Black swans and what to look out for in 2019

In mid-December, **Tell Media Group**, in co-operation with **Allianz Global Investors**, **Aviva Investors** and **HSBC Global Asset Management**, invited three CIOs from Swedish asset owners to discuss the outlook for 2019 and asset allocation challenges. **Caroline Liinanki**, editor of Nordic Fund Selection Journal, and **Niklas Tell**, founder of Tell Media Group, moderated the roundtable.

By: Niklas Tell Photo: Christer Salling

The discussion, which was held at Nobis Hotel in central Stockholm, started with the participants sharing their thoughts on which asset class that had been the biggest disappointment over the past year.

LARS-GÖRAN ORREVALL: "I think the biggest disappointment is something that's not in our portfolio: hedge funds. Hedge funds really should shine in the environment we had in October and November and they didn't – at least not as a group. We've decided not to invest in hedge funds and the main reason is that they're too expensive. We've had some historically but then it was a specific strategy or a specific fund that we wanted to have in the portfolio. I don't see why we should have a broad allocation to a wide group of hedge funds."

NIKLAS TELL: "IS THERE ANYTHING THAT YOU DO HAVE IN YOUR PORTFOLIO THAT DISAPPOINTED OR HAS BEEN LESS GOOD THAN EXPECTED?"

LARS-GÖRAN ORREVALL: "Not really. We have a lot of non-Swedish assets in our portfolio and the Swedish krona has been very weak so in some ways that has saved us. The performance in Swedish krona has been good, even if it hasn't been excellent in local currency."

ANDRIES HOEKEMA: "Is that a strategy or have you been lucky?"

LARS-GÖRAN ORREVALL: "It's a strategy. Having a lot of non-Swedish krona assets is one of the best diversifiers you can have because the Swedish krona usually falls when there's a crisis and that helped us a lot during the last financial crisis."

ANDRIES HOEKEMA: "We're a big emerging markets manager and that's an asset class that hasn't performed that well in 2018. Either you see that as a disappointment or you would expect it following the very good performance in 2017 and perhaps we're now back at a good buying opportunity."

MICHAEL GRADY: "For me, the biggest disappointment has been European equities. Many expected European equities to outperform in 2018 and they didn't."

MARIE GIERTZ: "We have a very traditional portfolio and even if we were somewhat prepared, the biggest disappointment has still been on the equity side. We've also been disappointed by the performance of the Swedish krona. As you said Lars-Göran, the krona should be weak when we have a crisis but now we have had a weak Swedish krona at a time of good global growth and a strong Swedish export sector. If FX is an asset class, then the Swedish krona has been the most disappointing."

STEFAN HOFRICHTER: "We had a couple of headwinds this year that explains a lot of what has happened. To some extent, the performance of many asset classes has been almost textbook-like. The slowdown in cyclical data and the monetary policy normalising is a perfect headwind for many asset classes. If I have to pick one asset class that has really disappointed, I will have to agree with Michael on European equities. Some of the damage has been self-inflicted by politicians and I'm not sure it will be much better in 2019 with European parliament elections just ahead of us."

ERIK CALLERT: "What disappoints me is when an asset class doesn't perform as expected. Equities haven't realised our expected return but it's a risky asset so it will go up and down. However, when we don't get the expected return from more stable assets, like high yield bonds, that's disappointing."

ANDRIES HOEKEMA: "What do you do when an asset class goes from a good risk premium to an even better risk premium?"

ERIK CALLERT: "As long as the fundamentals are in place and as long as default rates are stable, then you're ok. But as a long-term investor, you also have expectations from your clients to deliver fairly stable returns. It's a balance when you build your portfolio."

MICHAEL GRADY: "That's why I think asset class correlations have been a disappointment for many this year – that correlations didn't come out as expected."

STEFAN HOFRICHTER: "But isn't the breakdown of correlations what you should expect when monetary policy changes? The quantitative easing lifted all boats more or less and now we're going into the reverse and we therefore see cross-correlations coming down."

CAROLINE LIINANKI: "TAKING ALL OF WHAT YOU HAVE JUST SAID INTO CONSIDERATION – WHAT DOES THAT MEAN FOR HOW YOU WANT TO POSITION YOUR PORTFOLIO GOING FORWARD?"

LARS-GÖRAN ORREVALL: "We've been surprised by the strong performance of many asset classes for some time and just as everyone else, we've seen that we've moved into a more hostile environment for risky assets. We have de-risked the portfolio and today have some 50–55 per cent in risky assets."

NIKLAS TELL: "DID YOU SELL PUBLIC EQUITIES OR SOMETHING ELSE?"

LARS-GÖRAN ORREVALL: "We sold public equities because it's much easier to sell compared to private equity or infrastructure. We then invested in very safe fixed income instruments just to have cash available if there's a more severe crash. Then we can invest with much better risk premiums."

MICHAEL GRADY: "As a house, we've expected to see de-correlation occur between equities and bonds for a long time – and that has happened except for during the end of 2018. We run some large long-only multi-asset funds and we also run some large absolute return multi-strategy funds and when I think about where we were at the start of last year in terms of asset allocation compared to where we are today, we've reduced risk. We did that at a similar time as you mentioned Lars-Göran, in the late summer. We didn't think markets would fall 10 to 15 per cent but we saw

PARTICIPANTS

- **MARIE GIERTZ**
  Chief investment officer, Kåpan Pensioner
- **ERIK CALLERT**
  Group chief investment officer, Nordea Life & Pensions
- **LARS-GÖRAN ORREVALL**
  Chief investment officer, Skandia
- **ANDRIES HOEKEMA**
  Global head of insurance segment, HSBC Global Asset Management
- **STEFAN HOFRICHTER**
  Global economist and head of economics & strategy team, Allianz Global Investors
- **MICHAEL GRADY**
  Head of investment strategy and chief economist, Aviva Investors

MARIE GIERTZ
Kåpan Pensioner
Chief investment officer of Kåpan Pensioner. Before joining Kåpan in June 2017, she worked as chief economist at Swedish Export Credit Corporation and prior to that as chief economist at Länsförsäkringar.

ERIK CALLERT
Nordea Liv & Pension
Group chief investment officer of Nordea Life & Pensions. Before joining Nordea two years ago, he was chief investment officer and head of investments of SPP Pension & Försäkring.

enough risks to reduce the allocation to risky assets. As we look into the coming year, we're now putting a little bit more risk back on the table even if it's not a lot. We have increased our equity allocation but remain underweight duration."

STEFAN HOFRICHTER: "I think that the arguments that shaped markets in 2018 are still very relevant as we look into 2019. Growth is moderating, the liquidity provided by central banks passed the peak in 2018 and the political uncertainty is still high. The combination of a high level of debt, higher rates and a tighter monetary policy don't provide for a benign environment. That said, we don't expect a recession and we don't expect the Federal Reserve to go beyond what we see as a neutral rate."

NIKLAS TELL: "ERIK, YOU MENTIONED DISAPPOINTMENT VERSUS EXPECTATIONS. HAVE YOU CHANGED YOUR EXPECTATIONS AS YOU'RE LOOKING INTO 2019?"

ERIK CALLERT: "It's important to be long-term and have stable expectations. In the Nordic market, the occupational pensions market is part of the savings market and often the financial guarantee is an important part of the product. Duration is an important decision because if you have a gap versus your liabilities, you have less of free risk capital to put into risky assets. If you don't have a strong view on what the correct interest rate level should be, then it's probably a good choice to close the duration gap."

LARS-GÖRAN ORREVALL: "The product has been alive for more than 100 years but we've never been able to match our duration because the Swedish fixed income market was very short and fairly small. The major players couldn't really hedge their liabilities. I agree that you should close the gap if the interest rate is at normal levels but I would still argue that big players would have difficulties to hedge their liabilities in Swedish krona as the market is still too small and too short."

MARIE GIERTZ: "I agree with you, Erik, that it's important to have a long-term outlook. It's always difficult to predict turning points and we've been talking about a downturn for many years. We had the same discussion in 2015/2016 about de-risking the portfolio. It's difficult and dangerous to time the market but when you've seen growth for such a long time and when you see central banks normalising the monetary policy, then it's good to be careful. In times like this you need to consider the buffers you have and just looking at the liabilities we have and the solvency we have, we know that we can afford a downturn. Based only on our balance sheet, I would have increased risk in 2018 but decided against it because of the environment we're in. Instead of de-risking, I instead didn't use the full potential to increase risk. One thing that's frustrating and challenging is the divergence of central banks in the US and in Europe/Sweden. We have the global equity markets following the US, while the fixed income market is more local. Historically, the Swedish fixed income market has had a high correlation to the US. I'm not used to the current situation."

ANDRIES HOEKEMA: "Have you changed your long-term return expectations based on the fact that interest rates are down significantly since the financial crisis and since equities have performed very well over the same time period?"

MARIE GIERTZ: "We've diversified away from traditional fixed income and listed equities in order to have a better diversified portfolio and to have less volatility. We've invested more in the alternative assets."

ERIK CALLERT: "We're also looking at adding more alternative assets as it's a good fit since our investors are long-term pension savers."

NIKLAS TELL: "WOULD YOU SAY THAT YOUR ULTIMATE AIM IS TO CONSTRUCT A PORTFOLIO IN SUCH A WAY THAT YOU DON'T NEED TO CONSIDER RE-ALLOCATIONS EVERY YEAR? BASICALLY A PORTFOLIO THAT CAN WITHSTAND THE VOLATILITY WE ARE CURRENTLY SEEING IN THE EQUITY MARKETS."

ANDRIES HOEKEMA: "I think that comes down to investment philosophy. It's all about finding risk premiums in a well-structured and diversified portfolio. Price behaviour in markets must have a role to play in that process. When prices go down, valuations becomes more attractive and you allocate more. Many of us are long-term, asset allocation-driven value investors. Over the last five years, everything has become more expensive and with falling interest rates and changing regulatory frameworks, we saw a shift into alternatives. Another important factor is, of course, that many investors wanted to take advantage of the liquidity risk premium. We've seen a great balance sheet rotation – a shift from bank balance sheets to long-term investors."

NIKLAS TELL: EVEN IF YOU WOULD LIKE TO INCREASE ALLOCATIONS AS PRICES FALL AND TAKE PROFIT WHEN VALUATIONS ARE HIGH – AS LONG-TERM INVESTORS, HOW FREQUENTLY CAN YOU TRADE DIFFERENT ASSET CLASSES SUCH AS PRIVATE EQUITY OR REAL ESTATE?

LARS-GÖRAN ORREVALL: "I'm not a believer of a static asset allocation and you need to act as valuations and prices change. The problem is that it's difficult to come up with the correct valuations of different asset classes. The problem is also that the valuation is only important in the long-term. It's not driving markets over 12 or even 24 months. Then it's more about liquidity and other things that drive markets. What we're trying to do is to look for things that are very cheap or very expensive and then we make changes to the portfolio. You have to remember, however, that things can stay cheap or expensive for a very long time."

MICHAEL GRADY: "Erik, you mentioned earlier the challenge of managing drawdown risk and that's very real. Even if you have long-term investors behind you, most will be unhappy if they see the value fall. So even if we invest with a three-year horizon, we still need to manage the portfolio to avoid short-term drawdowns."

CAROLINE LIINANKI: "AND WHAT ARE YOU INVESTING IN TO DO THAT?"

MICHAEL GRADY: "That has been the challenge as traditional risk-reducing investments have not worked very well and we've therefore avoided that. We've been long the dollar versus a range of other currencies. That strategy has worked well. It's challenging to find areas where you want to hold duration."

NIKLAS TELL: "GOING BACK TO WHAT YOU SAID, LARS-GÖRAN, ON DOING ADJUSTMENTS WHEN YOU SEE EXTREME VALUATIONS. DO YOU SEE ANY OF THAT RIGHT NOW?"

LARS-GÖRAN ORREVALL: "I think it's fair to say that equities have been very expensive for a long time and they continue to be expensive. Looking at the valuation models that have worked historically, then you should expect nothing in terms of real return over the next seven years. We've decreased our US equity exposure and we have, of course, been too early because it has been a good performer. The problem is that other markets look less expensive than the US but when there's a downturn, the US market tends to fall less. We currently have less than 2 per cent in US equities but we have a lot in private equity so we're not out of the US."

LARS-GÖRAN ORREVALL
Skandia
Chief investment officer of Skandia. He has been with the firm for 12 years and before taking on the chief investment officer position, he was CEO of Skandia Investment Management, its asset management arm.

ANDRIES HOEKEMA
HSBC Global Asset Management
Global head of insurance segment in the client strategy team and has been working in the industry since 1997. He joined HSBC Group in 2006 and HSBC Global Asset Management in 2016. Prior to joining HSBC Group, he worked at Rabobank International.

MARIE GIERTZ: "We've seen this divergence between old and new economies for some time now, summarised with FAANG, and maybe that's why we've seen higher valuations in the US compared to Europe. I guess it depends on what you believe in – the new or the old economy. We all lived through the hype of the new economy back in the late 1990s but the difference this time is that these companies are making money."

STEFAN HOFRICHTER: "I've been looking at the valuations of the FAANGs and the cheapest one is Apple with a P/E of about 40, which is roughly the Nasdaq average. If you do it for all the others, you find very high valuations. These specific stocks seem to be very expensive whereas the average for Nasdaq and S&P500 is in line with its long-term average."

MARIE GIERTZ: "We talk about the fact that we've had ten years of expansion but if you look at equities over the last three to four years, most markets have been flat. It hasn't been that good to be in equities if you exclude the US. That's something we should keep in mind going forward. The question now is if emerging markets will come back and then it's of course important that the US economy continues to perform. One challenge today is to figure out how much of the current volatility is due to fundamentals and the business cycle and how much should be explained by the uncertain geopolitical situation."

MICHAEL GRADY: "At the beginning of last year, I agree that the US looked expensive. Today, that's a much tougher call. Emerging markets looks cheap again and trade at a 25 per cent discount to historical averages."

ANDRIES HOEKEMA: "Would you buy US equities or emerging markets today?"

MICHAEL GRADY: "We strive for a balanced portfolio..." (laughter)

STEFAN HOFRICHTER: "I think it depends if you're investing for 2019 or 2029. If it's for 2029, I would go with emerging market equities."

ANDRIES HOEKEMA: "I agree but you have to be granular when investing in emerging markets. The idea of global emerging markets is not the right way to look at it anymore. Investors are moving away from that and they are especially separating Asia from the rest of emerging markets."

CAROLINE LIINANKI: "I KNOW THAT YOU HAVE SOME MORE FOCUSED EMERGING MARKET EXPOSURES AT SKANDIA BUT HOW DO YOU APPROACH EMERGING MARKETS AT KÅPAN?"

MARIE GIERTZ: "In general, I think the difficulty is that it's the US that sets the tone and all other markets are beta plus. Yes, emerging markets are cheap right now but it's still falling more than the US in difficult times. In good times, emerging markets should perform better than the US because it will perform worse in bad times."

ANDRIES HOEKEMA: "Big Dutch investors used to ask us all the time to bring our China economist because they wanted to know what was happening to Chinese GDP growth as it will be 40 per cent of global GDP growth over the next ten to 15 years. When I then asked what they do with the data, they would tell me they put it into their 15-year projections for global GDP growth, which would underpin their ALM studies etc. At the same time, they might only allocate some 0.5 per cent to China, which is a massive investment decision to take. Given long-term projections, I would say it's prudent to increase allocations to emerging markets and especially when markets are weak."

STEFAN HOFRICHTER: "When you look at emerging markets over the last 30 to 40 years, the relative performance to developed markets has been both positive and negative but there has been no structural outperformance. Also, economic growth does not equal earnings per share growth so it's not a one way bet."

ROUNDTABLE – ASSET ALLOCATION, STOCKHOLM

NIKLAS TELL: "IS THAT ALSO BECAUSE WE'RE LUMPING A LOT OF DIFFERENT MARKETS TOGETHER UNDER THE EMERGING MARKET UMBRELLA?"

MICHAEL GRADY: "Yes, but I would like to go back the 2029 question. We haven't mentioned global trade wars yet, which is remarkable. I'd like to hear everyone's view if this is a short term 'Trumpian' detour of global relations or if this is a more long-term and more significant change."

STEFAN HOFRICHTER: "It probably goes beyond US versus China. I think the root of the problem is that we have seen a wave of populism around the world and the common denominator of all populists is that they're against globalisation. We see it in things such as the US-China trade war and in Brexit. I think it's a structural change and it will stay with us for some time and all other things equal, it's not good for growth."

MICHAEL GRADY: "I also think it will play out over a long time. It's not only a US view but a view shared by most developed markets that China can't grow at the same pace it has historically."

ANDRIES HOEKEMA: "There's also an argument that China will grow old before it grows rich as a result of the one child policy. There are some people who say that China is growing aggressively now because it has this window of opportunity before demographics change for the worse."

NIKLAS TELL: "ANOTHER TOPIC THAT WE HAVEN'T TOUCHED ON YET IS ESG, WHICH IS ESPECIALLY INTERESTING IF WE'RE SEEING GLOBALISATION BEING UNDER THREAT FROM NATIONALISM AS THAT WOULD WORK AGAINST SOLVING CLIMATE CHANGE CHALLENGES. IF WE LOOK AT ESG IN GENERAL AND CLIMATE CHANGE IN PARTICULAR – HOW IS THAT AFFECTING YOUR ASSET ALLOCATION DECISIONS? ARE CLIMATE CHANGE SCENARIOS MAKING ITS WAY INTO YOUR MODELS TODAY?"

STEFAN HOFRICHTER: "If you look at ESG as a way to manage risks in your portfolio, then it certainly has a role to play. And it's not only about buying the good and avoiding the bad but rather to see where you have change and momentum."

LARS-GÖRAN ORREVALL: "I would say that so far ESG has mostly been on the level of security selection. What we're doing now is a top-down study based on climate scenarios to see what impact it could have on asset allocation. We can't build that model ourselves so we're buying this externally. We will have the first report in January and we will bring that into our ALM study. The aim is not to save the world but to save the portfolio. We want to understand the risks we may face with different climate scenarios."

NIKLAS TELL: "HAVE YOU HAD ANY FIRST INDICATIONS FROM THE STUDY?"

LARS-GÖRAN ORREVALL: "Not really. We will have to wait and see."

MICHAEL GRADY: "I think it's interesting to see how strong the investor demand has become in this area. As you mentioned Niklas, populism is working against finding global

STEFAN HOFRICHTER
Allianz Global Investors
Global economist and head of Allianz Global Investors' economics & strategy team since 2011, covering global macro and capital markets developments. He joined the firm in 1996 as an equity portfolio manager and assumed the role as an economist and strategist in 1998.

MICHAEL GRADY
Aviva Investors
Head of investment strategy and chief economist. Since joining Aviva Investors as senior economist and strategist, he has been responsible for monitoring and analysing global macroeconomic, market and policy developments, and plays a key role in formulating the 'House View' and the risks to that view. Before joining Aviva Investors, he was senior economist at COMAC Capital, a global macro hedge fund. Prior to that, he spent a decade at the Bank of England.

solutions to climate change challenges but even if governments are not on board, we see investors and the private sector moving very quickly."

MARIE GIERTZ: "But where do you see the most demand? We're discussing ESG but I think it's a lot of focus on the 'E', especially in the Nordics."

MICHAEL GRADY: "I think it's broader than just the 'E' but it's more about security selection than asset allocation at this point in time."

ANDRIES HOEKEMA: "I think it depends on where you invest. If we're talking about emerging markets, there's obviously more focus on governance factors."

STEFAN HOFRICHTER: "It's not yet an asset allocation tool but general demand is growing. It used to be European institutional investors but we're now seeing more demand from Asia and more from retail investors. The next step for us is to implement ESG criteria for sovereign bonds."

ERIK CALLERT: "Sustainability is something that is top on the agenda for Nordea as a whole and we have a holistic approach as we're involved in so many areas. We have, of course, screened our portfolios but we want to do more going forward in order to truly integrate ESG into our processes. On top of that, we're looking to do more impact investing, which we can do as long-term investors.

CAROLINE LIINANKI: "WHERE WOULD YOU AS INVESTORS LIKE TO SEE MORE INNOVATION WHEN IT COMES TO ESG?"

ERIK CALLERT: "The simple answer is that we need innovative asset managers to create products that are aligned with our strategies."

CAROLINE LIINANKI: "ARE THERE PARTICULAR AREAS WHERE YOU WOULD LIKE TO SEE MORE INNOVATION OR JUST BETTER PRODUCTS?"

ERIK CALLERT: "I think transparency is key, especially when it comes to things such as carbon where we currently lack a common way of measuring."

STEFAN HOFRICHTER: "I think that's something that will come. There's a lot of political pressure right now to make that happen but it takes time."

MARIE GIERTZ: "I think the most important development is that we get more good metrics to work with. I don't think we need one common model. You can compare it to equity valuations, where different investors will work with different models but you do need good data to work with."

NIKLAS TELL: "BEFORE WE CLOSE THIS ROUNDTABLE I'D LIKE TO ASK WHAT POSSIBLE 'BLACK SWANS' YOU SEE AS WE MOVE INTO 2019? WHAT WOULD BE THE BIGGEST NIGHTMARE FOR PORTFOLIOS?"

MARIE GIERTZ: "Maybe a big credit event."

LARS-GÖRAN ORREVALL: "We have nominal guarantees and nominal liabilities so debt deflation would be the worst scenario."

STEFAN HOFRICHTER: "We talk about event risks but events could of course also be positive. I'm not saying it is likely but the UK might decide not to go through with Brexit and we could see a trade agreement between the US and China."

ANDRIES HOEKEMA: "I would say the breakdown of consensus politics is the biggest risk as that would bring back markets that are characterised by risk-on/risk-off, which is difficult to manage."