futurefund
Australia's Sovereign Wealth Fund

POSITION PAPER – THE DEATH OF TRADITIONAL PORTFOLIO CONSTRUCTION?

December 2022

POSITION PAPER – THE DEATH OF TRADITIONAL PORTFOLIO CONSTRUCTION?

DECEMBER 2022

Are we witnessing the death of traditional portfolio construction?

War, deglobalisation, inflation, and rising interest rates have quickly coalesced in ways never seen before.

These structural forces are challenging many of the assumptions underpinning the way investors have generated returns over the last three decades.

This short paper explores how these dynamics might change long-held approaches to investment – approaches that have succeeded in the past but may not in the years ahead. These thoughts follow on from our work on the New Investment Order in which we identified paradigm shifts that should encourage investors to think afresh about their portfolios.

We stand by those paradigm shifts – but we now see that they have played out simultaneously and much more quickly than we had originally thought. This is making portfolio construction far more complex and is why we think the fundamentals of investing are shifting, perhaps permanently.

How it has been

There have been 30 years of globalisation since the fall of the Berlin Wall; 20–30 years of remarkable Chinese growth; four decades of post-Volker interest rate declines; energy and food abundance; 13 years of extraordinary monetary policy (QE); a 30-year peace dividend, and a 30-year excess of global labour and capital mobility with ever declining costs of capital and lower tax rates.

These trends have provided a tailwind to investment returns, which can no longer be relied upon.

Most – if not all – of these trends are in reverse. A real possibility exists that investors face a world characterised by the fracturing of the global geopolitical order, bigger government, more extreme forms of monetary policy, and the risk of sustained higher inflation.

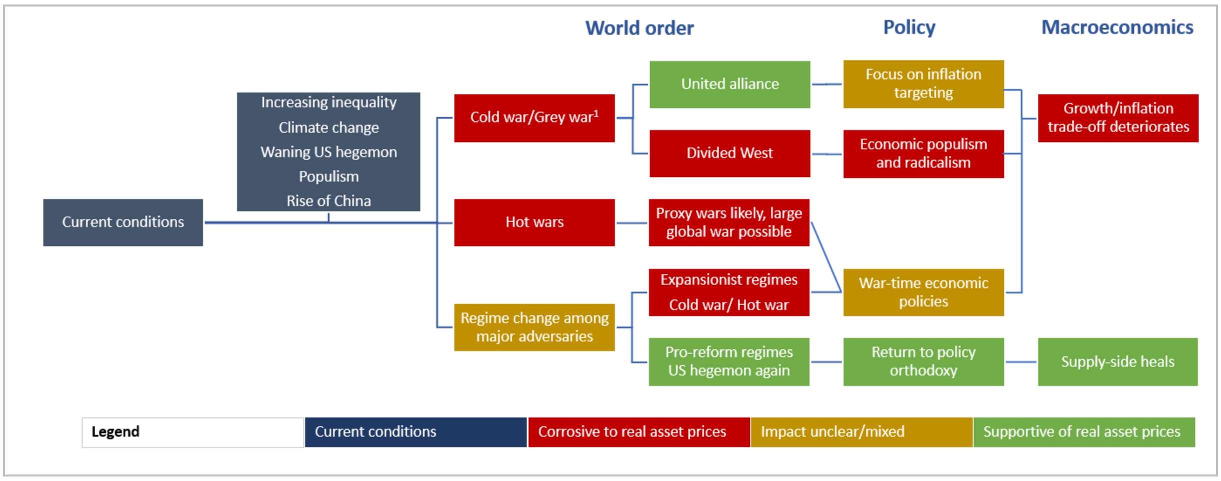
The stable low growth, low interest rate, low volatility and low inflation environment that investors have known is challenged and the future is far less certain.

As the investing landscape changes, investing models are called into question. Modern Portfolio Theory relies on long established views of correlation and diversification. What if those no longer hold true? How will unconventional fiscal and monetary policy further challenge market expectations? How will the breakdown in globalisation and the disruption of capital flows, supply chains, energy markets and migration impact real economies and financial markets?

How it could be

While we see the world changing we cannot predict it with certainty. Instead, we consider plausible scenarios to assist our thinking about what might be and Chart 1 describes some of these.

Chart 1: Uncertain times: How volatile events may affect returns



Note:
1. Grey war refers to major conflict that is not a traditional 'hot' war, eg cyber attacks on the financial system.
Source: *FFMA*

Some characteristics of these potential paths can already be observed.

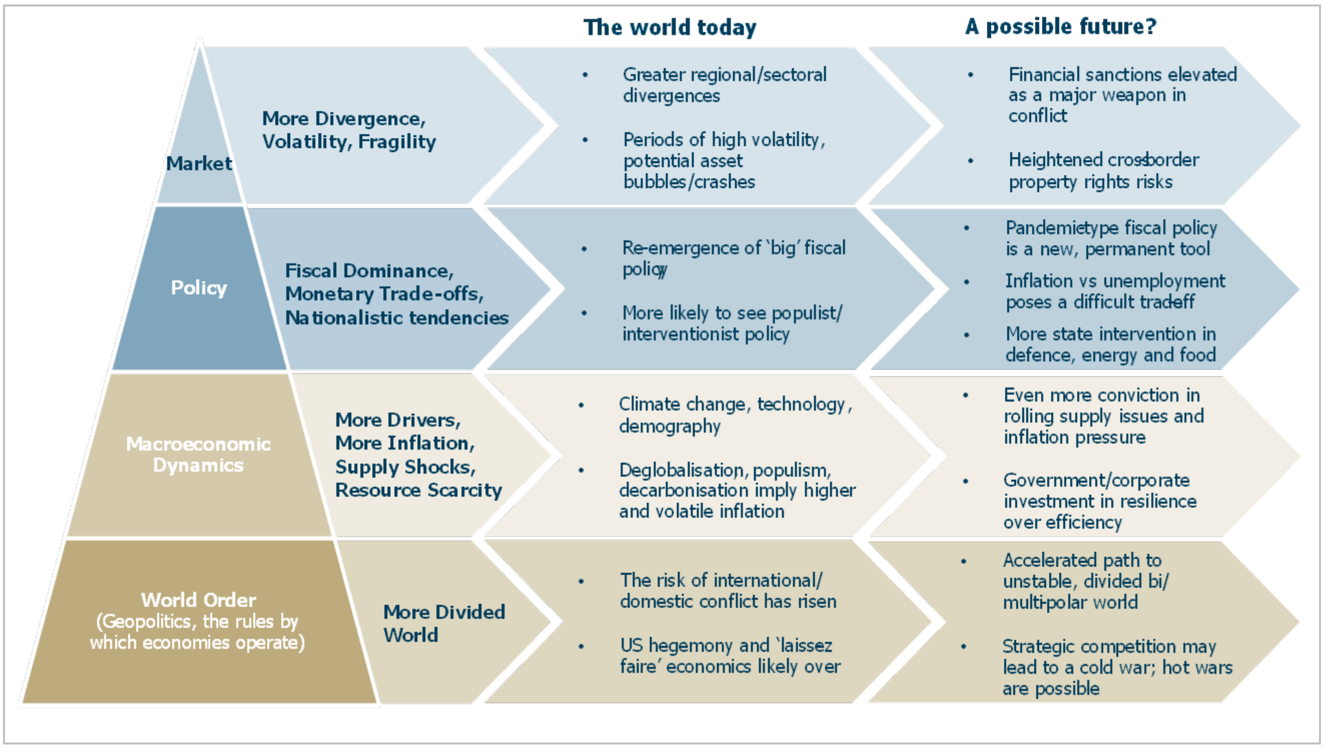
Russia's invasion of Ukraine, with its knock-on effects on energy supply and hardening geopolitical boundaries is a case in point. Together with extreme weather events and ongoing efforts to reduce carbon emissions it has also focused political pressure on energy and food security.

A growing focus on security and resilience over efficiency will have ongoing impacts on inflation and resource demand. If sustained over time, this can act as a regressive tax on activity and worsen the trade-off between growth and inflation.

The pathways illustrated entail a breadth of possible outcomes and a wide array of possible geopolitical, policy and macroeconomic contexts.

Chart 2 illustrates a plausible evolution from where the world is today. To be clear, we do not predict that this is what will happen. Instead, we suggest it is an indicator of some of the conditions investors may need to confront and navigate and illustrates the challenges that traditional portfolio construction models may face.

Chart 2: The evolving investment environment



In this kind of environment there is a real risk of simultaneous slow growth, high unemployment, and rising prices that has some parallels with the stagflationary period that struck developed markets in the 1970s, although there are also significant differences, meaning the path ahead is far from clear.

Investors need to consider this risk and assess whether their traditionally constructed portfolios will successfully navigate this environment, as well as the other plausible paths that could eventuate.

What this could mean for investment portfolios

Given where the world is today institutional investors are likely to need to work harder and employ different combinations of strategies than they have in the past. The structural tailwinds driving market returns are fading and headwinds are challenging investors' ability to achieve their return objectives, while levels of risk and volatility are higher.

Below we outline some of the key issues investors may need to assess as they seek to manage a less favourable outlook for long-term risk and return.

Alpha is more important than ever

Taking more traditional market risk will only have a limited impact on achieving higher real returns. In fact, it could increase the risk of large negative returns in the short-to-medium-term, with history suggesting such periods can extend across a decade.

Generating excess returns through alpha becomes ever more important but this presents challenges in the ability to identify and access those opportunities.

More regional differentiation

Higher geopolitical risks mean investors may have a greater preference for domestic exposures and a higher hurdle for investing in emerging markets. There is a greater chance of occasional, large asset and currency depreciations causing potentially heavy losses for unwary investors.

Superficial regional diversification may introduce unintended, poorly rewarded risks. For example, capital controls and confiscation may be more likely in certain countries.

More correlation caution

Structurally higher inflation levels and volatility may weigh on rates' defensiveness in a supply recession. Investors will need to search for alternative forms of defensiveness perhaps through differentiated hedging and alternatives, and seeking assets with a higher pass-through of domestic inflation.

Higher inflation levels and volatility

In a scenario of intermittent supply constraints, commodities could play a greater role in institutional portfolios. This exposure may be useful for portfolio resilience, even if they generate low returns.

A more dynamic approach

Large investors must now make more portfolio decisions that collectively 'move the dial'. This may require investors to resource differently and to put in place more robust and nimble governance arrangements, systems, and processes. Refreshed portfolio planning and dynamic positioning are likely to supplant set and forget approaches.

Foreign currency may no longer be defensive

Australian investors need to look at the world through a currency lens. The demand for Australia's commodities in a stagflationary world, where the need for global investment is profound (particularly to tackle climate change), will provide a tailwind to the Australian current account. This should benefit the Australian dollar but should also reduce confidence in the traditional defensive nature of holding foreign currency exposure.

Decarbonisation/energy transition

The world's transition to clean energy is accelerating, but the challenge remains enormous - and is similar in scale to the industrial revolution.

This is happening simultaneously with a world increasingly in conflict, with resources locked in different regions. This makes the transition challenge more urgent, less co-ordinated and more expensive.

Haven’t we seen this before?

History often provides important lessons for portfolio construction. The most natural period of relevance is the stagflationary era from the late 1960s to the early 1980s.

The 1970s was a particularly demanding period for traditional institutional portfolios, with a 60/40 equity/bond allocation losing about 2% each year in real terms.

Particularly damaging was the combination of high and volatile inflation and weak growth/high unemployment, making bonds poor diversifiers for equity risk. Rising real yields also severely dragged down equity valuations and returns.

While the period is instructive, there are also important differences, which we outline in Table 1 below.

Such differences, combined with significant uncertainty about how current events will play out, highlights why we can only take partial lessons from history.

Table 1: Key features of the 1970s stagflation (taken as 1969-1982) compared to our current outlook

Feature	1970s stagflation	Possible outlook
Geopolitics	• Post-war dividend • Cold War, USSR in decline	• More confrontation; hot wars likely • Competition for scarce resources exacerbated by carbon transition
Monetary policy	• Monetary policy not independent • Costs of high inflation not appreciated	• Independence/inflation targeting well established, but still exposed to political pressure • Institutional memory of 1970s conditions policy
Fiscal policy	• Populist loosening to deal with cost of living	• Greater role of fiscal is possible, given importance during pandemic • Energy/defence spending is inflationary near-term and may not be productive long-term
Inflation expectations	• Inflation expectations unanchored • Wage/price spiral	• Near-term inflation expectations have risen, longer-term have not • Income share likely to re-weight from capital to labour • Automation, as a supply response, could curb inflation expectations
Debt	• Low household and government debt • Material rise in real rates required to tame inflation • High real rates embedded in asset prices	• Globally, balance sheets are more levered and sensitive to rate rises • Less real rate rises needed to destroy demand and quell inflation • Asset price reactivity to incremental rises in real rates is higher

Feature	1970s stagflation	Possible outlook
Demography/ social trends	• Favourable demographics, baby boomers at working age • Unionisation and cost of living adjustments more commonplace	• Lower trend growth, higher dependency ratios, labour supply constrained • Potentially more scope for labour substitution using new technologies
Climate change & energy	• Climate change not recognised • US reliant on foreign energy – particularly from the Middle East	• Energy transition requires massive investment • US is net energy independent, China/Japan/Europe are net energy importers
Currency regime	• $US/gold peg at outset; de-peg meant lower $US and higher US inflation • $AU pegged/managed throughout with some revaluation higher allowed	• All major currencies are fiat and floating (except gold) • Some reserve diversification away from $US; $AU may benefit from commodity strength

Portfolio resilience is key for the Future Fund

Different investors have different objectives, cash flows and liquidity need, as well as widely differing beneficiaries. Investors need to carefully assess how their particular context will be impacted by a range of possible future scenarios

What seems likely is that how investors have invested in the past will need to change. For the Future Fund's part, we have long taken a total portfolio approach with a strong emphasis on genuine diversification. More recently we have begun to manipulate newer levers across the portfolio to help make it more resilient in the face of these converging structural forces.

Portfolio implications	More alpha	More volatility	More granular	More correlation caution	More domestic exposures	More defensive levers, inflation protection
Levers activated	More Private Equity	Focus on liquidity and dynamic asset allocation	Detailed levers for DM/EM	Broader currency basket	Added to Infrastructure	Added Gold, Commodities, Tangibles, Alternatives

Conclusion

We believe that the world we anticipated over the medium term in our *New Investment Order* paper is the world we are now in. It is a world that is radically changed – one that is testing investors' preconceptions.

It is also an investment environment that continues to evolve. There are no simple answers for the investment community. Traditional approaches have delivered strongly, but it is doubtful they are fit for purpose in the future.

As the outlook for traditional beta has declined and the toolkit for defending portfolio returns has shrunk, institutional investors need to reconsider what they invest in, where they invest, and how they make decisions. A deeper understanding of more nuanced and difficult risks is needed and history is an imperfect guide to how to do this.

It is a time for investors to challenge their models and assumptions and explore how they now need to balance risk and return.

The Future Fund

The Future Fund was established in 2006 as Australia's sovereign wealth fund. Its purpose is to invest for the benefit of future generations of Australians.

Valued at $193bn as at 30 September 2022, the Fund has returned 9.2% pa against a target of 6.6% over the last 10 years, and earned $133bn on the original $60.5bn in seed capital contributed by Government.

The organisation is also responsible for managing an additional five public asset funds collectively valued at $48bn. These funds support Australian medical research, drought and emergency response, farming communities, important initiatives in the Indigenous community, and the National Disability Insurance Scheme.

The Future Fund's latest portfolio update can be found here: https://www.futurefund.gov.au/news-room.