BlackRock

The ‘great moderation’ is over: How do portfolios need to change?

How do portfolios need to adapt for the future – to avoid a repeat of last autumn’s gilts crisis, but also to be ready for an era of political, economic and market volatility?

The answer is: it depends. Some pension funds were, and still are, on track for their endgame, and so nothing has changed for them, but others have been accelerated towards it, having much work to do to take advantage of the new position they are in.

A third group of schemes – which was probably well hedged and underfunded – will not have benefitted from the recent rise in interest rates and gilt yields to the same extent as this last group has. Those schemes still rely on growth assets to reach their funding target. The question is, how can they generate returns amid high inflation, and with policy changes on pension investing creating further uncertainty?

Investing in a more volatile world

While schemes could opt for the easy route following last year’s shake-up of portfolios – simplify investment by reducing diversification – Sorca Kelly-Scholte, client chief investment officer at BlackRock, says they can also find scale by investing in multi-asset pooled funds.

However, investors will find that the world looks markedly different today than it did for a long time. “We've had a step change in markets, we're in a new regime going forward,” says Kelly-Scholte.

The so-called ‘great moderation’, characterised by low inflation and interest rates and low volatility that marked the years after the global financial crisis, is over, she says.

“We think now that's gone. It's a much more uncertain and volatile world in the new regime – and we see that persisting,” she says.

This is illustrated by 10-year gilt yields reaching new heights in July and August this year nearly a year after the Mini-Budget first sent yields skyrocketing, as contradictory data has many market participants changing their minds over the outlook for the UK economy.

This environment is less forgiving, with greater dispersion of returns. Although the split between the foundational 60/40 portfolio might have been tolerable in the past, “you can't get the 60/40 or 40/60 equities bonds decision wrong now – you'll get punished in returns”, says Kelly-Scholte.

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Private markets move centre stage for defined benefit (DB)

Pension funds will need to pull different levers, becoming more granular in the portfolio and re-thinking allocations to alternatives. “If your scheme relies on growth assets for the foreseeable future, these need to be well diversified,” Kelly-Scholte says.

Private markets now form part of growth portfolios – not so much for the illiquidity premium, but because they are a growing part of capital markets, and to be able to access big themes like climate change and artificial intelligence effectively, which requires careful deal sourcing and structuring.

DB schemes have seen their allocation increase considerably in recent years, particularly those with £1bn or more in assets. Last year, private equity made up 21.5% of the weighted average equity allocation (6.6% simple average) of DB schemes, up from just 6.1% in 2012, according to the latest Purple Book.1

Investment in often illiquid private markets is not just for immature schemes with a long time horizon. BlackRock has tested at what level of private market allocation schemes with a cash outflow of 8% per annum would feel a liquidity squeeze.

“We found the danger point was a 20% allocation to private markets,” says Kelly-Scholte, noting that the most cashflow negative schemes tend to be largely derisked with lower leverage, while those with more leverage – which could arguably lead to a squeeze on cash – tend to be less mature, and therefore also less likely to be cashflow negative.2

This suggests that the ceiling for private market allocations may be higher than is often assumed – and may be even higher if the private markets allocation tilts towards income-earning assets.

Investors with high liquidity needs, such as mature defined benefit pensions, should be aware of the risks when allocating to private markets.

"I think the real reason for a desire not to have illiquids isn't that they don't fit if you're having a long-term portfolio invested for run-off but because some schemes want to be able to transact in the pension risk transfer market,” she says. This means DB pension funds’ endgame choice now has a considerable and arguably greater impact on how they build multi-asset portfolios than it did some years or even months ago. If the endgame is run-off, there is potentially a role for private markets, especially income private markets.

Trustees need to take their own decisions

There is now a policy debate over whether DB assets should invest ‘productively’, even if the definitions of productive finance vary. Kelly-Scholte does not see this policy discussion influencing pension funds at a decision-making level so far, noting that several steps would need to be taken before that will be the case.

But she thinks that the debate about productive investment and the use of pension surpluses by the sponsoring company will go on for some time, noting that sponsors are not currently incentivised to take risk – they must secure benefits and cannot easily access any excess funds in the scheme, making it potentially more difficult to invest in the business.

A few voices are beginning to challenge the notion that the right answer for fully funded schemes is to go to a pension risk transfer, she says, but for many it is still the stated goal.

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Derisking is also driven by The Pensions Regulator's draft DB funding code, and Kelly-Scholte says she was encouraged by the latest version of it.

"The first iteration was quite sort of rules-based, but I think that this formulation of the DB code really does allow for that full flexibility and to make the case for how you've approached the problem, within guidance. That's a good thing, because we do want to discourage the herd. We want people to be able to think about this in their own way," she says.

Tectonic shifts will force investors to adapt

As big external forces shape the investment landscape, there are risks but also opportunities ahead. BlackRock identifies several mega trends that will impact capital markets, including climate change and resource scarcity, technological breakthroughs, rapid urbanisation, emerging global wealth, demographics and social change, and the change in consumption and expenditure that comes with these.

The opportunities in these can be found by getting granular within asset classes and harnessing some of these forces – for example, decarbonisation of the economy, which Kelly-Scholte says will be transformative for capital markets.

New technologies make the green transition possible. "We describe ourselves as techno-optimists," says Kelly-Scholte. "But we're also maybe policy realists, so we think policy will be a little bit slow to catch up and really drive those harder to abate sectors."

As global warming is pushing humanity to decarbonise, another shift is happening. Geopolitical fragmentation is leading to deglobalisation – for investors, this means investing in 'global' buckets is no longer the right approach.

"We might need to think more regionally again," argues Kelly-Scholte. For equities, this might mean more deliberate regional weightings, greater diversification through sector or style bias and considering introducing an allocation to high dividend yield equities or convertible bonds.

Fixed income still has a role to play, she says, but the magnitude and breadth of the changes being seen in markets, economies and politics mean trustees need to think more carefully about their fund's fixed income exposure. Government bonds cannot provide the safe haven they did historically amid interest rate volatility and uncertainty around inflation.

"That doesn't mean we don't think there's a role for duration in multi-asset portfolios," says Kelly-Scholte. "We think you just need to be more thoughtful about where exactly you take that duration."

Investors need to be dynamic – for now. However, it is important to acknowledge that what works best keeps evolving, she says. "We need to continue having that debate. It always is an important part of the response to a new regime."

Sources

1. Pension Protection Fund, The Purple Book, 1 December 2022

2. BlackRock Investment Institute, The core role of private markets in modern portfolios, March 2019

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