# LGPS CENTRAL LIMITED TACTICAL ASSET ALLOCATION

ISSUE 10 • June 2020

LGPS Central Limited

**FOR PROFESSIONAL CLIENTS ONLY**

## CIO SUMMARY

**Introduction**

Welcome to the tenth edition of our LGPS Central Limited ("LGPSC") Tactical Asset Allocation ("TAA") Report. We hope that you, your family and friends are safe and in good spirits.

Summary of Strategy Thoughts

Since the publication of the previous edition of this report, governments have initiated huge spending plans and Central Banks have provided monetary support to the struggling economy. This two-fold support has helped many of the equity indices recover from the steep losses recorded in the previous quarter. This support also benefitted Fixed Income assets.

The world economy is in the process of re-opening, although the number of infections keeps on rising. The world is trying to avoid the huge cost of keeping the economy closed and the unemployment that results from that. More knowledge is being gained about the virus and work is progressing on vaccines that may help reduce its mortality rate. This provides more comfort to governments to reopen their economies and keep these open with localised lockdowns being imposed where cases happen to be on the rise. Following this process of reopening, the macro data showed an initial V-shape recovery, however the base level was very low, and the initial V-shape was mainly driven by the pent-up demand that materialised on reopening the economies. The continuation of the recovery most likely will not follow a V-shape, but rather a radical(the shape of a square root symbol), with a much flatter slope of recovery moving forward that will most likely depend on various factors: (a) continued fiscal and monetary support, (b) the level of unemployment after the furlough schemes come to an end, (c) consumer behaviour which will determine to a large extent the survival of many SMEs, and (d) a second wave of infections and what medical solutions will be available if/when that second wave occurs in the autumn/winter.

We are downgrading growth assets to **slightly underweight** from a **significant overweight** last quarter. Key changes are the high valuations, which although forward looking, are way ahead of the economic recovery.

We are upgrading stabilising assets to **slight underweight** from **significant underweight** given the tailwind provided by the central banks.

We are downgrading income assets to **slightly underweight** from **slightly overweight**. The main driver behind the downgrade is Property, with Offices and, in particular, Retail having a hard time. Risky liquid assets such as EMD and Credit continue to be recommended as **overweight**.

Given that the three broad asset categories – income, growth and stabilising assets – are underweight, the obvious question would be what solution can be found. Therefore, in this edition of the TAA report we have added a special feature from Colin Pratt on "If nothing looks cheap, what are the investment options?", which attempts to answer this question.

In terms of factors, the model is **overweight** on **quality** and **low volatility** and **underweight** on **size**. Then on currencies we continue to remain positive on Sterling despite the current poor economic environment and the approach of the end 2020 Brexit negotiation deadline. With the current low level of domestic rates, the increasing size of the domestic deficit and oversold nature of Sterling, we believe much of the bad news is already discounted. Recent US Dollar trading has seen some long-term support levels breached and indicates the beginning of a new weak USD period, which may be exacerbated as we approach the Q4 US presidential election period. JPY and EUR continue to trade in response to the market's perception of relative risk.

Although the risk section of this report has maintained the same risk factors, we have updated these factors to reflect their development.

Gordon Ross (CIO)

## LGPS CENTRAL LIMITED'S VIEW ON WEIGHTINGS

The following table gives a summary of our view on the 6-18 months tactical positioning horizon.

Table1: Weightings ▲ Upgraded, ▼ Downgraded compared to previous quarter

| | Significant Underweight | Underweight | Neutral | Overweight | Significant Overweight |
|---|---|---|---|---|---|
| Estimated Probability | 80-70% | 70-65% | 55-45% | 70-65% | 70-80% |
| BROAD ASSET CLASS | | Income & Growth ▼<br>Stabilising ▲ | | | |
| GROWTH ASSET CLASS | US Equities | GEM Equities ▼<br>EU, UK Equities ▼<br>Private Equity ▼ | Japan Equities ▼ | Commodities<br>Asia Pac Equities | |
| INCOME ASSETS | Property ▼ | | Infrastructure ▲ | | Credit, EM Debt |
| STABILISING ASSETS | JP Bonds | Index-Linked ▲<br>IG Bonds<br>UK Bonds ▼ | EU Bonds ▲ | Gold<br>US Bonds | |
| INVESTMENT STYLES | Value ▼<br>Size ▼ | | Momentum ▲ | Growth ▲ | Quality/ESG ▲<br>Low Volatility ▲ |
| CURRENCIES | | US Dollar | | GBP, Yen, Euro | |

**LGPSC's view on "Weightings":**

- We increase the allocation to Stabilising Assets from significant underweight to underweight. We decrease the allocation of Growth Assets from significant overweight to underweight, and we also decrease Income Assets from overweight to underweight mainly due to Property. We downgraded Property based on valuations and economics, and also on increased market risk.
- Growth Asset valuations are not as attractive as they were at the end of Q1 and our sentiment indicator toward these decreased significantly.
- Stabilising Assets we keep at underweight mainly due to their high valuations.

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## BROAD ASSET CLASSES

Table 2: Growth/Income/Stabilising Assets

| | Model Score[1] | View | Investment Notes |
|---|---|---|---|
| GROWTH | -2 | Underweight | Downgraded from overweight to underweight, based mainly on high valuations and unfavourable sentiment. |
| INCOME | -1 | Underweight | Reflects negative scores of Property due to high valuations, unfavourable economics and increased market risk. We continue to favour Credit and Emerging Market Debt. |
| STABILISING | -1 | Underweight | Reflects the high valuations of the stabilising assets. |

Table 3: Historical Annualised Returns in local currency (* except for the 3 months, where total return is used)

| | 3 months* | One year | Three years | Five years | Ten years | Twenty years | Bloomberg Ticker |
|---|---|---|---|---|---|---|---|
| GLOBAL EQUITIES | 19.3% | 2.0% | 6.6% | 6.9% | 9.8% | 4.5% | FTAW01 Index |
| PRIVATE EQUITY | 25.8% | -3.2% | 5.4% | 11.3% | 12.7% | NA | IPRV LN Index |
| PROPERTY | 13.2% | -6.1% | 3.6% | 6.3% | 10.6% | 10.1% | REIT INDEX |
| INFRASTRUCTURE | 13.8% | -14.4% | -0.9% | 2.3% | 6.9% | NA | SPGTIND Index |
| HIGH YIELD | 10.7% | 0.4% | 3.0% | 5.2% | 8.4% | 9.8% | HL00 Index |
| UK GILTS | 2.6% | 11.3% | 6.3% | 6.4% | 6.0% | 5.8% | G0L0 Index |
| UK INDEX-LINKED | 10.5% | 9.5% | 7.0% | 8.7% | 8.7% | 7.1% | G0LI Index |
| GOLD | 13.0% | 31.1% | 14.7% | 14.0% | 6.1% | 10.7% | XAUGBP Curncy |

Source: Bloomberg (NB: assumes dividends were reinvested), Note: Listed proxies have been used for Infrastructure, Property and Private Equity.

Table 4: Correlation Matrix (5 year historical correlation)

| | FTSE All World AW TR GBP | iShares Listed Private | DJ REIT | S&P Global Infra | Sterling High-Yield | UK Gilt | UK Inf-Link Gilt | XAUGBP Index |
|---|---|---|---|---|---|---|---|---|
| GLOBAL EQUITIES | 1 | 0.783 | 0.737 | 0.855 | 0.681 | -0.075 | 0.124 | -0.153 |
| PRIVATE EQUITY | | 1 | 0.64 | 0.733 | 0.615 | -0.005 | 0.178 | 0.076 |
| PROPERTY | | | 1 | 0.815 | 0.609 | 0.248 | 0.368 | 0.048 |
| INFRASTRUCTURE | | | | 1 | 0.714 | 0.175 | 0.313 | 0.061 |
| HIGH YIELD | | | | | 1 | 0.053 | 0.226 | -0.135 |
| UK GILTS | | | | | | 1 | 0.799 | 0.470 |
| UK INDEX-LINKED | | | | | | | 1 | 0.378 |
| GOLD | | | | | | | | 1 |

Source: Bloomberg Note: listed proxies have been used for Infrastructure, Property and Private Equity

**LGPSC's view on Broad Asset Classes:**

- We can see from Table 3 above, that during the three months of the second Quarter, most of the asset classes had returns significantly above their ten and twenty year averages. This shows that their valuation is high on a relative basis.
- From Table 4 we can see that the best asset class to protect both equity and high yield exposure is not UK sovereign bonds (gilts) but rather gold, which has a higher negative correlation.
- While our recommendation is to be slightly underweight across asset classes, this recommendation still allows room for a selective approach. Therefore, while we would not particularly recommend an asset group, our recommendation is to be selective, as within each asset group, one can find niche opportunities.

[1] Refers to LGPSC model as described on page 7

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## GROWTH ASSET VIEW

Table 5: Growth Assets

| | Model Score[1] | View | Investment Notes |
|---|---|---|---|
| UK Equities | -1 ▼ | Underweight | Underweight driven by unattractive valuations and negative currency impact due to strong outlook for Sterling. |
| NORTH AMERICA Equities | -6 ▼ | Underweight | Increased underweight due to high valuations, negative sentiment and economic outlook, as well as increased market risk over coronavirus and political uncertainty. |
| EUROPE Equities | -1 ▼ | Underweight | Downgrade to underweight, due to unattractive valuations after recent market recovery. |
| JAPAN Equities | 0 ▼ | Neutral | Despite the positive economic score, the valuation metric is high. |
| ASIA PAC Equities | 2 | Overweight | No change, economic growth potential, sentiment remains neutral, potential to pick up after recession. |
| GEMs Equities | -4 ▼ | Underweight | Downgraded based on valuations and market risk. Covid-19 has impacted the region negatively. |
| PRIVATE EQUITY | -1 ▼ | Underweight | Moved to underweight from overweight due to high valuations. |
| COMMODITIES | 1 | Overweight | Provides no yield but can be added as a diversifier and potential inflation hedge. |

**LGPSC's view on Growth Assets:**

- The main change across Growth Assets is expensive valuations which have changed the model weights for most of the underlying assets.
- We are underweight most of the regional Growth Assets, except for Commodities and Asia Pacific Equities. Asia Pacific Equities have better economic, currency and valuation scores in comparison with other regional equity markets. Our overweight in commodities reflect positive sentiment and currency scores.
- After Q1 20 markets have recovered part of their falls, however further falls reflecting the economic reality, could push markets down.

## INCOME ASSET VIEW

Table 6: Income Assets

| | Model Score[1] | View | Investment Notes |
|---|---|---|---|
| CREDIT | 3 ▲ | Overweight | Further increase the overweight position due to improved sentiment and market risk. |
| EMERGING MARKET DEBT | 2 ▼ | Overweight | Reduce slightly the overweight position due to higher valuations. |
| PROPERTY | -5 ▼ | Underweight | Valuations, sentiment, economics and market risk – all have a negative impact on Property. Due to current uncertainty, commercial real estate is under pressure (retail and offices.) |
| INFRASTRUCTURE | 0 ▼ | Neutral | Downgrade to Neutral due to lower valuation score. Renewables & sustainable energy exposure is the segment we favour. |

**LGPSC's view on Income Assets:**

- We prefer Credit and Emerging Market Debt over Property and Infrastructure due to their better economic scores. In addition, with recent market dynamics, illiquidity has also become a key risk topic which is reflected in the investment cost score and thus negatively impacts both property and infrastructure.

## STABILISING ASSET VIEW

Table 7: Stabilising Assets

| | Model Score[1] | View | Investment Notes |
|---|---|---|---|
| UK BONDS | -1 ▲ | Underweight | Reduced the underweight position due to improved sentiment score reflecting Central Bank support. |
| INDEX-LINKED | -1 ▲ | Underweight | Similar to UK bonds, the reduced underweight position reflects better sentiment due to Central Bank support. |
| US BONDS | 1 ▼ | Overweight | Reduced to small overweight due to deteriorating scores on currency and market risk. |
| JP BONDS | -5 ▼ | Underweight | Increased underweight due to market risk, while the economic score continues to be negative. |
| EU BONDS | 0 ▲ | Neutral | Raised to neutral due to higher currency score. |
| IG CORPORATE BONDS | -1 ▼ | Underweight | Cut from neutral to slight underweight due to higher valuations and increased market risk. |
| GOLD | 1 | Overweight | Favoured Stabilising Asset. Rating is unchanged. |

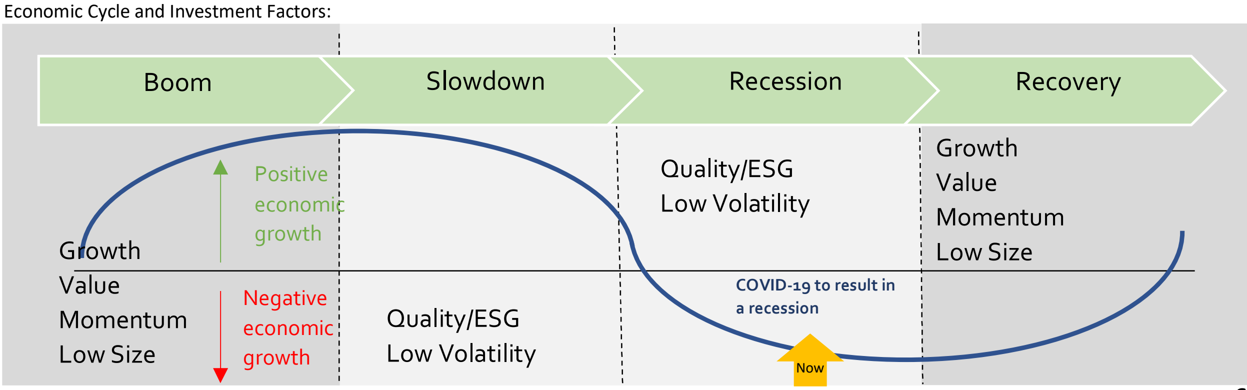
**LGPSC's view on Stabilising Assets:**

- Regionally, on government bonds, we are underweight all but US Treasuries, mainly due to high valuations, and European bonds, which are neutrally positioned.
- We maintain the sentiment score for all bonds at neutral to reflect the support from Central Banks and also the risk in case this support is withdrawn.
- Gold offers good diversification and a hedge against currency debasement which we are witnessing

## INVESTMENT FACTORS (EQUITIES)

Factor Based investing provides a way of potentially adding outperformance relative to a market-cap-based approach at a much lower cost than active investing. It recognises that the market-cap-based index does not provide the best risk-adjusted return for a portfolio given its natural overweight to momentum, large cap and expensive stocks. In the following factor model, we have taken the seven factors of value, growth, income growth, size (small cap), ESG, low volatility and momentum and then applied the same criteria we use to consider other asset classes in our model assessing each factor for valuation, sentiment, economic suitability, risk suitability, investment cost and currency. Investment cost in factor-based investing is low relative to the other asset classes, though the momentum factor (given their higher turnover) and ESG factors (given their higher index costs) are both scored neutral. Given all strategies are global, the currency scores are all neutral. Note that ESG and quality share similar characteristics. Climate change as a factor is little correlated to specific economic cycles given its long-term investment impact horizon of 10-20 years. The graph below summarises the preferred overweight factor(s) depending on the various stages of the economic cycle.

Economic Cycle and Investment Factors:



## FACTOR ASSET VIEW

Table 8: Investment Factors

| | Model Score[1] | View | Investment Notes |
|---|---|---|---|
| Value | -1 ▼ | Underweight | Downgraded to slight underweight due to higher valuation, also its sentiment and economics scores have decreased |
| Growth | 1 ▼ | Overweight | Decreased the overweight position due to perceived higher market risk |
| Size | -5 ▼ | Underweight | Our view on small caps has turned negative due to high valuations, high market risk and negative economic score |
| Momentum | 0 ▲ | Neutral | Increased to neutral to reflect a better valuation score, and slightly improved market risk |
| Low Volatility | 3 ▲ | Overweight | Increased to overweight due to improved scores on valuation, sentiment, economics and market risk |
| Quality/ESG | 3 ▲ | Overweight | Increased to overweight mainly on attractive valuations |

**LGPSC's view on Investment Factors:**

- Our favourite factors change from Value to Quality/ESG and Low Volatility.
- Least favoured factor now is Small Size.
- Given that the economic recovery is lagging behind current valuations, and uncertainty lies in front of us both about the coronavirus development and the state of the economy once fiscal support is withdrawn, it comes as no surprise that small companies may be vulnerable, and Quality & Low Risk factors are favoured.

## ABOUT LGPS CENTRAL LIMITED'S SCORING MODEL

LGPSC's model scores each asset class against its valuation, sentiment, economic outlook, market risk, currency and investment cost (scored between -2 and +2). Positive scores suggest strong overweight positions and negative scores, strong underweight positions. Where a zero is assigned, our view is neutral. The scores for the different assessment areas, e.g. valuation, sentiment etc. are then added to derive the final score for that asset class. Please note that sentiment is measured as to whether an asset class is over owned or over loved. We prefer to own asset classes that are under owned and under loved. We are constantly developing this scoring to include other variables such as ESG measures and technical factors.

## RECESSION WATCH

The safety nets which many governments implemented through furlough schemes are approaching their ends, as are the lockdown measures imposed on many economies. It will be key to know what the way to normality will look like, and while two medicines were discovered to mitigate Covid-19 impact, the virus is still among us with the global infection rate rising daily. Larry Summers mentioned that if the customers feel fearful when going shopping, then complete recovery is hard to be expected. Given that consumption represents roughly 70% of a developed country GDP, it is hard to see how a return to normality can happen with the virus around us. As a second wave of infections may start in many countries in the autumn/winter period, most likely, the recession will be with us for the rest of the year. Due to the supportive stance of governments and central banks, it is anticipated that the recession depth will be managed well. It is still hard to know how long the recession may last, however we believe that we could see a recovery next year.

***LPGS Central Limited View** – We see a recession for the rest of the year. 2021 could mark the start of the recovery.*

## Q2 LGPS CENTRAL LIMITED MARKET UPDATE[2]

Q2 presented governments with a choice – should they focus more on health issues or on economic issues, both of which were caused by Covid-19. Governments found themselves balancing these two and whenever one diminished, their focus shifted to the bigger concern.

The second quarter of 2020 saw governments slowly re-opening their economies and easing Covid-19 lockdown measures, given that on the medical front there were two medical discoveries to help with the fight of Covid-19. However, the number of Covid-19 infections are still rising globally. The accelerations of virus cases in Latin America, India and parts of the US are concerning. The outbreak in Europe appears to be more under control while in much of Asia and Australasia, the number of cases has virtually ground to a halt. The re-opening of economies allowed equity markets to enjoy a strong quarter and recover from the mass market sell-off in March. The US S&P 500 recouped almost all its losses from the previous quarter after rising 19.95% in Q2. The European markets also made recoveries with the UK FTSE 100 rising 8.78% and the EuroStoxx 50 rising 16.05%. Emerging Market equities also advanced but gains were limited due to the re-emergence of tensions between the US and China. MSCI Asia (ex. Japan) was up 17.61% overall in the quarter, despite posting losses in May after reactions to China's proposal of a new national security law in Hong Kong. MOEX Russia was also up, posting gains of 9.34% in the quarter.

The Flash Composite PMI (company survey) data in June showed an easing in the economic downturn in the US, UK and Eurozone as the indices were higher than the previous quarter but still below the neutral 50.0 value. This uptick is likely because of the easing of lockdown restrictions. A figure above the neutral value indicates an expansion whereas a figure below indicates contraction.

The Michigan Consumer Sentiment Index had another big drop in April as more US jobless claims were filed as expected. Over the quarter, the index remained relatively steady with a small pick-up in June due to the easing of lockdown restrictions, allowing more businesses to re-open. The VIX decreased to levels seen just before lockdowns were put in place, indicating the panic may be over.

As economies were slowly re-opening, the main political headlines before the pandemic took centre-stage, were starting to influence markets again. Fears of a no-deal Brexit resurfaced, causing Sterling to fall. China's proposal of a security law in Hong Kong sparked further tensions between the US and China, negatively impacting the Emerging Markets.

Risk appetites climbed in Q2, meaning the USD looked less attractive as a safe-haven asset, resulting in a weakening in the currency. Sterling also weakened due to fears of a no-deal Brexit, as well as the prospect of negative rates.

Investors continued to invest in certain safe-haven assets such as gold, which rose by 12.92% during the quarter. The price of oil increased 80.96% resulting in its best quarter in 30 years, masking the volatility in the sector in April when the oil price fell to record lows due to slumps in demand and Saudi Arabia and the UAE significantly boosting output. It bounced back in May as demand increased following the easing of lockdown measures and was much less volatile in June, ending the quarter at $41.15 per barrel.

The Bank of England (BoE) recently increased its quantitative easing programme by a further £100bn which allowed the UK 10Y gilt yield to remain low at around 0.2%. Corporate bonds outperformed government bonds due to stronger demand for riskier assets.

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[2] Performance for the quarter measured over period of 31/03/2020 to 30/06/2020

Central Banks and governments have provided huge amounts of stimulus measures, helping the private sector. Central Banks have also made it clear that they are willing to use their full firepower to keep government and borrowing costs low. The Federal Reserve and the BoE have maintained their rates at 0-0.25% and 0.1% respectively. Andrew Bailey, the Governor of the BoE, announced that the Bank has considered negative interest rates to expand its policy toolkit and although there is no immediate plan to cut rates below zero, he has not completely ruled out this option.

## Q2 LGPS CENTRAL LIMITED RESPONSIBLE INVESTING UDPATE

Following the transition to virtual-only AGMs over the last few months, the 2020 proxy season has mostly come to a close. To date, the Covid-19 pandemic appears to have had little impact on shareholder engagement. In the U.S. a record number of shareholder resolutions covering ESG issues such as climate change, diversity and lobbying expenditures, have had majority support this proxy season. Globally, investor support for climate change resolutions has increased by 7% (from 16% to 23%) year on year. These are indications of increasing backing on ESG issues from asset managers who have formerly resisted voting against management. The number of shareholder proposals that made it onto the AGM ballot paper this season has increased from previous years. This implies a shift in trend of companies negotiating away resolutions and is perhaps indicative that when, talking to their investors, companies are focusing on immediate liquidity and cash management rather than ESG issues during the pandemic.

The Covid-19 pandemic has resulted in delays both to COP26 and in the acceleration of climate change policies. Certain governments, including the EU and Canada, have incorporated instruments supporting a climate transition in their economic recovery plan. However, there are concerns that the support will not be far stretching enough and may be hindered by governments focusing on tackling unemployment and an economic recovery. Globally, government stimulus packages allocated ~$500bn to high-carbon industries with no conditions to ensure they curtail their emissions, while only designating ~$12bn towards low-carbon industries[3]. To stimulate economic growth, the U.S. has weakened environmental regulations, including waiving environmental reviews of new infrastructure projects and reducing air pollution controls. The upcoming presidential election in the U.S. may see a change in the tide, with the Democrats recently releasing an ambitious climate plan which aims to implement carbon pricing, sets a 2050 carbon neutrality goal and proposes to eliminate emissions from cars and power plants in 2035 and 2040, respectively. So far this year, the Chinese government have proposed or approved the construction of 40 gigawatts worth of new coal plant projects, which is equivalent to Germany's entire capacity. These measures are concerning and undermine the previous efforts and commitments these nations have made toward a climate transition.

At the beginning of the lockdown executives and CEOs took cuts to their base salaries, annual bonuses and in some instances long-term incentive plans in solidarity with other stakeholders affected by the Covid-19 pandemic. The majority of wage cuts were taken voluntarily but, in some sectors, regulatory pressure was applied, for example the PRA expected banks not to pay cash bonuses to executives. Whilst initially a positive step in executive remuneration, many of these sacrifices have since been reinstated. This seems premature given that the Covid-19 pandemic is continuing to have far-reaching consequences, with economies facing recessions, record breaking GDP declines and temporary mass unemployment. Of more concern are the long-term incentive packages being handed out to executives. If awards are granted during the market crash, there will be significant windfall once the market recovers. Executives at Prudential, Reach and ITV all took pay cuts or forfeited their bonuses, however at the same time, were given long-term incentive plans on current share

[3] As of 07/06/2020. Source: Bloomberg New Energy Finance

prices. Whilst Prudential's chief executive's salary was reduced by £23,000 down to £1.15m, on that very day he was awarded a long-term incentive plan worth £878,873. Approaches to remuneration during the pandemic appear to be varied, however there are a number of executives who are set to gain considerably, suggesting that in some instances the initial sacrifice was merely a token gesture.

During the height of lockdown, global greenhouse gas emissions temporarily dipped. As expected, the reopening of countries paired with economic growth initiatives is driving emissions back up, in China alone emissions have risen 4-5% year on year in May. This fuels concerns that economic stimulus will cause higher global emissions levels than those documented pre-Covid-19, mirroring emission rebounds seen after the Global Financial Crisis of 2008.

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## RISK ANALYSIS

Table 9: Risk in order of probability

| RISK | LGPSCL Possibility | LGPSCL Impact | Change on quarter | Comment | LGPSC favoured assets to protect against the risk |
|---|---|---|---|---|---|
| CORONAVIRUS | High | High | → | Governments around the world introduced fiscal policies and central banks ramped up monetary policies aimed at addressing the stress in the economy due to social distancing around the globe. The key risks are a lengthy recession, and the relaxed measures governments have introduced resulting in a second wave. In addition, there are concerns regarding the shape of the economic recovery. | Clients without equity protection should consider re-establishing protection when equity indices approach previous heights. Selectively investing in Quality Assets and a diversified portfolio. |
| EQUITY DOWNTURN | High | High | → | The probability of a 20% equity downturn is still there as equity indices returned to previous heights while the real economy still has to catch up. There is still increased uncertainty on corporate earnings, dividend cuts, share buybacks, defaults and the risk of a second wave of a coronavirus, adding to the uncertainty. | Safe haven assets such as gold. Renewing equity protection should be considered. |
| NO DEAL BREXIT | Medium | Medium | ↑ | Trade negotiations haven't advanced positively, and this has increased the No Deal Brexit scenario. There are less than six months left. | Current tactical asset allocation will be dominated by the Coronavirus crisis and this risk might become more relevant when the current crisis is under control. |
| GLOBAL RECESSION | High | High | → | Indicators point towards a global recession as the coronavirus has impacted all major economies. Governments across the globe have started relaxing the imposed measures. The uncertainty arises due to the potential for a second wave forcing new lockdowns (although local). | Hold a well-diversified portfolio. Once the recession is gone, factors such as Size and Value are expected to perform best. |
| POLITICAL RISKS | High | Medium | ↑ | US presidential election later this year could lead to a less market friendly party and candidate winning the election. There are concerns regarding social unrest based on racial movements. | Overweight protective assets such as Gold. |
| ISOLATION & PROTECTION/CHINA | High | High | ↑ | China has faced criticism from the US with respect to its attitude towards Hong Kong and Taiwan. Globally, cross-border corporate takeovers may be restricted. EU officials stated companies in the EU zone will not be allowed to be bought under market stress conditions. | Current tactical asset allocation will be dominated by the Coronavirus. |
| CREDIT RISK/DEBT ISSUES | High | High | → | High yield bond defaults will likely be below what otherwise would be expected if not the FED support that was provided. The risk is that many companies may become zombie type of companies. Still, with 50% of bonds being rated BBB there is a risk of downgrades from IG to HY. Emerging market debt will depend mainly on the price of oil. Three countries are very close to default: Argentina, Lebanon and Ecuador, while Canada and the UK were downgraded. | Selective Credit and IG Corporate Bonds. |
| CURRENCY RISK/<br>STERLING<br>STRENGTH/US$<br>WEAKNESS | Low | Moderate | → | US dollar in high supply will make the dollar the worst performing currency. The flight to quality, which would usually see the dollar up, is now broken and is replaced by the Japanese yen due to cross border currency swaps. Expectation for a long downtrend in the USD. The currency preference will be (in declining order) GBP, YEN, EUR, USD; in particular, GBP strength and USD weakness is expected. | Buy GEM equities, commodities which historically benefit from a weaker dollar. |

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| RISK | LGPSCL Possibility | LGPSCL Impact | Change on quarter | Comment | LGPSC favoured assets to protect against the risk |
|---|---|---|---|---|---|
| CLIMATE-RELATED TRANSITION RISK | Medium | Moderate | → | The EU Carbon Price has recovered to previous mid-€20 heights.<br><br>The market share for electric cars in the EU has doubled between Q2 19 and Q2 20.<br><br>The outcome of the US presidential election later this year continues to be a key climate related transition risk. The current administration has persisted in weakening environmental regulation.<br><br>A number of countries, including the EU and Canada, have included support for a green recovery in their Covid-19 economic recovery plans. | Underweight Energy & GEMs, overweight Renewables and Sustainable Investment themes such as Infrastructure. |
| CLIMATE-RELATED PHYSICAL RISK | Medium | Moderate | → | To encourage economic growth, countries are providing stimulus toward carbon-intensive industries. China is planning to increase coal-fired power plant by 40GW, which is a larger increase than 2018 and 2019 combined.<br><br>Initial reports suggest that greenhouse gas emissions are rising to above pre-Covid-19 levels. | Hold a well-diversified portfolio. |
| LIQUIDITY RISK | Low | Low | ↓ | Liquidity risk measured in terms of bid-ask spreads has moderated as the fear subsides. | |

**LGPSC's view on "Scenario Risks":**

- We can compare the current situation to juggling two balls in one hand. One of the balls can be called the "health risk ball", the other ball can be called the "economic risk ball". As soon as one of these balls starts approaching the ground, it is immediately caught while simultaneously launching the other ball in the air, which eventually will start approaching the ground as well. No ball should be accidentally allowed to fall on the ground. This act of fine balancing is what is required and is the biggest risk we are facing.
- We also have reviewed the likelihood and impact of risks, and we now see that the biggest risks as a global recession and a second wave of Covid-19 in the autumn/winter.
- We highlight that holding a diversified portfolio still offers the best protection against those risks. Equity protection may be necessary. Specific risks such as a weakening US$ can be mitigated by hedging the currency risk.

# If nothing looks cheap, what are the investment options?

Colin Pratt – Investment Director, Manager of Managers

All Pension Funds look to achieve an acceptable level of return for an acceptable level of risk and achieving this return is crucial. At present it seems much easier to suggest that the vast majority of investment classes look expensive than it is to argue that there are plentiful bargains to be had, but this may prove to be an incorrect assessment and Pension Funds need to maintain exposure to risk assets at reasonable levels if they are going to have any probability of hitting their return targets. Before considering any solutions, let's start with **The Laws of (Human) Nature:**

1. **When we feel fear, we run for cover –** Covid-19 unlocked the laws of human nature as the fear of the unknown made investors run for cover, unleashing more selling than buying pressure onto the market with the impact of sharp price falls in liquid risk assets. Especially when this fall is seen in the whole economy, as measured with the fall of the UK GDP as shown on Figure 1,


*Figure 1: the UK GDP fall erased almost 20 years of growth (source: Bloomberg)*

which brings us to the 2nd law of human nature:

2. **In the face of fear, the strong protect the vulnerable –** Central Banks and Governments reacted quickly and decisively in pledging massive fiscal and monetary support, with the intention of keeping the economy functioning and protecting jobs as far as possible. This protection has allowed us to witness (a) market prices reaching close to their pre-Covid-19 levels, which is out of touch with the real economy which hasn't completely recovered and (b) a strong monetary and fiscal response which has increased money supply. The level of money supply can clearly be seen from Figure 2:


*Figure 2: FED, BOJ and ECB balance sheets combined (source: Bloomberg)*

This leads us to the 3rd law of human nature:

3. **We value less what is abundant and we value more what is scarce –** money creation may reduce the value of money (an increasingly abundant resource) relative to gold (a scarce resource). The days of banks holding enough gold to back the value of money and credit are gone and the current monetary system has outgrown the amount of gold used to back it up.

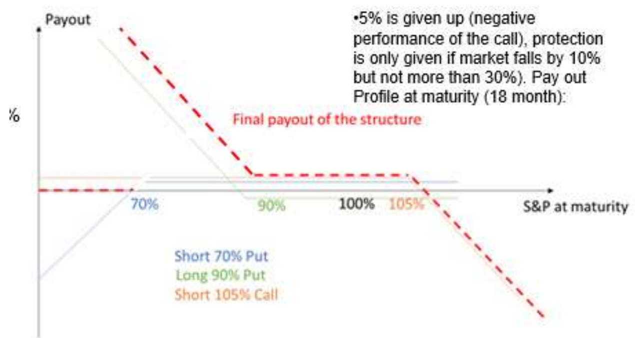
   Currently, we may live in an environment with growth way below trend combined with deflationary pressures. The risk we face, however, should the money printing continue, and central banks don't scale back their balance sheets, is significant. Anyone guess where we may be heading to if central banks don't scale back? It is far from inconceivable that inflation and lack of faith in currencies (individual or collectively) may have a meaningful impact going forward.

   This article will focus on options that obey these laws and may assist in achieving the required long-term investment returns.

**A) Equity protection** *(Law 1: When we feel fear, we run for cover)*

Equity protection can be achieved using puts and calls on major global indices to protect equity assets against market falls. The major characteristics of these strategies focus on (a) level of protection, (b) duration of protection and (c) cost of protection.

The most popular form of equity protection is a zero-cost equity protection strategy.




This strategy provides protection for our equity assets up to a certain percentage of market falls, but only after a certain trigger level has been reached. In order to finance this protection, the investor has to give away upside returns in the event that the market rises above a certain level – this is what finances the protection. The graph provides an example pay-out structure at maturity of such equity protection (without considering the equity assets) on the S&P 500. In order for equity protection to be truly effective, a dynamic management of the strategy is required.

This means that, should the market fall and the protection become effective, consideration needs to be given about when to unwind the protection and cash it in. If no action is taken the options will mature naturally and any return will be based on market levels at that point. As an example of this, the S&P 500 fell over 30% from its 2020 opening position and at the time of writing this article it has recovered almost all of this loss. Inactivity would have been very costly unless the market falls again – a large gain (which offset much of the equity losses) has now disappeared.

The exact levels of protection achievable and upside that needs to be given away will depend on the market environment. Other considerations will also need to be taken into account, such as the availability of cash/government bonds to use as collateral if the market moves upwards. The following graph shows how the example equity protection on the S&P would have performed historically.


In a very bullish market, the equity protection loses money which will be offset by the equity assets performing positively. However, when we observe severe market falls such as in December 2018 or recently, the protection will perform positively balancing out some of the negative performance of the equity assets.

**B) Gold** *(Law 3 – We value less what is abundant and we value more what is scarce)*

Gold is recognised as the oldest form of money in the world still in use today. Gold coins were first used in the Lydian Empire in around 550 BC, although gold was highly prized by Ancient Egyptians many years before. In more recent times, many of the world's currencies were fixed to gold at a set price with paper notes freely convertible to gold. The system proved untenable, however, and the gold standard ended in 1971. In the time it has been able to float freely, gold has risen from $35 per ounce to around $1,750 today, below its all-time high of around $1,900 in 2011. Away from the shackles of the fixed pricing system, gold has been highly regarded as a medium of exchange or store of value, appreciated for its scarcity and aesthetic attributes. As long as this remains the case, it is certain to retain value. In short it has come to be recognised as an asset class in its own right with a strong track record of wealth preservation over time.

While investing in gold comes with no current income, its main benefit lies within the context of the overall portfolio. Historically some of gold's strongest years have come in recessionary periods when equity markets have been weak, thus providing downside protection to portfolios. An allocation to gold can help to reduce overall portfolio volatility and enhance returns. One of the best predictors of the price of gold is the change in the real interest rate (i.e. the nominal interest rate adjusted for inflation). In the short term, while real interest rates continue to be low, gold tends to perform well, partly because it is seen as a more attractive alternative to cash. In the long run, with central banks pursuing expansionary monetary policies, this will increase the scarcity value of gold in relation to money. Thus, further easing measures, particularly in the US, given that gold prices are denominated in dollars, would likely result in increasing money supply and thus more distrust of paper money and more interest in gold due to its limited supply.

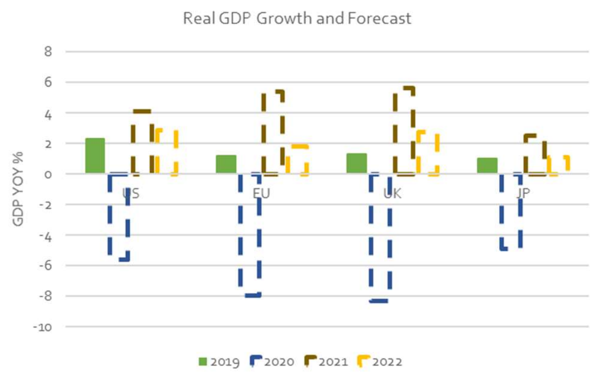
**C) Hedge Funds** *(Law 1 – When we feel fear, we run for cover)*

Hedge Funds use many different strategies, and many have the ability to go 'short' – to sell assets that they do not own – as well as to own assets like a conventional investor. As the fear factor kicks in, it is this short position that provides the cover and saves us from the negative impact from the market fall.

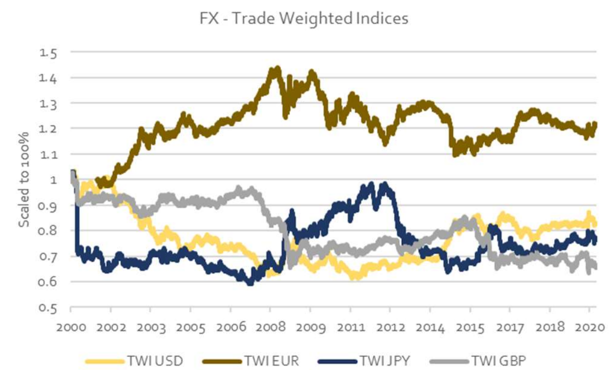
A major hindrance to investment returns are the high fees charged by the industry, which act as a significant headwind to the returns received by investors. The best managers are very sought after and difficult to access, given that they tend to have capacity constrained strategies, but with good strategy/manager selection and the right market conditions an exposure to hedge funds can protect and add value. They can fit into an investment strategy as a source of significant risk diversification, given that their returns are generally generated in a considerably different manner to almost all other investments within a Pension Fund.

The ability to short positions means that hedge funds are not reliant on market direction to gain positive returns, and a skilled manager has the possibility of producing positive returns in any market conditions. The general focus of hedge funds on controlling risk and not losing capital tends to lead to an understandable, and fully expected, underperformance in rising markets. The biggest disappointment for investors in them, however, has been the lack of protection achieved when it has been needed most – and hence, the asset class has seen some notable reductions in allocations from institutional investors in recent years.

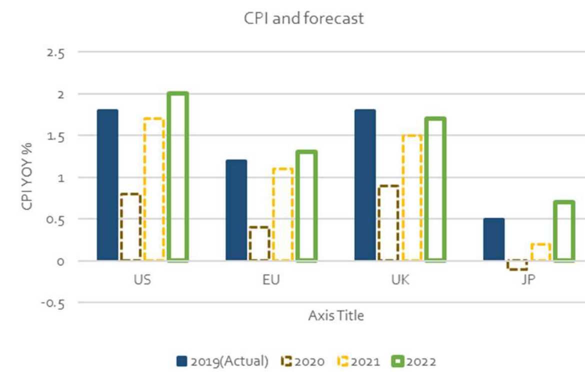
## APPENDIX 1: ECONOMIC OUTLOOK



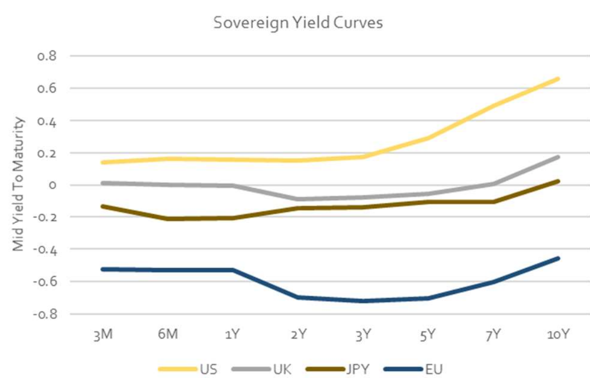

**The current crisis has impacted 2020 GDP growth**



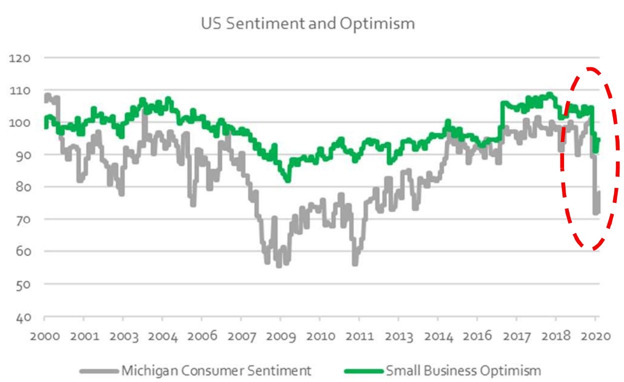

**Trade weighted indices have stayed at depressed levels.**



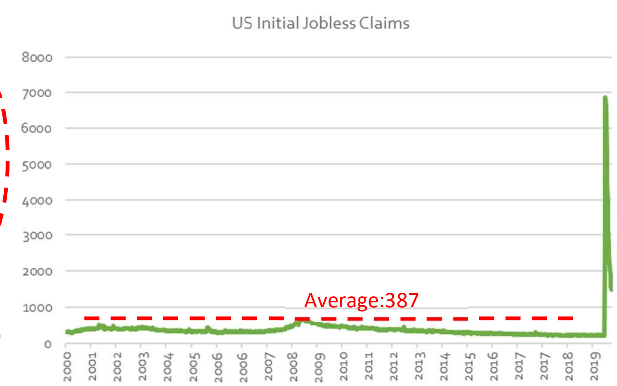

**For 2020 deflationary pressures are building up**




**Positively sloping yield curves reflecting the money printed impact on the long term.**




**Consumer confidence and small business optimism declined sharply**




**Initial jobless claims retracted in Q2 after the spike in Q1, while unemployment remained high**

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Source: Bloomberg, OECD, data as of 30/06/2020

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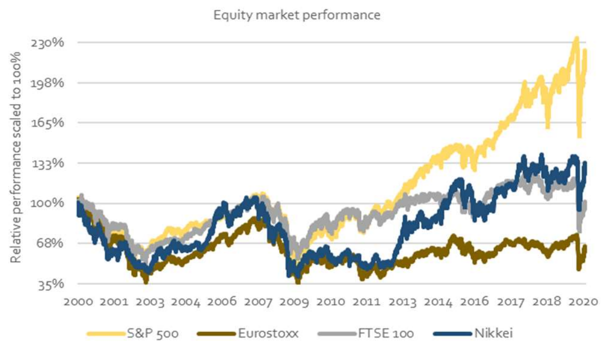
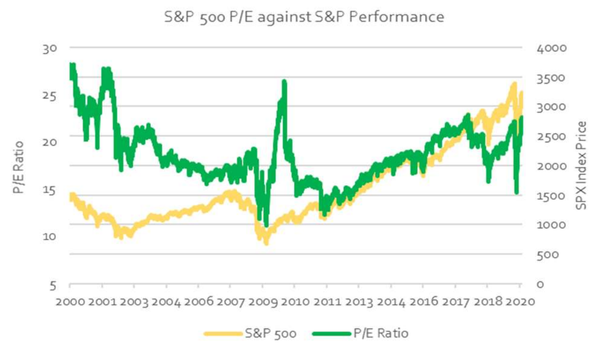
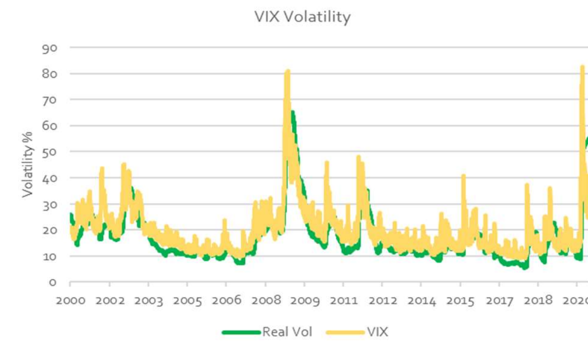
## APPENDIX 2: MARKET OUTLOOK



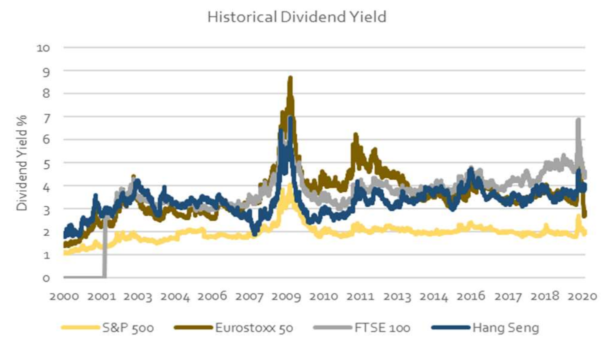

**Markets have recovered to a large extent, given the support of governments and central banks.**




**P/E ratios recovered after the strong fiscal and monetary response**

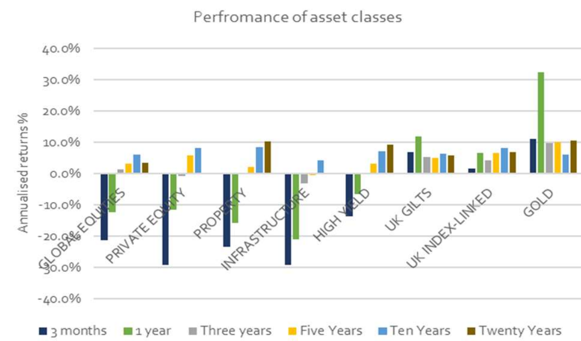



**...VIX (fear) dropped...**




**Dividend yields dropped as share prices rose, however we expect many companies to announce dividend cuts**


**Corporate bond spreads declined, following the FED's purchase programme.**




**During the uncertainty, gold performed best in Q2**

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Source: Bloomberg, OECD, data as of 30/06/2020

## APPENDIX 3: INVESTMENT IDEAS – MEET THE TEAM

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**Please contact Callum Campbell, Head of Client Services and Stakeholder Relations, if you would like to discuss the views outlined in this report with LGPS Central's Investment Directors**

### 1 Selective Overweight Private Equity (J. Sidhu)

- Deal volumes will thin out as buyers await clarity on business activity levels.
- Liquidity is expected to dry-up as exits are curtailed. Fewer capital calls are also expected.
- Valuations and asset prices are expected to decline in line with mark-to-market movements and depressed Q2 business volumes.
- Some accretive add-on acquisitions are taking place at better valuations than pre-crisis.
- New capital raising will take longer.

### 2 Underweight property (M. Hardwick)

- Corrections taking place, more action probable
- Industrials to continue as best sector (by default)
- Covid-19 causing re-evaluation of space requirements across most sectors
- 'Other' sector is vulnerable to revaluations of hotel & leisure
- Likelihood of large-scale redundancies post-furlough, dampening occupational demand
- Above factors should lead to good opportunities - just not yet!

### Overweight Infrastructure (M. Hardwick)

- Torrid time for GDP facing infrastructure showing signs of easing as economies open
- Core type assets in high demand, bond pricing to sustain this
- Rising investor allocations to support demand going forward
- UK Government using as fiscal tool, watch to see how ambitious plans are funded
- Covid-19 may bring changes but long-term trends intact
- Hold off on open-ended funds until valuations fully reflect reality in underlying holdings

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## 4 Underweight Fixed Income (G. Ross)

- Historically low Gilt yields remain unattractive with the prospect of increased issuance to fund fiscal stimulation may push yields higher
- Intermediate peripheral EU bonds (Italy, Spain, Portugal) offer attractive hedged yield pickup in GBP terms
- Global interest rates likely to remain low over the next several years with little immediate sign of inflationary pressures.
- Credit markets offer excellent value given the recent increase in yields and spreads and with the underlying support of the Central Bank purchases
- Sterling has shown recent volatility, although the approach of Brexit may lead to some uncertainty, however the currency continues to remain attractive relative to other majors

## 5 Neutral Equities (M. Davies)

- Our near-term outlook is for a recession, EPS forecasts for 2020 and 2021 still appear too high in our opinion.
- We would not chase the equity market higher at this level, with the market having priced in a V-shaped recovery which is seemingly disconnected from the real economy.
- Central banks have so far succeeded with their stimulus packages, but for global equities to make sustainable new highs, global EPS need to make sustainable new highs, and that seems some way off.
- Focus should be on companies that can weather storms, with strong balance sheets, low debt, market leading positions, and with sustainable business models. Smaller businesses that were marginal before the crisis are not necessarily coming back just because of Central Bank printing.

## GLOSSARY:

| | |
|---|---|
| **GEMs** | **Global Emerging Markets** |
| **ESG** | **Environmental, social and governance** |
| **LTM** | **Last twelve months** |
| **IG** | **Investment Grade** |
| **VIX** | **S&P Implied Volatility Index** |
| **IPO** | **Initial Public Offering** |
| **OPEC** | **Organisation of Petroleum Exporting Countries** |
| **FAANG** | **Facebook, Apple, Amazon, Netflix & Google** |
| **UNPRI** | **Principles for Responsible Investment** |
| **YTD** | **Year to date** |
| **PE** | **Private Equity** |