Standard Life Investments

GARS – a review of the last year

August 2016

Market environment

The last 12 months have been challenging for risk assets, given renewed fears of a Chinese hard landing, plunging commodity prices and central banks driving bond yields into negative territory. During this time, markets have oscillated between extreme pessimism about global growth prospects and new highs for some risk assets. Concerns over the possibility of recession influenced the US Federal Reserve's decision to signal a more gradual path of interest rate hikes.

Our view was that a significant proportion of the weakness in economic activity was due to factors that were likely to fade in importance as the year progressed – the drag on investment from lower energy prices, for instance, and the delayed consumption response to improving real incomes. The scare in the US May non-farm payrolls report notwithstanding, our sanguine view has mostly played out, but has yet to be reflected in central bank action.

For some years, we have considered the actions of central banks as key to asset pricing, and this premise underpinned our limited equity holdings. In the last year, the impact of central bank action has become more apparent, with the QE programmes of Japan and Europe being largely responsible for driving global bond yields into negative territory. Astonishingly, over 36% of global government bonds now have a negative yield – something we would have thought unlikely a year ago. Clearly, this is a new world for investors and policymakers alike. The efficacy of monetary policy looks to be waning, as risk assets fail to lure investors. Instead, it has further fuelled investors' hunt for income through bonds in countries such as the US, which have seen sharp reductions in yield, despite these already being far below previous long-term averages.

The most recent data support our assessment that the negative effects of the UK's vote to leave the EU will be mainly confined to the domestic economy. Despite this, the forces that produced the result are clearly affecting political stability across the developed world. Nevertheless, we currently expect US economic growth to improve in 2017, as the inventory drawdown comes to an end and the earlier drag from collapsing energy investment fades. Emerging markets have their own problems, with a wide range of governance issues clearly evident.

12-month performance summary

Over the course of the past year, the Global Absolute Return Strategies Fund (GARS) invested in a total of 42 investment strategies. Of these, 11 delivered a positive return, 17 were essentially flat and 14 delivered a negative return. At the same time, the magnitude of the negative positions was greater than the positives, resulting in the portfolio's sizeable negative return overall, an outcome that falls short of previous years' performance.

Our analysis of the drivers behind GARS' performance showed that in periods where markets have responded to rational, long-term economic drivers, the portfolio did well. Unfortunately, there have been too many periods of pessimism where irrationality and short-termism have reigned.

Despite being down over the year, from a portfolio construction perspective, GARS has coped with these bouts of pessimism, showing low levels of volatility relative to risk assets. In other words, GARS behaved as we would expect in terms of risk, but returns were disappointing due to our long-term investment views being markedly different from the short-term factors that have frequently driven markets.

In terms of our long equity exposures, our focus was in markets supported by central bank stimulus, namely Europe and Japan. However, these markets delivered -14% and -22% respectively in the 12-month period, despite more encouraging long-term signs. Combined with our global miners investment (exited in H2 2015), this resulted in a negative contribution to portfolio performance of circa 2%. We had, however, recognised that the environment for equities would be uncertain. Therefore, the overall allocation to this asset class was – and remains – at a historic low level of 12%, where it has been since the start of 2016.

Looking at credit, we gradually increased our exposures over the review period from a historic low level, taking advantage of the credit market sell-off in H2 2015. This provided a positive return to the portfolio of around 0.3%.

We hold a range of interest rate investments that seek to benefit from improving growth trends in some regions and deteriorating growth trends in others. Overall, these strategies made a negative contribution to the portfolio of around 0.5%. Over the year, global growth expectations deteriorated more than we expected. Consequently, the investment gains from our positions in Australian interest rates (+1.5%) were outweighed by losses from our three US interest rate positions (-1.1%) and our exposure to emerging market debt (Mexican and Brazilian government bonds -0.5%), with smaller negatives elsewhere.

Related to this deteriorating global growth trend was the expectation that interest rate hikes would be postponed, which is painful for many financial firms. Our relative value equity positions in European banks versus insurers, and US banks versus consumer staples therefore delivered negative returns. At an overall portfolio level, however, our relative value equity exposure contributions were flat, owing to strong performance from our US large-cap versus small-cap and US technology versus small-cap investments.

Worries over the pace of US rate increases materially hurt the trade-weighted dollar over the year, with our US dollar investments costing roughly 0.6%. Notably, though, our long Mexican peso versus Australian dollar exposure cost 0.7%, with small losses from other currency-related investments.

Finally, our stock selection strategy (the aggregate alpha of internal equity and credit mandates) was negative for the year. Within this, the equity portfolios were the source of the negative alpha, owing to our preference for smaller firms that were less able to benefit from currency weakness through export activities.

What reassurance can we give that GARS will get back on track?

Our investment process involves developing a 'central case' that reflects our view of the direction of the global economy and markets. However, in seeking a positive return, we wish to avoid depending entirely on our central case proving accurate over all periods. Therefore, we hold a range of investments that we believe are likely to perform well together in a variety of market scenarios.

Over shorter periods, financial markets may become somewhat detached from economic reality – in turn exhibiting wild optimism and extreme pessimism. As fundamental, long-term investors, we aim to look through short-term market noise and focus on opportunities that we believe are grounded in economic reality. As noted above, in recent months there has been considerable pessimism regarding the global economic outlook. Essentially, markets were forecasting a global recession, a view we do not share. Although we position GARS to perform well in many different market scenarios, it is unlikely to perform particularly well in one that is so different to our central case.

The diversification we build into GARS provided some degree of protection over the past year. However, when market behaviour is being driven by views markedly different from our own central case, it does not always prevent the portfolio from losing money.

We have experienced such periods in the past: 2008 for example and mid-2010-2011. Another useful historic comparison is 2009, when our central view transpired rapidly and GARS generated a return of 20%. As in the past, we stay true to our investment process and philosophy: keeping return-seeking risk on the table in as diverse a manner as possible. Accordingly, we are confident that we will revert to the positive return profile enjoyed in previous years.

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