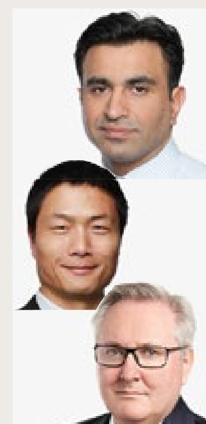
SPONSOR'S COMMENT



SWITCHING GEARS FOR AN UPHILL RIDE

Portfolios can be built to withstand a profoundly changed economic environment and return outlook without blowing through their risk constraints, write Jahangir Aka, head of official institutions, Ziling Jiang, head of EMEA institutional solutions, and Joe McDonnell, head of portfolio solutions EMEA, Neuberger Berman.

OMFIF's latest survey of global central banks revealed some predictable factors affecting reserves management in the current economic environment. Inflation, geopolitics and protectionism were the most prominent. Monetary policy tightening and the threat of economic slowdown were the other key concerns.

They are familiar to many investors. Inflation, exacerbated by disruption to supply chains worldwide caused by Covid-19, war, geopolitical tensions and protectionism, is being met with tightening financial conditions even as growth begins to slow. That is translating into low expected returns for both equities and bonds, even after this year's market corrections. It also suggests higher volatility in economic cycles and markets, and tighter correlations between equities and bonds. These factors are likely to make diversification more critical but more difficult.

Central bank foreign exchange reserves managers, sovereign funds and public pension funds have distinct mandates, but they all place importance on capital preservation, meeting long-term nominal or real target returns and liquidity.

These objectives look increasingly like an impossible trinity. Capital preservation is now unlikely to be achieved with core, developed market government bonds, where both volatility and yields are rising. Nominal return targets appear increasingly unattainable and real return targets appear even more ambitious, given the growth and inflation outlook. And if core government bonds are relied on for liquidity, that requirement now clashes with preserving capital and meeting return targets.

In our conversations with investors, we find many unsure about what to do, or unable to act because of investment policy constraints put in place when the outlook was more favourable.

MANAGING RISK, SUSTAINING RETURNS, HEDGING INFLATION

Official institutions will need to make three major decisions over the coming months. First, core government bonds need to be partially replaced with assets that can sustain low correlation with equities but continue to deliver positive total returns. For sovereign funds and public pension funds, liquid alternative investments such as hedge funds may have a role. For all investors, credit markets will become more important, and liquidity needs are often overestimated. Investors could start to think not only in terms of liquid assets, but in terms of liquidity generators – less liquid but higher-income assets such as mortgage-backed securities, high-yield bonds and private credit.

Second, investors need to assume more credit and liquidity risk in fixed income, as opposed to interest rate risk. In equity, at current valuations, taking more liquidity risk – as opposed to more non-domestic risk – is prudent: sovereign funds and pension funds could allocate more to private equity. After years of increasingly passive investment, active management will be necessary to sustain returns, following a decade of strong performance by beta, growth and momentum.

Third, portfolios need to be better hedged against inflation. Real estate will have a key role because it can combine the capital appreciation of a real asset with highly inflation-sensitive rental cash flows, but has also exhibited resilience during most recessions.

THREE HYPOTHETICAL PORTFOLIOS, RE-OPTIMISED

Can these moves respect the risk and credit-quality profiles of current portfolios? We believe they can.

We created three hypothetical portfolios, based on typical central bank, sovereign fund and pension fund investors among our clients. We calculated the duration and average credit rating for each portfolio and, using our latest capital market assumptions from March 2022, their expected return and volatility. We then used the same capital market assumptions, but a broader menu of asset classes, to create newly optimised allocations with the same volatility, portfolio duration and credit rating.

We also observed some practical constraints

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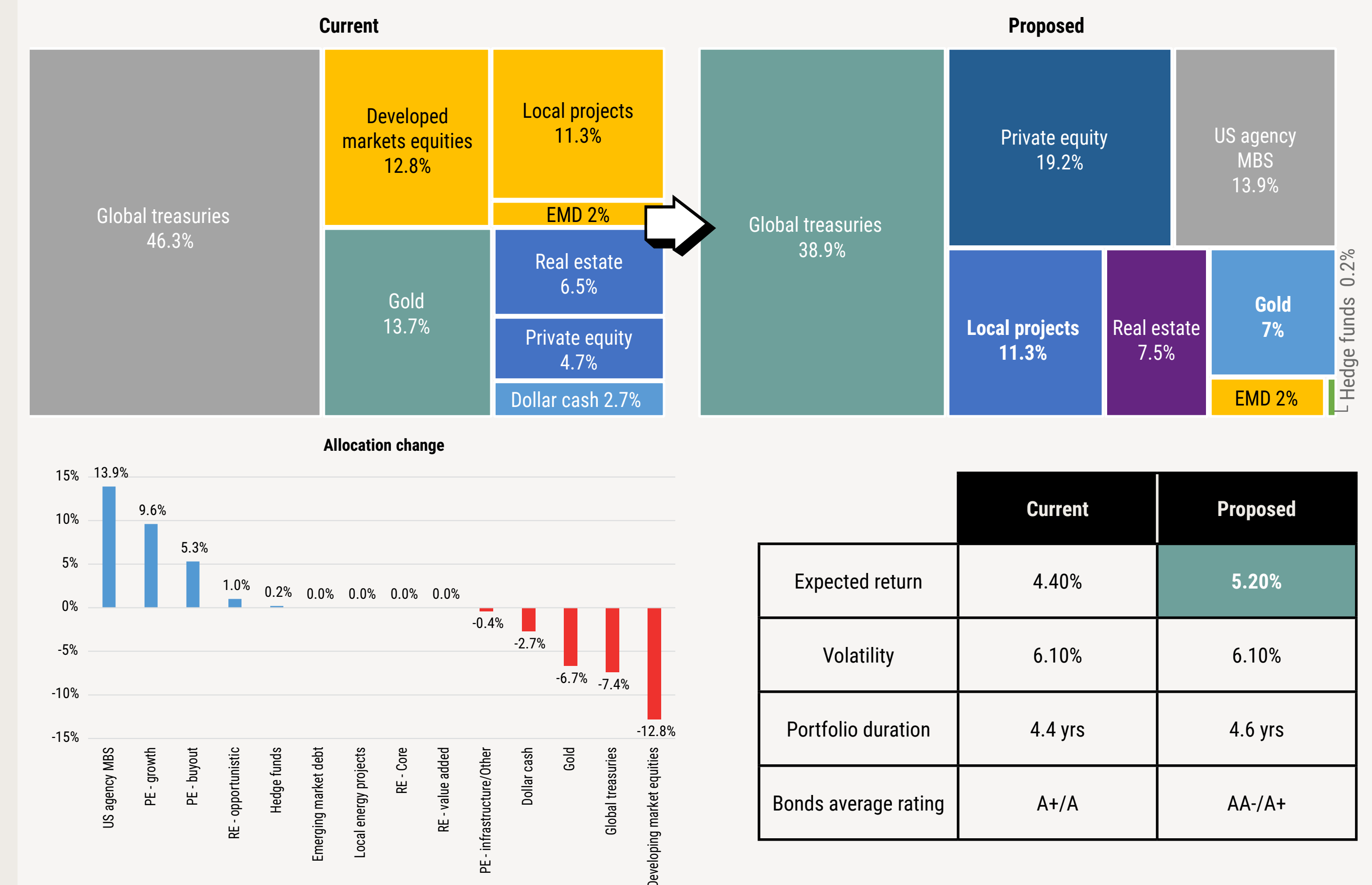

	Current	Proposed
Expected return	4.40%	5.20%
Volatility	6.10%	6.10%
Portfolio duration	4.4 yrs	4.6 yrs
Bonds average rating	A+/A	AA-/A+

1. SOVEREIGN FUNDS TAKING LIQUIDITY RISK FOR MORE GROWTH POTENTIAL

Source: Bloomberg, Neuberger Berman

appropriate to these institutions. Turnover relative to the original allocations was capped at 30%. For sovereign funds and pension funds, we capped growth-orientated private equity at 10%. For pension funds, we required at least 10% to be allocated to both domestic government and corporate bonds. And for central banks, we subjected all new asset classes to a 10% cap, required at least 10% in both dollar and non-dollar cash and capped the aggregate high quality liquid assets haircut to 20% of the value of portfolio assets.

It is important to note that, even with these constraints, these mechanical optimisations should be considered as 'way markers' for the direction of travel, rather than detailed recommendations.

For the central bank investor, the optimisation reduced cash and government bonds in favour of a substantial allocation to US agency MBS and small allocations to private equity and real estate. This preserved the portfolio's volatility at 2.2% and its duration at around four years, while lifting the portfolio's annualised expected return to 2.7% from 1.9%.

For our sovereign fund investor, there is much more scope to take liquidity risk (Figure 1). Cash, government bonds and gold were reduced, and MBS and real estate were introduced. Most notably, public-market equities were completely swapped out for private equity, joining an existing allocation to local projects. We would not advocate such a radical change, but we think the result points in the right direction – taking more liquidity risk and becoming more actively managed. Once again, 80 basis points of expected return were added with no change to the observed risk profile.

We see a similar move in the pension fund portfolio. Public-market equities were substantially cut to make room for more private equity. Exposure to domestic markets across asset classes was rejected in favour of more global exposure, especially in high-yield bonds. However, domestic treasuries and corporate bonds still account for 40% of the allocation, reflecting liability-matching requirements. Investors could instead manage duration with more capital-efficient, derivatives-based programmes. Hedge funds were boosted as a meaningful source of liquid diversification. For the pension fund, an additional 90bp of expected annualised return was generated with the same risk profile.

MORE RESILIENCE

The world has changed profoundly over the past six months. Putting aside the war in Ukraine, inflation in developed economies is at levels unseen for 40 years and interest rates are rapidly rising after more than a decade of loosening financial conditions. The world is facing the first genuine cyclical economic slowdown since the beginning of the century and a broad correction to stretched equity and bond valuations.

All types of official institution portfolios can be made more resilient against the emerging conditions with relatively modest re-allocations that do not consume more risk budget. We can never be sure that these new allocations will outperform the old ones, but we can be sure that they are more thoroughly diversified. This raises the probability of acceptable performance in a wider range of economic and market scenarios. •