# Asset allocation challenges in times of war, inflation and rising interest rates

In September, **Tell Media Group**, in cooperation with **Aegon Asset Management**, **Blackrock** and **Schroders**, organised a roundtable discussion in Copenhagen with Danish investors, focusing on asset allocation challenges and opportunities. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the discussion.

By: **Niklas Tell** Photo: **Christer Salling**


The discussion started out with Caroline Liinanki asking the investors about their expectations going into 2022 and what the biggest surprises have been this year.

**MIKKEL SVENSTRUP:** "We run a risk parity strategy, so we have just as much interest rate risk as we have equity risk. That's one of the reason we lost more on fixed income than equities during the first half of the year. Our expectation going into this year was that inflation would moderate and we kept our allocation to fixed income and that has been a position that has done very well over the last ten years. We were basically planning for business as usual. Everyone is, of course, talking about inflation and we've had an inflation factor that has been working well and did so in the first quarter of this year as well. But then there was the situation in Ukraine and central banks started to become more aggressive than expected. When we had inflation at around 4 per cent, politicians and central bankers could live with that. But when we had an additional 4 percentage points, everyone started running for the door. And that has been hurting the portfolio."

**IRENE HOLMSLYKKE:** "I very much agree with what Mikkel just outlined. We were expecting inflation but we were not prepared for interest rates to rise as much as they did on the long end of the curve. We started to protect the portfolio but it has still not been enough."

**BERTIL FROM:** "What has surprised me was the energy crisis. Going into 2022, we actually expected inflation to rise. We run our portfolio more on a total return basis, so for that reason we hedged all of our interest rate risk at the beginning of the year. With negative interest rates and a flat yield curve, we didn't see that we were paid for taking interest rate risk. I'm in the lucky position right now that we have a positive return on the fixed income and credit portfolio and our real assets have also performed well. Where we have lost money has been in the equity portfolio."

**NIKLAS TELL: JOHANNA, WOULD YOU SAY THAT THIS IS SIMILAR TO YOUR OWN EXPECTATIONS GOING INTO THIS YEAR OR WHEN YOU SPEAK TO CLIENTS?**

**JOHANNA KYRKLUND:** "Our strategy is very much focused on timing the rate cycle and we were positioned for the Fed raising rates, so in that sense the sell-off in equities and fixed income fitted into our investment frameworks. What was more surprising was the war in Ukraine and how stringent the zero-Covid policy has been in China. Overall, it's unusual to see so many uncorrelated major events happening at the same time."

**OLAF VAN DEN HEUVEL:** "We saw, of course, inflation last year and we expected it to come down slowly this year. That didn't happen but clients have not moved a lot. What surprised me were the rallies we've seen over the last couple of weeks. That just seems wrong to me. Another thing worth highlighting is that sustainable investments have had a tough time this year but that's obviously something we still are committed to. Looking back, in a global crisis such as this one, the only safety valve to let the pressure out is FX and we should have done more there."

**KARIM CHEDID:** "At the start of the year, we expected the economy to start stalling after the post-Covid economic reopening and that has been in line with our expectations as activity data has slowed. What shocked me was the persistence of the supply chain disruptions and that, of course, ties into what Johanna said about the uncorrelated events that we've seen. In addition to the zero-Covid policy in China and the war in Ukraine, we've also had climate events that have played a role in protracting the supply chain disruptions and add to inflationary pressures."

**NIKLAS TELL: LOOKING BACK OVER PANDEMIC PERIOD, MAYBE COUPLED WITH THE GEOPOLITICAL TENSIONS WE'RE SEEING, WHAT ARE SOME OF THE LESSONS LEARNT OR LESSONS THAT SHOULD HAVE BEEN LEARNT?**

**BERTIL FROM:** "I think one important lesson is the value of having dry powder. That's so valuable. The investments we did back in April 2020 are some of the best investments we've ever made. If you don't have money to buy when markets fall, you can't make good investments. Because when your portfolio is hit by a black swan event, it's too late to change your asset allocation, so you need that dry powder to use during those events and to buy the dips."

**NIKLAS TELL: WOULD YOU SAY THAT TACTICAL ASSET ALLOCATION IS BECOMING MORE IMPORTANT THAN STRATEGIC ASSET ALLOCATION?**

**BERTIL FROM:** "I'm not saying it's more important because strategic asset allocation is still key. But the tactical asset allocation is important and even if there's an opportunity cost in the short term of holding cash, you're compensated for that cost in the long run."

**KARIM CHEDID:** "I agree. We've moved from a regime of low volatility when it comes to GDP and inflation to a situation where we're likely to see more volatility going forward. That creates an environment where you probably will need to revisit your strategic asset allocation more frequently than you did in the past."

**MIKKEL SVENSTRUP:** "My experience is that we know very little about the future and you therefore need to stay humble. The window of opportunity in the spring of 2020 was very brief and timing the market is difficult."

**JOHANNA KYRKLUND:** "To me, the pandemic was the first major crisis that we've all lived through. You really have to

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CEO of PFA Asset Management, the investment arm of the pension company PFA. Before joining PFA in August 2020, she spent more than 10 years at Danske Bank in different roles. She started her career at Realkredit Danmark.

BERTIL FROM
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go back to the world wars to find a similar common and global experience. We don't live through events like these without changing behaviour – at least over the short and medium term. The pandemic created a reshuffle of the labour market and we established new ways of working and it's difficult to go back to the way it was before. The pandemic was very much about human behaviour. When it comes to geopolitical risks, I think it's fair to say that's here to stay. Normally, there's no transmission mechanism to the markets and it's normally a binary outcome, which is difficult to price. Once the event happens, even if it's a bad one, we can price that. What's different this time with the war in Ukraine is that there's a transmission mechanism via the commodity market."

NIKLAS TELL: YOU MENTIONED CHANGING HUMAN BEHAVIOUR DUE TO THE PANDEMIC. HOW DO YOU TRANSLATE THAT TO MARKETS? WHAT DOES IT MEAN FOR DIFFERENT ASSET CLASSES?

**JOHANNA KYRKLUND:** "We have all these shocks happening at the same time but ultimately they all push in the same direction in terms of the fundamental growth and inflation trade off. That's what's so weird about it. The shocks come from all directions but the outcome has been a deterioration in the growth and inflation trade off. When you look at the link between growth and inflation over the last 20 years, it has basically been flat. We've been in a period where no matter the output gap, the inflation was always 2 per cent. People were talking about the Fed put but I don't think that the Fed is providing a put to the market. It was rather an outcome of not having an inflation problem. What we're setting up for now is more similar to the 1990s. You don't have to believe in a 1970s scenario but you have to assume that the last 20 years was an exception to how growth and inflation will work. This means that central banks are having a much tougher time now compared to the last 20 years and as investors, we're in a high-volatility environment and it requires a new approach to portfolio construction. The good news is that yield is coming back and that fixed income again will play an important role in portfolios."

**OLAF VAN DEN HEUVEL:** "I have a slightly different take on that. Over the last 10 or 20 years, we've been talking to clients about a declining labour force, especially in Asia and in Europe, but nothing has really happened. At the same time, we all knew that the central bank policies were way too accommodative with a lot of free money pushed into the system and that should lead to inflation. That also didn't happen for a long time. Now, it has all erupted and we see the inflation that we expected and we see labour force shortages that we've also been expecting. With a declining labour force, we expect long-term growth to be lower and we therefore don't think that interest rates need to be very high going forward. The big question mark is what's happening to globalisation, which was a deflationary force for a long time. That might be changing and then the question is whether inflation will fall back to 2 per cent or stay at 3 to 4 per cent."

**JOHANNA KYRKLUND:** "I think it will stay at 3 to 4 per cent because we've had a significant reshuffling of the labour force due to the pandemic. And we will not get the same help from globalisation, which for a long time was very deflationary. On top of that, we have the energy transition, which is inflationary. We're fundamentally changing the engine and during that transition, there will be shortages and it will take some time for things to catch up. I'm not saying that interest rates need to go to where they were in the 1990s because I think inflation will come back down but I don't think it will fall to 2 per cent."

**KARIM CHEDID:** "I also think there's a big difference between Europe and the US because the inflation drivers have been different. It's more broad based in the US whereas it's primarily related to food and energy in Europe. As we fall from the peak, it will be interesting to see if it's quicker in Europe, which I believe. I think the Fed will be the last to pivot but eventually they will and they will probably be ok with inflation at 3 or 4 per cent."

**BERTIL FROM:** "I think the ECB and the Fed eventually will succeed. They have the power to reach their inflation target but it will come at a cost if they set the target at 2 per cent. It will, however, also be a cost if they set it too high because that will guide the long interest rates and the cost for public debt, which is too high in many countries in southern Europe and also in the US. If we continue down the road we're heading right now with the deficits we're seeing, it's only a matter of time before we see problems. That's something we're worried about and we're trying to make sure not to have exposure to government bonds from weaker countries because it's not sustainable. These countries have not used the last couple of years to consolidate their fiscal balances."

CAROLINE LIINANKI: WHICH ASSET CLASS OR TYPE OF INVESTMENT IS THE MOST DIFFICULT TO ASSESS AT THE MOMENT?

**JOHANNA KYRKLUND:** "I find European equities quite hard to assess. Coming back to what we said before, in the US we're dealing with a rate cycle and we're used to pricing equities on the back of interest rates. The problem with Europe is the geopolitical risk, which is very much a function of what's going on with Russia. It's an unknown. On the one hand, Europe looks very cheap right now but there's a tail risk there that I have difficulties in calling."

**IRENE HOLMSLYKKE:** "I agree. Europe is difficult to assess at the moment. The question is also if Europe and the US will stay correlated or if they will move less in sync going forward."

**MIKKEL SVENSTRUP:** "I have to be honest and say my conviction on calling European versus US equities is very poor. The tilts we would make are very small and it's not a question I spend very much time on."

**KARIM CHEDID:** "It's interesting to hear the discussion on Europe because what stands out is how most investors agree to be bearish on Europe. If you look at ETF flows, we saw inflows from November 2021 until February 2022 and since then all those positions have been sold. US investors don't own Europe any longer. It's cheap and very under-owned and that's typically an environment when Europe has outperformed. The problem is that the outperformance has historically lasted very briefly."

**JOHANNA KYRKLUND:** "If you just invest like the index you will have half of your assets in the US. We've liked the US for a long time and then that hasn't been an issue. But should we really have half of our assets in US equities? So for me, it's not really a question about timing the market but it's more of a strategic question."

**OLAF VAN DEN HEUVEL:** "It's also interesting that for a US company, all of a sudden these European trophy assets are looking very cheap. I guess it's only a question of time until we start to see more M&A activity from US companies looking to buy in Europe."

**JOHANNA KYRKLUND:** "We've seen a lot of activity in the UK already but the problem has been that it has been private equity companies buying listed companies, so a lot of good companies have been taken out of the index."

**BERTIL FROM:** "We run a bottom-up stock-picking portfolio and we have some 30 names in our equity portfolio. When you do bottom-up and have a value bias, which we do, you end up being overweight Europe. Has it been successful

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this year? No, it hasn't but long term we've been able to buy great companies at very low valuations. You have to accept the volatility, of course, but I don't see volatility as a risk because we're allowed to take a long-term view."

CAROLINE LIINANKI: ONE OF THE BIGGEST TRENDS AMONG NORDIC INVESTORS HAS BEEN THE INCREASE IN ALTERNATIVE ASSETS. WILL THAT CONTINUE GOING FORWARD WITH RISING INTEREST RATES? YOU HAVE BEEN ADDING A LOT OF ALTERNATIVE INVESTMENTS AT PFA IN RECENT YEARS BUT WILL YOU KEEP DOING THAT?

**IRENE HOLMSLYKKE:** "I don't think we will build our alternatives portfolio further but we will not decrease it either. We are where we want to be right now. We like private equity and real estate. When it comes to infrastructure, we see that margins are being squeezed but then again, there's still a lot of infrastructure that needs to be built."

**MIKKEL SVENSTRUP:** "We're in a similar situation to most professional investors. Last year was fantastic and we saw great returns from alternatives. If you're an existing investor in alternatives, you're probably overweight and you will not do much more. To be honest, my concern is that there has never been more dry powder in the private equity space and the commitments will be invested regardless whether there are good opportunities or not. And higher interest rates will, of course, not help leveraged buyouts. I think we're at a crossroad and I don't really know which way it will go."

NIKLAS TELL: I ALSO ASSUME THAT YOU DON'T NEED TO LOOK FOR ALTERNATIVES TO FIXED INCOME ANY LONGER BECAUSE YOU CAN ACTUALLY BUY TRADITIONAL FIXED INCOME AND GET A RETURN.

**JOHANNA KYRKLUND:** "Historically, you got some 5 per cent on government bonds and that was a very nice thing to have in the portfolio. In some sense, I think that has been what some have tried to replicate – a 5 per cent return with low volatility. At Schroders, we've been investing a lot in our fixed income capability in order to be ready for great opportunities going forward. We're not there yet and I haven't bought it for my portfolios yet but opportunities will come."

**OLAF VAN DEN HEUVEL:** "One driver has, of course, been the fact that capital requirements for banks have been going up over the last 10 years or so. Therefore, there will be a continued need for private debt going forward as someone needs to provide credit to the economy."

**BERTIL FROM:** "I agree. Regulation is also driving the market. As the banks are driven out of the lending business and with a continuous need, the credit market will increase. We implemented an exposure to credit last year and we're currently discussing if we should increase our exposure. Interest rates are up and credit spreads have increased and you get 6 or 7 per cent on good BB and B companies. It's absolutely an area to look into."

NIKLAS TELL: WE BRIEFLY DISCUSSED INVESTMENTS IN FOR EXAMPLE INFRASTRUCTURE AS FIXED INCOME REPLACEMENTS. WITH WHAT'S CURRENTLY GOING ON IN THE ENERGY MARKET, HOW DO YOU VIEW REGULATORY AND POLITICAL RISK?

**MIKKEL SVENSTRUP:** "I don't think that's new. It's something that's always been there."

**IRENE HOLMSLYKKE:** "I think it has increased in general because now with the war in Ukraine, regulators will have an excuse to intervene in market pricing. As an example, the Danish government has just implemented a cap for how much real estate rents can be adjusted to inflation."

**JOHANNA KYRKLUND:** "I think an important line was crossed during the pandemic and we got used to a lot of government intervention. We had rules of how many people we could have at home for dinner etc. Now we have an energy crisis and we look to the government to tell us what to do. What was interesting with the pandemic was that it accelerated change that was already underway. Another thing that has happened is that governments are much more willing to step in to address challenges. It wasn't clear to me that governments would step in and offer support when the pandemic first hit. The response we saw was very different compared to the situation after the financial crisis in 2008. The level of support we've seen in the last couple of years would have been unthinkable back then."

**OLAF VAN DEN HEUVEL:** "One thing that's interesting to me is that we all know we need a lot of investments in sustainable energy and whenever there's a new wind park to be financed, we're all queuing up. There's enough money but not enough projects."

**MIKKEL SVENSTRUP:** "There are too few projects and it's also a case of 'not in my backyard'."

NIKLAS TELL: IN THE LIGHT OF MORE GOVERNMENT REGULATION AND THE PUBLIC BEING MORE WILLING TO ACCEPT GOVERNMENT INTERVENTIONS, DO YOU THINK THAT WILL CHANGE? WILL GOVERNMENTS SIMPLY DECLARE THAT IT WILL BE IN YOUR BACKYARD?"

**MIKKEL SVENSTRUP:** "Yes, I think that will happen."

NIKLAS TELL: WE'VE TOUCHED A BIT ON SUSTAINABILITY BUT WHAT'S YOUR TAKE ON THE WAY ESG HAS BEEN COMING UNDER PRESSURE LATELY? HOW SHOULD WE VIEW THAT DISCUSSION?

**MIKKEL SVENSTRUP:** "I think the ESG debate was taken too far by people saying that you would always be better off by being an ESG investor. That's, of course, not the case because there will be periods when other types of companies perform. Yes, in the long-term oil companies maybe won't be around but they can make a lot of money until that happens."

**KARIM CHEDID:** "I think we've learnt three lessons over the last couple of years. We've had a few cycles of different ESG performance in a short period of time and that has given us a good case study. In 2021, we saw ESG indices outperforming parent indices because of the quality tilt and rally in tech and growth sectors. Then in 2022, ESG underperformed because of the performance of energy and the selling in tech and growth stocks in Q1. So the first lesson is that these exposures should be positioned correctly and investors need to understand that there are sector tilts. You have a tech overweight and an energy underweight in ESG indices and that will influence performance. The second lesson is that you need to engage also with so-called brown sectors. If you're looking long term and you're convinced that companies with a plan to transition will do better, then you don't need to divest from energy, for example. There are different shades as you move from brown to green. And the final lesson is that the dynamic has changed when it comes to the net-zero transition. Yes, the transition will come at a cost and it will be inflationary but with energy prices rising, the difference between brown and green has become smaller. It will still be a cost to shift the engine but the cost is smaller today."

ROUNDTABLE – ASSET ALLOCATION



NIKLAS TELL: IS THIS DISCUSSION ALSO A REFLECTION OF MIXING ESG PRODUCTS AND ESG AS A RISK FRAMEWORK?

**MIKKEL SVENSTRUP:** "I was just writing down 'what is ESG?'. It's an opinion – it's not a science. There are many opinions. It's just very important that you explain what you're doing and what you're not doing."

**BERTIL FROM:** "The world is complicated and you can't put it into an ESG box. When you make investments, you need to look at different scenarios and you should be able to invest in an oil company as well. However, when you do that, you need to find a company that behaves correctly. We can't be naive, which we have been and that's why we're in the situation that we are. We wanted cheap energy and we got that from Russia."

**JOHANNA KYRKLUND:** "I think you obviously need to take these factors into account but at the same time, you don't want to introduce unnecessary rigidity in the portfolio. What you believe to be true today might not be the case five years from now so you don't want to have an exclusionary approach because that means that you decide at this point in time what's right and what's wrong. You need to look at each company individually rather than excluding entire sectors. Another key element when it comes to ESG is that it's more complex than simply looking at the carbon intensity. Governance has always been something that has been cared about and the 'E' has been an easy factor to measure. What's underrepresented is the 'S', so looking at the employment a company provides etc. You need a more nuanced conversation around ESG."

CAROLINE LIINANKI: WHAT ARE YOUR THOUGHTS ON THE ONGOING REGULATION IN EUROPE WHEN IT COMES TO SUSTAINABLE INVESTING?

**JOHANNA KYRKLUND:** "I think it's necessary because ultimately it's raising the bar."

**KARIM CHEDID:** "I agree and it's partly about setting common standards because even with regulation, we still have a definition challenge. There's still a lot of work that needs to be done for everyone to be speaking the same language."

**IRENE HOLMSLYKKE:** "I think we do need some regulation in this area. Then we can, of course, discuss whether the current regulation will take us where we need to be and whether it's helping clients. From the investment side, it's good with some standards because then there's something to relate to and something to discuss. It's a difficult area and some regulation will, of course, be wrong. But doing nothing is not the answer."

**MIKKEL SVENSTRUP:** "I think we as an industry brought it on ourselves because we said that if we just do this, the world will be a better place. I'm just concerned that we spend all our time and resources on 'tick-the-box' exercises that will have no impact on the real world. I think it has been too easy for politicians to point to the financial industry to solve all the problems. We can do some of it but politicians can do more. Regardless of how much we do, there will still be externalities that are not priced."

**JOHANNA KYRKLUND:** "I think engagement is one area where we can make a difference but we need to be smart about which battles we pick. We need to focus our efforts and if we do that, then we can influence companies to change for the better and at the same time unlock value for our customers."

**MIKKEL SVENSTRUP:** "Three years ago, we launched an ESG questionnaire with more than 100 questions. We got the data back and compared with the companies in our portfolio and in listed markets and then we sent back an individual report to each of the companies that answered. We're not telling them what to do and we're not naming and shaming them in public but simply pointing out the facts about where they're performing better or worse than their peers. All the companies that got that report participated again the following year, so there's value in giving them something back."

**JOHANNA KYRKLUND:** "We're sometimes under pressure from the media to take more of a public stance on individual companies but that's not in our interest. We would rather work with the companies in making changes for the better. If you're a responsible owner, you work with the companies to search for a better outcome for all."

NIKLAS TELL: LASTLY, WHAT WOULD BE THE BIGGEST NIGHTMARE FOR AN INSTITUTIONAL PORTFOLIO?

**JOHANNA KYRKLUND:** "For me, it's good that central banks are taking action. It would be worse if they stayed behind the curve. It's better to take the pain. We need real returns and the biggest threat to that would be high inflation for a long time."

**OLAF VAN DEN HEUVEL:** "Markets still expect inflation to come down towards 2 per cent. However, structurally I think it's more likely that we will end up with inflation at 3 or 4 per cent and then we have a big problem because all growth over the last 30 years has been financed at 2 per cent and lower."

**MIKKEL SVENSTRUP:** "I don't agree. I actually think that could be a good thing for Europe as it will be a way to slowly deflate our way out of the debt problems that we're facing."

**OLAF VAN DEN HEUVEL:** "But that only works in an environment of growth and I don't see that for Europe."

**IRENE HOLMSLYKKE:** "I think geopolitics is the biggest risk. The reason, as said – it will increase the political risk of when and how the governments will react economically."