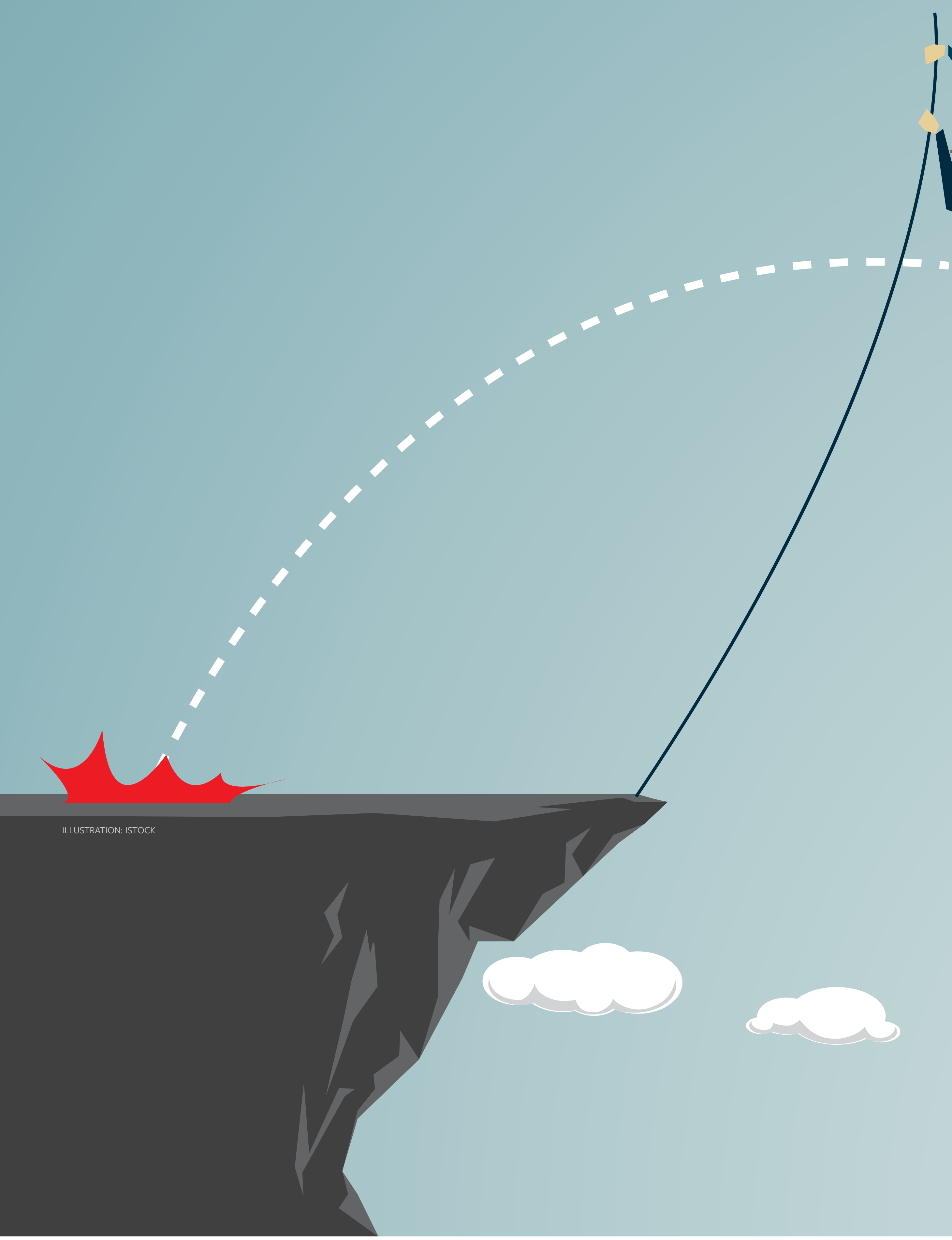
ROUNDTABLE



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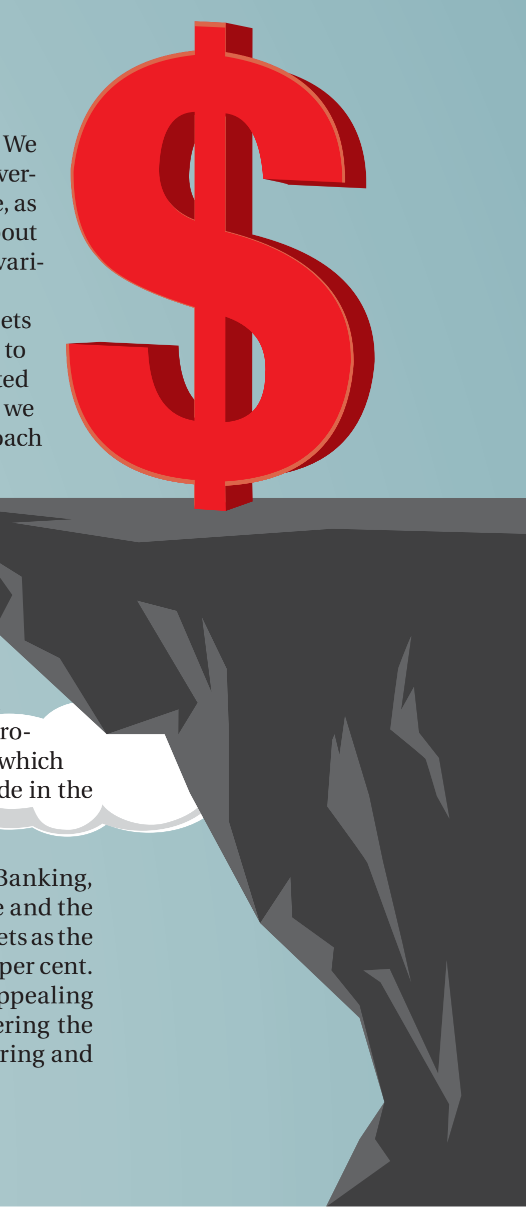
Less pain, more gain

Our panellists give their take on building portfolios that can generate steady returns as uncertainties and a Fed rate hike loom



UNCERTAINTIES loom for Asia and emerging markets following the US election and the prospect of more interest rate hikes. Investors hunger for the "holy grail" of investments – a portfolio with income and steady capital gains. We tap our experts for their views.

Genevieve Cua: What types of yield-generating assets do you find most attractive today on a risk-adjusted basis and why?

Johan Jooste: The overall spectrum of yield-generating assets is very broad indeed. It includes most equity markets (dividends paid count as income) as well as the whole range of fixed income securities. Also included are property assets of various descriptions.

The idea behind a yield-generating portfolio is thus a very broad concept, as most assets available in markets deliver yield. More likely than not the issue rather revolves around risk: The general idea is that purely income-producing securities are less risky than the ones that have progressively greater focus on capital growth as a source of return.

In the current environment, the idea that capital-growth strategies have become too risky for their return has taken hold, and investors turn in ever-increasing numbers to strategies that have income at their heart and less dependent on capital growth as a source of return.

So, the rise in popularity of income as a portfolio cornerstone has brought into the fray a great focus on various fixed income asset classes that were previously not used in portfolios by many investors. In principle, the way to assess a strategy in a portfolio context depends more on risk and expected return, and less on whether or not that return is driven by income or capital.

Many of the fixed income assets that have previously been deemed "niche" have become mainstream post-crisis. These include high yield bonds and emerging market bonds of either corporate or sovereign origin.

Traditionally, these have been higher-yielding than ordinary corporate bonds, but with a known volatility that made it necessary for investors to treat them with a greater degree of circumspection than the more staid government bonds or high grade corporate bonds that had previously been the staple of balanced portfolios.

Kin Weng Pang: From a risk-adjusted basis, emerging market (EM) assets, especially EM debt, continue to score well relative to other asset classes. Over the last few years, the search for yields has pushed the yields of most of the income-generating asset classes, such as high yield bonds and investment grade bonds, to record low levels.

EM assets, on the other hand, have not enjoyed such a rally as investors remained wary of the asset class after the taper tantrum in 2013. More recently, with economic data stabilising and a softening US dollar in 2016, investors have finally started to look at emerging markets again. Therefore, over the last few months we have seen some strong inflows into the asset class.

However, with the recent victory of Donald Trump in the US election, EM assets have become much less attractive. The potential reflationary effort by the fiscal stimulus through infrastructure projects, tax cuts and the repatriation of a large sum of overseas earnings by US companies, as well as the lower importance of monetary stimulus, are likely to result in a much stronger US dollar, higher inflation and ultimately higher interest rates and bond yields.

In addition, the potential of additional tariffs on global trades could put a halt to the recovery of emerging economies. Therefore, although emerging markets remain attractive from a quantitative perspective, we believe the uncertainty is skewed more towards the downside for emerging markets.

But it remains too early to tell whether all these measures are going to be implemented, and the extreme market divergence (for example Mexican peso, US Treasury yields and small cap US equities) looks overdone. We believe it is possible to see some convergence of these trends in the near future, as investors gather more information about the details of Mr Trump's policies on various fronts.

At the moment, we believe US assets such as US high yield bonds are likely to be more "defensive" from a risk-adjusted yield over the shorter-term. However, we believe a diversified and active approach to asset allocation remains key to generating yield given the continuous heightened uncertainty in the markets. Such a strategy should allow investors to benefit from the broadest set of income opportunities, and the active approach to risk management will look to include appropriate hedges against downside risks, which should offer investors a less bumpy ride in the process of generating income.

Didier Duret: At ABN AMRO Private Banking, developed markets equities in Europe and the US are the most attractive yielding assets as the pure dividend yield is near or above 3 per cent. Emerging Asia is nonetheless more appealing on a total return perspective considering the revival going on in global manufacturing and the new cycle on the IT sector.

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to wealth experts for their views on picking yield-generating asset classes.

Johan Jooste is *Chief Investment Officer, Bank of Singapore*. Johan has 20 years of experience covering financial markets in foreign exchange, fixed income and multi-asset investing, and hedge funds. Most recently he was chief investment officer of Azure Wealth, a private client wealth management firm. In his spare time Johan devotes attention to collecting antiquarian books and enjoys fly-fishing in remote locations.

Kin Weng Pang is *Multi Asset Fund Manager, Schroder Investment Management*. Kin Weng has held a fund management role at Schroders since 2008. He looks after the day-to-day management of multi-asset portfolios, portfolio construction and risk management. He is a member of the Equity Risk Premium group as part of the global multi-asset research investment process. He enjoys reading, skiing and spending time in the mountains marvelling at God's creation.

Didier Duret is *Chief Investment Officer, ABN AMRO Private Banking*. As chairman of the Private Banking Global Investment Committee, he provides ABN AMRO investment advisers, private bankers and clients with comprehensive advice and financial market strategy covering 40 markets. He constantly finds links between his personal passion for classical music and his professional passion in the way he directs his team.

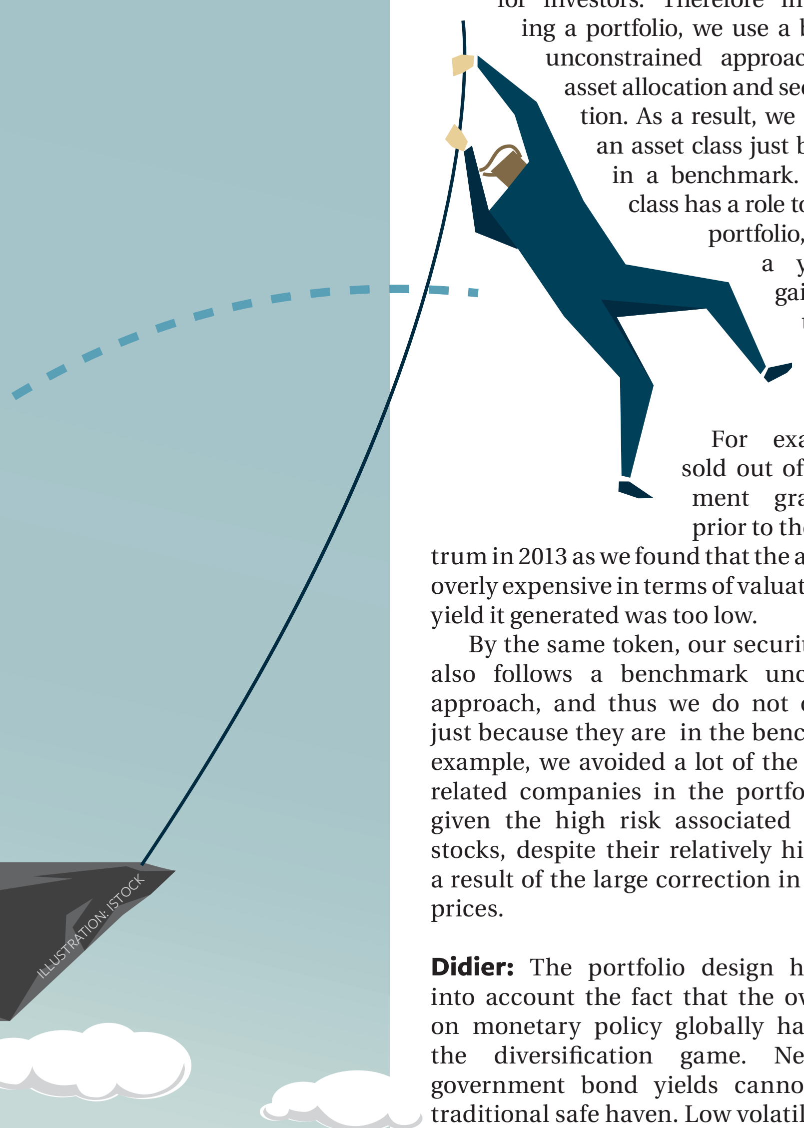
Genevieve: What is your approach in designing a portfolio that generates yield and hopefully capital gains as well?

Johan: When designing a portfolio that is dominated by yield assets, the general principles of portfolio design still apply. First there is the concern to ensure that the portfolio delivers the required balance of risk and return. How correlated are they? How risky are they? How does the maximum drawdown behave under a severe stress test? All of these factors are as relevant when designing a yield-focused portfolio as any portfolio.

One of the issues facing a portfolio that is overweight yield strategies is that it will have a high concentration of risk relating to interest rates. A sudden rise in interest rates will affect a portfolio of bonds more negatively than one with a greater balance towards other assets. To compensate, it thus makes sense to try to diversify very comprehensively on the basis of as many other factors as possible such as geography, credit quality, industry and the like.

Kin Weng: As mentioned above, we believe in the benefit of diversification and our portfolio construction aims to achieve the best risk-adjusted yield through a well-diversified portfolio not only from an asset class perspective, but also from a security selection perspective.

In addition, we believe that a benchmark approach is not the best to achieve income for investors. Therefore in constructing a portfolio, we use a benchmark-unconstrained approach to both asset allocation and security selection. As a result, we do not own an asset class just because it is in a benchmark. Each asset class has a role to play in the portfolio, either from a yield/capital gain perspective or risk management perspective.



For example, we sold out of US investment grade bonds prior to the taper tantrum in 2013 as we found that the asset class is overly expensive in terms of valuation and the yield it generated was too low.

By the same token, our security selection also follows a benchmark unconstrained approach, and thus we do not own stocks just because they are in the benchmark. For example, we avoided a lot of the energy/oil-related companies in the portfolio in 2015 given the high risk associated with these stocks, despite their relatively high yield as a result of the large correction in their share prices.

Didier: The portfolio design has to take into account the fact that the over-reliance on monetary policy globally has modified the diversification game. Near-negative government bond yields cannot act as a traditional safe haven. Low volatility equities play this role now. Bonds will act as a last resort defence. The role of real assets such as real estate and commodities is magnified by the desire among central banks to prop up inflation. Cash is a tactical buffer to operate in times of rapid change in the risk regime.

Genevieve: What type of asset allocation do you recommend for a balanced risk yield-generating portfolio and how do you go about securities selection?

Johan: Equally, from the perspective of diversification, it makes sense to include, subject to client risk tolerance, some dividend-focused equity strategies. While equities are more likely to suffer fluctuation than bonds, a steady stream of dividends coupled with a risk profile that differs from bonds may be a sensible way to dampen overall volatility in the portfolio.

In this way, a portfolio will display a strong bias towards income, but still have the potential to generate capital gains. It has to be borne in mind that the degree to which equity is blended into a yield portfolio is a discussion that has to be had with clients, given the fact that it can introduce a degree of price variability that may be in conflict with the return objective of the portfolio.

Another factor that has to be considered is default risk. Many income strategies are tilted towards credit risk as a source of income. This is fine in economic conditions that do not stress the ability of firms (or sovereigns) to repay debt. It becomes an issue if conditions change.

A portfolio can inadvertently be exposed to greater cyclical risk than intended by too much credit concentration. To mitigate this, the idea would be to focus on sector and geographical diversification, and also the more technical aspect of capital structure. More senior-ranking securities will be safer than junior-ranking ones from the same entity, all else equal.

Kin Weng: Given the nature of equities, volatility of the asset class is much higher than that of fixed income. For example, for a 50/50 equity/fixed income portfolio, equities contribute up to 80 per cent of the volatility of the overall portfolio. Therefore, for a portfolio with a more balanced risk contribution from equities and fixed income, it requires an allocation of 30-40 per cent to equities and 60-70 per cent to fixed income.

But a static allocation is unlikely to give you the best investment outcome given the hidden risks from asset and currency exposures, as well as the changing valuation and correlation between different asset classes. Therefore, an active approach to asset allocation is important for investors.

For security selection, we believe that the most important is not to chase yields at any price and to focus on the quality of the income the companies generate. It is dangerous to chase income assets if valuation is expensive. A good example is in the first quarter of 2013, when a large amount of yield-seeking money piled into already expensive high dividend-yielding stocks, only to see some large underperformance afterwards.

For the second point, we believe the quality of the income that a company generates matters. For example, reliance on raising debt to increase dividend payments is unlikely to be sustainable over the long term.

For credit, if the company relies on rolling over its debt to stay afloat but does not generate enough cash flows to support its interest payments, the risk of default and/or restructuring might not justify the investment even though it might be paying a high yield. Therefore, our approach to security selection is to ensure we do not chase yields blindly by avoiding overvalued stocks, while ensuring the income that the company generates come from a sustainable and competitive business model.

Didier: Our allocation favours equities, listed real estate EM bonds and global high yield as a source of yield and capital gains. Asia ex-Japan equities act as pure return drivers. Commodities and inflation-linked bonds are seen as inflation hedges.

Genevieve: What risks are you most mindful of in relation to a yield-bearing portfolio and how might you mitigate these?

Johan: The market is in a state of flux after the US election result. Overall, the risk of inflation seems to be preying on investors' minds, pushing up yields very aggressively. This illustrates the risk of over-exposing portfolios to rate risk. Credit risk seems fairly priced right now, especially in markets potentially less affected by US trade policy – US high yield, for example. EM assets are under pressure, but we are more comfortable in credit than equity in EM markets. Government bonds look like poor value by comparison, especially in developed markets.

Kin Weng: Currently we believe the biggest risks facing a yield-bearing portfolio are currency and interest rate risks. As mentioned in our response to the first question, we believe the role of monetary policy is likely to be smaller going forward, which could potentially result in higher interest rates over the medium term. Therefore, some hedges on interest rates using bond futures or interest rate swaps will be important for investors to reduce the impact of rising yields on their income portfolio.

Similarly, for investors holding corporate credit (investment grade or high yield), the potential losses from widening spreads should not be overlooked. Therefore, appropriate hedges using credit-default-swaps (CDS) to hedge against the volatility would also help in the current environment.

On the other hand, the rising US dollar is likely to put pressure on a number of currencies, especially those in emerging markets and Asia. From Singapore-dollar based investors' point of view, it would be beneficial if the US dollar exposure is not fully hedged back to the Singapore dollar.

Didier: The biggest risk is policy error on both sides. There is a fine line between underestimating the risk of a recession considering the slow growth prospects or underestimating the risk of inflation should commodity prices pursue their ascent. Political risk is rising but this is a double edged sword, with the positive risk of accelerating the fiscal stimulus on one side and the creation of a new international disorder on the other side. Both risks will be put to the test in the months to come. W