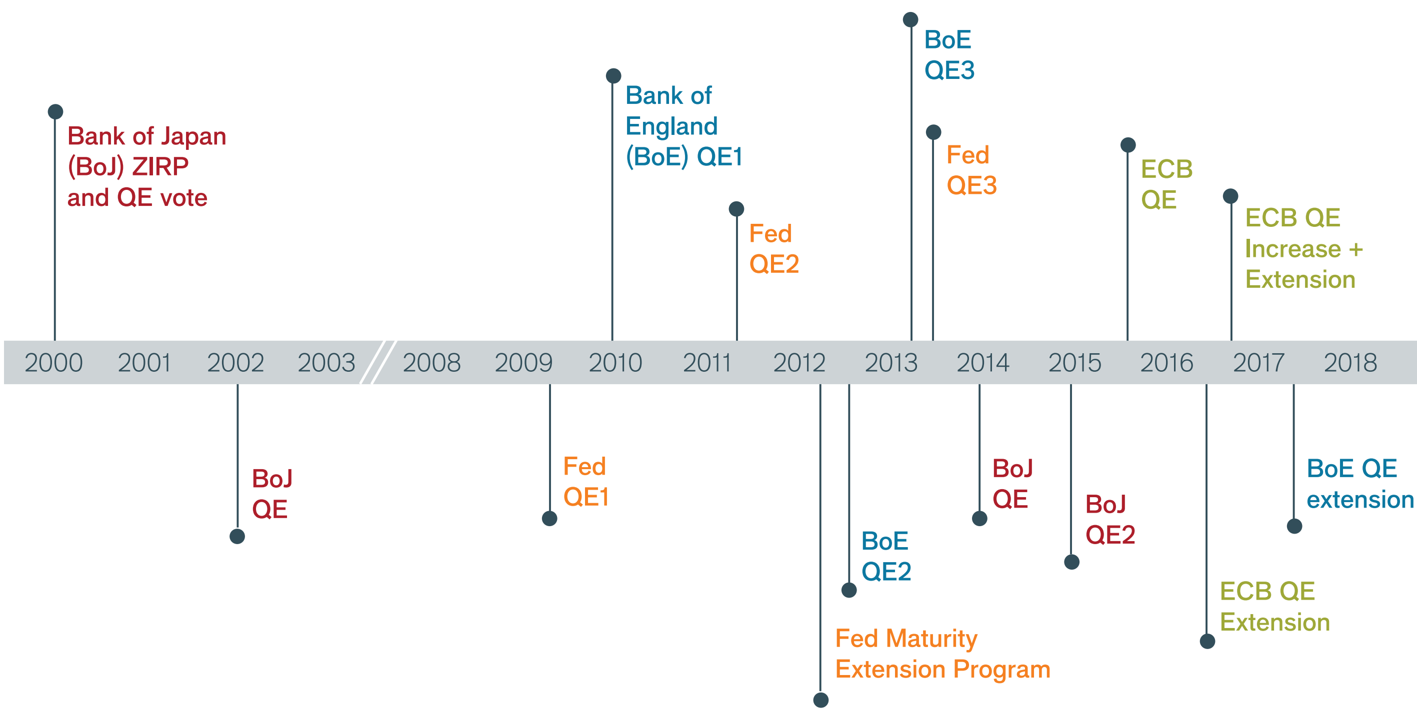
The bursting of the housing market bubble gave birth to the Global Financial Crisis where fear gripped and paralyzed global financial markets. Major central banks responded in kind by lowering their policy rates to zero (or negative for some) and implementing large-scale quantitative easing programs. Yet, most do not fully appreciate how varied the actual timing of the policy responses were from region to region, as shown in Exhibit 3.

The Fed moved decisively, lowering the federal funds rates to zero in December 2008 and launching the first quantitative easing program in November 2008. In stark contrast, the ECB's responses were glacial, waiting until September 2014 to lower its policy rate to zero and March 2015 to launch the first quantitative easing program – almost six years after the Fed arrived at the same accommodative policy position. Because the ECB and the related eurozone governments were slow in arresting the financial crisis, the eurozone may not be able to normalize its monetary policy for the next several years, especially in light of the following:

1. The likely UK exit from the European Union on March 29, 2019.
2. Key ECB interest rates will remain at their present levels at least through the end of 2019.[3]
3. Changing of leadership at the ECB when Mario Draghi's term comes to an end on October 31, 2019.
4. The view of many investors that credit is in late cycle.
5. The view among many investors that the U.S. will experience a recession in 2020.

Given the uncertainty surrounding Brexit and Mario Draghi's forward guidance, it seems unlikely the ECB will change its interest rate stance in 2019. Additionally, the ECB may find it difficult to raise rates this late in the credit cycle, especially if the U.S. were to enter into a recession sometime in 2020.

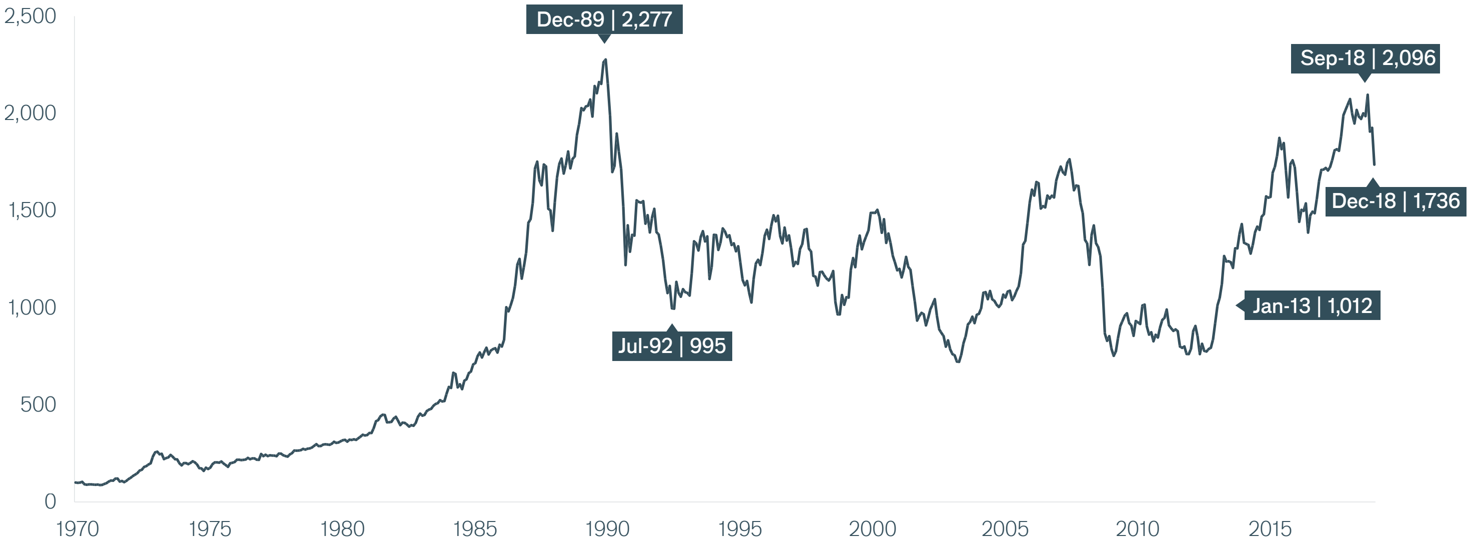
Exhibit 3: Timing of the Quantitative Easing Programs



Source: Bank of England

[3] Mario Draghi, ECB press conference, March 7, 2019.

Exhibit 4: Is the Eurozone the next Japan?



Source: MSCI Japan Index, 1/1970 through 12/2018

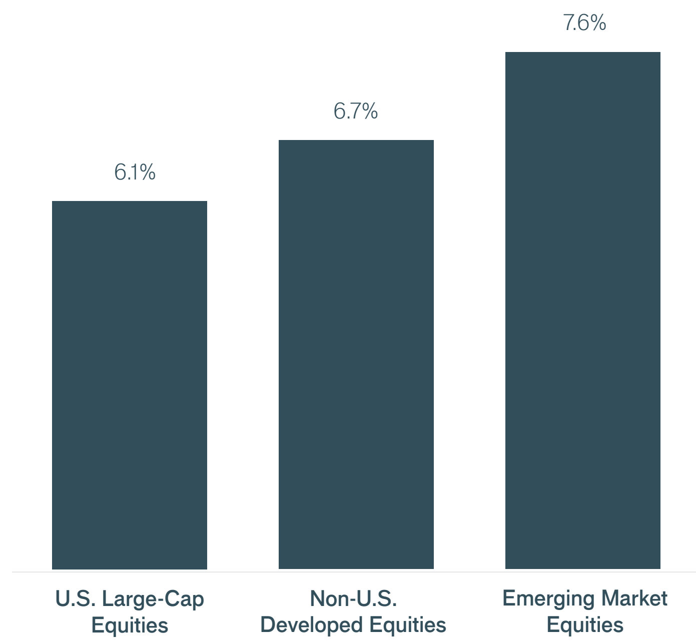
If the ECB cannot raise its policy rates high enough (and they remain at or below zero), it is not too far-fetched to ask whether the eurozone will become the next Japan in regard to low investment return environment. As shown in Exhibit 4, Japanese equities never recovered from the 1989 peak and for the following 29 years lost 0.17% per year in local currency terms – a nightmarish scenario for pensioners and investors.

Return expectations for all risk assets can be decomposed as the combination of a risk-free rate and an expected risk premium. As shown in Exhibit 5, most institutional investors assume a positive risk-free rate, even for non-U.S. developed equities.

The 10-year expected return for non-U.S. developed equities stood at 6.71%, higher than the 6.07% for U.S. large-cap equities.[4] There is a cognitive dissonance here: how can the expected return for non-U.S. equities be higher than for U.S. equities if the neutral risk-free rate in Germany and Japan are expected to be lower than in the U.S.? If one assumes a long-term risk-free rate of zero for non-U.S. developed markets, then the resulting risk premium for non-U.S. developed equities is 6.71% – a figure that is far too high.

There are many differences between Japan and the eurozone; therefore, one should not simply impute Japan's experience for the past three decades to the eurozone. However, prudence, based on the foregoing observations, indicates that long-term return assumptions of non-U.S. developed equities should be meaningfully lower than what is anticipated among most institutional investors.

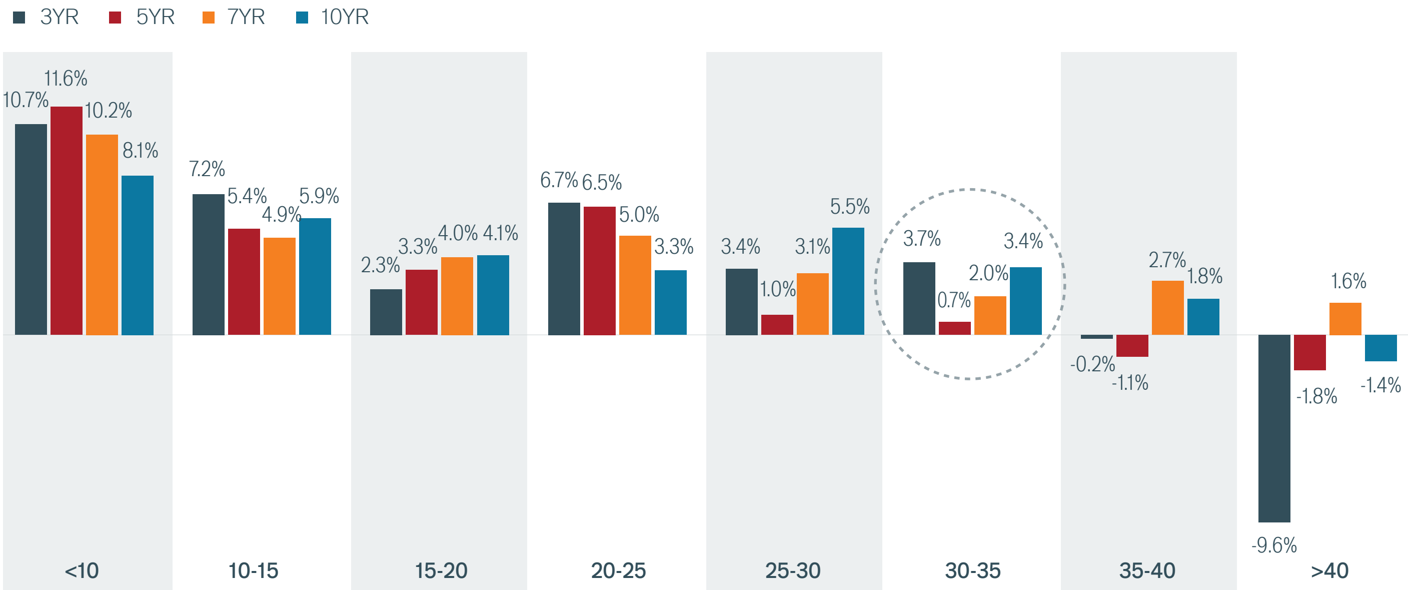
Exhibit 5: Return Expectations for Developed Markets Are Too High



Source: Horizon Actuarial Services, LLC. Survey of Capital Market Assumptions 2018 Edition.

[4] Horizon Actuarial Services, LLC. Survey of Capital Market Assumptions 2018 Edition.

Exhibit 6: U.S. Equity Forward-Looking Returns as Indicated by Shiller P/E Ratio (1/1881 – 12/2018)



Source: http://www.econ.yale.edu/~shiller/data.html, 1/1881 through 12/2018

Note: Shiller P/E provides a measure of relative value across time. In general, an inverse relationship between Shiller P/E and forward-looking returns exists.

Is Valuation for U.S. Equities Stretched? Is a Bear Market Waiting in the Wings?

The short answer is "we don't know." For that matter, no one knows. However, reasoning based on aggregate equity valuation, the level of aggregate corporate profits and the level of equity volatility all point to lower future long-term U.S. equity returns vis-à-vis the historical long-term average or the current forecast of U.S. capital market assumptions.

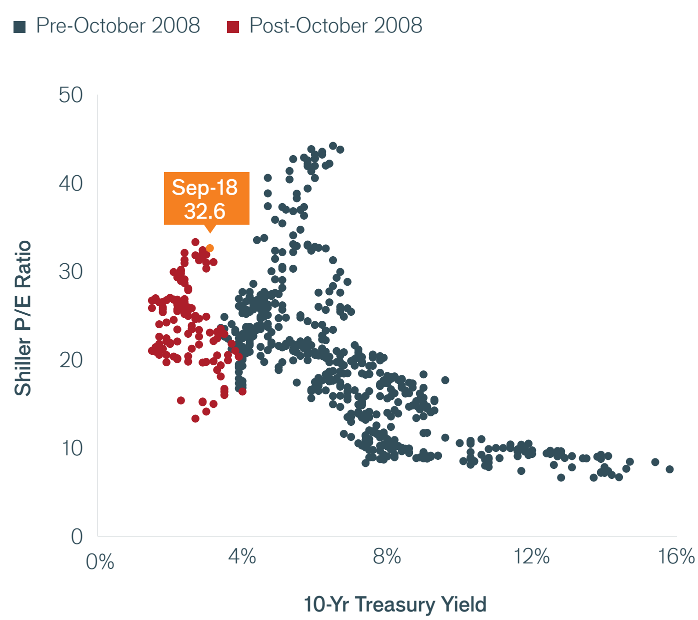
Valuation

The level of equity valuation is time-varying and dependent on the projected growth of future earnings and the assumed rate used to discount those earnings. By historical measures, the current U.S. equity valuation level appears stretched and augurs lower expected returns for years to come (as shown in Exhibit 6). Historically, when the Shiller P/E ratio was between 30 and 35, the average forward returns for U.S. equities for the next three, five, seven and 10 years have all been lower than 4.0%.

Having said that, there is a good reason why today's Shiller P/E remains high compared with its own history. Previously, we remarked that the return for any risk asset can be decomposed as the combination of a risk-free rate and an expected risk premium. Prior to the Global Financial Crisis, the accepted norm for the neutral U.S. policy rate was around 4.0% nominal, 2.0% real. After the crisis, the consensus view is that there has been a structural step down in the neutral U.S. policy rate in the range of 2.0% to 3.0% nominal.

If the long-term expectation for the neutral policy rate has been revised downward, one should observe its impact on equity prices. That is precisely what we observe in Exhibit 7 where we plot the Shiller P/E against the 10-year Treasury yield. In aggregate, the equity valuation is higher today, in part, due to lower risk-free and lower assumed discount rates.

Exhibit 7: Equity Valuation vs. 10-YR Treasuries



Source: http://www.econ.yale.edu/~shiller/data.html, monthly data from 1/1962 through 12/2018

Aggregate Corporate Profits

Generally speaking, a positive relationship exists between the level and trend of corporate profit margins and P/E multiples: the higher the level and positive the trend of corporate profit margins, the higher the P/E multiples and vice versa.

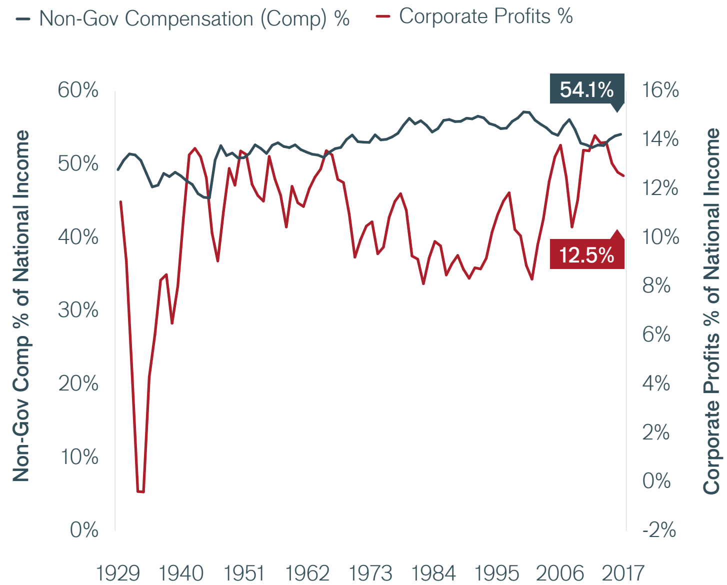
The aggregate corporate profit as a percentage of national income peaked at 14.2% in 2012 and has been trending down, as shown in Exhibit 8. A negative trend in the aggregate corporate profit would be another reason why investors should approach U.S. equities with caution. A caveat is in order: a declining aggregate corporate profit does not mean that all corporate profits at the individual company level are declining. In fact, this may be an environment where one may want to increase the quality of equity portfolios by seeking exposure to companies with quality franchises, balance sheet strength and durable earnings whose profit margins tend to be relatively stable.

Equity Volatility

The Cboe VIX® Index (VIX Index) moves inverse to the stock market. As a rule of thumb, when the stock market falls sharply, the VIX Index tends to spike and vice versa. What has been unusual about the VIX Index has been the absolute level for the past several years, but especially during the second half of 2017.

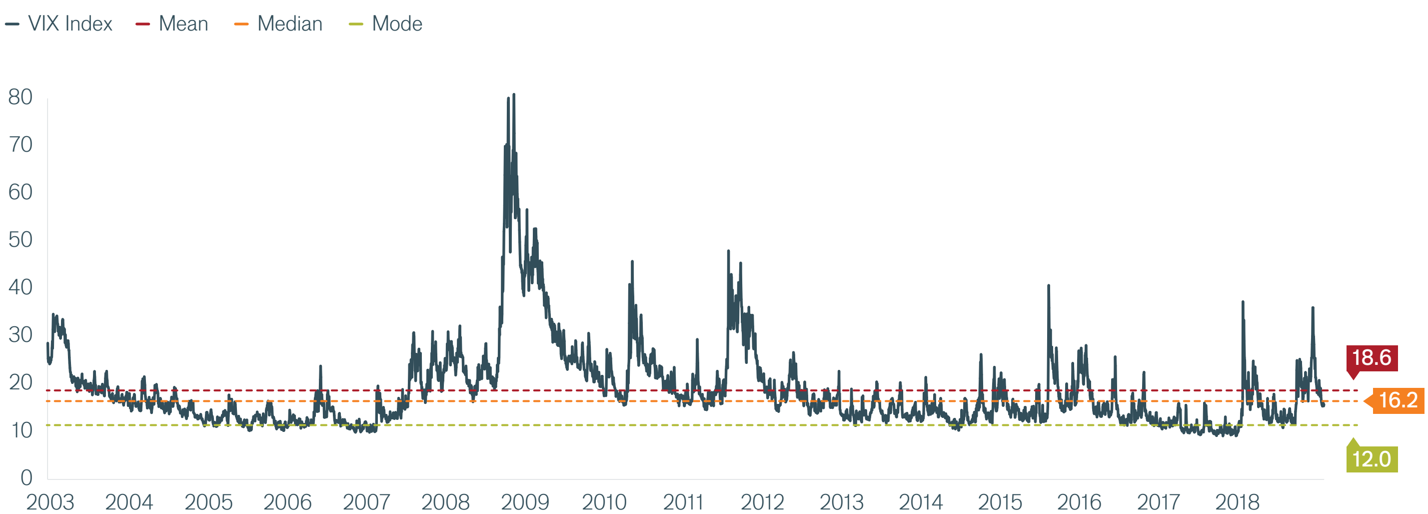
The VIX Index hovered around 10 between May and December of 2017. A reading of 10 is roughly half the long-term mean for the VIX Index and appears to be the floor for the time period presented in Exhibit 9. Given this observation, it should not surprise anyone why U.S. equity returns were so strong in 2017 and why we witnessed more normalized levels of equity volatility during 2018. Equity volatility could not remain depressed at such low levels for too long. Furthermore, if the Fed's accommodative monetary policies were the reason for lower asset price volatilities, then the reversal of accommodative monetary policies should result in higher asset volatilities. Finally, as long as the risk of the Fed making a monetary policy mistake remains real and, as a result, the VIX Index level remains elevated, one should expect lower U.S. equity returns for the foreseeable future.

Exhibit 8: Aggregate Corporate Profits as a Percentage of National Income



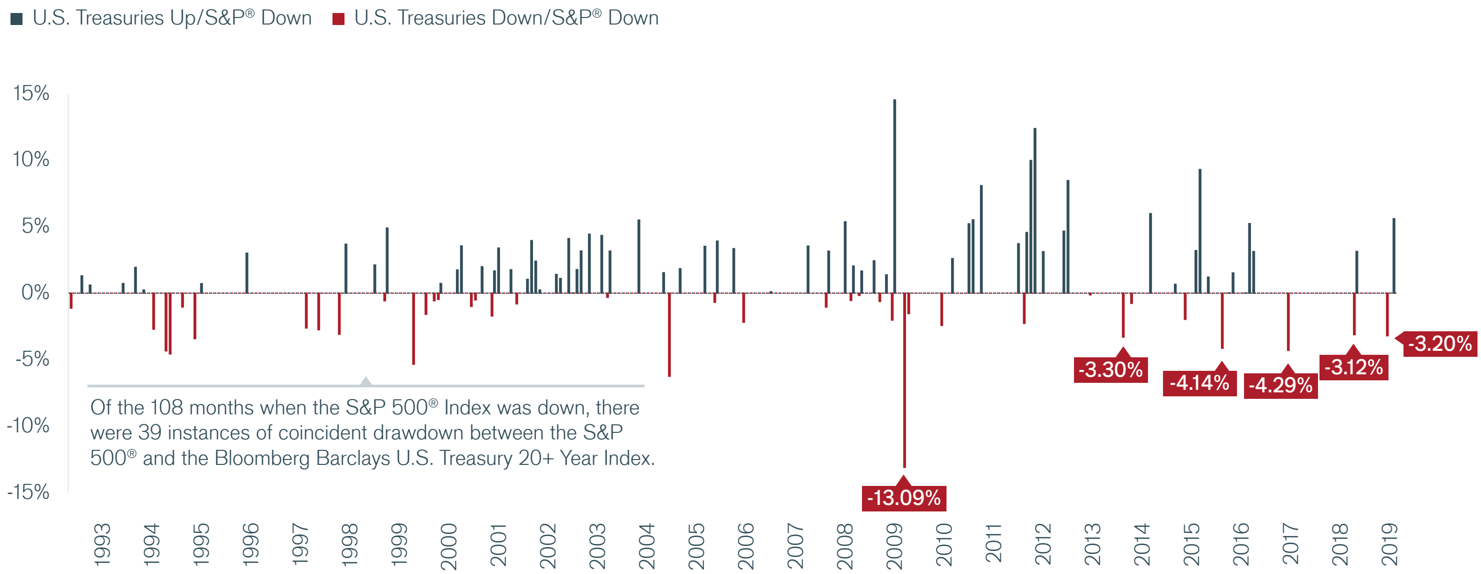
Source: Bureau of Economic Analysis, 1929 – 2017

Exhibit 9: The VIX Index was Too Low in 2017 and 2018



Source: Bloomberg, 1/2003 through 12/2018

Exhibit 10: Coincident Drawdown: S&P 500® Index and Long Treasuries



Source: Bloomberg, 3/31/1992 through 12/31/2018. The highlighted figures represent the performance of the U.S. Long Treasury Index.

Will Treasuries Provide Downside Protection when Equities Fall?

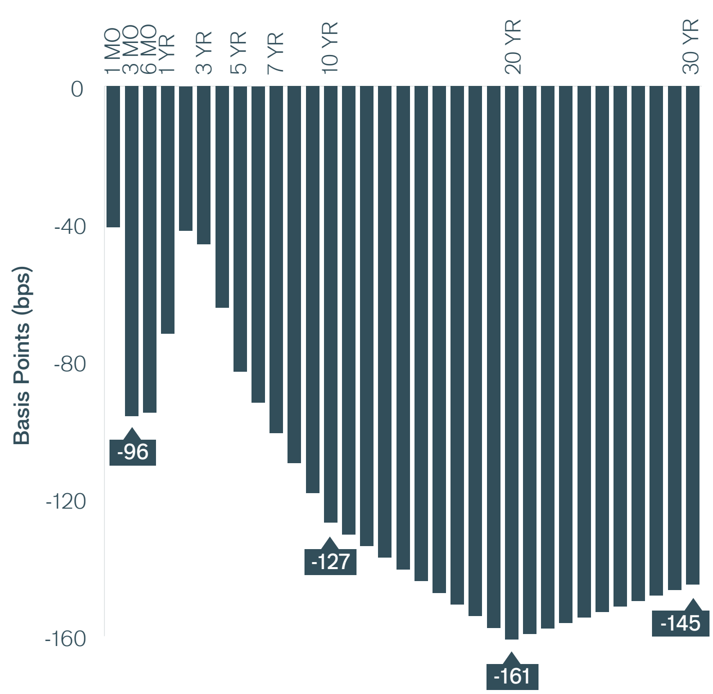
Generally speaking, U.S. Treasuries have served as a "safe haven" when equities sell off sharply. Indeed, the long-term average correlation between the Bloomberg Barclays U.S. Treasury 20+ Year Index (U.S. Long Treasury Index) and the S&P 500® Index is -0.15.[5] However, this question is being asked against a backdrop of rising interest rates and tapering of the Fed's balance sheet.

As shown in Exhibit 10, U.S. Treasuries do not always provide downside protection. Between March 1993 and December 2018, there have been 39 months of coincident loss between the S&P 500® and the U.S. Long Treasury Index. In the highlighted months, except for January 2009, the reason for the coincident losses for equities and bonds has been either the fear of rising rates or the fear of rising inflation. Therefore, if the fear of rising rates is the reason for the equity sell-off, then U.S. Treasuries may not provide the protection that investors seek. However, if deceleration in earnings growth is the reason for the equity sell-off, then U.S. Treasuries will most likely provide protection against the equity sell-off. It is simple math: if interest rates are expected to rise, then prices of the U.S. Treasuries have to fall.

There is another reason why U.S. Treasuries may not provide as much downside protection in the current environment as in the past. Consistent with the view of a structural stepdown in the neutral U.S. policy rate, as shown in Exhibit 11, today's absolute level of interest rates is meaningfully lower than pre-Global Financial Crisis levels.

As of December 2018, the yield on the 10-year Treasury was approximately 130 basis points lower compared to the pre-financial crisis levels. Thus, U.S. Treasury yields have less room to fall today than in the past, unless the Fed allows for negative nominal interest rates in the U.S.

Exhibit 11: A Stepdown in U.S. Treasury Yields (Pre- vs. Post-2008)



Source: U.S. Department of Treasury, 12/31/2007 vs. 12/20/2018

[5] Bloomberg. 3/31/1992 through 12/31/2018.

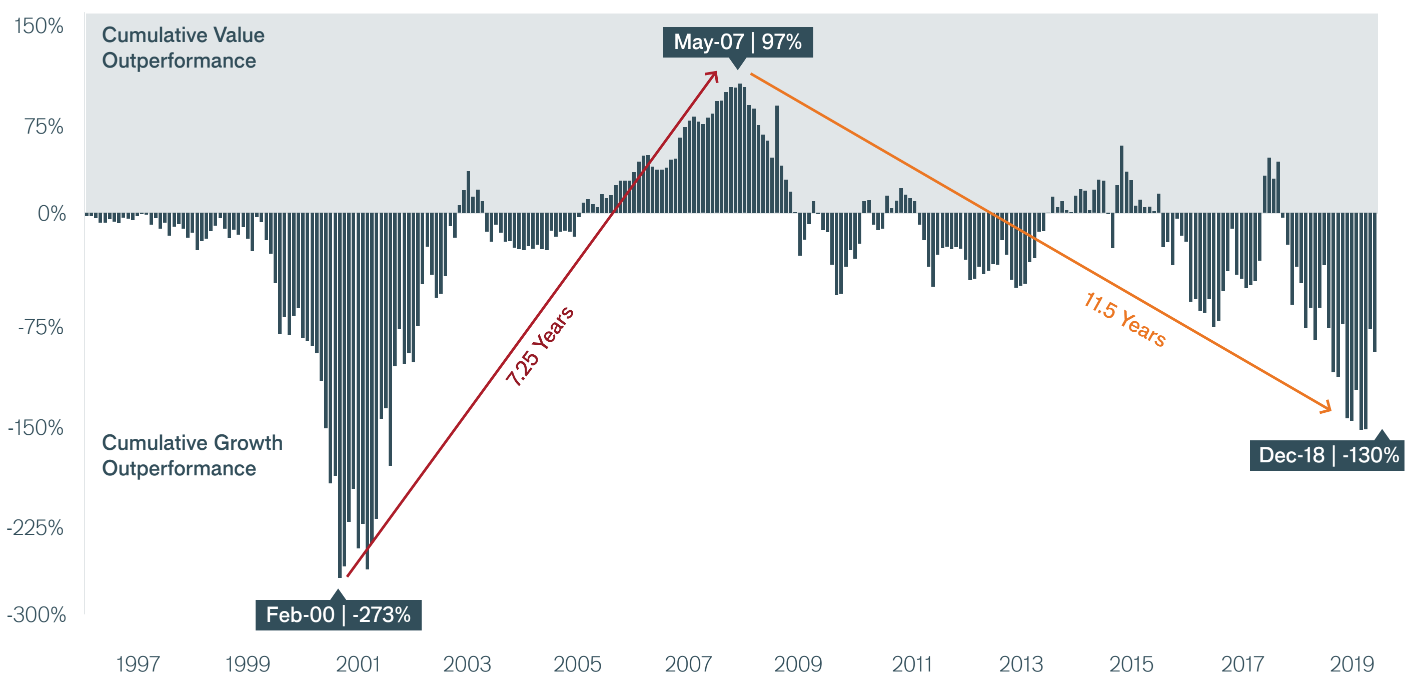
Is Value Investing Dead?

We've been here before. Back in the throes of the technology-media-telecommunications (TMT) bubble, many value investors were excoriated for "not getting it." At the end of 1999, a few months before the turn, a reputable institutional value portfolio manager received a firing call from a client who sarcastically yelled through the phone: "It's been a pleasure making no money with you!"

Despite a prolonged period of value stocks lagging growth counterparts, in our opinion, there is a danger in pronouncing value style dead. As shown in Exhibit 12, value and growth styles do not rotate leadership very often: the value leadership from 2000 to 2007 lasted about seven years and the current growth leadership from 2007 to 2018 about 11 years. The duration of the current growth leadership tells us nothing about when the style rotation to value will occur. Interestingly, the current sector allocation of the S&P 500® Growth Index, as shown in Exhibit 13, seems to indicate the current growth leadership may be in late cycle.

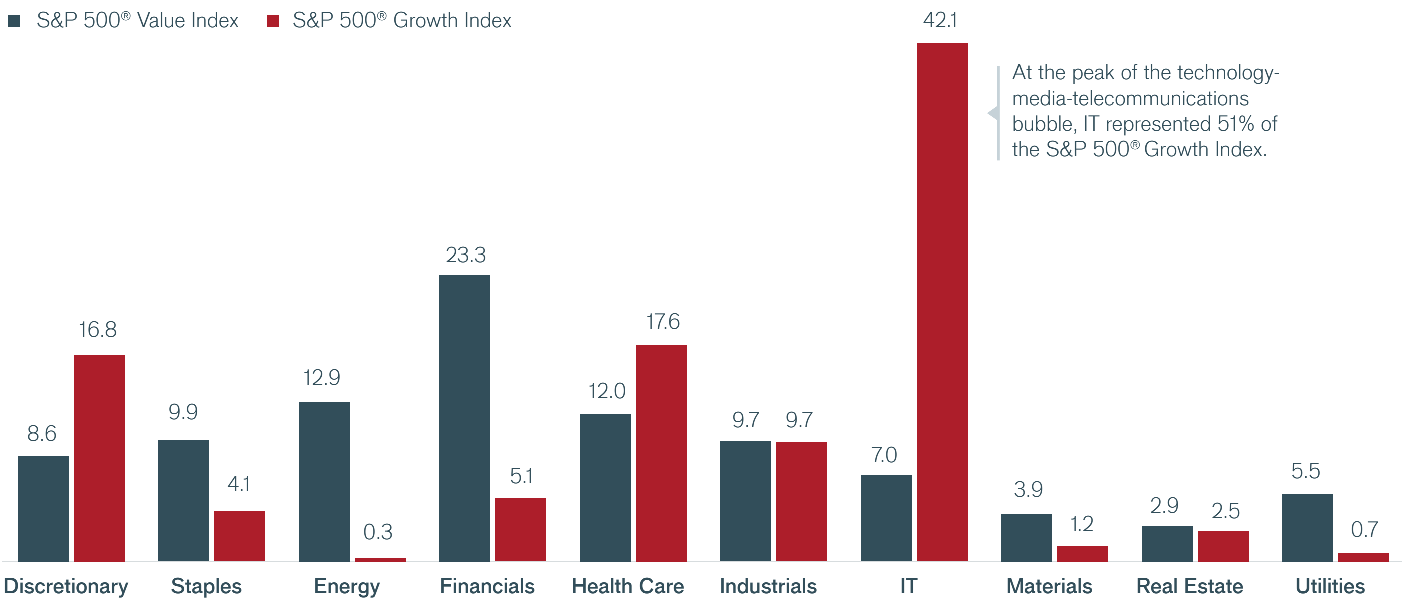
At the apex of the TMT bubble, the information technology sector represented roughly 50% of the S&P 500® Pure Growth Index. As a point of comparison, on September 30, 2018, the information technology sector represented about 42% of the index. If one reclassified Amazon as an information technology company, as opposed to a consumer discretionary company, the IT weighting would increase to 48% – almost matching the IT sector weight at the peak of the TMT bubble. This is not to suggest that we are in another TMT bubble, but to simply compare the growth cycle that ended in February 2000 and the current growth cycle.

Exhibit 12: Value versus Growth Cycle



Source: S&P Dow Jones Indices, cumulative return of Value - Growth from 6/30/1995 – 12/31/2018

Exhibit 13: Is Value Dead?



Source: S&P® Down Jones Indices, sector allocation as of 9/30/18

Implications

In our opinion, long-term return assumptions for U.S. and non-U.S. developed market equities appear too high given the current valuation and the aggregate profit margin levels in the U.S. and the expected neutral risk-free rates in international developed economies. Like Japan, for the past three decades, the eurozone may not be able to normalize its monetary policies and bear the cost of their gradual policy response to the Global Financial Crisis in the years to come. Pensioners and investors may bear this cost through meaningfully lower future returns from their investments.

To address lower future expected returns, we propose the following:

1. Reset the return expectations of trustees and investment committees meaningfully lower. (Unfortunately, this is easier said than done.)
2. Pull different levers of active management to help close the gap between the plan level required rate of return and the expected policy level return based on strategic asset allocation (hereafter referred to as the "return gap").
3. Don't give up on value.

When active management is mentioned, our minds automatically turn to long-only active equity management, and those who do not believe in long-only equity management tend to dismiss it outright. But active management is much more than just long-only active equity management. By active management we mean active – as opposed to static – asset allocation and active beta management, high-active-risk fixed income management, capital efficiency and high-conviction equity portfolios.

Active Asset Allocation

Most institutional investors take a passive approach to their strategic asset allocation. Take the global equity structure, for example: most defer the regional allocation decision to MSCI and passively follow the MSCI ACWI's regional allocation even though a survey of long-term capital market assumptions among institutional investors shows higher compound returns for emerging markets (7.6%) than for U.S. (6.1%) or non-U.S. developed markets (6.7%).[6] This is one of the reasons why we challenged institutional investors to reassess their emerging markets equity allocations in our "Emerging Markets Equity: What Do They Know?" paper published during the first quarter of 2018. Since emerging markets may not suffer from the same major headwinds that developed markets are currently facing, investors should consider reallocating a portion of assets or increasing their allocations to emerging markets equity.

[6] Horizon Actuarial Services, LLC. Survey of Capital Market Assumptions: 2018 Edition.

Active Beta Management

To maximize compound returns over time, one must be long-term in investment horizon but short-term and active in managing portfolio risk; that is, one must be active in managing portfolio risk seeking to minimize large losses and participate in large gains. The strategic asset allocation most of us rely on, by design, takes a passive approach to beta risk management – in the past, we have referred to this as passive beta management. Passive beta management, "... cannot address the acute tail risk inherent in most institutional portfolios because asset diversification fails during times of market stress when correlation among risk assets converges to one."[7] Therefore, we challenge investors to explore adaptive beta management approaches designed to maximize portfolio compound returns while mitigating the acute tail risk present in most institutional portfolios.

Diversifying Alternative Strategies

Today, the tail risk that most concerns investors is an environment where equities, credit and duration all experience large coincident drawdowns. As a hedge against potential tail risk, some investors began investing in long-duration Treasuries, trend following strategies or both. As remarked earlier, U.S. Treasuries have generally provided protection against falling equities, as long as rising rates or rising inflation were not the reason for the sell-off in equities. The trend following strategies are considered long volatility strategies. Conceptually, when volatility rises and equities fall, the trend-following strategies should counterbalance the fall in equities. In our opinion, what is missing in this diversifying mix of strategies are diversifying alternative strategies (both discretionary and systematic) that exhibit low (less than 0.3) to no correlation to equities and bonds and target a long-term return between the 3-month T-Bill + 4.0% and the 3-month T-Bill + 6.0%. Because they are nondirectional in nature, their success should not depend on the direction of or trend in equity or fixed income markets.

In 2018, none of these three diversifying strategies generated positive returns: the U.S. Long Treasury Index returned -2.0%, the SG Trend Index, -8.1%, and the SG Multi Alternative Risk Premia Index, -4.6%. No investment strategy can perform as intended in all instances; therefore, despite a disappointing 2018, we implore investors to not lose faith in the effectiveness of these diversifying strategies based on one calendar year return.

High-Active-Risk Fixed Income Management

Many investors agree that in the future, most fixed income returns will come from carry as opposed to price appreciation. Given that view, it is unlikely that traditional core or core plus fixed income strategies will generate returns high enough to close the return gap. In long-only equities, the consultant community has been uniformly advocating high-conviction equity strategies with the potential to generate higher levels of excess return. It is curious to us why this high-conviction investing advice has not been extended to core plus managers who have shown greater consistency in generating excess returns than active long-only equity managers. Multiple research reports by Rogerscasey (now Segal Marco) have demonstrated year after year that performance persistence is much stronger in active core fixed income strategies than in active long-only equity strategies. In light of the aforementioned research, it is entirely rational to apply a high-conviction, high-active-risk approach to core plus strategies seeking to generate higher excess returns, as long as the investment manager does not lose sight of the overriding objective of core fixed income: to reduce equity risk in the overall plan structure.

Capital Efficiency

To generate higher return from a fixed base of assets, investors may consider becoming more capital efficient through judicial use of notional leverage. Given the advancement in financial engineering, the cost of investing in asset class betas has become relatively cheap. Therefore, investors can gain exposure to long-only equities or duration through index futures that require very little capital outlay and invest the remaining capital in uncorrelated, low-risk absolute return strategies whose return target may range 1% to 3% above the 3-month T-Bill. The net result is active management through portable alpha structure where one combines passive management in asset classes such as large-cap equities and core fixed income where excess returns may be low and hard to come by and absolute return strategies where investors get compensated for bearing different and uncorrelated sources of risk.

The portable alpha structure is just one among many ways investors can maximize capital efficiency. The use of notional leverage is a common practice among diversifying alternative strategies referenced above. Therefore, investors should not limit or dismiss outright strategies or structures that inherently rely on judicious use of leverage in an effort to generate high returns.

[7] Janus Henderson Investment Insight Series: "A Hole in Strategic Asset Allocation." August 2016.

Don't give up on Value

Since the beginning of the growth cycle in June 2007 to December 2018, the S&P 500® Pure Value Index has lagged the S&P 500® Pure Growth Index by about 3.0% per year (6.7% vs. 9.7%). Despite the recent underperformance, as remarked earlier, there is a real danger in pronouncing value style dead. Some have referred to value investing as a reversion approach to investing; that is, as long as there is no permanent impairment to the underlying earnings potential of the company, the earnings will eventually normalize and the stock price will revert and follow the normalized earnings. Value investing does not have to outpace growth investing to make it compelling. As long as value stocks are able to close the performance gap to growth stocks and deliver returns that are close to the long-term average for equities, they will be compelling on a go-forward basis. Unless the long-term historical relationship between value and growth has fundamentally changed, we see no reason to give up on value.

Conclusion

Despite the Fed's orderly forward guidance on future monetary policies, the market reaction to their policy decisions seem disorderly, as evidenced by broad increases in asset class volatilities. We have no views on how equities or bonds will perform or whether value will finally outpace growth over the short term. In fact, 2019 may turn out to be a banner year for equities due to the "presidential cycle" effect.[8] Over the longer term, however, it behooves investors to reset their long-term return assumptions lower and risk estimates higher. And, given a potential shift in monetary policies in the U.S., the UK and eurozone plus the resurgence of asset price volatilities, caution, patience and selectivity may be in order for the next several years. A shift in money availability, a shift in real interest rates and a shift in the value of the dollar is bound to have a material impact on investors' portfolios.

[8] From 1926 to 2018, the S&P 500® Index return for the third year of the presidential term has averaged 18% per year.

About the Author

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Suny Park is Vice President, Senior Managing Director and Chief Institutional Client Strategist at Janus Henderson Investors. In this role, Mr. Park is responsible for providing thought leadership on key issues and customized client analysis to institutional investors in the United States and Canada.

Prior to joining Janus in 2012, Mr. Park served as the Head of Global Portfolio Solutions and co-head of Investment Research for Rogerscasey in Darien, Connecticut. Past experiences also include international equity research for Northern Trust Global Advisors, business acquisition and distressed loan investing for GE Capital Services, pricing of weather derivatives for Koch Industries, and public accounting for Deloitte & Touche. Mr. Park received his bachelor of science degree in accounting from The King's College and an MBA in analytic finance from the University of Chicago, Booth School of Business. He holds the Chartered Financial Analyst and Certified Public Accountant (inactive status) designations. He has 28 years of financial industry experience.

For more information, please visit **janushenderson.com.**

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