Investing in 2013: Themes, Opportunities and Risk in a Post-Crisis World

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Are we in a Post-Crisis World?
CB balance sheets expand and market vol falls

Source: LGIM

Source: Thomson Reuters Datastream
But where does this leave us?
Safe havens have become barren islands

Source: Barclays Equity Gilt Study 2012 edition
Produced by TPS - Kelvin Storey

Value at 31/12/2012 estimated at 2%
But where does this leave us?
Real returns look likely to be modest

Real asset returns versus real interest rates 1900-2012

Source: Dimson, Marsh and Staunton
Reasons to be cheerful
Economic convergence and renewal

Source: Odey (asset obsolesce)
Build robust and resilient asset portfolios
Diversified with exposure to multiple return drivers

Diversify away from reliance on the equity risk premium
Build robust and resilient asset portfolios

Growth Fixed Income portfolio construction

Alpha focus

- Private Debt: 20%-40%
- Absolute Return: 0%-25%
- Credit Opportunities (or High Yield): 20%-40%
- EMD: 20%-40%

Beta focus

More illiquid

More liquid
Exploit competitive advantage
Private debt (illiquidity premium)

- **Senior Loans (6-10% p.a.)**
- **Property mezzanine (8-12% p.a.)**
- **Corporate mezzanine (12-15% p.a.)**

Return expectation vs. Risk
Tilt towards long-term winners

Equity portfolio

- Developed Markets
- Small Cap
- Emerging Markets

Low Volatility

Sector Valuations - Ratio of High Quality to Low Quality
(Based on Average of P/B, P/E and P/CF)

Relative Valuation of High Quality / Low Quality

<table>
<thead>
<tr>
<th>Year</th>
<th>1995</th>
<th>1997</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>0.7</td>
<td>0.9</td>
<td>1.1</td>
<td>1.3</td>
<td>1.5</td>
<td>1.7</td>
<td>1.9</td>
<td>2.1</td>
<td>2.3</td>
</tr>
</tbody>
</table>

1995 1997 1999 2001 2003 2005 2007 2009 2011
Build in inflation sensitivity

**Portfolio structuring**

- **Inflation-linked assets:**
  - Inflation bonds
  - Inflation derivatives

- **Inflation-sensitive assets:**
  - Cyclical equities
  - Commodities
  - Real Estate
  - Infrastructure
  - Private equity (selected strategies)
Behave dynamically as events unfold

Sample ‘dynamic evolution’

- Banked gains on credit after spreads tightened
- Introduction of Emerging Market Debt based on EM governments’ fiscal strength
- Increased Emerging Market Equity exposure on expectations of continued growth
- Increased currency hedge ratio on concerns of Sterling over-depreciation
- Introduction of Global Small Cap and Global Low Volatility to increase diversification, and to enhance risk/return profile
- Reallocated cash position to Global Low Vol.
- Tactical switch to Emerging market equity from Global Low Vol equity
- Introduction of High Yield debt

- Increased Emerging Market Equity exposure on expectations of continued growth
- Introduction of Global Small Cap and Global Low Volatility to increase diversification, and to enhance risk/return profile
## Invest efficiently and effectively

### Buy & maintain credit

<table>
<thead>
<tr>
<th>Traditional Active</th>
<th>Buy &amp; Maintain Credit</th>
<th>Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over invest in highly indebted entities</td>
<td>Invest based on stock-specific considerations</td>
<td>Lower absolute risk (and relative to liabilities)</td>
</tr>
<tr>
<td>Sector concentration (particularly financials)</td>
<td>Reduced sector and stock concentration</td>
<td>Lower absolute risk (and relative to liabilities)</td>
</tr>
<tr>
<td>Index benchmarking may increase turnover</td>
<td>Sell only if credit situation worsens</td>
<td>Lower turnover and therefore costs</td>
</tr>
<tr>
<td>Higher management fees</td>
<td>Low fees as ‘watching’ brief not ‘outperform’ brief</td>
<td>Value for money given ‘capital preservation’ bias</td>
</tr>
<tr>
<td>Benchmark influences duration</td>
<td>Duration can be tailored</td>
<td>Flexibility</td>
</tr>
<tr>
<td>Likely seller where securities fall below investment grade</td>
<td>Hold if remain acceptable on a yield to maturity basis</td>
<td>May enhance return</td>
</tr>
<tr>
<td>Benchmark ‘sells’ bonds 360 days before maturity</td>
<td>Bonds can be held to maturity</td>
<td>Better capture of amortisation on approach to maturity</td>
</tr>
</tbody>
</table>
Invest efficiently and effectively

Ownership: Farming versus hunting approach
Summary

- Build robust and resilient asset portfolios
- Exploit competitive advantages
- Tilt towards long-term winners
- Build in inflation sensitivity
- Behave dynamically as events unfold
- Invest effectively and efficiently
... or to put it another way