2021 Risk Management Conference

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Virtual event coverage

Canadian Investment Review

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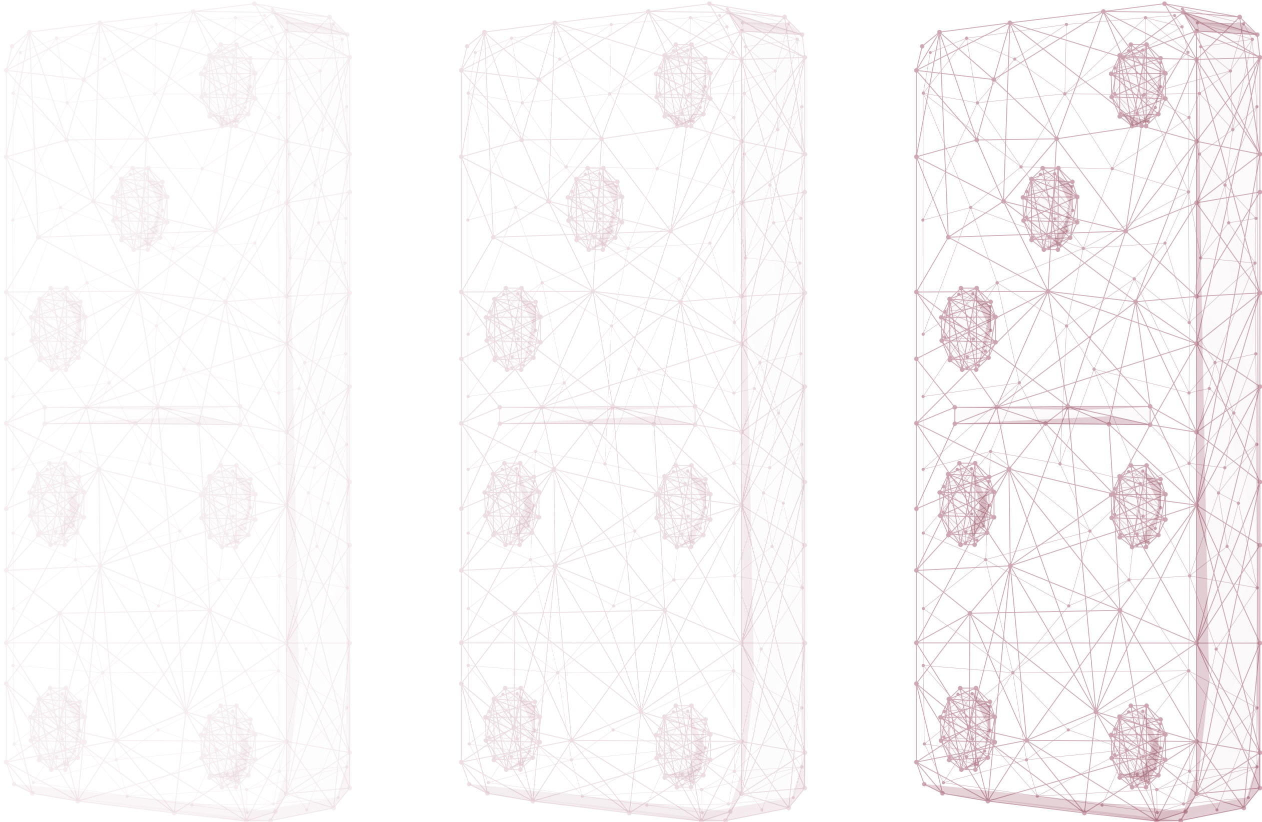

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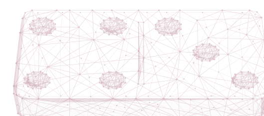
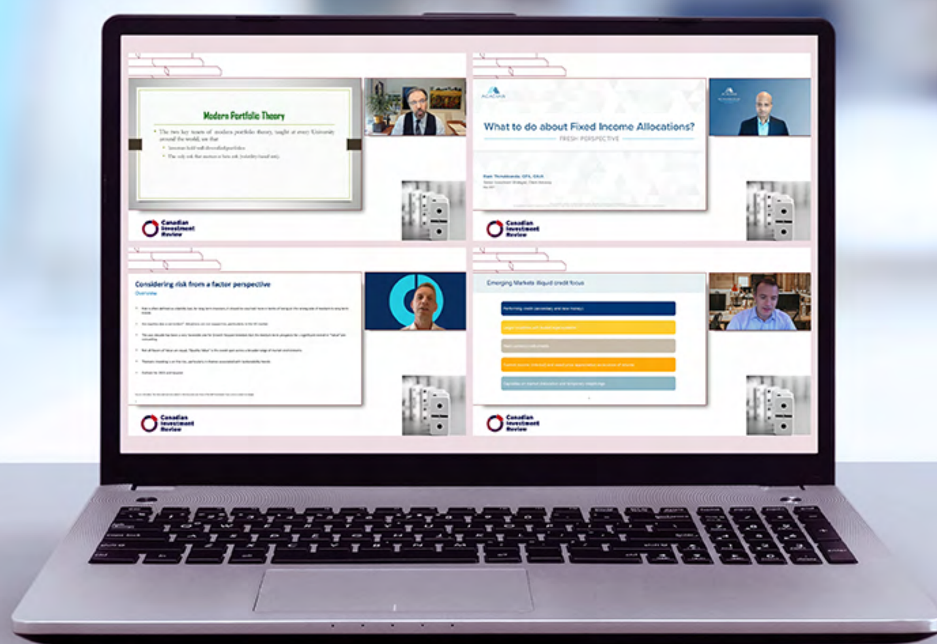


Introduction



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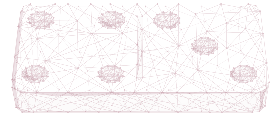
By: Gideon Scanlon
Editor, *Canadian Investment Review*

In 2020, the very notion of business as usual came to an abrupt end.

As supply chains collapsed, offices closed and people went into isolation, pension plan sponsors were forced to adapt to the new reality. New ideas about asset allocation and risk mitigation strategies began to gain traction among plan sponsors.

In May, a group of four world-recognized authorities on risk management and investing discussed some of these fresh perspectives at the 2021 Risk Management Conference. Beyond their calls to consider new ideas, the presenters also urged plan sponsors to reassess even the most widely accepted ideas about approaches to risk management – from modern portfolio theory to the role of sovereign bonds in portfolios.

Iconoclasm, it seems, was the call of the day. Keynote speaker, George Athanassakos excoriated the mainstream approach toward diversification. Soon after, Ram Thirrukonda warned of the hidden dangers of the embedding of short-put-like risk exposure in hedges. Then David Philpotts used economic data to explain why the next decade looked bleak for North American equities. Finally, Mihai Florian took a skeptical position to global investments – going as far as to warn against making asset allocations to a BRIC nation.



Understanding value investing

George Athanassakos
Professor of Finance
Western University's Ivey Business School

During the keynote session on May 27, George Athanassakos, a professor of finance at the Ivey School of Business and the founder and chair of the Ben Graham Centre for the Advancement of Value Investing Education, was quick to take aim at modern portfolio theory.

"Academics regard diversification as a substitute for due diligence. They believe that stock-by-stock analysis is a wasted effort and that diversification will save us all."

Athanassakos takes exception to this perspective, pointing out even if diversification does reduce risk, it also dilutes returns. "Why not invest directly in government bonds and cut to the chase?"

He also noted other reservations he held about this approach to risk management. As a value investor, he said he believes in narrowing one's focus to a more limited number of stocks and conducting intensive research on each to determine if they're being undervalued by the market. "In my mind, the problem with modern portfolio theory is that it regards diversification as a substitute for due diligence."

In his argument, Athanassakos also pointed out that diversification would work if the only risks in the markets were the risks we knew that we did not know about—as risk works in a game of roulette. "Unfortunately, risk is not like roulette. In roulette, the odds are fixed. What we observe arounds us does not affect the odds. Risk looks more like a poker game, where what we observe around us affects the odds."

"A few years ago, French mathematician Benoit Mandelbrot showed that if you plot the daily stock returns of the Dow Jones for the last hundred years, it does not plot out as a bell curve. The far edges are too high."

According to Athanassakos, these "fat tails" – as Mandelbrot referred to them – show the inherit unpredictability of markets.

"While diversification does not protect against the risks we do not know we do not know, the margin of safety employed by value investors does."

Value investors, Athanassakos explained, conduct extensive due diligence in order to understand the businesses they invest in – and use a checklist. "Do I understand the business? The business model? The business risk? Is the company conservatively financed? Do I like the management? Does the company have a competitive advantage? Does the company generate high returns on capital? Does the stock price provide a margin of safety?"

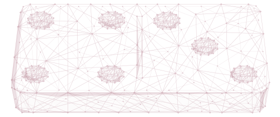
"We like to buy companies analysts do not pay much attention to. We believe in this case we have an informational advantage. We like being independent – not following the crowd and doing whatever we hear on CNBC."

While he does not believe that diversification is a portfolio panacea, he does not reject the idea of diversification outright.

> "Portfolios underperform, not because their managers lack stock-picking ability, but, rather, because institutional factors force them to over-diversify."

"As value investors, we don't totally reject diversification. If we did, we'd buy only one stock. We don't – we have a portfolio of 15 to 30 stocks. We believe that some diversification and a margin of safety can protect US against both the risks we know we don't know and against the risks we don't know you don't know."

He ended his speech by saying: "Portfolios underperform, not because their managers lack stock-picking ability, but, rather, because institutional factors force them to over-diversify."



What to do about fixed income allocations

Ram Thirukkonda
Senior Vice-President, Senior Investment Strategist, Client Advisory
Acadian Asset Management LLC

In the second speech of the 2021 Risk Management Conference, Ram Thirukkonda, senior vice-president and senior investment strategist in the client advisory team at Acadian Asset Management, discussed what investors could do to address bleak prospects for the traditional risk reduction and returns generation roles played by fixed income allocations. Like Athanassakos, he didn't shy away from iconoclasm, at one point telling delegates: "Bond risk reduction benefits can no longer be assumed."

Thirukkonda began his session with an overview of the role sovereign bonds have historically played. "Many of you will recognize the secular decline in yields of sovereign bonds that has dominated many fixed income allocations. It is a well-known, global trend."

In outlining sovereign bonds' slow fall from grace, he described how their declining yields first saw them become equity risk offsets in the 2000s. Over the past decade, expectations in terms of their traditional roles have declined even further. "You can see very clearly that in the 90s, around two-thirds of the allocation was attributable to cash and bonds. This gradually declined and as of 2019, it stood at about a third of the portfolio."

To fill the void left by sovereign bonds with declining expected returns, a gradual rebalancing occurred. As portfolios shed bonds, they replaced them with equities and equity-like investment classes with higher return expectations. This, argued Thirukkonda, does little to mitigate risk. "This glacial rebalancing has actually amplified equity-like risks, rather than diversifying away from it."

Not only did he suggest equity and equity-like investments were a poor replacement for the risk reduction role previously played by sovereign bonds, but he also challenged several other strategies pursued by portfolio managers. "The outlook for fixed income allocations looks challenging. The risk reduction that investors have come to rely on may degrade. Investors may have reallocated to strategies that, in many cases, exacerbate risk."

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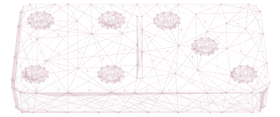
The cost of direct hedges, argued Thirukkonda, was often overlooked. Uncorrelated investments, such as hedge funds, often embed short-put-like risk exposures. Others such as real estate are subject to distortions in reported performance. "If investors were to experience a longer and more profound shock, it would reveal the true underlying nature of these investments."

He also highlighted the weaknesses of rudimentary approaches using simplistic, static allocations to gold as an example. He noted that gold can be more appropriately considered a conditionally defensive asset whose returns are strongly dependent on views on currencies, as well as macro drivers such as real yields, and inflation.

In order for investors to find durable fixed income replacements to sovereign bonds, Thirukkonda suggested pension plan sponsors embrace sophisticated approaches commensurate with their objectives. "From a returns perspective, this means exploiting asset breadth in a liquid fashion. Incorporating economic and fundamental drivers and almost deliberately avoiding labels. From a risk perspective, this implies the use of a robust model that is concentration averse, tail-aware and forward-looking."



Value re-evaluated

David Philpotts
Head of Strategy, QEP Investment Team
Schroders

In the third speech of the 2021 Risk Management Conference, David Philpotts, head of strategy for the QEP investments team at Schroders, focused on global equities from a factor perspective.

He said investors often associate the short-term noise around markets as risk, but the real risk to manage is being on the wrong side of longer term trends.

"When we consider the areas where investors often get asset allocation wrong, we need to think more about valuations. Valuation by itself doesn't tell us much about the short term, but it is the best indicator we have of prospective longer term returns."

The biggest risk today is the level of market valuations themselves at present. "Equity returns over the next decade are almost certain to be a lot lower than they were in the past decade."

Philpotts also argued that, while many growth-focused investment strategies have been very profitable in the past decade, this is very unlikely to be repeated. Instead of just focusing on the standard dichotomy of "growth" vs "value", he suggested investors pay attention to the quality of stocks that have been historically underpriced in the market. "I would define quality as stocks in control of their own destiny – stable, profitable and finally sound. They might not be the fastest growing, but they are stable growers and are well-governed."

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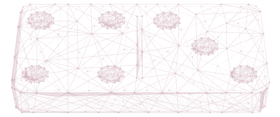
Until recently, the best performing stocks have been expensive and typically lower quality as investors have focused on the shorter term impact of lockdowns associated with the global pandemic. "However, going back three decades, the best stock market performers have been reasonably priced quality stocks by some margin. Historically, it hasn't been profitable to pay for high-value companies regardless of their growth or quality credentials."

Since the arrival of vaccines late last year, 2021 has so far seen a reversion to the longer-term trend. He said, "the world has already started to move on in an investment sense with many prior losers benefitting from a broad based market rotation. However, this process has much further to run before valuations return to their longer term norm."



A global strategy for illiquid and private credit

Mihai Florian
Senior Portfolio Manager
BlueBay Asset Management, a subsidiary of RBC Global Asset Management

In the fourth speech of the 2021 Risk Management Conference, Mihai Florian, a senior portfolio manager at BlueBay Asset Management, a subsidiary of RBC Global Asset Management, returned to the topic of declining yields.

Developed market illiquid and private credit strategies were once attractive alternatives to enhancing yields and reducing volatility in portfolios, he said. "What we've seen is an explosion of private credit strategies in the past 10 years. In the past three years, there's been north of $100 billion deployed in this market."

In the current market, argued Florian, investor interest and declining interest rates have reduced yields for those employing this strategy. "Over the last five years, investors have seen returns start to decrease. The risk that is being taken has started to increase."

Still, he suggested there's some merit to the approach. Rather than abandoning it altogether, he advised investors to broaden the geographical remit of their investments beyond developed markets. "We see that there is an opportunity – emerging markets illiquid credit – because this is an area where we have yet not seen material allocations. There are not a lot of managers looking at it."

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By focusing on a select subset of high-quality emerging market illiquid credit investments, investors can enhance returns without significantly increasing credit risk, he noted. "Regulatory constraints have impacted banks' behaviour and capacity to provide credit. Banks are acting in an arranger capacity that has exacerbated volatility and credit dislocation. This, argued Florian, is especially detrimental to borrowers in emerging markets, where banks provide 90 per cent of investment capital.

Similar investments in developed markets, credit in developing markets holds the promise of high returns and excellent protections for investors, he said. However, it isn't a strategy without risk, noted Florian, highlighting the legal and ethical risks posed by investing in emerging market illiquid credit. "You need to be able to navigate in these jurisdictions. It doesn't matter what the opportunities are. It is sometimes better to step away. Russia, for example, is a jurisdiction with a huge market and a lot of opportunities. But we actually question the ability to enforce on contracts and underlying security."

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