GARS – Looking forward

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Standard Life Investments

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Introduction

In recent months, Global Absolute Return Strategies (GARS) returns have fallen short of the level we expect over the longer term. In this piece, we explain why we strongly believe that GARS' returns will improve, as they have following such episodes in the past. We discuss some of our current strategies and why we expect the flexibility inherent in our investment approach will be critically important in future.

For over 10 years, GARS has generated a steady return for clients, in-line with its objectives. Over time, we expect the performance of GARS (the red line in Chart 1) to oscillate around the blue target-return line. Sometimes it will be above target, at other times, below. We aim for these deviations to be as small as possible. Moreover, deviations have been small compared to those of other assets with similar return potential. Chart 1 shows that there have been three distinct periods when GARS' returns were below target: 2008/9, 2011 and over the last year. In addition, over its lifetime, GARS' long-term returns have exceeded the target of cash +5% over rolling three-year periods around 75% of the time.

Chart 1: GARS performance

Source: Standard Life Investments, GBP gross performance from 12/06/2006 to 31/08/2016. Fund performance is based on the UK institutional pooled pension fund, gross of fees. Target is defined as cash +5%.

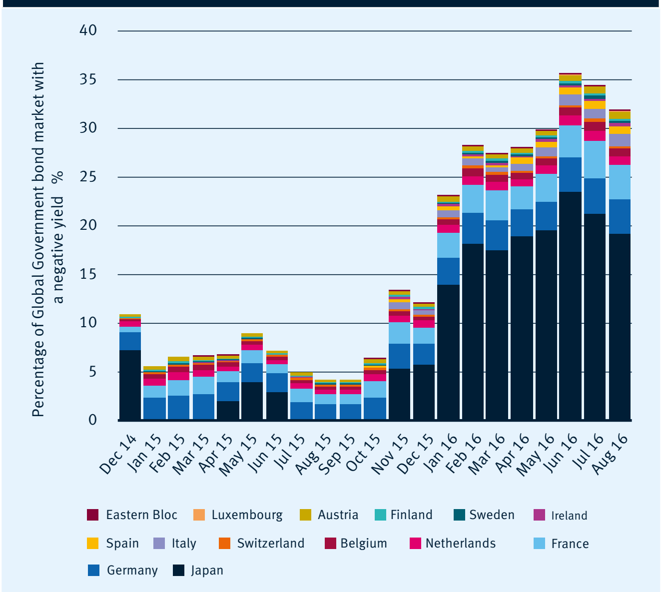
The current market environment

At the end of 2015, GARS' 3 and 5-year annualised returns were both around 6.0%[1] but in recent months these figures have deteriorated, to 3.9% and 5.6% respectively[2]. What has been happening in markets over this time?

During three distinct periods in the last year, markets have responded to a variety of factors, including central bank action and concerns over growth. This has led to exceptional demand for government bonds, driving yields on over a third of them into negative territory (see Chart 2). With investors relentlessly pursuing income-generating assets, yields globally have become compressed, distorting valuations almost beyond recognition.

The series of events that unfolded during the past 12 months differed greatly from our central view and in fact resembled a combination of the 'tail-risk' events for which we stress-test the portfolio. In that respect, GARS performed in-line with our expectations. This tells us that risk management and diversification remain sound, with negative returns deriving instead from an unusual and extreme set of market circumstances.

Chart 2: The growing world of negative-yield government bonds



Source: Standard Life Investments, Bloomberg, August 2016

There are other times in history when valuations have become similarly distorted. In the 'dot-com boom' of the late 1990s, new valuation measures were conjured up to justify the vastly inflated prices of technology companies. In the end, fundamentals reasserted themselves, as they generally do. However, we must take care to recognise when fundamentals themselves are changing. When this happens, we respond through our investment process and philosophy. This has led us to make subtle but material alterations to the GARS portfolio throughout its history, including in recent months. We are confident these changes will ensure GARS performs well in this uncertain environment.

We choose investments for GARS on the basis of their fundamental long-term (typically three year) return potential. So far in 2016, global investors have displayed significant short-termism, often focusing on single datapoints, creating wild swings in asset markets.

[1] UK institutional pooled pension fund, gross of fees to 31/12/2015 [2] UK institutional pooled pension fund, gross of fees to 31/08/2016

Recent economic releases have been largely in-line with our central expectation for the direction of the global economy. In our view, the main developed economies are transitioning to a new equilibrium, where long-term growth is lower than in past market cycles.

What has caused this drop in global growth? Over the past 30 years or so, economies such as the US and Western Europe have been boosted by a variety of tailwinds: efficiency gains from automation, the establishment of global supply chains, declining tax rates, falling inflation and interest rates, as well as burgeoning emerging market demand. Now, these drivers have either slowed significantly or ended completely. The outlook is further clouded by headwinds, such as high levels of public and private sector debt, as well as the economic and political uncertainty arising from shocks like the UK's vote to leave the EU.

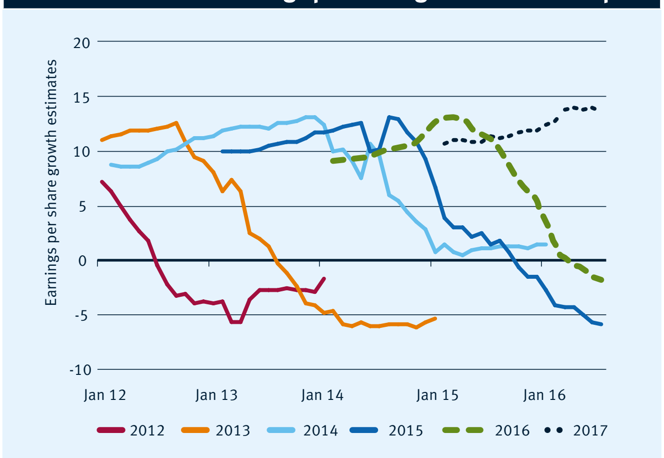
Reflecting these challenges, we recently downgraded our long-term return expectations for a range of developed market equities and sovereign bonds. We believe GARS' flexible investment mandate, long-term investment horizon and ability to provide robust diversification make it particularly well-placed in this climate.

Our investment views

We build our investment views with the longer term in mind, typically three years. Over that period, we expect global growth to remain positive but below longer-term historic averages, and with considerable scope for different behaviour across sectors.

The relatively muted growth outlook and fairly demanding valuations mean that our allocation to equity markets is low by historic standards. Our return expectations for many markets fail to justify a larger allocation, and we are concerned at the higher level of risk in emerging markets. Our favoured equity market is Europe, where valuations are less demanding and there is greater potential for corporate earnings to surprise positively. It is widely expected that European earnings may decline marginally this year, but the outlook for 2017 is considerably stronger and consensus estimates have been rising (see Chart 3). Our equity portfolio focuses on higher-yielding stocks that look particularly attractive in the global search for income.

Chart 3: Consensus earnings per share growth MSCI Europe



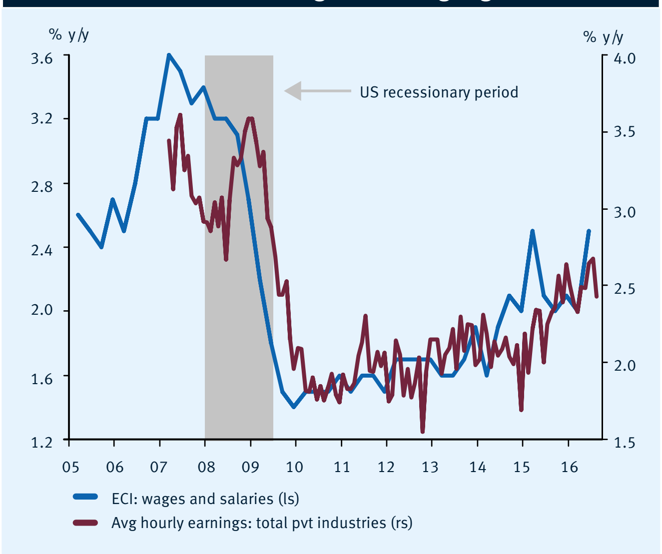
Source: Thomson Reuters, MSCI, IBES, Morgan Stanley

With income scarce, global Real Estate Investment Trusts (REITs) also look compelling and we recently added selected REITs according to our geographic preferences. For instance, our UK real estate exposure is low due to the impact of Brexit. We are also cautious on Hong Kong's overheating property market. Conversely, we are marginally overweight in the US where we focus on prime, high-quality real estate.

For credit markets, the current 'Goldilocks' outlook should be supportive i.e. growth is not so strong as to prompt large rate hikes or re-allocation away from high yield to equities due to higher potential upside. We currently hold US, UK and European investment grade bonds, as well as high yield credit, having added substantially to these positions in the past year when yields were particularly attractive.

Owning government bonds has been a rewarding strategy so far this year but, as mentioned earlier, valuations in many markets have moved beyond economic fundamentals and are unattractive on any longer-term view. Our positions reflect contrasting regional views. We believe the US economy is at or close to a self-sustaining growth path. Employment conditions are tightening and, although wage growth has been fairly modest, the trend is clearly upwards. In the medium term, this will cause US inflation expectations to rise from their currently depressed levels, heralding further interest rate rises (see Chart 4).

Chart 4: Measures of US wages trending higher



Source: Bureau of Labor Statistics, DB Global Markets Research

Meanwhile, the Australian economy is feeling the impact of a decline in demand for commodities such as iron ore, which has fuelled above trend rates of growth for some time. Interest rates have been cut to stimulate growth, and we believe may fall further. To benefit from our contrasting views of these two markets, we have implemented a relative interest rate position that will profit if the differential between US and Australian 10-year interest rates narrows.

We have also taken a position in UK interest rates relative to German rates. We expect the UK economy to weaken in the aftermath of the referendum result. The Bank of England has already taken action and this support will likely be maintained. On that basis, the difference between UK and German 10-year interest rates is set to keep narrowing.

The prevailing growth-constrained environment also presents investment opportunities in currency markets, as growing numbers of countries intervene in their exchange rates. As well as being useful sources of return, some of our currency positions have valuable risk-diversification characteristics, cushioning the portfolio in the event of further economic instability. To illustrate, our position preferring the US dollar over the Korean won generated a strong return in the third quarter of 2015, when some of our other investments (notably our long equity positions) were losing ground. The fact Korean growth is heavily geared towards economic activity in China meant the won weakened when the latter slowed during this period. Elsewhere, amid record-low yields, positions such as the Indian rupee versus Swiss franc earn us in excess of our target return from currency carry alone (on account of India's higher interest rates relative to Switzerland's), without the need for movement in the overall exchange rate.

Summary

GARS remains a compelling investment proposition. The combination of robust diversification and sound long-term investment ideas has generated consistent solid performance for long-term investors. Above all, this reflects a disciplined process and a well-resourced, highly experienced investment team.

All of these elements remain intact. We are confident that as long-term economic fundamentals reassert themselves, the portfolio will resume positive momentum, as it has after previous periods of below-target returns.

Important Information

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