‘Financial repression’ driving investors into shares

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The word ‘unprecedented’ gets used too frequently. However, it’s spot-on to explain the time we’re living in. Just look at share markets. March 2020 saw the fastest US share market sell-off in history, only to be followed by the strongest ever 50 day positive return. No wonder investors are searching for ways to protect themselves from extreme volatility.

Unfortunately, ‘financial repression’ brought about by central bank policies have compromised the capacity of ‘defensive assets’, such as government bonds, to protect portfolios. Ultra-low interest rates and quantitative easing (QE),[1] has squashed defensive assets’ return potential. Consequently, investors are being compelled to go further along the risk curve in the search for decent sized returns.

The prices of ‘risk-free’ or near risk-free assets like government bonds, (and even investment grade corporate bonds), have become so steep that, all else being equal, the relative attractiveness of more risky assets (like shares) have improved. ‘Equity Risk Premium (ERP)’ is the term for describing the attractiveness of shares versus other assets.

Right now, the ERP is about as attractive as it has been over most of the past 12 years, a remarkable situation given the decade-long post GFC bull market. But having shares as the only game in town isn’t a good thing.

Shares are a valuable part of a diversified portfolio, but can’t be the only asset class in a portfolio, especially as share prices relative to their earnings, across many share markets, are steep by historic measures. So, with the usual suspects like bonds less able to fulfil their traditional defensive and diversifying roles, how can investors get some protection into their portfolios?

Reimagining diversification

Despite diversification being compromised, responsible investors can’t give up on it. Rather, it needs to be pursued in different ways. Currently our portfolios, while well-diversified across lots of different assets, the risk exposure looks like barbells. Risk is concentrated at either end of the spectrum — cash-like assets at one end and developed market shares at the other end.

One of the things we’ve been doing has been to selectively take profits on strongly performing stocks in Australian and global shares. We seek defensiveness in stocks not through style bias but rather by giving portfolio managers the freedom to control risk in the best way they see fit.

One example being our proprietary defensive Australian shares strategy where the Australian shares portfolio manager uses put and call options to manage portfolio risk. By trading away some of the upside in exchange for downside protection on stocks or sectors that may be at risk, we end up with a more predictable return path. This type of defence makes sense in an environment of uncertainty.

We’re also using currency defensively. Historically the Australian dollar (AUD) and global shares have been positively correlated, providing the opportunity for investors to play defence by holding offshore assets in less risky currencies like the US dollar or Japanese yen. The defensiveness works through the

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[1] QE, as it’s generally referred to, is form of unconventional monetary policy in which a central bank, such as the US Federal Reserve, Bank of Japan, European Central Bank, buys assets such as government bonds from the open market to inject money into the economy.

offshore currency outperforming the AUD, so if share markets fall, the value of the foreign shares falls less in AUD terms.

Given the limited government bond return outlook, we continue to search for other assets that might protect investors in a scenario where the economic growth outlook remains downbeat and where interest rates may possibly go even lower. We think gold may have a role to play in such a situation, especially as central banks appear determined to supress interest rates, keeping them below the rate of inflation.

It seems counterintuitive, but ‘volatility’ can also play a defensive and diversifying role because volatility rises when share markets fall sharply. We had exposure to volatility, through derivatives strategies, in our portfolios during the March quarter sell-off and it was helpful in offsetting some of the losses from share exposures at the time. Derivatives strategies that invest in volatility can deliver investors the protection trade-off required in today’s complicated investment climate.

Return potential and portfolio positioning

Due to a strong rally in risk assets after the sharp sell-off in the late March/early June quarters, the return potential from shares has decreased. The share market rebound has been driven entirely by price rises as the earnings growth outlook for the vast majority of companies remains both subdued and uncertain.

Share markets appear to have adopted a glass half full perspective as valuations imply a return to company earnings growth in the coming year. This optimism is debatable and thanks to our *Investment Futures Framework*[2] we aren’t hostage to successfully guessing whether earnings will indeed rebound next year or not. Instead, we develop 40+ investment scenarios that force us to be intensively aware of risks in each situation.

The return potential from government bonds continues to remain deeply unattractive, and while investment grade corporate bonds’ return potential is low when considered in isolation, they provide a better option for accessing interest rate risk than government bonds. At the same time, the return potential and diversification benefit of foreign currency exposure has increased as the AUD appreciated from below fair value to near fair value during the quarter.

Changes in return potential across shares, interest rates, credit and foreign currency have prompted some adjustments to our multi-asset portfolios.

During the June quarter, positioning across MLC Horizon 2 to 7 portfolios was adjusted to increase foreign currency exposure. The AUD and global share markets tend to move in the same direction, after a rally in the AUD across the June quarter the appeal of foreign currency has improved to near where it was at the beginning of 2020. This decision to increase foreign currency reverses a move back to benchmark (from overweight) in the March quarter, and locks in profit from the appreciation in the AUD.

Aside from the above profit-taking move in foreign currency, key recent portfolio activity and positioning has been directed at the MLC Inflation Plus portfolios. MLC Horizon portfolios inherit these exposures through investments in Inflation Plus, and MLC Index Plus portfolios through the real return strategy which is managed similarly to Inflation Plus. The changes to the MLC Inflation Plus portfolios include:

- An initial allocation to all-maturity global investment grade credit. This new exposure sits alongside an exposure to short-maturity global investment grade credit and Australian credit. Additionally, our Horizon and Index Plus portfolios’ existing exposures to all-maturity global investment grade credit were increased.

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[2] *Investment Futures Framework* is the architecture for MLC’s investment approach. The Framework recognises a vast number of possibilities, including remote possibilities like global pandemics. It imagines what *can* happen, rather than narrow casting by trying to guess what *will* happen.

- Locked in some profits by rebalancing from well-performing shares exposures.
- Increased the exposure to China’s share market.

The COVID-19 pandemic is a once in 100 year shock to the economy, the effect of which will persist for some time to come. Reactions of governments and central banks will continue to evolve to try and accommodate these impacts. Investing in this level of uncertainty is difficult and requires flexibility and an acceptance that the future is unknowable. Investors still need to take risk to generate return for their portfolios, but in this volatile environment we think there is a benefit in utilising a range of defensive strategies. At MLC, our multi-asset portfolios are diversified across assets, currencies, and styles but also across defensive techniques to increase the chances of improving portfolio outcomes. We’ve also maintained a high level of liquidity to protect our portfolios from adverse outcomes, preferring to stay nimble and adjust to changing conditions.

More information on each portfolio’s positioning is available in the fund commentaries available on the Fund Profile Tool on https://www.mlc.com.au/fundprofiletool.