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Investment intelligence

DGFs for income and capital growth through market cycles

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- Generating income is a priority for pension schemes, with many facing increasing cashflow requirements
- Despite these immediate cashflow needs, many schemes still also have long-term capital growth objectives
- A multi-asset income solution offers the potential to deliver both through market cycles using dynamic asset allocation

Steven Andrew, fund manager, M&G Episode Income Fund

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Central banks on the loose

The trend towards looser monetary policy worldwide is unwelcome news for yield-hungry investors. In the US, the Federal Reserve has paused on rate rises, with markets now predicting it will make multiple cuts this year[1]. In Europe, the European Central Bank has injected fresh stimulus via its 'TLTRO' lending programme and bund yields have reached all-time lows[2]. And in the UK, the Bank of England is reticent to raise rates due to political uncertainty. Based on these observations, yields on traditional income sources are likely to remain low in the coming period.

Sustained yield compression over the past decade means many pension schemes now rely on income from assets at risk of delivering low or negative capital growth – not only government bonds, but increasingly other defensive assets, whose yields can also be correlated to discount rates. At the same time, many schemes have reduced exposure to growth assets, such as equities, to prevent volatility from eroding their capital. However, these decisions have the potential to compromise long-term asset growth objectives and can even prove unsuccessful in the short term too, given 90% of assets experienced price declines in 2018[3].

The extent to which most financial asset classes can continue to benefit from this loose policy environment is likely to be limited. Multi-asset approaches that can seek value flexibly can be well-placed to succeed in these conditions, but may need to be increasingly dynamic to respond at sufficient speed and scale to changes in the environment.

[1] Source: Bloomberg, 5 June 2019
[2] Source: Bloomberg, 3 June 2019
[3] Source: Deutsche Bank, 3 January 2019

Why use a multi-asset income solution?

Generating income is a priority for pension schemes. As contributions decline and members draw pensions in growing numbers, cashflow requirements are leading schemes to focus on optimising the quality and quantity of income from their asset portfolios. However, an excessive focus on income throws up equally pressing questions about how schemes can ensure their long-term viability through capital growth. For many, these dual objectives can conflict or become challenging.

The solution can lie in multi-asset income strategies, which invest across asset classes to deliver high-quality income, including from growth assets, in both developed and emerging markets. Their broad exposure recognises that no single asset can provide a 'magic solution' for pension schemes. Equity dividends, bond coupons and property income are all potential income engines, but each also carries its own risks.

How can diversification be achieved?

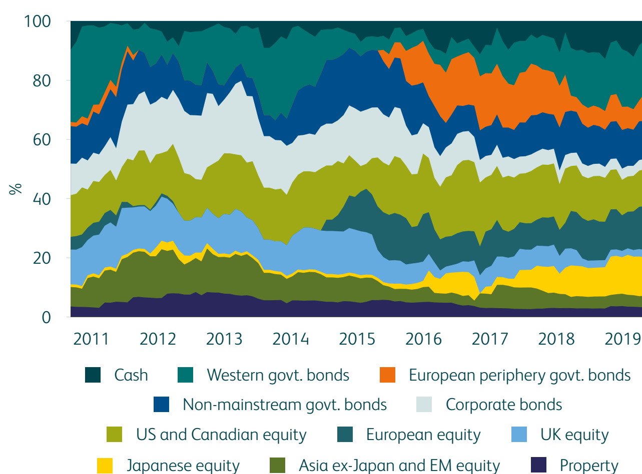
Diversifying effectively is frequently challenging today. Many financial assets, particularly in developed markets, have become more correlated both to one another and to monetary policy expectations. A decade of yield compression has led to some investors including alternative asset classes such as private debt, private equity and infrastructure in multi-asset investment strategies.

However, alternative assets can still be expensive, which can both lower their potential for capital growth and add liquidity and default risk. Alternatives can also be

correlated to the same macroeconomic fundamentals as mainstream assets, such as interest rates and economic growth. In addition, the need to hold such assets to maturity can reduce an investor's ability to respond to changes in the market environment, which may increase opportunity costs.

We believe it is possible to deliver on long-term income and capital growth objectives by predominantly allocating capital in liquid markets, such as equities and mainstream bonds. This involves dynamically scaling positions in more meaningful amounts than would be typical for traditional multi-asset strategies. This significantly increases the potential to perform over the course of a market cycle, given asset valuations and correlations can shift materially and frequently in the short-term. Our approach provides opportunities to respond quickly to market changes and maintains a forward-looking view of asset correlations at all times. Figure 1 illustrates how a multi-asset income strategy might achieve this.

Figure 1. Dynamic asset allocation for multi-asset income



Source: M&G, 30 April 2019. For illustrative purposes only.

Where do we see value in liquid markets?

At current valuations, we view equities as providing significant compensation relative to their risks over the medium term. Within the asset class, banking sector stocks in developed markets are trading at a forward price-earnings ratio of 9.5x and a forward dividend yield of 4.6%. This compares to 15x and 2.7% respectively for the MSCI World Index[4]. It is always crucial to distinguish between genuine opportunities and value traps, but with so much negative sentiment already priced in to banks, we currently observe an asymmetry between their upside and downside potential.

Emerging market assets, particularly those that offer high carry, can also provide effective diversification through their idiosyncratic behaviour. This diversification is beneficial during periods when assets within developed markets are highly correlated. In emerging market fixed income, government bonds from Brazil and Mexico are among the most attractive opportunities, with real yields of 5.1% and 3.6% respectively[5]. However, price volatility in emerging markets (in both directions) necessitates dynamic allocation to manage risks and returns.

In developed market fixed income, we believe government bonds from Germany and the UK are unsustainably valued and we have generally avoided both for several years. US Treasury yields look more attractive and, despite the costs of hedging for UK investors and the recent yield rally, still provide greater scope for diversification than gilts. We maintain a cautious view on credit markets, as spreads are still relatively narrow by historical standards. Credit can also be highly correlated to economic factors and therefore equities, while offering a lower risk premium.

Is it possible to grow capital and income at this stage of the cycle?

It is worth remembering the frequency and extent to which market sentiment has shifted recently. At present, financial markets are pricing in a continuing global slowdown, as they did in 2016. This is in stark contrast to the jubilation of 'synchronised global growth' in late 2017 and subsequent US inflation fears in 2018. The fact that consensus views can change so dramatically and quickly demonstrates the limited usefulness of forecasting what will happen next in the market cycle. Our view is that current data do not signal a US recession and that trying to predict changes to future data is not a sustainable way to deliver outperformance.

Instead, we look for opportunities where the prices of income-generating assets have become dislocated from their fair value based on known facts and observable data. We believe this provides a better indication of a financial asset's potential to deliver positive total returns over the medium to long term. In the shorter term, returns can also be supported by capitalising on extreme market pessimism, as demonstrated by the recovery of equity markets in early 2019 from previously depressed levels. In this respect, dynamic asset allocation can supplement performance at any stage of the market cycle and reduce the conflict pension schemes currently face in meeting their income and long-term capital growth objectives.

For more information, please visit www.mandg.com/multiasset

[4] Source: Bloomberg, 5 June 2019

[5] Source: Bloomberg, as at 28 May 2019. Real yields on Brazilian 10-year bonds and Mexican 30-year bonds.

Contact

United Kingdom

Grant Hadland
+44 (0)20 3977 2496
grant.hadland@mandg.co.uk

Sam Collings
+44 (0)20 3977 2880
sam.collings@mandg.co.uk

www.mandg.co.uk/multiasset
www.mandg.co.uk/equities
inst.eqma@mandg.co.uk

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