Autumn 2021 Edition

Godfrey Pembroke Outlook

How might investors behave post COVID-19, and what new trends will influence changes in the investment and wealth management industries?

Investing and economies post COVID-19

It may seem a little presumptuous to be speaking of a post COVID-19 world while the pandemic continues to weigh so heavily across the world. More than 2 million people have died, and more than 100 million people have been diagnosed with the virus.[1] Tragically, those numbers may keep rising until mass inoculation occurs, but finally, a turning point is in sight.

Three vaccines – from Pfizer-BioNTech, Moderna, and Oxford-AstraZeneca – are beginning to be rolled-out, and according to the World Health Organisation, there are more than 200 COVID-19 vaccines still in development.[2]

Cautious optimism is remerging and causing people to look forward.

The world tends to change in both predictable and unexpected ways after a crisis occurs. The investment and wealth management industries are not excluded from this.

For example, three years before the GFC, passive mutual funds (equivalent to Australia's retail managed funds) and Exchange Traded Funds (ETFs) accounted for just 14% of US assets under management. Fast-forward to 2020 and they accounted for 41% of US assets under management.[3]

Of course, the rise of passive investing, and especially ETFs, is not a US-only phenomenon. Australia has participated in this global trend with the local ETF industry's funds under management ballooning from around $1.5 billion in 2008 to $55 billion recently.[4]

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[1] Johns Hopkins University & Medicine. Coronavirus Resource Centre. https://coronavirus.jhu.edu/map.html

[2] www.abc.net.au/news/2021-01-24/covid19-the-other-vaccines-in-development/13069922

[3] *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?* by Kenechukwu Anadu, Mathias Kruttli, Patrick McCabe, and Emilio Osambela. www.federalreserve.gov/econres/feds/the-shift-from-active-to-passive-investing-potential-risks-to-financial-stability.htm

[4] *Rise of ETFs sends ripples across cosy industry* by David Bassanese. www.afr.com/companies/financial-services/rise-of-etfs-sends-ripples-across-cosy-industry-20190915-p52rjq

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Many reasons drove this trend, including the perception of passive investing being less risky than active management, the mindset that cheaper is always better, and the uneven track records of many active managers relative to their benchmarks. The tipping point was created by the crisis.

This global pandemic, a phenomenon radically different from all previous due to the interconnectedness of today's global society, will produce its own tipping points. How might investors behave post COVID-19, and what new trends will influence changes in the investment and wealth management industries?

Tipping the future is always fraught with the risk of ending up with egg on your face, but what follows are our thoughts on how the post-COVID period may progress.

Comeback of active management

For starters, active management might make a comeback. It has never gone away as many investors recognise that it isn't a case of active versus passive, so much as active and passive, together, as part of well diversified portfolios. A combination of active and passive may achieve more for total portfolio outcomes than either in isolation.

For the past decade, investors have enjoyed the benefits of low volatility, ultra-low interest rates, and central banks, led by the US Federal Reserve, willing to sooth investment market at the first sign of trouble. All-in-all, it resulted in a period of strong equity and fixed income markets gains, even after accounting for March 2020's 'COVID crash.'

Now, in the aftermath one of the most volatile periods, equity and fixed income markets have seen – with potentially more to come – an environment has emerged where the case for active management is high, again.

With the prospect of a greater dispersion between winners and losers in share markets (and other asset classes), risk management becomes more essential than ever. Successfully navigating this complicated environment is likely to shine a spotlight on the benefits of active management once again.

More attention on Environmental, Social and Governance (ESG)

Since the 2006 launch of the United Nations Principles for Responsible Investment (UNPRI) and associated integration of environmental, social and governance factors in investment management, ESG has largely been cast as an institutional investor issue.

However, it may be necessary to reassess other investors' motivations as we emerge from COVID-19. The pandemic has impacted nearly everyone's life. Social commentators have noted that during this period, people have been taking stock on what is truly important to them and what brings the most meaning to their lives.

This may change how more people think about their investments. It could lead to increased emphasis on ESG factors driven by a desire to invest in and support the companies that stepped up to help their communities during the pandemic and stand for qualities more aligned with investors' personal values.

We may begin to see the blurring of the lines between personal values and financial goals accelerate, which will require a greater focus on asset and wealth managers matching investor motivations with investment intent.

Andrew Droste, of executive search consultants Russell Reynolds Associates, said: "COVID-19 has exacerbated inequities and underscored the importance of companies expanding the strategy and risk management processes to include key stakeholders beyond shareholders.

"Long- (and short-) term value and profits to shareholders are diminished and cannot thrive over the long term if there is an erosion that occurs among employees, customers, supply chains, governments, or society at large."

Widening the scope of investments

With a greater ability to take risk, high net worth investors may be well-placed to take advantage of distressed and high-growth opportunities. This may take the form of both liquid and less-liquid products, including private-equity.

Private equity funds that raised capital on the heels of the GFC — to acquire controlling equity positions in already established privately-held businesses — outperformed listed share markets and also suffered fewer defaults.[6]

Because private equity investors are active managers, they can intervene in the operations of their portfolio companies in times of crisis, rather than be passive stakeholders. This capacity was important during the COVID-19 crisis and with what follows.

Furthermore, managers of private equity investments during economic turbulence are often more able to negotiate favourable terms. Finally, private equity allows for flexibility with regards to type and timing of company exits – which is not a feature of public share markets.

At the same time, governments will be faced with getting people back to work, which may lead to large infrastructure spending potentially creating opportunity in both infrastructure debt and equity markets.

[5] *Three key investment trends for a post COVID world* by Manesh Narayan. www.refinitiv.com/perspectives/future-of-investing-trading/3-key-investment-trends-for-a-post-covid-world

[6] *Prequin Quarterly Update: Private Equity & Venture Capital Q2 2020*. Insight on the quarter from the leading provider of alternative assets data.

An even more thorough search for income

With official interest rates in advanced economies sitting near zero, it has become increasingly difficult for investors to find reliable income sources. Achieving investment income at levels comparable to the pre-GFC era is likely to lead to interest in more resilient real estate sectors, and possibly a greater reliance on corporate bonds.

Furthermore, Australian investors who have traditionally focused on domestic banks for their high dividend yields and franking credits may find attractive income providers in the far wider opportunity set available in global equity markets. That said, there's no getting away from the reality that seeking income in a near zero-interest rate world may require investors to develop a higher risk tolerance.

Importance of new sources of diversification

Owing to bond yields being so low (prices high), their traditional role as diversifiers in portfolios is under challenge. This may prompt more interest in alternative assets as another source of diversification as they provide returns that are not strongly linked with the performance of mainstream assets.

Alternative exposures include 'low correlation strategies' that aim to deliver returns mostly independent of share market performance. Likewise, there are multi-asset 'real return strategies' that don't have common restrictions such as asset class limits, enabling managers to build strategies that are well diversified and can cope with a range of risks.

Insurance-related investments are also gaining more attention as their returns are primarily derived from accepting insurance risk. Returns from these investments are, by their very nature, largely uncorrelated with share markets, hence they provide substantial diversification benefits to portfolios.

President Biden may super-charge the US economy...

All this brings us to the current situation in investment markets and economies.

There are expectations that the new US administration of President Joe Biden will deliver a massive 'pick-me-up' for the American and global economies through big spending programs.

Just before taking office, Mr Biden detailed a US$1.9 trillion coronavirus rescue package titled the *American Rescue Plan* with proposals[7] including:

- Direct payments of US$1,400 to most Americans, bringing the total relief to US$2,000, including December's US$600 payments
- US$50 billion toward COVID-19 testing
- US$350 billion to state and local governments to keep their frontline workers employed, distribute the vaccine, increase testing, reopen schools and maintain vital services
- Increasing the federal minimum wage to US$15 per hour

Stage two of President Biden's economic program will tackle his longer-term agenda.

During the presidential campaign, Mr Biden proposed more than US$5 trillion over 10 years in new spending, with much of it front-loaded into the first few years. The proposals covered infrastructure and climate policies, domestic manufacturing, research and development, health care benefits, education, and childcare, among other things.[8]

At this stage, it isn't clear which of these policies will take priority, but infrastructure and climate-oriented policies appear to be high on the list.

Turning policy into legislation requires winning the support of both houses of the US Congress where President Biden's Democratic Party holds razor-thin majorities. Party discipline is not a feature of the Democrats and compromising with independent-minded members, especially in the senate, may be required to pass big-ticket items.

Still, it's very difficult to imagine America going down the austerity road and so, on balance, there's a good chance that the US will be spending big over the next few years. At the same time, the US Federal Reserve (the Fed) has revised its monetary policy to say it will tolerate inflation going above its 2% goal (a level not breached since the GFC).[9]

This marks a shift from previous cycles when the Fed tightened interest rates before inflation threatened to break out. All this represents a sea change with policymakers clearly signalling that they intend to run the economy at a high pace with the aim of returning to pre-COVID-19 unemployment levels.

[7] *Biden's $1.9 trillion Covid relief plan calls for stimulus checks, unemployment support and more* by Thomas Franck. www.cnbc.com/2021/01/14/biden-stimulus-package-details-checks-unemployment-minimum-wage.html

[8] *Q&A on the policy outlook under Democratic control.* Goldman Sachs Economics Research, 11 January 2021

[9] *Guide to changes in the 2020 Statement on Longer-Run Goals and Monetary Policy Strategy.* www.federalreserve.gov/monetarypolicy/guide-to-changes-in-statement-on-longer-run-goals-monetary-policy-strategy.htm

...and inflation

While the inflation threat has been conspicuously absent since the GFC — in fact, undershoots of inflation targets have been a greater problem for central banks — there are reasons to believe this time could be different as central banks seem committed to letting inflation run faster than usual before tapping the brakes of higher interest rates.

There are also other trends that could contribute to higher inflation.

Thanks to COVID-19, governments are under pressure to produce more 'essential items' such as pharmaceuticals and related products, at 'home' rather than relying on overseas supply.

Reducing dependency on overseas supply for genuinely essential items by switching to more domestic production is understandable, but there is also a risk of over-shooting if more and more industries are pressured to 'come home.'

It is possible that the list of what's judged to be 'essential' just keeps growing and growing.

Lower prices are one of the great benefits of global production for many things taken for granted ranging from clothing to white goods to cars, phones, TVs, furniture and much more.

Higher prices are an obvious risk if countries reverse course from global production because producing items for smaller domestic markets is more expensive.

There is a risk that investors have become so used to very low inflation that they struggle to envisage the possibility of higher inflation. Successful investing looks out for dangers ahead to avoid them, and this generation of investors and their advisors need to be thinking about inflation now, rather than when it's on top of them.

Successful investing derives from avoiding dogmatism and only preparing for one possibility. Markets are dynamic and good investment approaches responds to ever-changing risk and return potential.

So, while inflation is a risk to be alert to, there is also the possibility that the disinflationary environment may stretch a little further.

One of the consequences of crises is that they bring forward changes than can take many years to otherwise eventuate.

The 51st annual meeting of the World Economic Forum convened in January 2021 with the theme being "The Great Reset." There is no reason to think that the wealth industry will be exempt from the need for innovation and new thinking.

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