Market and economic insights

BMO Universal MAP Funds

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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 Universal Multi-Asset Portfolio (MAP) range, 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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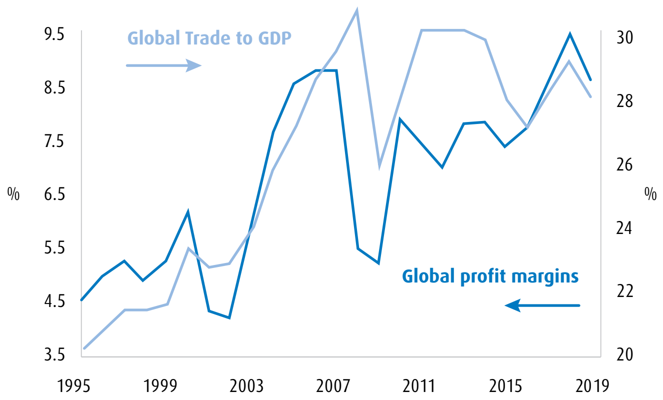
We are less pessimistic than many market commentators – seeing opportunities for dynamic asset allocation and rigorous stock selection.

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 may 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 looking to maximise their rewards in a lower return world, there are three important considerations. The first is cost. When returns are lower than average, high investment charges will inevitably weigh more heavily on performance. This is why we have kept fees on the Universal MAP range as low as possible, with ongoing charges capped at just 0.29 per cent (and 0.39 per cent for the Sustainable Universal MAP range).

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 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.

Keep it traditional

We believe that we can meet our clients' goals by staying within the boundaries of traditional assets. This means we will not be abandoning government bonds. While their accepted attributes as a haven in times of market stress may have waned

somewhat, they remain an important backstop, especially if interest rate policy turns negative in the US and the UK. For this reason, government bonds will remain, next to equities, fundamental to our asset mix.

We are also 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. ESG screening and sustainable investment are deeply and consistently integrated in our Sustainable Universal MAP funds.

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.

Bringing institutional expertise into the retail fund space

Although it seems likely that we are entering a long-term low-yield environment, we believe the breadth of resources we have at our disposal within the Universal fund range gives us the firepower we need to deliver consistently attractive returns on a risk-adjusted basis.

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

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