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Are Excess Optimism and Overconfidence Driving Global Markets to Unrealistic Levels?

The Conrad Hotel in Bangkok was the venue for an animated discussion on global capital markets hosted by Boston-based US funds group GMO. The gathering of distinguished market practitioners and GMO portfolio managers mulled over a variety of fascinating topics. Can investors make money in long-only multi-asset investing in this late market cycle environment? Is the 60/40 portfolio a thing of the past, and how does a multi-asset strategy invest today? Is the EM domestic consumption story alive and well, and what EM strategies should investors adopt?

The key takeaways

Asia's wealth management community faces numerous concerns

Very elevated valuations in the US and some other equity markets, a growing corpus of negative yield bonds globally now estimated at more than USD19 trillion, volatility, trade wars, Trump's tweets, Hong Kong's troubles, other geopolitical concerns, and a host of other issues are all cause for worry, with a consensus view emerging from the guests that greater portfolio diversity is desirable, taking in more alternatives, often potentially less liquid and longer-term.

Valuations might indicate a new norm

On the one hand, the bond market, at least in the US where the yield curves are inverted, appears to indicate a recession is coming, while the equity market seems to be saying, everything is great, we are going to get a soft landing, the Fed is going to have to cut rates and engineer a nice slow-growth economy.

But current conditions might also indicate slow growth or stagnation

The data points for equities and fixed income and market participants' behaviour might actually be saying rates will keep falling and that we are stuck in a new world of very slow, low growth in the US, or even worse in some of the major developed countries, with only slightly more growth in emerging markets.

Cheerleaders for the low and slow scenario?

Perhaps the stock markets, especially in the US, are therefore actually cheering on the sustained low and slow growth view, adopting the view that the discount rates on the future dividends, the future cash flows, are going to stay low forever.

In the face of such uncertainty, build robust, diverse portfolios

In light of the genuinely opaque direction of world markets and what could be considered absurd central bank strategies, investors should seek out portfolios that can behave robustly across any environment that lies ahead.

Will things revert to the mean?

Some leading analysts and investors believe that valuations of debt and equity revert to the mean reversion over time. For equities, that means around 16 times profits after tax and an anticipated return of about 6% after inflation. But that, of course, means bad news, especially for US equities.

Cast off the burden of the 60:40 portfolio strategy

The traditional 60% stock, 40% bond portfolio, is now potentially more of a burden, possibly a trap, than before, when normalised conditions meant a more traditional approach.

GMO currently takes a 43% equity viewpoint

In GMO's benchmark-free world view, it currently has a 43% equities allocation, with emerging markets (EM) a considerable portion of that, because GMO believes EM can offer a selection of opportunities that come out at roughly 1X book and less than 9X earnings with a 4.6% dividend yield.

Steering away from fixed income

And GMO's benchmark-free strategy now eschews the old 40% bonds rule. The strategy currently has a 20% allocation to FI - while they find the returns from the space subdued, areas like Emerging Market Debt offer some attractive opportunity.

Away from 60:40 strictures investors can migrate to alternatives

Alternative assets can, if assembled well, produce a cash plus 4% return with no exposure or limited exposure to equity markets and limited exposure to interest rates.

Choose your alternatives wisely

GMO pointed to some alternatives its benchmark-free strategy has taken up, including merger arbitrage and put selling, for example.

Results speak for themselves

The GMO benchmark-free strategies have since inception in 2001 delivered north of 8% annualised returns and with nearly half the volatility of the S&P and with a Sharpe of 0.9. Looking ahead, portfolio managers anticipate the potential on a medium-term horizon to deliver CPI plus 5% over a market cycle.

Take the EM (Value) highway

Some might see the universe of EM stocks globally as relatively cheap. However, while valuations are broadly more appealing, careful attention must be paid to buy into stocks that are de-linked from major market correlations, avoid domestic political and global geopolitical risk, and which leverage the growing dynamism of the retail consumer, the ever more voracious buyers of financial services, consumer items, the user of rising infrastructure and travel opportunities and so forth.

Avoid the risks, avoid contagion

Having seen the Asian financial crisis of 1997/98 and other EM crises in Brazil, Russia and other markets, it is vital to sidestep political risks and potential contagion.

Pick your countries wisely

Disparity between the situations and the valuations on offer in the roughly 200 EM countries allows for the potential to build country-driven portfolios first, and then to mine down into the best sectors in each country, for example infrastructure or REITs in Thailand, financial services in Taiwan, banks in Brazil, internet/tech in China.

Take the four steps

EM investing should, therefore, be about the disciplined effort to find the right countries, find the right sectors, find the right businesses, and then manage risks.

Hedge your bets with a systematic global macro strategy

GMO operates a systematic global macro strategy with USD10 billion in assets currently, and steers well clear of the 60:40 theory, investing to achieve a target cash plus 9% return through the cycles, buying into four asset classes, equities, bonds, currencies, and commodities.

The world filtered through derivatives

The GMO systematic global macro strategy trades futures and forwards in these four asset classes, using around 65 futures contracts around the world.

The vital importance of analysing the underlying realities

Deep analysis and an agnostic view on the benchmark or traditional portfolio theories, allow GMO to buy into what it sees as pockets of opportunity such as in equities EM, where there is some good value, as well as selected UK and European equities, while avoiding the 'terrible' US markets.

Take your positions

The GMO systematic global macro strategy bases its activities on its advice to investors to avoid long positions in government bonds unless the investors are making a spread trade. For currencies, the strategy is now long Norwegian Krone, short the Swiss Franc, short the Euro, and short gold, where the managers think the price has run too far. Alternatives are sought out that offer returns lowly correlated to equities and lowly correlated to bonds."

Beware the unexpected

A final word came to warn investors of the potential for an unexpected rise in inflation, against perceived global investor wisdom apparently, viewing their portfolio positions from a wide-angle perspective. If indeed inflation returns, the potential for a major disruption in the fixed income market is significant. ■

THE DISCUSSION INVOLVED ESSENTIALLY FOUR ELEMENTS. First, some of the guests highlighted concerns they have in investing on behalf of their wealth management clients. Then three portfolio managers (see associated box on GMO) spoke at considerable length on these three topics and strategies, supported by reference to an excellent and immensely detailed PowerPoint presentation.

Long-Only Multi-Asset Investing in Late Market Cycle Environment. This covered the discussion of the typical 60/40 Portfolio and the 'Lost Decade', price versus value and GMO's multi-asset solution.

Accessing the EM Domestic Consumption Story. This looked at topics such as why diversification is important, the idiosyncratic risks involved in EM investing, the evolution of opportunities in EM, opportunities for investing in Thailand and other EM markets and the implications of the trade conflicts.

And the third big topic was the GMO systematic global macro strategy that launched first in 2002 and today holds around USD10 billion.

Guests express concerns

A leading private banker based in Bangkok opened the discussion by expressing some of the concerns their bank's clients have in the current market environment. "In face of volatility, trade wars, Trump's tweets, Hong Kong's troubles and other issues, we stress portfolio diversity and our clients are also focused on fixed maturity investments," she said.

Another guest representing a multi-family office in Singapore agreed with these concerns and layered on the over-valuations in some equity markets, especially the US, debt at a historically high level globally, negative interest rates in Europe, an inverted dollar yield curve, and other metrics. "Our clients typically have USD2 million to invest outside their property and other assets," he noted, "and they worry that their financial market portfolios are out of kilter now, or could be soon."

"I see nearer-term concerns," said another invitee. "For the last year, we have done well, particularly with a more defensive approach and very overweight medium and long-term treasuries. But are they still safe? The dilemma that faces us is on a sort of 6- to 12-month view, maybe even shorter. We see a polar opposite in risk markets appearing positive for the next year and such as Treasuries being very negative. It is unusual. Can central bankers handle all this, or are they overestimating their capacity to handle things? We have really no idea as to whether things are going to be really good or really bad for the next 12 months."

Keeping it benchmark agnostic

With that, Rick Friedman took the floor, to highlight what he called GMO's most 'free' portfolio, the Benchmark Free strategy, aimed at delivering inflation plus 5% over full market cycles.

"Let me address the macro question first," he said, and armed with the slide presentation, he talked the guests through some of his views.

"On the macro side we do not try to make big calls on conditions because there is always going to be some event or another,

TENGEN ZHANG & MEHAK DUA
GMO

RICK FRIEDMAN
GMO

whether it is the worries about Greece defaulting a few years ago, or Brexit currently, the possible breakup of the EU, Russia invading Crimea, Iran, trade wars, or whatever. But looking at yields, the short answer is there is not much to get excited about, and you must be pretty careful how you position a portfolio today."

What are we seeing? Reality or a new reality?

"On the one hand," he remarked, "the bond market is saying, at least in the US where curves are inverted, a recession is coming, while the equity market seems to be saying, everything is great, we are going to get a soft landing, the Fed is going to have to cut rates and engineer a nice slow-growth economy."

But he noted that these data points and this type of market participant behaviour might actually be saying rates will keep falling. "In this scenario," he commented, "we are stuck in this new world of very slow, low growth in the US and even worse outside in major developed countries, with perhaps slightly more growth in emerging markets, but also slowing, and in that situation of a world with no inflation pressures, interest rates stay low and we are really kind of stuck."

Accordingly, Friedman extrapolated that "perhaps the stock market is actually cheering that view, saying that the discount rates on the future dividends, the future cash flows, is going to stay low forever. Honestly, we actually don't know the answer to that."

In the face of the historical and projected data and market environment, Friedman, therefore, explained that what GMO is doing is to build portfolios that are robust across any environment that lies ahead.

A crazy crazy world

"Right now, it is fairly crazy, with more than USD17 trillion of debt that has negative interest rates, and although 90% plus of investment-grade bonds that have a positive yield are traded in the US, everything else outside the US is now negative. Now, we are not going to tell you we have precision to know exactly where an anchor might be, but we know that the Fed themselves has no idea and always gets this wrong, so for example about 10 months ago the Fed was projecting end of year rates at 3.5%. But look at where we are now, far lower and falling."

He acknowledged that while the US earnings have been strong in the past decade, the US market seems to be saying that will last forever, for 50 years, for 100 years. "They are paying up in anticipation of those current earnings almost doubling right now," he remarked. "That means their buying has left the markets very expensive on all valuation metrics. So, we need to think about what you do about this."

With that, Friedman asserted the GMO view that things tend to revert back to long-term averages over time. "The mean reversion case says everything goes back to kind of a world in which you pay about 16X or 17X earnings for companies and you expect to make a return of about 6% after inflation. Well, we do not know the path ahead, so we just say that seven years from now everything will be at fair value. That is our best guess."

Extrapolating from this point, Friedman said this means bad news for major US equities, not quite such bad news for smaller stocks, and 10-year US Treasuries at 1.25%.

"But we also run the scenario of GMO being wrong, acknowledging that the world is different, that we may be in this low rate world forever, so price multiples would be higher, not 16X or 17X, but 19X or 20X."

Looking at a wide variety of metrics, and possible outlooks, Friedman concludes that the traditional 60% stock, 40% bond portfolio, is a thing of the past. "GMO's success is down to taking risk when we are getting paid to take risk and avoid-

ing risk when things are overpriced. Right now, we don't have 60% or 65% in equities, we have 43%. That is as much as equity as we can stomach owning."

In GMO's world view, in its 43% allocation, EM and specifically EM Value is a considerable portion of the equity portion, because it is possible on recent valuations to have built a portfolio that in September was trading at 1X book and less than 9X earnings with a 4.6% dividend yield.

And the GMO benchmark free strategy does not have 40% in bonds. "We simply don't understand how you can get paid in bonds unless you really believe that central banks keep doing what they have been doing and taking yields even more negative," he explained. "But monetary policy has not really been working around the world, so there is more risk of a recession or continued sluggish growth, resulting in yet more fiscal response in different countries, which could lead to a little bit more inflation globally and rising rates, and that would crush obviously long-duration bonds and even stocks."

Friedman then explained that with less than 60% or 40% in stocks or bonds, they have turned increasingly to alternatives. "What we like about alternatives is we can make a cash plus 4% return with no exposure or a limited exposure to equity markets and limited exposure to interest rates. So, the result is we have a portfolio that looks rather unconventional, built over points in time."

He then pointed to some alternatives GMO has adopted, including merger arbitrage and put selling, for example. "For merger arbitrage, you are underwriting the chance that the deal blows up, there is kind of an insurance premium embedded in there. Another is a fixed income and currency-related strategy that has had a great couple of years.

AMIT BHARTIA
GMO

A new world in a new era

Friedman drew his portion of the presentation towards a close by looking back over time. "Way back in 2003 we had 60% in stocks, 40% in bonds, the traditional split," he recalled. By August of 2008 we had shifted to a lot of cash and cash plus strategies, we were very defensive in that period. Then we began buying equities again in October of 2008, as assets went from being expensive to at least fairly valued and we started to build positions in, we started buying more and more and more. By April of 2009 we had turned over more than half of our portfolio and we were back to making money in nine months, while it took a traditional 60/40 balanced portfolio a few years to do so."

Friedman noted that GMO already has a small handful of clients in Thailand today that are investing in GMO's benchmark free strategy. "Since inception in 2001 it has delivered north of 8% annualised returns and with nearly half the volatility of the S&P and with a Sharpe of 0.9. We are looking for investors with a medium-term horizon, and we aim to deliver CPI plus 5% over a market cycle.

The EM Domestic world according to GMO

Amit Bhartia took the floor to explain GMO's strategy for emerging markets (EM). His first comment is that comments such as EM is cheap are too simplistic. "EM is a very complex asset class, it is non-homogenous, given often the poor quality of data and other idiosyncrasies, so it is critical to look at the asset class from a multi-lens perspective," he observed. "From our viewpoint, there are more than 60 different indicators that result in us classifying EM in three buckets. We take a completely data-driven perspective that helps us to manage risk, and position the portfolios efficiently."

He recalled that in his early career during the Asian financial crisis, he had started buying Thailand when the market was down 80%, but it then fell another 50%. "In EM these crises are all too common," he said, "and we see that in Russia, Brazil, China, India, and other places over many years, sometimes so bad it looks like 1929 must have done in the US. So, risk is critical, and we monitor the key variables,

and thereby aim to avoid crisis and possible contagion. On top of that, we layer valuations in a variety of metrics and sentiment, which is a contrarian indicator, so our analysis clearly highlights when there is too much exuberance, and risk needs to be cut back accordingly."

He pointed to the GMO emerging domestic opportunities strategy that launched in 2012 when valuations were appealing. And today, he indicated that valuations remain reasonable, and other factors mean this is an encouraging moment for EM.

"The risks of sharp falls of 20% or more as in 2011, 2013 and 2015 are low," he stated. "And divergence between the countries and sectors within the EM asset class remains fairly high, so this year Thailand is up about 10% in US Dollar terms. While India is down about 6% plus, and Russia is up about 20%. So as we expect that to continue, it is a good time for an active manager to find ideas and invest accordingly."

Bhartia explained that his strategy is to find domestic consumption ideas across EM which are as much uncorrelated to global development. This means no energy stocks, no materials stocks, and so forth. "Our approach is buying uncorrelated domestic sources of alpha and build a portfolio," he reported. "Today, about 10% of the portfolio is in Thailand and there are a lot of interesting ideas within Thailand from a global context that help me achieve my objectives. Such as REITs, or infrastructure companies. Similarly, private banks in Brazil and the insurance industry in India."

A score of EM countries to choose from

He classified the emerging domestic opportunities' strategy universe as about 20 different countries with about 800 stocks across MSCI. "We take a combination of top-down, bottom-up and very strong risk management to help achieve our objectives, as we are also very conscious of political risks, which can destroy stocks that might appear fair value."

"We take a combination of top-down, bottom-up and very strong risk management to help achieve our objectives, as we are also very conscious of political risks, which can destroy stocks that might appear fair value."

This also means that Bhartia and team avoid sectors which have incredibly competitive, high regulation risk, as the governments often tinker with them, and this eliminates almost 20% of the 80 stocks at one shot. "Within that revised universe we then build the portfolio and we are benchmark agnostic, so we recognise we can be wrong, but incorporate strong risk management, resulting in our downside beta in down markets historically at just 0.5 to 0.6."

The process, he explained, comprises four steps - find the right countries, find the right sectors, find the right businesses, and manage risks. "So, for example, we like Thailand and have been consistently huge overweight over the last five to six years."

He then highlighted dynamic allocation. "When we set out in 2011-2012, EM was higher risk, so to mitigate the risks, about 20% of our portfolio was in multinational companies, such as Nestle, or Unilever, which are major players in emerging markets but have a recurring cash flow from developed markets. But today that figure is less than 8%, with the slack taken for example by Brazil which was less than 2% and is now closer to 8%, largely because politics and the outlook have improved. India is currently less than 2.5%."

He moved on to discuss individual sectors and stocks, once the country allocation has been formulated. Thailand REITs, Thai infrastructure, Chinese internet, Taiwan financials, all currently offer quality businesses and are fairly priced in GMO's view.

"Today, he remarked, "the Chinese internet sector market capitalisation is more than entire EM universe 25 years ago, so EM is clearly not one asset class, there are plenty of sub-asset classes within the broad EM asset class itself."

He then highlighted some of the key differentiators at GMO, including what he termed 'forensic accounting' to identify companies who are doing aggressive accounting. "And as to risk control," he explained, "we do this based on four metrics, resulting in us being able to avoid cluster risks and contagion."

Less downside risk, while retaining most upside potential

As to performance, Bhartia reported that the GMO emerging domestic opportunities strategy, which today holds around USD2 billion in assets, has done significantly well in down markets because of these uncorrelated ideas, although in up markets it tends to underperform.

"But that's the whole idea is to participate about 80% to 85% in up markets and capture about 60% to 70% in down markets," he concluded. "That is why we achieve solid performance and keep risks to the minimum. We count some 50 or so investors from family offices to sovereign funds across the world."

Next up was Dr Martin Emery, a portfolio strategist for GMO's Systematic Global Macro team and who is also the co-founder of the GMO systematic global macro strategy that launched first in 2002.

"We manage a global macro strategy from Sydney, Australia, with around USD10 billion in assets currently. We have a wide variety of clients across Asia-Pacific, but we also have a global client base in North America and Europe as well. We have been seeing a lot of interest in our types of strategies, globally."

60:40? Yes, that used to work...

Emery explained that back about a decade ago portfolio building was still focused on 60/40, 60% in equities, 40% in bonds, and then building some alpha around the edges.

"But today, things have changed markedly," he reported. "As my colleague Risk Friedman noted earlier, the US equity market is horrendously expensive on any metric, and if you have a look at some of the valuations for US equities at the moment, we expect that to actually return less than cash. And on the bond market side, as we know there is some USD19 trillion of negative-yielding debt already, and growing. So, overall you will be lucky to do as well as cash on the 60/40 basis, not the cash plus 4% most people believe can be achieved, they are still in what I call a 60-40 trap."

DR MARTIN EMERY
GMO

Buying into the future, the GMO way

He explained that the GMO global macro strategy is essentially looking for a cash plus 9% return through the cycle, buying into four asset classes, equities, bonds, currencies, and commodities. "We trade futures and forwards in, so about 65 futures contracts around the world using these four asset classes. And we have done rather well across the cycles across the 17 plus years since we set out."

He pointed to pockets of opportunity that he and his team see, including EM where there is some good value, as well as selected UK and European equities, but avoids the 'terrible' US markets.

On bonds, he advises avoiding taking long positions in government bonds unless the investors are making a spread trade. For currencies, the strategy is currently long Norwegian Krone, short the Swiss Franc, short the Euro and also in the sub-set is short on gold, where Emery sees the price having risen because negative bond yields are making investors turn to gold "as a cash box".

"However," he noted, "we feel gold is tremendously expensive at the moment. Lots of central banks have been buying into gold, but we see that reversing at some stage."

Again, in the effort to avoid the 60/40 trap, Emery and team work on alternatives. "We see alternatives offering returns lowly correlated to equities and lowly correlated to bonds."

"My biggest risk, biggest concern at the moment, not only in this portfolio, but I think for markets in general, is inflation surprise," he cautioned. "I think some positive inflation surprise will actually come and cause major disruption in the fixed income market." ■

GMO's Four Decades of Value-Seeking, Contrarian Investing Success

Global asset management firm GMO is a USD66 billion Boston-headquartered global asset management firm founded in 1977, with offices in six locations around the globe. One of the co-founders is Jeremy Grantham, a well-regarded value investor often quoted in the same breath as Warren Buffett. Grantham's quarterly letters and seven-year forecasts are widely read in the industry.

GMO describes itself as a partner in investing. The firm reports its investment teams are "grounded in a long-term, valuetion-based investment philosophy", an approach GMO believes provides the best risk-adjusted returns.

GMO embraces long-term investing principles. As a private partnership whose sole business is investment management, GMO maintains the firm is designed to invest the way the team believes will deliver the best results over the long-term for our clients. GMO's stated position is that the firm is willing and able to take and hold significant and unconventional positions when they see markets move to extreme valuations.

GMO takes a contrarian value investment approach to identify and exploit opportunities and the rationale behind this approach is that economic reality and investor behaviour cause securities and markets to overshoot their fair value. GMO focuses on compounding wealth for its clients by identifying mispriced opportunities and then exploiting them in a systematic and disciplined way.

The firm's literature explains that GMO has for more than 40 years partnered with a broad range of sophisticated institutions, financial intermediaries, and families to provide the investment expertise they need to meet their goals and fulfil their missions.

"Investing on behalf of our clients is GMO's sole focus," the company reports. "Across asset classes and around the world, our investment teams identify and exploit long-term opportunities and develop solutions that both anticipate and respond to client needs. GMO clients benefit from our diverse expertise, intellectual curiosity, and open culture of debate, as well as from our ability and willingness to take advantage of contrarian market opportunities. Clients also receive access to all of our industry-leading, insightful investment research and commentary."

GMO explains that the realisation of its value-based approach if effected through a collection of investment teams with focused specialities. GMO also highlights its commitment to ESG investing, reporting that ESG factors can have a meaningful impact on the long-term success of companies and countries. "Our investment teams incorporate them where we believe doing so will improve investment results."

GMO believes in differentiated research and is proud to serve some of the most prestigious and sophisticated investors globally. GMO prides itself on candid, academically rigorous market insights and advice that underpin the research that the firm undertakes.

The company is present in Boston, San Francisco, London, Amsterdam, Singapore and Sydney.

Three leading GMO portfolio managers spoke at the Q4 2019 event

Rick Friedman

Friedman is a member of GMO's Asset Allocation team. Prior to joining GMO in 2013, he was a senior vice president at AllianceBernstein, and before that a partner at Arrowpath Venture Capital and he was earlier a principal at Technology Crossover Ventures. Friedman earned his B.S. in Economics from the University of Pennsylvania and his MBA from Harvard Business School.

Amit Bhartia

Bhartia is a portfolio manager for GMO's Emerging Markets Equity team and oversees fundamental research. Additionally, he serves as CEO and an executive director of GMO Singapore Pte Ltd. Prior to joining GMO in 1995, he worked as an investment advisor in India. He earned a Bachelor of Engineering at the University of Bombay and an MBA at the Institute for Technology and Management in Bombay. He is a CFA charter holder. One of the markets Bhartia has been promoting for the past two years is Thailand, on which he remains very positive.

Dr Martin Emery

Dr Emery is a portfolio strategist for GMO's Systematic Global Macro team. He is also the co-founder of the GMO multi-asset absolute return strategy. Prior to re-joining GMO in 2013, he was the head of quantitative strategy at Macquarie Equities in Asia and served in a similar capacity for the Commonwealth Bank. He previously worked on GMO's Systematic Global Macro team from 1999 to 2001 and also worked for Westpac Investment Management. He currently serves as an Adjunct Professor in Economics and Finance at the City University of Hong Kong. Dr Emery has a Master's Degree and a PhD in Finance from the University of New South Wales.