Market and economic insights

BMO Sustainable Multi-Asset Income Fund

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Multi-Asset Solutions, EMEA

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Five factors to fear?

While many balanced investors are understandably worried about low returns becoming the 'new normal', BMO Global Asset Management believes that allocating smartly can more than offset the drag that structural challenges could exert on portfolios.

With extraordinary central bank intervention likely to keep government bond yields anchored at ultra-low levels, investors in traditional balanced portfolios are faced with the prospect of much lower returns. Indeed, for a typical asset mix comprising 60 per cent equities and 40 per cent aggregate bonds, average annual returns could, according to some estimates, drop to 3.5 per cent in the 2020s from around 10 per cent in the previous forty-five years. We are less pessimistic and see opportunities in markets that our Sustainable Multi-Asset Income Fund, with its dynamic asset allocation approach and rigorous stock selection, can exploit to help our clients meet their goals.

A shifting backdrop

While much has been debated about the impact on markets of the massive and unconventional monetary response to the 2008 Global Financial Crisis and, currently, the coronavirus pandemic, we see five structural factors influencing the outlook for assets. In a non-stationary world characterised by evolving challenges such as a changing climate and rapidly ageing populations, the past is unlikely to be a reliable guide to the future. So, what should long-term investors be monitoring?

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Key risks

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

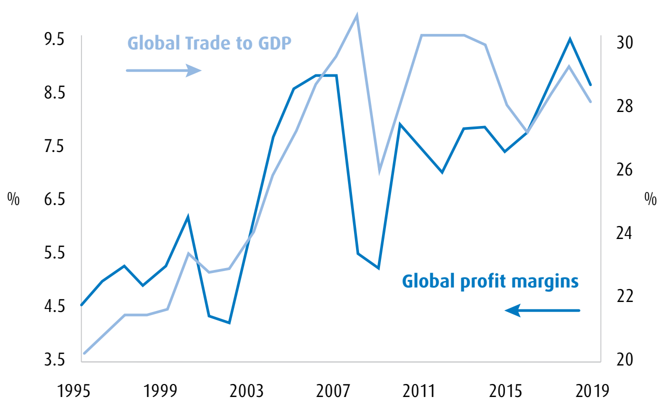
Screening out sectors or companies may result in less diversification and hence more volatility in investment values.

1 A retreat from globalisation

In the early years of the decade, the rise of technology, the lowering of national borders and the emergence of vast multi-national corporations led to expectations that the world's newly interconnected economy would enter a new growth paradigm. But early momentum has faded, with globalisation rates levelling off in the last decade in the face of burgeoning populism, rising protectionism and growing antagonism between the US and China.

Deglobalisation is expected to lead to lower productivity growth and tighter profit margins for large multi-nationals. With many global supply chains originating in the developing regions, emerging market assets are particularly vulnerable to this trend. However, there are other implications, such as a return of bargaining power for local labour forces, regulatory change and an increase in effective corporate tax rates. In this context, the large multi-nationals may need to either accept lower profit margins or become more localised in their most profitable markets and even consider withdrawing from their less profitable ones.

Globalisation and global profit margins 1995 – 2019, Annual



Source: J.P. Morgan, MSCI, IMF.

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But while deglobalisation may weigh on future rates of economic growth, we also see opportunities for investors. As countries de-link from each other, economic and financial correlations between markets may decrease and present opportunities for greater diversification in multi-asset portfolio than has been evident in the era of coordinated central bank policy. Moreover, portfolios will become less sensitive to the fortunes of the US technology giants as their cross-border influence wanes.

2 A changing post-pandemic world

The coronavirus pandemic is likely to be a catalyst for further deglobalisation, but it is only one of a number of important influences. For consumers, the watchword will be caution, with greater adoption of social distancing and households increasing their savings.

For companies, it will be all about resilience. Businesses will be looking to diversify and duplicate their supply chains and ensure that sufficient liquidity is always on tap. Operations will also be moved on-line as much as possible.

There will be significant change for governments, who will have to contend with a huge rise in debt. Belief in central bank independence may be eroded with an expectation of greater coordination of monetary and fiscal responses.

The main winners in the post-pandemic world are likely to be those with the scale to survive, (i.e., large companies), and

the healthcare and technology sectors. The losers are likely to be smaller companies, emerging markets (ex-Asia) and bond investors investing at very low yields.

3 A worsening savings glut

The uncertainty created by events such as the pandemic induces caution, which in turn encourages companies and consumers to increase their savings. Baby-boomers are setting aside more capital to pay for their increasingly long retirements as life expectancy rises, while nervous corporates are diverting funds away from much-needed investment to build up their cash piles. The consequence is that the preference for safer assets is forcing bond yields ever lower.

4 Accelerating climate change

The possibility of a meaningful acceleration in climate change has potentially dire ramifications for the global economy, with sea-level rises and extreme weather being notable threats not only to economies but to human life itself. The struggle to contain the pace of change could be undermined, however, by governments shifting focus away from expensive climate policies as they increase loading on their already over-stretched balance sheets, but we believe that companies that offer sustainable solutions are likely to continue to perform well.

5 A return of anti-trust legislation

The final structural challenge for global growth is that large American firms have historically been regarded as threats to US democracy. As companies engage in closer cooperation, the rise in business concentration and market power is viewed by many as causes of worsening income inequality and low middle-income wages. The race for the White House is far from over, but Biden remains the front runner, and with the potential for a 'clean sweep' in the November elections of President as well as control of both the Senate and Congress, Biden would have the ability to get new policy into law quickly. A Biden administration may increase regulation on very large companies, including the possibility of breaking up social media giants such as Google and Facebook.

How should we invest in the face of these challenges?

For balanced investors seeking a reliable income stream as well as looking to maximise their rewards in a lower return world, there are three important considerations. The first is sustainability. As well as wanting to align financial decisions with their values, many people recognise that adopting a more sustainable approach makes sense from an investment perspective too. Long-term sustainable investment allows good returns whilst investing in companies that help to solve global environmental and societal challenges. A sustainable investment philosophy is also likely to lead to a portfolio of forward-thinking companies that are better placed to navigate the financial challenges of a rapidly-changing world. The portfolio's bias away from fossil fuels is an example of investing in businesses that have a clear vision of a sustainable future.

The second is the need for flexible asset allocation. Financial markets do not travel in a straight line and a dynamic strategy that exploits the peaks and troughs that are typical of the

> We are less pessimistic than many market commentators – seeing opportunities for dynamic asset allocation and rigorous stock selection.

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economic cycle is likely to fare much better in the long run than a static allocation. We regularly update our strategic and tactical asset allocations to reflect evolving fundamental views and to take advantage of changes in market valuations.

The third factor that is critical to protect hard-earned returns in a lower growth environment is risk control. We aim to identify scenarios with severe consequences but low probabilities and incorporate some investments that can provide positive returns to offset negative returns from the core portfolio in those scenarios. Examples include using options on equity or bond markets, and changes to currency exposures or thematic equity baskets. Our process covers implementing tactical risk-mitigating positions alongside major strategic decisions.

Blending alternatives with the traditional

We believe that we can meet our clients' goals by constructing a dynamic blend of alternatives with traditional assets. A key focus of our sustainable investment philosophy is avoiding companies that do harm, and investing in businesses that make a positive impact on society and the environment.

But it doesn't stop there. We seek to be active owners of corporate bonds and equities, by thoughtfully exercising our voting rights and using our shareholder voice to engage with our investee companies to drive meaningful improvement. We are convinced that environmental, social and governance (ESG) factors will be a driver of enhanced investment returns over the long term, as well as helping to offset the damaging impact of accelerating climate change on economic growth and portfolio values.

In the coming decade, balanced investors will be forced to cast their net wider, accept more dynamic asset allocation and push out their time horizons. Structural challenges may be complicating the outlook further still, but investors should consider that history has shown that economies and markets have invariably emerged stronger from periods of flux and disruption, aided by a surge in innovation.

Although it seems likely that we are entering a long-term low yield environment, we believe an actively and responsibly managed multi-asset portfolio can offer investors meaningful investment returns while also making a meaningful positive impact on the world around us.

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