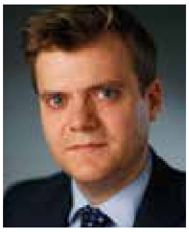
Multi-Asset Portfolio Solutions

Q4 2015 Letter

by Larry Hatheway, Group Head of Multi-Asset Portfolio Solutions and Group Economist, and Julian Howard, Investment Director

January 2016

Larry Hatheway



Julian Howard

2015 Overview

2015 confounded consensus expectations for market performance. At the start of the year, the influential Bank of America Merrill Lynch fund manager survey noted that global investors were reducing their cash holdings and adding exposure to US equities and bonds. Two thirds of those surveyed believed that equities would outperform other major asset classes. Many were overweight European equities while allocations to oil and emerging markets remained cautious. As we now know, global equities as measured by the MSCI AC World index were down on the year - investor optimism proved largely misplaced.

Regionally, the US call worked in absolute terms but predictions of a US profit rebound were not validated. Hopes for European equities were fulfilled, but not enough emphasis was placed on Japan, whose equity market turned out to be the strongest of the three regions. Investors' avoidance of energy and emerging market equities proved wiser.

Consensus expectations regarding the world economy were also confounded. China slowed more than expected and global growth probably dipped below 3.0% for 2015, flirting with common definitions of a 'growth recession'. In the US, growth was predicted to be 2.5%, much lower than the average 3.3% rate recorded from 1950 to 2014. Collapsing energy and commodity prices also pushed rates of inflation well below consensus estimates. Finally, investors predicted a first US rate hike in the third quarter of 2015, but weaker data, low inflation and market turmoil postponed the Fed's move until December.

Equities

After a strong start, global equities slumped in the third quarter of 2015, prompted by weaker growth, collapsing commodity prices and China's mini currency devaluation. Hardest hit were emerging markets and commodities. In the US, corporate profits came under pressure from a stronger dollar, falling commodity prices, reduced investment in the energy sector and some upward pressure on labour costs. Higher real wages and cheaper oil should have translated into more spending, but the US savings rate remained high and consumption ex autos was muted.

European equities enjoyed stronger gains, given an improved earnings outlook and the benefits of a weaker euro. Expectations for ECB easing and signs of improved credit growth were also supportive factors. The UK market was unable to escape the commodity downdraft, although mid-caps fared better. Japan did well on the back of earnings optimism as well as renewed emphasis on governance and shareholders' rights.

The overall picture for global equities remains mixed. Elevated valuations, stuttering profits growth and narrow market leadership are worrisome signs for US equities. Earnings potential is greater in Europe and Japan. Despite compelling valuations, fundamentals in most emerging and commodity markets remain challenging. Hence, a repetition of the strong returns posted since 2009 seems unlikely for global equities. But regional and sector dispersion offers opportunities, while themes such as quality and secular growth should also be differentiators in 2016.

Fixed Income and Credit

Bonds, as measured by the Barclays Global Aggregate Index hedged to USD, posted marginally positive returns in 2015. But dispersion of performance was significant. US high yield fared significantly worse, dragged down by the energy sector and liquidity concerns. Emerging market bonds were a further source of concern. According to the Bank for International Settlements (BIS), emerging market non-financial private sector borrowing has jumped from 60% of GDP in 1997 to 120% at the end of 2014. With an era of "abundant bond financing" (BIS) coming to an end and given the prospect of further Fed 'normalisation' a reassessment of emerging market risk has commenced.

Currencies

A defining feature of 2015 was dollar strength. Following gains of nearly 10% in trade-weighted terms, the question is how much further can the dollar appreciate? Many observers have noted that the dollar tends to weaken during Fed tightening cycles. Yet history may not be a reliable guide, given highly expansionary monetary policies underway in Europe and Japan, as well as latent weakness in emerging currencies. Widening yield gaps between the US and Europe or Japan may also support the dollar. Much depends, of course, on the resilience of the US economy to the tandem of global economic weakness and dollar strength. Any faltering of expectations for Fed normalisation could undermine the dollar.

GAM

Portfolio positioning*

Given the elevated uncertainty in the fourth quarter of 2015, we opted to reduce equity allocations in multi-asset portfolios from broadly neutral to outright cautious. Regionally, we preferred Europe and Japan versus the US and UK but especially versus emerging markets.

Our managers lagged the global equity index during 2015, but the fourth quarter saw better performance. Relative returns from US and UK managers were challenging as value remained out of favour and commodities continued to sell off. However, European, emerging market and selected global equity managers fared better.

In fixed income and credit, results were mixed. Total return funds lagged even the modest gains posted by the aforementioned global aggregate bond index. As a result, we are reviewing their long-term efficacy. Insurance-linked and mortgage-backed exposures remain an integral part of the allocation. Select junior-rated financial bonds also stood out positively but we will be reviewing the exposure in light of a potentially smaller opportunity set in 2016. Credit long/short funds had a subdued year but we believe higher market dispersion bodes well for future performance. We recently added two new funds focusing on vanilla bonds and US high yield. In the former, we believe value can be added by actively allocating across maturity, region and bond type. The latter aims to extract higher yields, while emphasising better quality and liquidity than that offered by the wider market.

Alternatives – encompassing macro trading and equity long/short – were the top performing asset class during the year. In retrospect, a larger allocation would have been beneficial but it should be borne in mind that the universe of managers is limited and risk diversification remains a priority. Finally, our tactical allocations played a key role in protecting wider portfolios in the final quarter and we will be placing particular emphasis on asset allocation flexibility and prudent risk management in this area.

Conclusion

Uncertainty and volatility will probably define 2016. Expected returns in both stocks and bonds are likely to be subdued compared to the performance achieved from 2009-2015. For equities, valuations and earnings growth are less attractive in the US, with modest potential in Europe and Japan. Fundamentals remain challenging in emerging and commodity markets, particularly given the probability of further deceleration of China's growth. A tighter labour market accompanied by trend-like growth will prompt the Fed to proceed with policy normalisation, putting modest upward pressure on long-term US interest rates. Corporate credit spreads have limited scope to narrow and some deterioration of credit quality is likely.

As a result of lower expected returns, capital preservation will become paramount. Approaches emphasising total returns delivered by carefully constructed portfolios of non-directional, risk-adjusted exposures should attract more investor interest. In addition, flexible asset allocation, adapting to rapidly changing market conditions, will be vital. For professional managers seeking to protect and grow their clients' assets, the real work is just beginning.

* Where relevant, since not all our clients are invested in the same strategies. Nonetheless, common themes run across our allocations, an overall flavour of our positioning remains informative.

For more information, please visit www.gam.com

JN6762 January 2016