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How asset allocators can navigate a new world order

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Investor portfolios are unprepared for the new world order that is emerging. The next 40 years will look radically different from the last 40 years for asset allocators. Investors face not only a radically new energy dynamic, but also must contend with an uncertain inflation outlook, and questions over global growth. This is a very challenging situation, and the reality is that portfolios are not structured for a rising inflation environment with a strong energy and commodities sector. Rather they are mostly structured for low inflation and ESG-friendly investments.

For the last four decades, investors could generally depend on bonds and equities to deliver a negative correlation. But since the Ukraine invasion, we have seen bonds and equities go south, while commodities soar higher. However, the inherent volatility of commodity prices, barring the traditional safe-haven qualities of gold, does not alone give a reassuring line of defensive positioning. Hence, we believe allocators must expand their diversification while using active management to take advantage of market dislocations. From looking beyond growth and value relativity to expanding alternatives exposure, I outline how asset allocators can apply this approach.

Quality is king in equities

The new world order makes the growth and value dynamic relatively less relevant. Against a backdrop of higher inflation, more uncertainty, and lower growth, quality is king. This means looking beyond the growth and value relative opportunity, and focusing on higher-quality, lower-volatility names which can be found in a range of sectors from healthcare and consumer staples.

For active managers, the volatility has provided fertile entry points, but we must remember this is an environment where growth is slowing and inflation is still building. Clearly, rising prices will also benefit the energy and materials sectors. Energy prices are also driving a relative value trade between the US and Europe. Asset allocators have been shunning Europe in favour of the US as Europe looks more vulnerable from a security and energy perspective.

There is no doubt that Europe is more exposed to the events in the Ukraine and remains reliant on Russian oil and gas. The inflation dynamic is also different. While the US is seeing broader level of inflation implying economic growth, Europe inflation indicators signal lower economic growth and higher input costs.

Take advantage of high-yield gloom

High-yield bonds have also endured negative market sentiment. This is an extraordinary situation; high yield is normally an attractive asset class in an inflationary environment but has been going down due to sophisticated investors using high yield bond ETFs to create hedging positions.

Long-term active managers such as our Partner Polen Capital Credit argue that while it is impossible to forecast when this current widening trend will reverse, this year's drawdown has created an attractive entry point to invest in the high yield bond market.

They believe the current sell-off is being driven by exogenous factors, rather than a change in underlying business fundamentals, which remain healthy and, in aggregate, stand at pre-Covid levels. Further, indicators of credit stress remain stable as the current default rate remains historically low, as do indicators of future defaults such as the distressed ratio.

Diversify through alternatives

Since the financial crisis, supportive monetary policy has allowed equities and bonds to drive returns – and bonds have protected their portfolios when equities suffered. Now we have both bonds and equities drifting downwards, and there is no risk-off asset shielding portfolios. This is a big challenge for asset allocators.

With bonds and equities failing to inject diversification into portfolios, we advocate for a greater allocation into alternatives, from real assets to illiquid and liquid uncorrelated strategies. Hedge funds have had their detractors but over the decades they have been shown to be able to shift dynamically into the right markets at the right times, as well as take advantage of bear markets by being short. This has been illustrated by the current crisis, the recent rise in inflation and corresponding commodity prices as well as the downward trend in bond prices. For example, the cost-effective liquid hedge replication strategy US listed ETF, iMGP DBI Managed Futures has delivered more than 10 per cent so far this year as of March 21, with long commodities and short duration being the largest contributors to gains.