VP BANK

Making your portfolio fit for the future

Investment theme

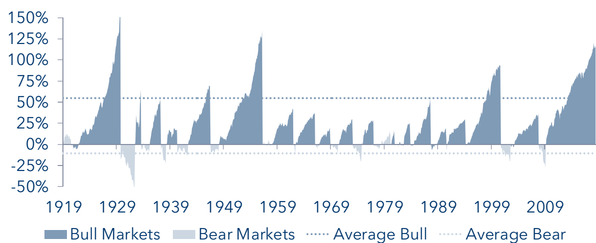
DESPITE OCCASIONAL SETBACKS, RECENT YEARS HAVE SEEN POWERFUL TRENDS ON THE FINANCIAL MARKETS, WITH ALMOST ALL ASSET CLASSES POSTING ABOVE-AVERAGE GAINS. IN FUTURE, HOWEVER, WE EXPECT THE INVESTMENT ENVIRONMENT TO BECOME MORE CHALLENGING. THIS WILL NECESSITATE AN INCREASED FOCUS ON RISK. INVESTORS SHOULD REVIEW THEIR PORTFOLIOS TO ENSURE THAT THEY ARE FIT FOR THE FUTURE.

Mature bull markets

Since the end of the financial crisis the financial market environment has been close to ideal. Moderate economic growth and negligible inflationary pressures have legitimised the central banks' reflation policies. This has been good news for almost all asset classes, leading to a "bull market in everything", as the UK magazine The Economist has aptly put it. The fall in bond yields as a result of central bank asset purchase programmes has enabled bond investors to achieve enormous capital gains. At the same time the resultant yield famine has encouraged investors to move into corporate bonds and risk assets such as equities. Looked at historically, the current bull market in US equities is already exceptionally long-lived. The last 100 years have seen only one phase with stronger gains. The bull run in bonds is unprecedented. Yields in the US have been in decline since the early 1980s and in Europe since the mid-1990s.

Phases of above-average capital gains have occurred time and again in the history of the financial markets. What is special about developments in recent years is that both equities and bonds have posted exceptional advances over a protracted period, as the following chart makes clear.

Cumulative gains and losses in a mixed US portfolio (50% equities und 50% corporate bonds)



Sources: VP Bank, Shiller, Bloomberg, St. Louis Fed

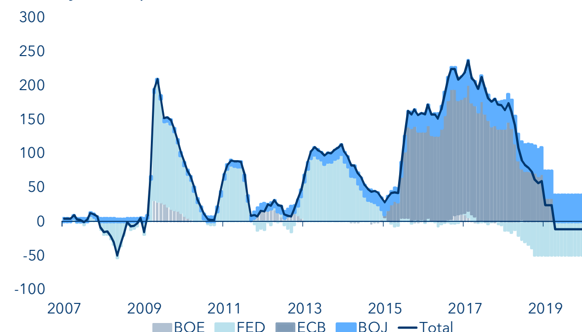
Sustained buoyant conditions have not been confined to the financial markets. Many countries have also experienced an unusually long economic upswing. This applies especially to the US, where the economy has been growing year on year since 2010.

Markets in transition

The past years' gains have been a boon for investors, but now they are becoming a stumbling block. Climbing asset prices have pushed up valuation ratios in virtually all classes of investment, reducing their further upside potential.

The capital market environment is also changing, spearheaded by the US Fed. Eight interest rate hikes have brought US borrowing costs close to a neutral level. Since the autumn of 2017 the Fed has also been gradually scaling down the reinvestment of maturing securities. It has thus become the first major central bank to start reversing the prodigious expansion of its balance sheet that occurred in the course of its counter-crisis measures. Other central banks are still some way behind on the path towards normalisation, but the flow of liquidity from the major central banks is steadily being reduced and will shift into negative next year.

Monthly asset purchases from Central Banks



Sources: VP Bank, Bloomberg

This gradual change of course not only affects the markets in which the central banks have intervened directly. Since the Fed started on the phased downsizing of its balance sheet, we have seen an increase in equity market volatility, albeit from an unusually low level.

Facing up to the risks

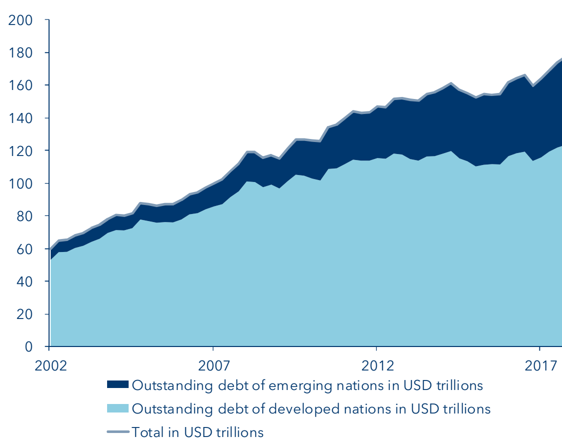
Given these changes in the capital market environment, investors need to focus more systematically on potential risks. The move away from expansionary monetary policies presents a major challenge. Monetary normalisation in the US has so far proceeded without problems, but it is not clear that this will still be the case when other central banks follow suit and likewise adopt a more restrictive stance. That could have a substantial braking effect.

The fact is that we are in uncharted waters. A key factor is bond yields, which have been depressed by central bank purchases. Cheap money has pushed global debt to an even higher level than at the time of the financial crisis. This

makes the economy and the public sector more vulnerable to an upturn in borrowing costs.

Although there are no immediate signs of recession, the longer the boom lasts the greater is the probability of an economic slowdown. The setback does not have to be as severe as after the financial crisis ten years ago, but the mountain of debt in many countries and/or the continuing expansionary slant of monetary policy reduces the fiscal and monetary scope for countermeasures. Added to this are smouldering structural problems. Imbalances in the eurozone, for example, could flare up again in the event of serious economic difficulties.

Global debt (all sectors)



Sources: VP Bank, Datastream

Income inequality is fuelling dissatisfaction in large parts of the population and poses a threat to social cohesion. Political extremists on the left and right thrive in this situation, and their unbridled ideas are often inimical to economic prosperity. Many countries are already showing trends towards protectionism and nationalism.

Disinvestment is a bad choice

Looming risks often prompt investors to get out of the market entirely. But it is still unclear whether, when and in what form the risks will materialise. Heightened risks and increased volatility do not lead directly to negative returns, especially in a solid environment of robust economic activity and strong earnings growth. Equity valuations are admittedly historically high, but they are not extreme. The same cannot be said with equal conviction of bond yields, but central banks will not quit the field precipitately.

Numerous studies show that in the long term it pays to be invested. Investors receive a return to compensate for the risks they take. Premature exiting from the market can involve substantial opportunity costs in the form of lost returns. Rising optimism in a mature market leads to handsome capital gains, whereas holding cash for a long period results in a creeping erosion of wealth. Inflation (albeit low at present), combined with rock-bottom interest rates in many currencies, eats into the real purchasing power of cash assets.

What should investors do?

We basically advise investors to stay in the market but to carefully examine their portfolios with reference to risks, weightings and individual positions. Strong gains in recent years may have radically altered the portfolio's structure. Key points to bear in mind include the following:

- An excessively one-sided or aggressive positioning should be avoided. Risk-exposed asset classes should be reduced to the strategic weighting.
- Sensible diversification. Avoid a concentration of risks in particular sectors, regions, countries, companies or foreign currencies.
- If there might be a need for future liquidity, attention must be paid to the investments' liquidity risk.
- Avoid risk assets that generate only a negligible yield.
- When investing in emerging market bonds, hard-currency issues should be preferred to issues denominated in local currency.
- Bond quality should not be seriously compromised for the sake of a regular income.
- Equities of companies with high levels of debt and poor cash flow, especially in cyclical sectors, are particularly vulnerable to correction.

We regard the following approaches and investment choices as useful in an increasingly difficult environment:

- In the bond sector, issuer selection is gaining importance and should take precedence over yield considerations. Bonds with a credit rating or price that is not justified should be sold.
- Passive (i.e. index-tracking) investments should be treated with caution, especially in the bond sector. The higher an issuer's debt, the greater is that issuer's weighting in the index. Moreover, low yields and long maturities have increased the interest rate risk.
- The yield outlook is particularly feeble in the CHF and EUR markets. Instead of opting for (inadequately rewarded) higher credit risk, investors without concrete liquidity needs can switch to private debt investments in order to improve the risk/reward profile.
- Superficially highly rewarding investments like high yield bonds should be avoided or at least reallocated into

more defensive strategies such as senior loans or supply chain finance solutions.

- A position in long-dated US Treasuries without currency hedging should help stabilise the portfolio via dollar appreciation and capital gains in the event of an equity market setback.
- Equities of good quality companies with forward-looking business models.
- Theme-based investments in companies that stand to profit from long-term structural trends.
- Selected alternative strategies should prove successful in the context of major valuation discrepancies and generally low yield expectations. If a part of the equity allocation is placed in alternative strategies, the market risk is reduced without completely sacrificing upside potential.
- A supplementary position in gold should also prove useful in difficult times.
- Alternative bond investments that have a low correlation with macroeconomic developments (e.g. catastrophe bonds) exert a diversifying effect and can provide an additional return.

In the current environment investors should pay greater attention to risk management but should also be ready to seize opportunities as they arise. Tougher phases on the markets provide useful openings for vigilant players. Market retreats can be used to make tactical equity purchases, while heightened volatility might enhance the appeal of specific structured products. In phases of strong confidence and narrow fluctuations, we advise partial hedging. Systematic writing of equity options can also be a way of earning an additional return.

Safely ahead – Portfolio check

VP Bank offers to carry out a comprehensive analysis of your securities portfolio in the form of a tailor-made “portfolio check”. Your portfolio’s structure, allocations and individual investments will be rigorously scrutinised, with bond and equity positions being subjected to a systematic quality analysis. Using a quality screening procedure, we will examine your equity holdings to ascertain their defensive characteristics, leverage, profitability and capital efficiency. In the fixed income sector, we will analyse the rating agencies’ assessment of your bond holdings and compare that with expected default rates based on our research partner’s credit models. We will also be pleased to suggest innovative replacement solutions for investments you may decide to discard.

Conclusion

After a long period of strong advances, the air on the financial markets is getting thinner and expected gains are no longer as high as in recent years. Central banks’ reflationary policies are being phased out. Risks are looming on the horizon, though the fundamentals remain positive.

Investors should stay in the market but should ensure that their portfolios are fit to deal with more difficult conditions ahead. Risks need to be identified and calibrated, and mature-cycle opportunities should be exploited. VP Bank will be pleased to help you analyse your portfolio and identify the risks to which it is exposed. With our assistance, your portfolio can be made fit for the future.

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