Capturing coronavirus and other remote possibilities in the Investment Futures Framework

By MLC

- Investment professionals can easily fall into the trap of trying to land on a preferred 'base case' and position portfolios accordingly.
- By contrast, our Investment Futures Framework steers us away from comfort zone thinking towards understanding the many things that could happen and then identifying the most appropriate trade-off between risk and return for each of the multi-asset portfolios we manage for clients.
- The Investment Futures Framework recognises the possibility of a vast number of scenarios with a great breadth of return possibilities. This includes highly likely scenarios as well as remote possibilities like pandemics, such as the current coronavirus outbreak.

Managing risks intelligently — those that can be reasonably anticipated all the way to outliers — to preserve as well as grow clients' capital, long-term, is the core of investment management.

Every investment manager has an investment philosophy and process to make sense of the world and to create order out of it.

The Investment Futures Framework (Framework) is our way of doing so in our multi-asset portfolios.[1] A feature of the Framework is the way it forces us to think about the range of things that can happen **(Chart 1)** as distinct from guessing what will happen.

Chart 1: Thinking about what could happen, rather than guessing what will happen

Source: MLC Asset Management Services Limited

[1] MLC's multi-asset portfolios comprise MLC Wholesale Inflation Plus, MLC Wholesale Horizon, and MLC Wholesale Index Plus portfolios.

Capturing coronavirus and other remote possibilities in the Investment Futures Framework

Investment professionals can easily fall into the trap of trying to land on a preferred ‘base case’ and position portfolios accordingly.

However, a single base case scenario, or even instances where an upside case and downside case are also developed, runs up against the world’s complexity. The Framework provides an antidote to the risk of biases inherent in trying to ‘narrow cast’ by minimising the range of issues for consideration.

In a world of endless information, this kind of narrow casting is a perfectly normal impulse. Unfortunately, mental short cuts can also result in reaching emotionally satisfying but far-from-accurate conclusions.

By contrast, the Investment Futures Framework actively steers us away from comfort zone thinking towards understanding the many things that could happen and then identifying the most appropriate trade-off between risk and return for each of the portfolios we manage for clients.

Capturing coronavirus in investment scenarios

Rather than imagining one or even several sets of outcomes and their associated investment returns, the Framework recognises the possibility of a vast number of scenarios with a great breadth of return possibilities. This includes more likely scenarios as well as remote possibilities like pandemics **(Chart 2)**, such as the current coronavirus outbreak.

The coronavirus crisis and the way it is disrupting societies, economies and markets demonstrates the Framework’s practicality and elasticity. Having pandemics as a possibility, even if remote, means that we’re prepared even when low probability events occur.

We’re not caught scrambling to analyse on the run. Perhaps the worst time to begin thinking about a low probability event is when it’s already underway.

Chart 2: Many futures are possible, including a global pandemic (scenario 25)

Investment Futures Framework

1	2	3	4	5	6	7	8	9	10
Steady state	Deflation – (reform driven productivity driven boom)	Stagflation (generic)	Rising inflation /shock (weak productivity)	Debt-driven growth	Disinflation	Inflationary growth	Investor pessimism –rise in risk premiums	Prolonged global growth and productivity boom	Strong growth, Australia and resources boom
11	12	13	14	15	16	17	18	19	20
Australia-only bust (world economy not weak)	Aust. economic crisis (world weak)	Profit share mean reversion	Credit / monetary expansion	Credit / monetary contraction	Steady/trend growth with mean reversion	Slowdown	Recession	Recovery	Aust. deflation – destructive (Japan 1990s)
21	22	23	24	25	26	27	28	29	30
Global depression stagnation (1930s)	Severe inflation risk	Financial collapse risk	Oil price shock – geopolitical risk	Global pandemic	Global catastrophe	Global catastrophe adverse economic environment	Global war / conflict	Protectionism – adverse growth and inflation	Exogenous risk drives investor uncertainty
31	32	33	34	35	36	37	38	39	40
China and emerging market risk aversion	Multi-speed world (zero probability)	Adverse productivity shock	Asian growth leadership	Paradigm shift – lower values for shares (higher return potential)	Paradigm shift – higher values for equities (lower return potential)	Speculative bubble	Bubble bursts (economy okay)	Policy supports higher inflation (expectations lag)	Debt deflation (weak growth, low inflation)

Source: MLC Asset Management Services Limited

Capturing coronavirus and other remote possibilities in the Investment Futures Framework

In the absence of the Framework and its vast number of scenarios, it's easy to fall into the trap of looking back to history to similar pandemics and extrapolating from them. However, history is, at best, an imperfect guide to the future.

Presently, some investors and commentators are looking back to the 2003 SARS outbreak for a 'compare and contrast' with Covid-19. However, just two pieces of information emphasise the limits of the comparison.

China's economy in 2003 was around 4% of global Gross Domestic Product (GDP) while it was 15% of global GDP in 2019.[2] Making assumptions on how coronavirus is affecting financial markets on out-of-date information, just because it happens to coincide with the most recent China-based outbreak, risks reaching unsound conclusions.

Thanks to the Investment Futures Framework, our portfolios were not caught completely unawares by the coronavirus outbreak and that may provide some reassurance for our clients.

---

[2] Source: *China: Percent of world GDP*. The Global Economy. Data sourced from The World Bank. https://www.theglobaleconomy.com/China/gdp_share/?. Accessed 3 March 2020.