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Asset Allocation and Risk Management in a Fractured World Economy

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Pensions and Asset Ownership Project
Investment and Governance Research
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The present primer is the first of a series of seven essays summarizing some of the comments made by diverse experts attending the **Singapore Economic Forum** EU ASEAN Roundtable held 12 November 2020 and the WPC & **G7 Pensions** Global Financial Forum (GFF) held 14 – 16 December 2020, titled ***Innovation, ESG & Inclusive Growth Transforming Capital Markets***. All thought leaders cited here spoke at the latter event, except otherwise indicated.

This short recension is by no means exhaustive or *verbatim*: it incorporates critical remarks and analyses made by the co-authors at the time of writing and publication (mid-Feb. 2021) & thus shouldn't be considered as a transcript of any particular roundtable – all the more since some of the sessions were held under (partial) Chatham House.

The session titled *Asset Allocation and Risk Management in a Fractured World Economy*, which gave its name to the present primer, brought together experts from across the European Union (EU), the Gulf Cooperation Council (GCC) and Australia, notably **Torbjörn Hamnmark**, Head of Strategic Asset Allocation, Sweden's Tredje **AP-Fonden** (**AP3**), the Rt Hon. **Nick Sherry**, founder & fmr. minister**,** AUS Ministry **Superannuation & Corp. Law**, one of the fathers of the 'Australian Pension Miracle' and Dr **Domenico Mignacca**, ED, Investment Risk, **Qatar Investment Authority** (QIA).

Panellists looked at some recent trends, including, notably:

- Paucity of detailed databases for some major economies/geographic areas can constitute a problem in modern asset allocation: Latin America, for example
- (the sometimes irregular) movements in asset pricings are attracting increased attention from the part of institutional asset owners, including central banks and sovereign wealth funds (SWFs)
- Significance of private markets including infrastructure, private equity and venture capital is increasing. Specific issues are: desired or 'ideal' target percentages in an overall portfolio mix, compared with, say, five years ago; appropriateness and eligibility for pension investors, including from a liquidity risk perspective
- Private equity may lack transparent monitoring mechanisms for investors who wish to promote E, S and G themes (D. Weeks)… but like for like, for an equivalent amount of money invested, they also offer engaged asset owners the possibility to have more say re the management of the company, compared to the (limited) influence they can exert on large, listed blue chips (N. Firzli). "The private equity paradox."
- Changes in significance of alpha and beta considerations are topics for active discussion, attracting ever-growing research from the part of asset owners. … And current views about some key sectors for investment were aired: (1) top corporates, e.g., Amazon and Microsoft; (2) oil and gas; (3) financial services; and (4) liquid and illiquid assets.

Torbjörn Hamnmark noted that, for global investors working in a financial environment increasingly defined by abnormally low interest rates, partly due to quantitative easing, "offering us in essence risks with no returns", mounting geo-economic tensions and accelerating technological disruptions etc. "we are in the twilight zone."

pictured clockwise

D. Mignacca, Qatar Investment Authority (QIA)

T. Hamnmark, Sweden's Tredje AP-Fonden (AP3)

The Hon. N. Sherry, founder & fmr. Minister, AUS Ministry of Superannuation & Corporate Law

N. Firzli, World Pensions Council (WPC)

D. Weeks, Assn. of Member Nominated Trustees (AMNT)

re the 'quest for yields', Torbjörn Hamnmark and other experts in attendance remarked that, in the recent past, [European and North American] "public pensions with a higher-than-average allocation to less liquid or riskier' assets have profited handsomely." The rising allocation trend to private markets will probably continue going forward, "but investors will need to be careful", assessing risks intelligently across asset classes and geographies.

Unorthodox central banking policies and their excesses were also discussed by **Baroness Ross Altmann**, Member of the **House of Lords**: in our current macro financial circumstances, "*pension investors should* [be able to] *allocate more towards infrastructure and other growth assets as government bonds now provide return-free risk."* She argued eloquently that short term monetary expediencies such as quantitative easing may not be compatible with *"the long-term sustainability of pension funds."* **Suzanne Bishopric**, Adv. Board Member, **Singapore Economic Forum** (SEF), fmr. CIO, UN Joint Staff Pension Fund (JSPF), concurred: *"increased participation in pension funds gives the common citizen shared ownership in a diverse array of assets. They allow every member to benefit from recent economic policies, such as artificially low interest rates, that inflate asset prices"*

> David Weeks, AMNT, asked panellists for their views about stock picking: "*should we rate boffin like skills of analysis, or rather barrow boy skills of buying low, selling high and beady timing? Most panellists thought that the best mechanism was [the use of] broadly based and intellectually diverse investment committees.*"

Conference co-chair & cofounder **Nick Sherry,** Singapore Economic Forum (SEF), asked about geographical considerations. Panellists thought that western economies will have a smaller share of global GDP in the future. China will have a bigger share. Two current issues which will probably have longer term impacts for investors are: (1) US/China trade relations; and (2) UK's post Brexit position in relation to the 'Asianized world economy.'

Nicolas Firzli, World Pensions Council (WPC), took the contrarian view [by the prevailing EU standards of the day], insisting that, whatever the outcome of the tense EU–UK Trade and Cooperation Agreement negotiations [which were eventually finalised and signed on 30 December 2020], "HM Gov wouldn't yield to pressure from Brussels regarding financial services" and that the alarmist notion of "droves of UK investing bankers and asset managers moving to Luxembourg as the ideal alternative to the **City of London**" was highly exaggerated: "Britain will thrive in the Post-Brexit era… which is also the Post-Covid era."

> Nicolas Firzli, WPC, insisted that "*The ESG revolution will be datafied and non-linear: in the short-medium term, the shift to renewable energy and other green growth assets won't prevent a rise in oil prices*", as China becomes the biggest user of both fossil and green energy… "*to pick up the relevant financial signals, the CIO of the future will need to view the world with digital eyes: assessing constantly techno-economic returns and legal-political risks on a combined geoeconomic plane*."

The Post-Covid era should also see an acceleration of the shift towards green growth, a major turning point in our economic history[1]. That meta theme was covered in various roundtables in the past three months. At the 12 November 2020 EU ASEAN conference, **Bridget Realmuto LaPerla**, Head of ESG Research, **State Street** Associates, presented the latest findings of her quantitative financial research team and her personal journey re 'ESG Metrics and Green Growth'. Her career started at the City of New York, focusing on 'the S in ESG': homeless prevention programming, helping underprivileged citizens: "What does success mean? ...You think of it almost as a mosaic… It takes time not only to align goals [between different public and private agencies] but also to define and measure consistently the impact of your actions."

At State Street Associates, we believe that "ESG data, like any data, needs to be scrutinized… New [data] technologies and [investment] frameworks will transform the financial industry. We're already leveraging some of it in our research" … Securities lending plays an essential part in our financial-economic system: "[some] asset owners and asset managers are already incorporating ESG into their lending programmes" …

> re ESG and securities lending, Bridget Realmuto LaPerla, State Street, explained that *"the lenders' voice is part of their stewardship efforts:* [truly] *long-term investors think multigenerationally, which aligns well with key ESG characteristics. These shifting dynamics between the security lenders and the borrowers are key* [to understanding the future of finance] *and ripe for more research!"*

Diversification was an essential, recurring theme apprehended from multiple angles throughout both conferences. Dr **Domenico Mignacca**, Executive Director, **Qatar Investment Authority** (QIA), shared with the audience the preliminary findings of his ongoing research work on *"single stock vs equally weighted (EW) and EW leveraged portfolios",* building in part on earlier research conducted with **Fabozzi** et al.[2]

The results seem to indicate that risk, measured as maximum drawdown, is the same for the leverage EW portfolio as for a single stock (a more detailed presentation of his findings will be made in next month's issue). Finally, Dr Domenico Mignacca also made reference to a recent paper[3] he co-authored with City of London quantitative finance practitioners, titled *Equally Diversified or Equally Weighted?* available at SSRN, cf. endnotes.

Baroness Ross Altmann, UK **House of Lords**, … **Chris Smith**, BM, **Westminster Pension**, ABS, **UNISON…**, **Suzanne Bishopric,** fmr. CIO, UN **Joint Staff Pension** (JSPF)…, **Bridget Realmuto LaPerla,** Head of ESG Research, **State Street** Associates

Nick Sherry closed the main session on Day 1 of the conference by remarking that the '**Australian Pension Miracle**' could be explained simply by three factors: "*smart diversification across asset classes and geographies, higher-than-average exposure to private equity, venture capital and infrastructure investments, and the legal-political autonomy of pension board members (trustees)."* The recently published Global Pension Assets[4] study conducted by institutional investment consultants **Willis Towers Watson** seemed to echo the Hon. Nick Sherry's assessment: "Australia has the world's most successful pension system."

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[1] Firzli, M. Nicolas J. (2017). G20 Nations Shifting the Trillions: Impact Investing, Green Infrastructure and Inclusive Growth. *Revue Analyse Financière*, (64), Q3.

[2] Kim, Y. S., Giacometti, R., Rachev, S. T., Fabozzi, F. J., & Mignacca, D. (2012). Measuring financial risk and portfolio optimization with a non-Gaussian multivariate model. *Annals of operations research*, *201*(1), 325-343.

[3] Fusai, G., Mignacca, D., Nardon, A., & Human, B. (2020). Equally Diversified or Equally Weighted?. *Available at SSRN 3628585*.

[4] Australia has the World's Most Successful Pension System, study finds, The New Daily, 21 Feb. 2021 https://thenewdaily.com.au/finance/superannuation/2021/02/21/australia-pension-super-world-beater/