Embracing Alpha in a Low Return World

Standard Life Investments

December 2016

Introduction

Over the more than 100 years since the start of the last century, most risk assets have reliably outperformed inflation, providing investors with attractive excess real returns. The apparent dependability of many asset classes to deliver such long-term returns encouraged a sustained shift by investors towards passive investment with the belief that these market returns could be captured at low cost.

However, this underlying assumption needs to be challenged. Much of the growth in investment returns has been driven by rates of economic growth, sustained by consistent global productivity growth. However, in recent years the pace of productivity growth has been declining, with likely negative implications for economic growth and subsequently for investment returns.

In this paper, we will demonstrate that this backdrop has significant implications for investors and the levels of return they both seek and require. Specifically, we will suggest that lower return potential from many asset classes should prompt investors to question whether they are being sufficiently rewarded for the risk they are assuming.

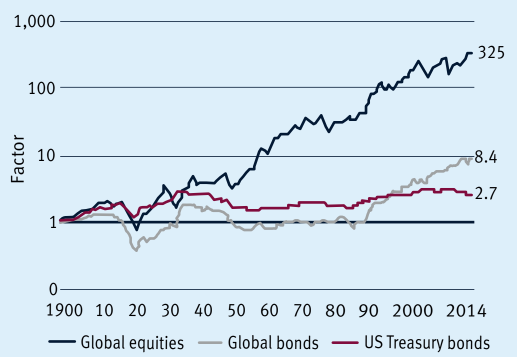
For example, if equity and bond markets deliver lower returns overall than historically has been the case, the value of an active approach comes sharply into focus, given that any additional returns generated above market levels are likely to form a larger component of an investor’s total return.

In this paper, we examine how and why these excess returns can be captured across different asset classes, and the benefit accruing to investors.

A historical perspective

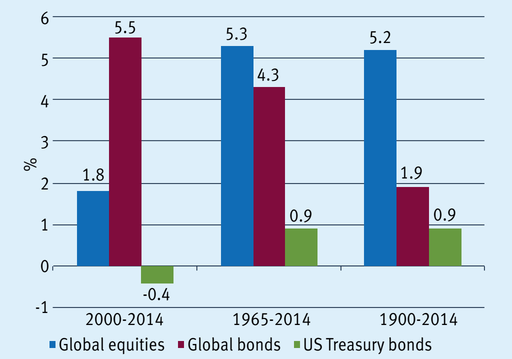
Since 1900, equities, bonds and many other asset classes have delivered attractive excess returns relative to inflation. Investors have been well-rewarded over the long run relative to the differing risks they have taken. The magnitude of this reward is starkly illustrated in Chart 1 below. Between 1900 and 2014, the real return from global equities (income reinvested) grew by a factor of 325. For global bonds, they grew by a factor of 8.4. On an annualised basis, the return from global equities over this period was 5.2% and for bonds 1.9% (see Chart 2).

Chart 1: Cumulative real returns



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2015

Chart 2: Annualised real returns



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2015

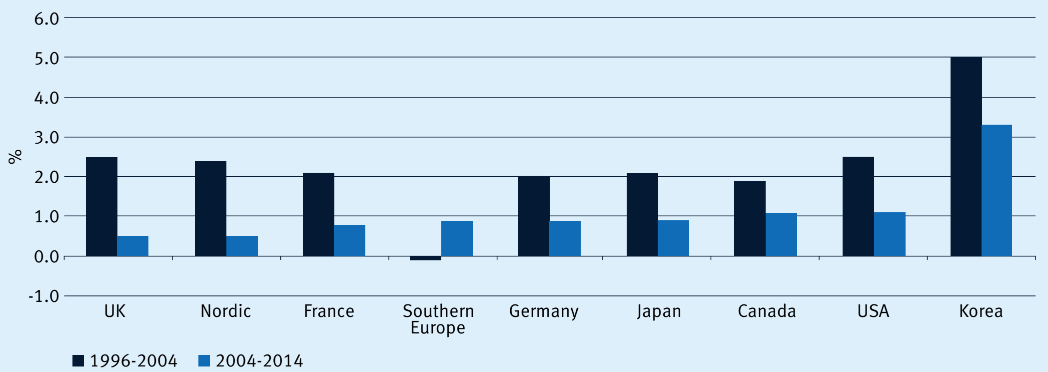
This is impressive performance indeed and, coupled with the belief that these levels of investment returns could be secured at low fee levels, has driven the sustained shift in investor allocations towards passive investment. However, what if the overall return potential of asset classes were likely to be materially lower than historic levels for the foreseeable future? Would investors still believe that they were being adequately rewarded relative to the levels of risk they were assuming?

The ‘productivity problem’

There is convincing evidence to suggest that investors should be prepared for lower returns than previously enjoyed across many asset classes, the primary reason being one of falling growth rates of global productivity. For the last 60 years, productivity – the amount the world produces for a given level of resource and capital – has increased by around 2% per annum. This is important to investors, as growth in productivity drives greater corporate profits and ultimately higher market levels.

Unfortunately, even before the 2008 financial crisis, productivity growth in developed markets had been slowing (see Chart 3). The economic contraction following the financial crisis perhaps masked this worrying trend; however, nine years after the US housing bubble began to deflate, Europe and Japan are still in a state of stagnation, US growth is mediocre and attention has now firmly returned to the world’s ‘productivity problem’. This has profound implications for investors seeking an adequate return from their investments.

Chart 3: GDP per hour worked, percentage change at annual rate



Source: OECD, Compendium of Productivity Indicators 2016

Stagnating productivity growth reduces the potential for long-term economic growth. Countries take far longer to escape from recession; raise employment levels; increase tax revenues; and succeed in repaying the costs of economic stimulus. They become trapped in a low interest rate, low inflation and, crucially, a low investment return environment.

Standard Life Investments' 10-year return projections across the main asset classes are detailed in Table 1 below.

Table 1: 10-year asset class return projections

Asset class	10-year return projection (p.a.)
Cash	
US	2.2%
UK	1.6%
Japan	0.3%
Europe Ex UK	1.0%
Government Bonds	
US	2.2%
UK	1.5%
Japan	0.5%
Europe Ex UK	1.8%
Corporate Bonds	
US	3.2%
UK	3.0%
Japan	1.8%
Europe Ex UK	3.2%
Equities	
US	5.6%
UK	5.2%
Japan	5.2%
Europe Ex UK	5.0%
Real Estate	
UK	5.0%
Europe Ex UK	5.0%

Source: Standard Life Investments, 30 June 2016

Active management – the rational response

If the passive holding of assets, such as equities or bonds, is likely to offer investors less reward in the future while remaining subject to historic levels of pricing volatility, it is rational to re-examine the merits of an active investment approach. If skill and stewardship of assets are able to produce the same levels of added value that they have proven to be able to do, active asset management will assume greater importance when any additional returns generated, in excess of market levels (the 'alpha'), represent a greater proportion of the total return received.

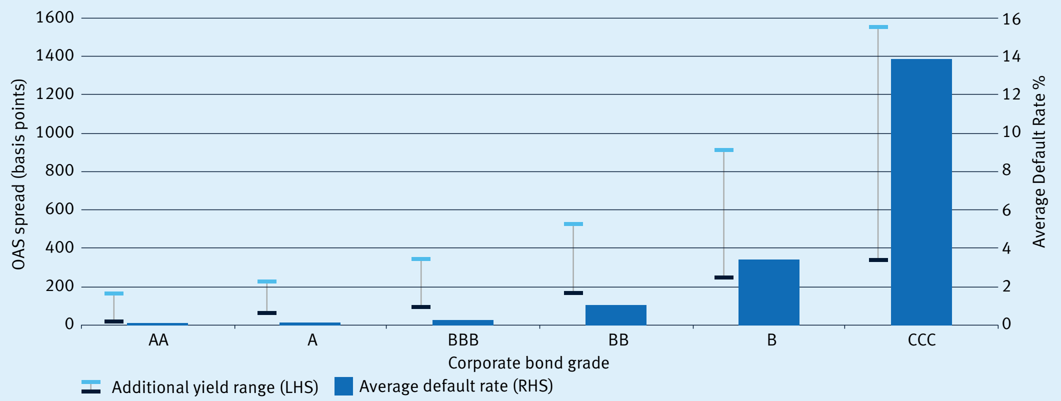
For example, today's low yields provide bond investors with minimal reward for the risk of default resulting from economic instability or corporate events. The tenacity of an active manager, able to identify corporate or government distress and so avoid downgrades and defaults, should be able to consistently contribute excess returns. These returns will compare favourably with the meagre benchmark returns currently offered to 'buy-and-maintain' investors.

Bonds

For active management, this proposition is supported by compelling evidence, specifically comparing the returns from active bond mangers within the investment grade universe to the yield of the relevant benchmark index. Since the global financial crisis in 2008, the ratio of annualised excess return of the median manager compared with the index yield has increased significantly from 0.11 prior to 2008, to 0.28 over the last five years (source: MercerInsight US Credit universe of managers).

Further evidence of the value of an active approach is illustrated in Chart 4 below, which shows the range of additional yield available on different grades of corporate bonds.

Chart 4: Corporate bonds - market structure



Source: Barclays, Moody's, July 2016

The extended lines cover the range of additional yield between the top 50 and bottom 50 bond issuers within each grade/category, as measured by the option-adjusted spread (OAS). Lower-quality bonds (moving towards the right of the X-axis) exhibit their higher risk through a greater tendency to default (see solid blue bars, measured by the right-hand scale). These bars capture the annual default rate for bonds within each ratings category.

Skilled, active investment managers can extract value by selecting bonds with the most compelling risk/reward characteristics. Evaluating whether markets have either overstated default risk or understated the potential for rating upgrades, provides an opportunity for the active manager to add value.

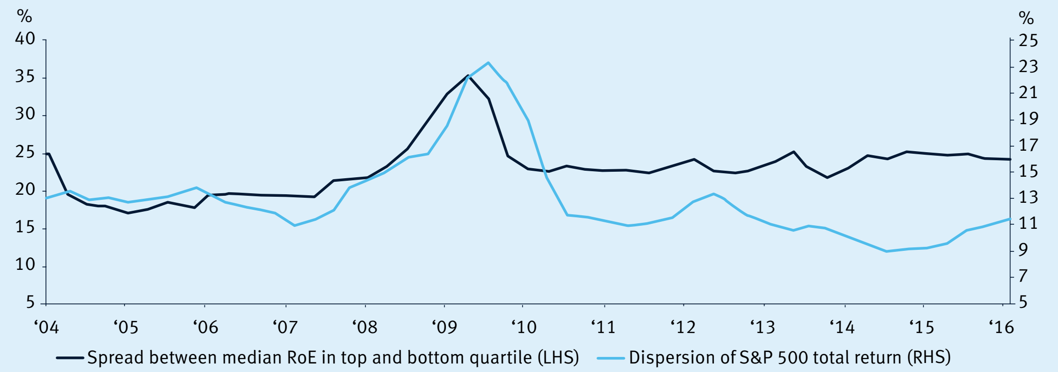
Additionally, bond default rates both rise and fall, as do yields, providing scope for the active manager to vary portfolio exposure across different categories and capture the highest reward per unit at different times.

Equities

A market backdrop where investment returns are likely to be lower for longer provides an equally attractive opportunity for active equity managers. The behaviour of individual stocks is likely to deviate to a greater degree from the overall market in an environment of low overall growth.

Chart 5 illustrates the post-financial crisis drop and modest, more recent pick up in the difference in returns for individual stocks (dispersion) in the S&P 500 Index from 2009 to March 2016. By contrast, Chart 5 also shows a marked improvement in the return on equity (RoE) of the best companies versus the worst over this period. The spread between the median RoE for the top and bottom quartiles of companies has actually widened by about 25%, when comparing pre and post-crisis levels.

Chart 5: S&P 500 dispersion of total return and return on equity (ex energy stocks)



Source: Deutsche Bank, Bloomberg Finance LP, 2016

Ultimately, the divergence between these underlying fundamentals and the relative lack of dispersion of individual stocks suggests that investors largely ignored differences in the quality of earnings. This reflects the rise of passive management in a loose monetary environment where the tide of quantitative easing (QE) money has 'lifted all boats'. As QE is gradually unwound by central banks, the fundamental merits and weaknesses of individual companies will matter more. It seems apparent to us that the recent increase in dispersion is the start of an ongoing trend that offers increasing reward for active managers able to uncover unrecognised fundamental stock-specific strengths.

Private markets

Within certain asset classes, active management has always been a necessity, primarily due to inaccessibility and continuing stewardship requirements. Collectively termed 'private markets' (as opposed to the public equity and fixed income markets already discussed), investments within real estate, private equity, infrastructure and private debt all offer increasingly attractive characteristics in a compressed return environment.

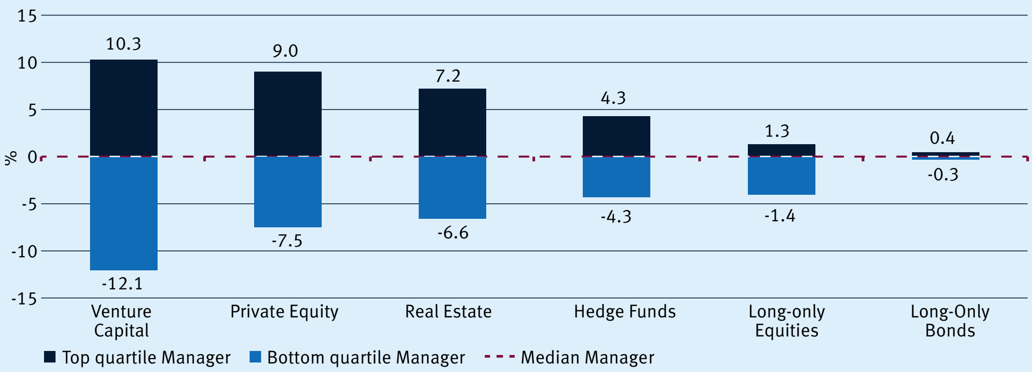
Compensating for their relative inaccessibility, infrequent valuations and trading, these asset classes generally offer an 'illiquidity premium'. This is often expressed via a higher income stream or higher long-term return potential than listed/public market assets with similar fundamental characteristics.

Accessing the illiquidity risk premium is particularly attractive in a low-growth environment and requires active management. Similar to traditional asset classes, in private markets the added value of active management is derived from both bottom-up asset selection as well as top-down allocation. In addition, the active manager is the steward of the physical asset (e.g. real estate or infrastructure projects) and can enhance its value independently from general market influences. This is a key attraction for investors seeking to select the 'right manager'.

The ability to actively manage and grow income streams from private market assets is an additional and key benefit in a low growth environment due to the higher level of operational control these types of investments allow. This presents a compelling opportunity for clients to capture alpha with the 'right manager', one who can demonstrate a consistent ability to select the right markets in addition to improving the physical and operational value of real assets and private market exposures.

Evidence of the value that active managers can bring to private markets investment is provided in Chart 6 below. This chart shows the range of return dispersion within the different types of liquid and illiquid strategies.

Chart 6: Average annual alpha relative to median manager 1996-2009 (%)



Source: Cambridge, Lipper, TASS, Mercer, NCREIF/Townsend, Alliance Bernstein, 2010

Recognising the value of an active approach

In a lower return environment, we have suggested that across the asset class spectrum, within both public and private markets, the rational investor will recognise the investment environment is increasingly turning in favour of active management. An active approach is ideally equipped to supplement the more meagre beta returns likely to be on offer to passive investors.

In addition, there is increasing evidence that investors are becoming more cognisant of the environmental, social and governance (ESG) factors within their portfolios and are looking to be increasingly 'responsible' asset owners. While this engagement can take many forms, again it is active management that is able to effectively fulfil this role. Unlike a passive manager, an active manager retains the option to invest or not.

Conclusion

In conclusion, in a world of lower growth and lower asset class returns, any investment alpha will become an increasingly larger part of overall returns and thus increasingly sought after. This implies that investors will increasingly rely on the skills and capability of their managers to capture investment alpha across both public and private markets. A global research platform, together with a robust and disciplined investment process, will be essential to enable asset managers to continue delivering meaningful and relevant outcomes for investors over the long term.

Important Information

This material is for informational purposes only. This should not be relied upon as a forecast, research or investment advice. It does not constitute an offer, or solicitation of an offer, to sell or buy any securities or an endorsement with respect to any investment vehicle. Any offer of securities may be made only by means of a formal confidential private offering memorandum. This material serves to provide general information and is not meant to be legal or tax advice for any particular investor, which can only be provided by qualified tax and legal counsel. Due to among other things, the volatile nature of the markets and the investment strategies discussed herein, they may only be suitable for certain investors. No investment strategy or risk management technique can guarantee return or eliminate risk in any market environment. Past performance is not a guide to the future.

Third party data services disclaimer

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by Standard Life**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner,

Standard Life** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data.

**Standard Life means the relevant member of the Standard Life group, being Standard Life plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

Visit us online

www.standardlifeinvestments.com

INVBGEN_16_1712_Investment_Insight_Lower_For_Longer_TCM 1116