INTERVIEW

A deeper dive into asset allocation

FTSE RUSSELL CONVENES

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Interviewed by

Jamie MacDonald, ex-portfolio manager, Point 72

Jamie: Mo, always great to see you.

Mo: Great to see you.

Jamie: So, Mo, let me start with this. I was watching an interview with Stan Druckenmiller recently and over his 45-year history he says this year, 2023, is the hardest one for him to make a call macro-wise. How do you feel about where markets are today, and what's your outlook?

Mo: Coming into the year, I think the expectation was a recession, right? So, whether we thought it was a mild recession or a more severe recession, most people have been pretty bearish. You can see that if you look at flows, for example, in money market funds, or even bank deposits which have been incredibly elevated.

Jamie: Well, I read recently that the short positioning of hedge funds had gone back to its highest peak since during high money times.

Mo: Exactly.

Jamie: But we're back up to the bearish times.

Mo: You think about professional investors, retail investors, all very pessimistic. Now what we've seen from markets is kind of exactly the opposite, we've seen growth back in favour, and I'll talk a little bit about that because I think under the surface there's a lot going on, so it's not the headline numbers but also what's going on under the surface. Equities have had a pretty good year, fixed income has had a good year. If you remember 2022, really tough for a 60/40 portfolio, we're seeing the exact opposite this year. Now if you get a little bit deeper, what I think is interesting, it's a very narrow market. So, you look at the top names in the indices, which are heavily dominated by the tech sector, you've seen most of the performance there. If you look at the top 10 names, even the top five names, they've driven most of the return, and the bottom 95% of stocks have really had a flat to negative year.

Even the Russell 2000®, which is a reflection of smaller capitalisation stocks, has had a challenging year. And the bond market is also telling us something a little bit different than the equity market. We still have a deeply inverted yield curve, which historically has been a sign of an impeding recession. So challenging market, I don't disagree with that comment, I think it is a very challenging market, although for an asset allocator, there are opportunities. And the 60/40 portfolio, in my opinion, is having a little bit of a renaissance, if you may, right? I mean it's coming back from a year where people basically were writing it off as a balanced portfolio solution, right? So, diversification, some of those concepts that historically maybe were harder for us to allocate to, like fixed income. Remember fixed income had very little expected return, or yield, for a very long period. Now those things are back in favour and I actually think it's a great opportunity for investors.

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> How should you allocate your assets today to set you up for success tomorrow?

Jamie: People are so quick to write things off, and the market can change relatively quickly. Everyone was dismissing the 60/40 portfolio, we're back again. I mean, me included, I was like, right, now is the time for value to outperform, some of these growth stocks came back. It's funny how the market can turn on its head. And it sort of looks where the psychology is, I feel like it's catching us out.

Mo: Yes, one of the people early in my career said the market is the greatest humiliator. It tries to humiliate the most people as it can. It's like, it's always trying to catch you on the wrong side of whatever the trend is. Which I think again, argues for a very balanced, diversified approach to asset allocation. Thinking about not necessarily what's happening in the short horizon, a day, a week, a month, but looking at the long-term trends, and also aligning those with your long-term goals. And that doesn't just mean individuals, right? I mean a pension fund, what is your funding ratio? What is your liability stream? A foundation, a perpetual organisation that has to, you know, be a going concern, and fund some sort of activity over a long period of time. How should you allocate your assets today to set you up for success tomorrow?

Jamie: We were talking a little bit beforehand about media and its role in financial markets. I watch financial news morning shows, you're on quite a few of them! Do you think we all pay too much attention with regards to the Fed, as to whether they hike 25 or 50, or I mean obviously we expected a rate tightening, but where we are now, so much debate is whether the Fed's going to cut, or whether they're going to raise, or what they're going to do. Do you think there's too much focus on that?

Mo: I mean at this stage it's probably not as important, right? I think if you were really good at forecasting and you saw what happened over the last year, that would probably be pretty important, right? Because change in discount rate of that magnitude, and by the way I'm not sure anyone was expecting that speed and that level, but now we're kind of in a period where I would say, we're getting close to done, right? So maybe you have another 25-basis point hike in July, like the market is expecting, but I'm not sure there's that much more to go.

Jamie: So, we're getting into the realm now.

Mo: Yes, so now focusing on it, I think is less impactful, or less material, than maybe we have been focused on it over the last couple of years. And then there was a period where there was no activity, so I'm not sure anyone was focused on it, right?

Jamie: That's true. I mean we talked about it for five or six years.

Mo: And then suddenly, it's really important again. And obviously drives everything, right? I mean you think about policy, I started my career in fixed income, so maybe I'm a little bit biased, but it's kind of the starting point of everything. If you understand what's happening with that discount rate, what's happening with policy, you can start to understand how other things will behave, right? Like equities, and what happens in private credit, what happens to crypto, like all of these asset classes that we're watching at the end of the day there is kind of a foundational policy related question that drives all of those asset prices.

Jamie: Let's talk about what it does to the banking system. We've obviously seen a couple of fallouts already as deposits were moving out of these banks, and they struggled to stay solvent, and then got saved. Do you think there's another shoe to drop in the regional banking world? There's talk of commercial real estate exposure, a lot of it sits on the balance sheets of these regional banks. Is that something we need to keep an eye on, or do you think it's manageable?

Mo: We definitely need to keep an eye on it, right? I do think that the tightening that we've seen over a short period of time is kind of unprecedented. Things will break which we saw. Now is that under control? I would argue that it's under control. Two reasons, one I think the industry was stepping in to obviously help, but also the backstop that the government provided which I do think has some implications longer term. Like what happens to the regional model as more of these regional banks disappear? I mean the big are getting bigger.

Jamie: Is that a good thing? Do we have too many banks in America?

Mo: I don’t know the answer to that, I think competition is always a good thing. And sure, regional banks did serve a purpose. You know, I think what will happen is, some of what they historically have done is going to go to other places, for example the private credit space and direct lending, right? I mean a lot of that was being done by banks. Now it's moving off into more like the asset management or private market, specialist boutique firms. I mean I think the market works it out, right? So, when there's a gap, someone is going to step in to fill that gap, but it is going to be interesting to see how that changes behaviour. I mean think about it, do you have a regional bank account?

Jamie: I do not. I have one with Chase.

Mo: One of the large banks. So that's a change in behaviour, and that was not always the case, you know? People banked at their local community bank.

Jamie: Yes, I just wonder if these banks, you know, sometimes history repeats itself. I just looked over at the UK, there's a building society I'd never heard of before, called Skipton Building Society, they're now doing a 100% mortgage. So zero deposit down, I read in the U.S. that Rocket Mortgage are doing something similar, very small deposits down, it just has the hallmarks of lending getting out of control again, which is strange given this environment, but, do you think we can ever see a kind of banking crisis, not similar to 2008, there's just so much credit out there that if it's lent in the wrong way it could happen?

Mo: Generally speaking, where we see a crisis, it doesn't repeat itself. So, if you've seen it in one area it's probably not going to come back. Because there's been controls put in place and regulation to address that issue. So regulatory capital, you know, the monitoring that the government now does. I think if I looked at the banking system today, I would argue it's way healthier than it's been historically, right? There's way more conservatism in the system than there was maybe during the last financial crisis. And to my point I don't think the crisis point repeats itself, it finds another place where we're not paying attention. It's usually where people are paying attention that it doesn't happen, right?

Jamie: True.

Mo: Right now, everyone says commercial real estate, I'm wondering if maybe, if it's that obvious it's probably not there.

Jamie: True, true. So, we talked a bit about equities, touched on a bit of credit, how about other areas of the markets? Are commodities an area you think are an exciting place to invest right now?

Mo: Commodities are always interesting because you can't really think about it in a traditional asset allocation. Most long-term asset allocators start with capital market assumptions, which tend to think about something's yield or expected return and volatility. Because there's no yield or dividend on a lot of these, like gold.

Jamie: Sure, it's not paying you anything.

Mo: Yes, so you can't really say here's the perfect way or here's the ideal weight in an asset allocation for the long term. People tend to think about commodities and other metals, agriculture, things like that, as more of a tactical asset allocation decision. And there are times where we do take some views on things like oil for example, and you know, it's part of our asset allocation framework when we think about horizons between six months and three years, rather than 10 to 20 years.

Jamie: Final question, Mo. You used to be a credit guy you were saying, and I used to be an equities guy, so I'm going to try and get you to give me some advice. Where rates are now, they're looking much more attractive, where on the yield curve do you think is the most exciting to be looking for investment? Are you looking for high yield? Is that exciting? Corporates? Where do you even start?

Mo: I'm really happy you asked this question because it's actually a topic with clients right now. Because short rates are so attractive, essentially you can get 4.5, 5% basically risk free, but you have to define what you mean by risk, right? When I think about risk, I also think about what's my real return like? What is the real rate of return? So, when we see the nominal return.

Jamie: You're like, well, after inflation what is it?

Mo: What is it after inflation? And then you also have to think about reinvestment risk. When you're on the shorter end of the curve, not only are you, you know potentially giving up some yield, although right now that's not the case because the yield curve is inverted, but you also have to think about reinvestment. So, when you do you get your proceeds, at what rate at that time could you redeploy those assets? Given what I said earlier about rates, if you believe the Fed is near done, and rates are going to be, you know, somewhere around where they are now or going down then you have reinvestment risk. When you go back to the market to redeploy, you're going to probably redeploy at a lower yield. So, thinking about that trade off, right? Thinking about, well if I extend duration, go out on the curve a little bit and lock it in, versus stay short and have that reinvestment risk, I think it’s a real topic right now with clients. And then you also have to think, what's the intention of those assets over the long term, right? Most people should not be sitting on a significant amount of cash, if they have long-term liabilities, or long-term goals, right? Because we understand the power of that inflation, or, you know, real return considerations have on a portfolio, we understand that. You know there's a risk premium attached to something, so taking additional risk comes with additional return, that's really the framework you should use. You have to kind of go back to that very simple framework and say, what am I trying to do? What's the timing of the cashflow that I'm looking for? And most often it's not cash, right? You know, that's not the answer, it's usually in riskier parts of the market that earn that premium.

Jamie: Got it. So, if I'm going to rent in Manhattan for the next two years, do two-year treasuries, lock in a good rate, and then…

Mo: Well look, if you got a mortgage a couple of years ago, you probably had a mortgage somewhere between 2.5 to 3%.

Jamie: It was 2.8.

Mo: Right, so you're actually earning a spread over your mortgage, and no surprise that supply, if you think about supply in the market, supply of real estate has been very tight because that trade-off is actually, no one's paying off their mortgage at 2.5%, right? Especially when short rates are at 4.5%.

Jamie: Mo, it's always so great to chat with you, thanks for taking the time to chat today.

Mo: Thank you, I appreciate it.

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