Allocation Insight

7.7.2017

Investing is about making relative choices

"Investment is the discipline of relative selection," as Graham, Dodd (and Cottle) wrote in their iconic book about value investing, Security Analysis[1], first published in 1934. The quote sums up the significance of asset allocation for an investor; discipline, patience and the importance of relative selection. One of Mandatum Life's key investment-related values is patience. It reflects our Group's way of investing and, according to our insight, leads to the best end result for the investor. The following text and tables present the grounds for the relative selection of asset classes both across the asset classes and within them.

We will maintain the fixed income-equity allocation at neutral and alternative investments at moderate overweight

Global economic growth is expected to further accelerate moderately, to +3.4% in 2017 and to +3.5% in 2018. The growth can be attributed to the favourable development of employment and consumer demand in both the US and Europe. In addition, the combined budget deficit of the G7 countries is on the rise for the first time in eight years – an indication of stimulating economic policy. The main indicators measuring corporate and consumer confidence also predict growth, although recently, the US economic data has been slightly weaker than expected.

Accelerating economic growth and companies' strong earnings performance give the equity market a positive vibe. A low and ascending interest rate level works in favour of equity investments, but stock price valuation levels have risen above the historical average. From an equity investor's perspective, this is problematic, because a higher interest rate lowers the current value of companies' future cash flows. Stock prices should reflect this, if the interest rate level settles permanently on a higher level than the current one. The reward paid to investors taking equity risk is clearly higher than that paid to government bond investors (Figure 1), but markedly lower than the return on long-term equity investments. That is why the equity/fixed income allocation in the portfolio is moderate, i.e. neutral.

The return expectations of alternative investments clearly exceed the return on liquid fixed income investments, which is why we weight alternative investments at the expense of fixed income investments.

[1]https://www.amazon.com/Graham-Dodds-Security-Analysis-Fifth/dp/B001DYD0I6

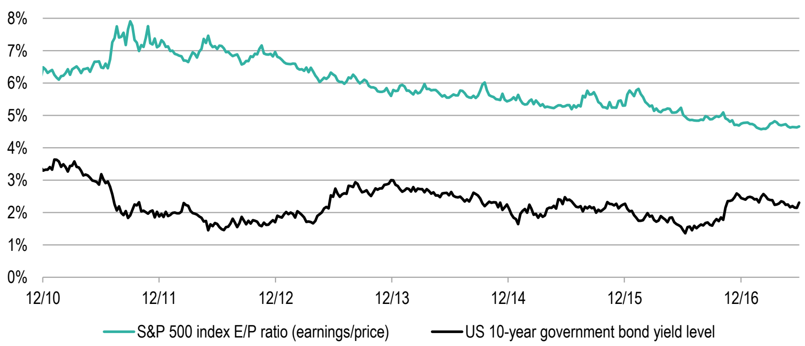
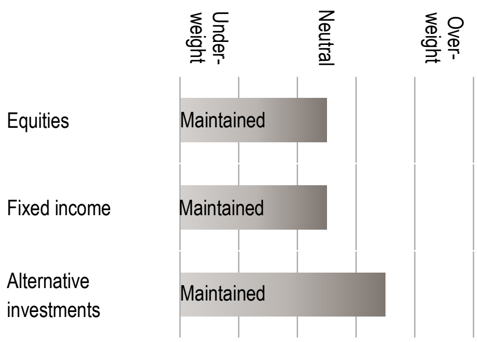
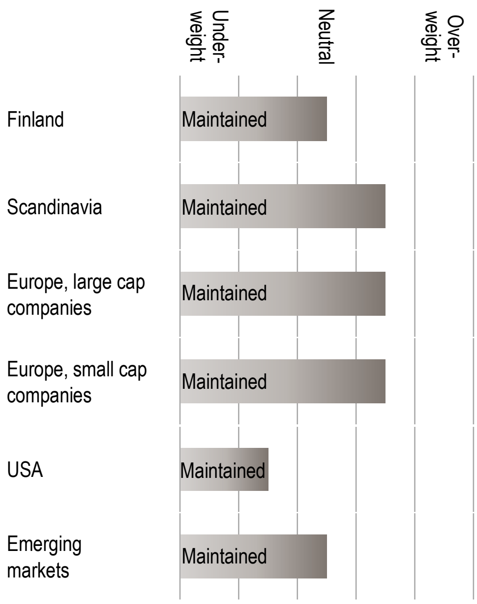


Figure 1: The reward paid to equity investors for taking equity risk is attractive compared to the return on government bonds. Source: Bloomberg

Asset classes



Equities



We favour European stocks

No major changes were made within equity investments in June. We continue to overweight European – incl. Nordic – stocks and underweight the US, while keeping emerging markets neutral. This weighting has proved excellent during the early part of the year. Although companies' business is highly international nowadays, the differences in the regional earnings growth trends and thus also the relative movements of stock indices still largely stem from placing the focus on domestic markets and currency impacts. The underperformance of European companies in relation to the US in terms of earnings, which has lasted for several years, turned around early in the year, and stock index development has followed suit (Figure 2). The clear weakening of the dollar in the early part of the year has also contributed to that trend. In June, European companies experienced weaker stock price development than the global market, which largely explains the slightly weaker value development of equity investments compared to the market index. However, we believe that the relative return on European companies will continue to improve following an upward earnings growth trend.

In fixed term investments we will focus on corporate bonds

Markets preparing for the normalisation of monetary policy in the US and the gradual winding down of stimulus in Europe raised interest rates and strengthened the euro at the end of June. Since the beginning of the year, the interest rate trend has been downward in the Western countries. Globally, however, loose monetary policy continues, and inflation expectations have not risen significantly within a year, even though the employment situation in the Western countries has clearly improved. Actual inflation has also become more moderate this year. Central banks thus have no particular reason to rush the normalisation of monetary policy, and the central banks' messages concerning the timetable have indeed been very moderate. However, the change in policy is likely to increase price volatility in all capital types.

Fixed income investment credit risk premiums grew slightly at the end of June, but continue to be on a low level. That is why we have been selective in making new investments and the cash weight is rather high. The strengthening of the euro at the end of June provided the opportunity to add more iShares 0–5 Year Investment Grade Corporate Bond ETFs, which contain short-duration corporate bonds. American, low-risk investment grade corporate bonds offer better yields than their European counterparts thanks to a higher interest rate level. Coming into June, the dollar risk in the portfolios was hedged in its entirety, but following the purchase, the dollar hedging ratio fell to around 75%.

In fixed income investments, the focus continues to be on Nordic corporate bonds. We see corporate bonds as more attractive, with low government bond return levels and with moderate pressure on the interest rate to rise. However, we have reduced the weight of high-risk, high-yield investments during the course of the spring and we are very selective about new investments. The fixed income investments' interest rate risk, measured in duration, is clearly more moderate than the market index, thanks to which the value of fixed income investments fell less than the overall market development during the interest rate rise at the end of the month.

In alternative investments, we focus on private debt

In alternative investments, we made an investment commitment in the ML Private Debt II investment basket, which invests in private corporate debt. We also made our first private equity investment through the Capman Buyout X fund. With the portfolio still under construction, the majority of the investments are still money market investments, but the portfolio's investment commitment rate is some 60%.

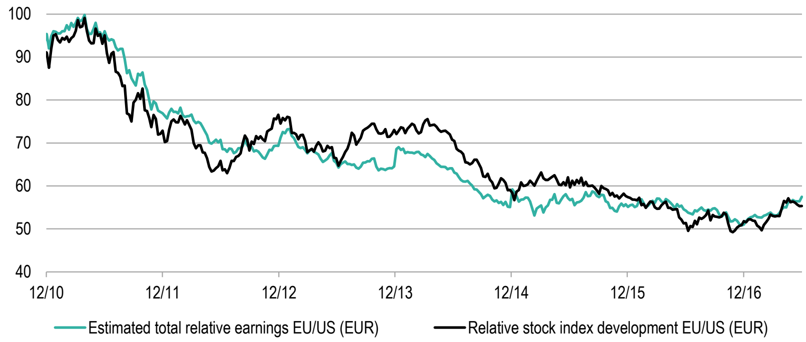
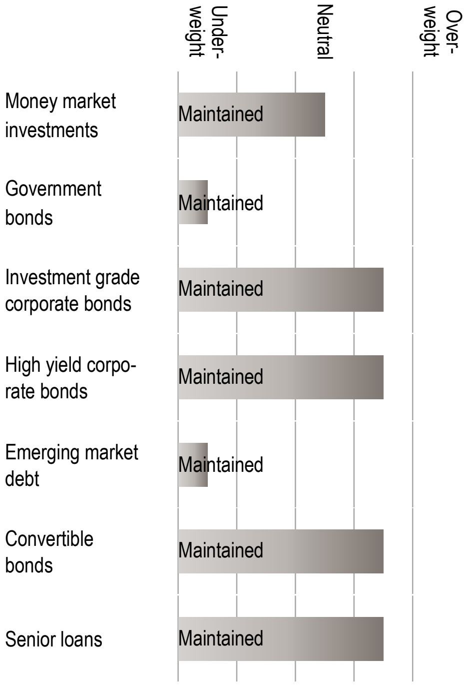
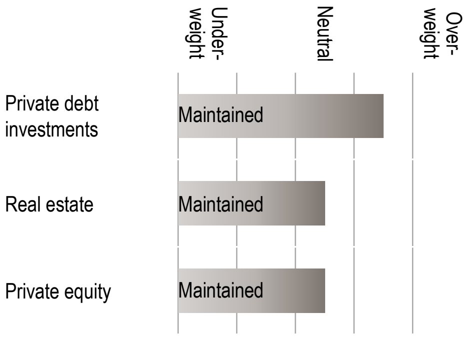


Figure 2: The earnings forecasts of European companies are, for the first time in a while, growing at a faster pace than those of American companies (green line) and the relative price development of stock indices follows this trend (black line). Source: Bloomberg.

Fixed income



Alternative investments



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