Russell Investments

Summit 2018

2018 SUMMIT

Snapshot

Bubbles grow
and bubbles burst.

Reduce risk.
Increase returns.
Reduce costs.

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Global market outlook: The late late (cycle) show

Snapshot

ANDREW PEASE
Global Head of Investment Strategy

Simple action: Having a process is vital

Global market outlook: It's very late in the cycle

In case you haven't heard, it's very late in the cycle. Of course, it *could* be different this time. Maybe we are only midway through an historic period of uninterrupted growth? Unlikely. By the standard of every cycle we've seen over the past 100 years, this one is *very* old. We are in the second longest bull market in history, only beaten by the one that started after the 1987 share market crash and ended with the tech bubble.

U.S. recession danger zone

In our view, the recession danger zone for the U.S. is in 2020, at the earliest. Although the reality is that no one has a good track record of forecasting market downturns. The point is, we shouldn't be overconfident in our ability to predict the future. Instead, we should be guided by a well-structured investment decision making process.

Remember, bear markets only tend to appear six months before a recession. It's perfectly possible that over the next year, a burst of late cycle euphoria drives equity markets substantially higher – but we believe that from here on out, the downside risks outweigh the upside. It's not all doom and gloom however as generally, shallow recessions typically follow big ones (and the financial crisis was the biggest economic downturn since the great depression). In addition, this time around, global developed economies don't have the sort of imbalances that drove the crash of 2008/09.

Geopolitical issues provide a huge amount of uncertainty

Tensions are high across the world. President Trump and Xi Jinping aren't backing down in their fight over trade wars. The ongoing Italian political saga is seeing a budget battle that could become a big problem for Europe as a whole. Across the pond, the U.S. Federal Reserve has tightened interest rates eight times, and they look set to continue raising rates each quarter. Meanwhile China's economy remains unbalanced and it looks increasingly like it won't be the source of demand growth for the global economy.

All of this would be easier to deal with if markets were cheap. But, this is far from the case, particularly in the U.S., where Shiller's cyclically adjusted price-to-earnings ratio is over 30x the average level of earnings over the past 10-years.[1]

Use a decision-making process

So, how do we deal with this investment environment? We use a decision-making process called "CVS: Cycle, Value and Sentiment". It helps us to objectively identify when markets are cheap/expensive, whether the cycle is tailwind/headwind and if the market sentiment is overconfident/pessimistic. The key to investing is having a structured process – it is vital.

[1] Source: Robert Shiller online data: http://www.econ.yale.edu/~shiller/data.htm, last observation as at 30, October 2018.

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END OF THE CYCLE ADAGES, SURVIVING BOOMS AND BUSTS

Snapshot

DAVID VICKERS

Senior Portfolio Manager

Simple action: Apply the process that suits your objectives, beliefs and framework

What does it mean to be late cycle?

Based on the assumption that we are indeed correct, and that we are late cycle, what does this actually mean? What should we expect? What should we do? And what biases should we be aware of?

Clearly the answer is to sell out of our holdings the exact day before the crash begins. Well, that is a noble pursuit – but carries with it a very low probability of success. Indeed, we can identify the pre-conditions of a bear market, and we can observe the kindling being added to the fire. What we can't do, however, is exactly identify the spark that lights the fire, i.e. the day before the crash. That will always remain an elusive, unknown day. In this case, what do we do? How do we prepare?

Behavioural bias

Today, battle lines are being drawn between asset management firms and investors over which method of preparation is preferable: to cut and run early and miss out on the last hurrah or ride out the volatility. This is why the silent hand of behavioural bias can be at its more destructive at this juncture. One of the biggest risks to investors' net worth is the portfolio decisions they make. Since wealth is generated from the compounding of returns, and this can be impacted by both (1) jumping out too early or (2) panicking and jumping out too late.

We need to recognise the important role that behaviour plays in determining returns at the end of the cycle. Risks can get exaggerated by emotive rhetoric from "wise heads" that tell us what we *want* to hear which gives conformation to our view – and thus firing cover to emotional bias. To prepare for this, it is sensible to think about what type of investor/organisation you are, what you can survive and what bias you might have.

Use fact not emotion: Apply a process

Much of what we do on a daily basis happens without thinking, it is called the X system – a process developed for survival. If our ancestors heard a rustle in the bushes, chances are they needed to run, not wait until they saw and processed that a sabre tooth tiger was charging towards them before they moved. Emotion is programmed to override logic and as such, the X system is very difficult to overrule. It is relied on particularly when problems are complex, information is incomplete, stress is high, and time is short! But that's not the best approach when it comes to investing.

Using historical fact not emotion, provides a better framework for thinking about what the best course of action might be, and what scenario needs to be played out for either strategy to be successful. Our process has got us leaning out and away from the risks in today's environment. Do you have a process that suits your objectives, beliefs and framework?

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ESG: INVESTING FOR BETTER OUTCOMES

Snapshot

PETE GUNNING
Global Chief Investment Officer

JOE HEMMANT
Global Head of Equity Research

EMILY STEINBARTH
Quantitative Research Analyst

Simple action: Define your ESG policy

The ESG landscape is rapidly evolving

There has been growing interest in responsible investing and environmental social and governance (ESG) issues from investors, regulators, money managers, governments and industry organisations. Thanks to this, the United Nations-backed Principles for Responsible Investment (UN PRI) and the changes we are seeing in the regulatory environment, ESG integration is becoming mainstream.

Responsible investing at Russell Investments

We believe that it is vital to integrate ESG at the firm-level and across all stages of the investment process. Active ownership, often referred to as stewardship, is one of the key ways we interact directly with companies on ESG issues. For example, in 2017, we voted 94,000 proxies and engaged managements/boards on issues like diversity, climate change and director compensation.[1] Manager surveys are also important and help to gauge the industry's commitment to ESG and stewardship. Key trends and individual firm data are used to establish a baseline score for how successfully firms are integrating ESG factors into their investment processes.

Product evaluation and ESG scores within our manager research process are another key component. Using a unique methodology, analysts measure how well managers demonstrate ESG integration. On a scale of 1-5 (with 5 being the highest), this ESG score rolls up into our overall product rating determining whether we hire a manager, or not.

Explicit and measurable ESG outcomes

We know that there are instances where investors are looking to implement explicit and measurable ESG outcomes. A typical way that investors first consider incorporating climate change into their portfolio is by reducing carbon exposure. However, divestment at certain levels can introduce significant active risks into the portfolio. Therefore, in our approach to low-carbon ESG solutions, we go beyond basic carbon exclusion – we also actively invest in companies that are participating in the transition to a low-carbon economy and/or have a high ESG score.

Looking forward

The investment industry has moved away from a world where ESG is all about values. New solutions are showcasing that there isn't a need for a trade-off. Dual objectives *can* be met – both in terms of investment value and values. It has become increasingly clear that regulation will require you to have an ESG policy, so get ahead and start defining yours today. For those who have already done so, look back over your policy and ask yourself: "does my policy still meet today's ESG demands?".

[1]. Source: Russell Investments, "Proxy voting and engagement report", 2017.

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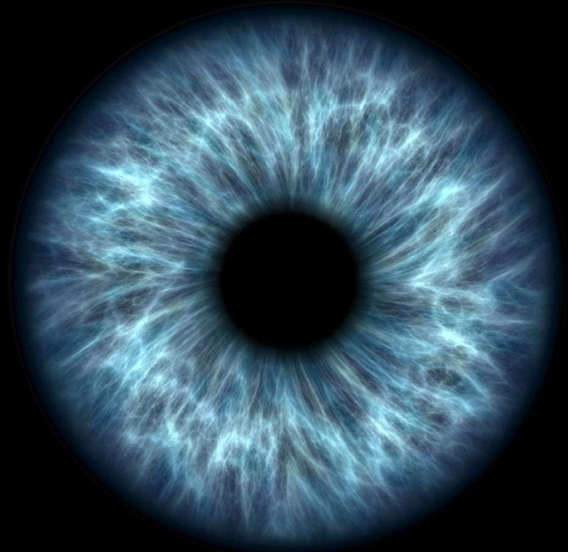
The future landscape of DB pensions

Snapshot

DAVID RAE
Head of Strategic Client Solutions



Simple action: Be prepared

The retirement funding gap

A recent report highlights the stark reality of the global retirement funding gap (the shortfall of assets to liabilities). [1] Today, this retirement gap is estimated at $70 trillion and is forecast to increase to over $400 trillion by 2050. In the UK, the size of the retirement gap is forecast to grow from around $8 trillion today to about $33 trillion over the next 30 years. The largest shortfall comes from the amount set aside by governments to meet tier one pension provisions and public-sector retirement obligations. Individual savings shortfalls and corporate defined benefit deficits make up the rest of the gap.

The changing pensions landscape

Defined benefit pensions schemes have been on a significant journey of transformation for some time now. Around 20 years ago, most schemes remained open to future accruals and trustees were able to accommodate some short-term risk in pursuit of higher long-term returns. Today, active members make up less than 10% of total corporate defined members.[2] Trustees and corporate sponsors are now less able to tolerate investment risk and have to accept lower future returns. This is compounded by the low-return outlook.

In this session, we asked the audience for their perspective on issues affecting the future of defined benefit pension funds. Over 70% of the audience felt that liability hedging would remain the key risk management focus for their schemes going forward.[3]

The new ESG regulations that require trustees to enhance their Statement of Investment Principles and reporting is expected to have a “significant impact”, according to 74% of the audience.[3]

Consolidation in many forms has been a key theme for pension trustees over recent years. With the emergence of commercial consolidators on the scene, we asked the audience whether they thought these would take off in the UK. The response was mixed, with 40% being unsure, while 56% of those with a view thought that commercial consolidators were here to stay.[3]

Where will we go from here?

Fortunately, the big changes that we have seen in the risk management of pension funds over recent years leave them less exposed to market variability. Over the coming years, we expect the key risk management framework will move to focus on cashflows rather than liabilities. We do think that there will be a normalisation in transfer activity, but believe that it will continue to be an important feature. And finally, we anticipate that consolidation, in all of its guises, will be an exciting area of opportunity for trustees.

1. Source: Figures are quoted from World Economic Forum, “We’ll live to 100 – How can we afford it?”, May 2017.
2. Source: Office for National Statistics, “Occupational Pension Scheme Survey”, 2017.
3. Source: Russell Investments’ 2018 Summit polling results

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Emerging market equity with a focus on china

Snapshot

KATHRINE HUSVAEG
Senior Portfolio
Manager

Simple action: Review your allocation to EM and China

Emerging markets versus developed markets

Emerging markets (EM) have lagged developed markets for a prolonged period of time. In 2017, emerging markets rebounded sharply, with the MSCI EM index returning +37.7% for the year.[1] However, this year has been more challenging for risk assets and EM has sold off by 15.7% year to date.[1] China-U.S. trade-war tensions, monetary tightening as well as the strength of the U.S. dollar over 2018, has weighed heavily on emerging markets.

These returns are not reflective of the underlying fundamentals; for example, earnings growth has remained solid at 14.6% for the year to date.[2] This dislocation between EM fundamentals and market returns bodes well for the prospective returns of active stock pickers. Furthermore, EM valuations look attractive and the cycle backdrop is broadly supportive. Sentiment indicators pointing to oversold territory, support a potentially desirable entry point for those with underexposure to this asset class and who may have missed the stellar returns in 2017.

Spotlight on China equity

As a recognised, important engine for global growth and forecasted to become the largest economy in the world by 2030 (taking an 18% share of global GDP), China is simply too big to ignore.[3] It is the largest component of the EM opportunity set, however index inclusion is currently dominated by Chinese companies listed offshore.

China's onshore stock market

China's onshore market (known as the A-share market) is the second largest stock market in the world with a market capitalisation of $6.5 trillion; yet, it is currently only 77 basis points of the EM index.[4] Why? Historically, the A-share market has been harder to access for foreigners as they had to apply for, and be awarded, a quota to invest. Investments were also subject to strict capital account controls making it less attractive for many asset owners. Capital market reforms, alongside the launch of the two Stock Connect programs, Shanghai-HK in 2014 and Shenzhen-HK in 2016, have increased the access to and attraction of the market to foreign investors. MSCI recognised this progress by including the onshore market in its global indices earlier this year, albeit with a partial inclusion rate.

China (onshore and offshore combined) will only increase in the index and could easily exceed 40%. Furthermore, as China's weight in the index has grown, we have observed an increasing underweight to the market among EM portfolios as measured by the median. Therefore, investors wanting exposure to this opportunity set should not rely entirely on their EM or global portfolios to provide it. There are always risks within and facing EM equities. That said, many of the risks lie outside of the asset class and current valuation levels provide investors with some margin of safety.

1. Source: Factset, data as at 31, October 2018.
2. Source: Datasteam, data as at 30, September 2018.
3. Source: PWC, "The Long View: How will the global economic order change by 2015?", 2017.
4. Source: Factset approximated figure and MSCI Emerging Market Index, both as at 31, October 2018.

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Private markets: An alternative during volatile times

Snapshot

JULIA CORMIER
Client Portfolio Manager

Simple action: Use experts to get better results

Why are institutions moving towards private markets?

According to the 2018 Greenwich survey, roughly 60% of respondents expect to make significant changes to their current portfolio allocations over the next three years.[1] Why? (1) Diversifying risk, (2) lower future return expectations and 3) rising interest rates. Combined, these three reasons make private markets an attractive alternative to traditional assets. Private markets have historically offered attractive risk adjusted returns and now many market participants are increasing allocations to the space.

The investment opportunity set has changed over the last 20 years

The change in the opportunity set is in part because of the decline in the number of publicly listed companies, particularly in the U.S. In 1996, there were approximately 7,300 U.S. publicly listed companies. Today there are about 3,700.[2] Over a similar period, private markets have grown from $0.5 trillion to $5 trillion (excluding direct and co-investments).[3] In addition, institutional investors have allocated assets to private debt as an additional source of yield.

Manager and asset selection matters

Manager selection is especially important in private markets because of nuanced complexities and the long-term nature. Historically, there has been a wide dispersion of returns among private markets managers, seeing thousands of basis points between the top and bottom quartile managers. As part of our "CVS: Cycle, Value and Sentiment" process, we take a 12-18 month forward-looking view of private market assets. Although our views can and do change, a high-level summary of our current perspective is:

In general: We prefer private debt over private equity across private markets due to cycle and valuation considerations.

Private debt: We prefer asset-backed strategies over pure cashflow based lending and senior secured financing relative to junior credit, from a cycle perspective.

Private equity: We are being very selective and favour smaller and more complex deals where value can be added through operational expertise, rather than financial engineering.

Real assets (real estate and infrastructure): In the U.S. and Europe, we have a general preference for debt over equity. In Asia we are more comfortable with real estate equity because pricing is generally favourable relative the U.S. and Europe.

1. Source: Greenwich Associates, "UKII-18", 2018.
2. Source: The Journal of Financial Economics Vol. 123, No. 3, "The U.S. Listing Gap," March 2017.
3. Source: Hamilton Lane, data as at July 2018.

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Innovation: Enhanced Portfolio Implementation

Snapshot

CAROLYN TSALOS
Director, UK Institutional

LOGAN HILKIN
Implementation Portfolio Manager

RONNIE SABEL
Senior Portfolio Manager

Simple action: Explore opportunities to enhance your return

MIFID II, transaction costs and going beyond the *traditional* approach

With MIFID II putting more focus on transaction costs than ever before, it is important that investors and asset managers consider new and innovative ways to manage costs. For asset owners, capturing alpha as efficiently as possible is a primary objective. Transaction costs however, can act like a heavy weight. The more efficiently they can be controlled, the more of the intended alpha can be captured.

Traditionally, when a manager is appointed, they are responsible for both idea generation and the implementation of a portfolio. Yet many managers who are good at stock picking are not always as strong at trading and trade timing. Moreover, they are focused on their individual mandate, without visibility of an asset owner's broader portfolio. However, separating insight from implementation can enable additional efficiencies in transaction cost reduction whilst preserving the intended portfolio exposures.

Enhanced Portfolio Implementation is an implementation approach pioneered by Russell Investments, developed specifically to maximise net-of-fee returns and minimise transaction costs. This can work in either single-manager or multiple-manager structures.

How does Enhanced Portfolio Implementation (EPI) work?

EPI applies a number of techniques designed to reduce portfolio turnover. The largest driver of these is reducing the number of transactions. The second element is improving the quality of execution versus that of the existing managers. Finally, where there are multiple managers held in the structure, we net opposite transactions. This has delivered turnover reduction of 35-45% p.a., leading to an improved net-of-fee return between 20bps and 45bps p.a. (excluding additional savings made from reducing each mangers' workload).[1]

Please note that transaction reduction techniques are applied very sensitively, ensuring that we preserve more of the intended manager alpha, without losing the intended manager exposures.

What are the benefits?

Overall, there are four key benefits achieved by Enhanced Portfolio Implementation: (1) lower costs, (2) improved portfolio efficiency and control, (3) better access to managers, and (4) improved governance including ESG considerations.

[1.] Source: Russell Investments, data as at 31, October 2018.

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Did the regulatory review "fix" the transition management industry?

Snapshot

GRAHAM DIXON
Director, Transitions, Analytics

IAN MCKNIGHT
CIO, Royal Mail

RICK BOOMGAARDT
Independent

MIRJAM KLIJNSMA
Managing Director
Implementation
Services (Chair)

Simple action: Engage with a trusted provider when making changes to your portfolio

What is transition management and why is it beneficial to asset owners?

Asset owners make changes to their roster of asset managers for any number of reasons. With the costs of those changes being anywhere between 20%-30% of the expected annualised alpha from the underlying manager (if managed correctly), it is unsurprising that in a low yield environment when every basis point counts, there is an increased focus on these costs.[1]

Transition management is a highly specialised area that looks to minimise these costs whilst also minimising the risks inherent in making these changes. Transition management has been hugely beneficial to clients, providing not just a framework for managing costs and risk, but also transparency into how they are measured and reported.

What scandal happened in 2011 and what impact did it have on the industry?

The transition management industry has, however, had its fair share of scandals. At the heart of these scandals were principally two firms who took additional remuneration from transition events that they managed, without disclosing this to their clients. These additional fees were often a multiple of the fees that they had actually disclosed.

After a thorough review by the Financial Conduct Authority, they concluded that there was not a problem with the regulations in place, but that there were flaws in either the business model or the culture at the firms in question. On this panel we hosted the former head of transition management from one of the teams involved in the scandal, an impacted client and a specialist transition consultant involved in exposing the fraud.

We discussed the importance of business models and the different types of firms that offer transition management services. The general consensus was that if a scheme does not have the bandwidth or experience internally to monitor the transition manager (and does not want to use a specialist consultant to do this on their behalf), then it probably is most appropriate to engage themselves with a firm who (1) acts as a pure agent in a fiduciary capacity (2) provides alignment of interest and (3) will also provide transparency around their track record.

What are the lessons learned and what does the future hold?

Transitions can be very complex events, but with the right oversight and proper understanding of those complexities, the potential savings and risk-minimising benefits to clients are considerable. Trust and understanding is vital. Schemes should therefore engage with a provider who offers complete transparency into their business model, track record and remuneration process.

[1.] Source: Russell Investments. Estimated costs based on alpha expectations of Russell Investments funds and actual transition costs for the 3 years to 31, December 2017.

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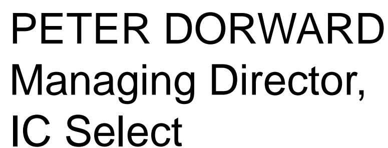
The changing fiduciary management landscape

Snapshot

SARAH LESLIE
Head of UK Fiduciary Management



PETER DORWARD
Managing Director,
IC Select

Simple action: Use experts to get proper results

The rise of fiduciary management

The fiduciary management market has developed substantially since 2009 and has exhibited massive growth. Why? For some, growth has been driven by external market factors such as increasing complexity, greater information and regulation. For others, growth has been internally driven, often by time constraints, resulting in the need for greater resource and expertise.

Whatever their reason for adopting a fiduciary management approach, many schemes have seen an improvement in their outcomes and ultimately, an improvement for the end member. However, concerns continue to be highlighted about whether these improved outcomes represent the best for schemes, prompting the Competition and Market Authority's (CMA) ongoing review.

Focus on the CMA

The CMA's review of investment consultants and fiduciary managers collected data from across the UK. They found that the "big three consultants" i.e. Aon, Mercer and Willis Towers Watson held (and still hold) nearly half of the fiduciary management market size. This alone would not be a cause for alarm: however, the growth they experienced was significantly more than the other two large players including Russell Investments, over the last 10 years. This growth combined with (1) the lack of open tendering, (2) the fact that 50% of schemes selected their incumbent consultant and (3) schemes were found to often pay over 20% higher fees if they had not tendered – raised concerns for many.[1]

The CMA's proposed remedies seek to introduce mandatory competitive tendering, disaggregation of fees (particularly third-party costs) and to develop FM performance standards. The CMA's final report is due to be released in March 2019.

What do we think about CMA reforms?

In many cases we feel the CMA are addressing genuine concerns with sensible measures. However, they could have gone further in some areas such as insisting on regular reviews or oversight of fiduciary managers. In other areas, such as tendering partial fiduciary mandates including private markets, we feel this could be costly and counter-productive as few schemes in practice are likely to take action.

What is clear above anything else is the huge gains that will be made from the increased transparency. Transparency across the sector in both consulting and fiduciary management – as well as in all organisations more broadly – will give trustees the tools to challenge providers, and to find the best service for their members.

[1] Source: CMA, "Investment consultants market investigation: Provisional decision report", 2018.

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Navigating the new order of fixed income

Snapshot

ADAM SMEARS
Head of Fixed Income Research

A new regime: From QE to QT

For 10 years now, central banks across the world have delivered varying levels of quantitative easing to combat the financial crash of 2008/09. By purchasing high volumes of fixed income assets, central banks have also succeeded in suppressing market volatility and distorting markets. Lately, fundamentals have improved, and the market is no longer in a state that requires aid. Market growth is now sufficient enough for the support system to be removed. Today therefore, we find ourselves in a new regime: central banks are raising interest rates and beginning to move towards quantitative *tightening* – selling assets and unwinding balance sheets at a rate like never before.

The result of this new environment has seen heightened volatility across markets and worsening liquidity conditions. The unprecedented amount of quantitative tightening is likely to cause economic imbalances such as inflationary pressures and a tight labour market. In the U.S. specifically, we are already seeing the latter take effect with very low unemployment and growing numbers of excess workers.

What does this mean for investors?

We are already seeing knock-on effects from the unwinding of central bank support. For instance, spikes in implied volatility (as measured by the VIX) during 2018 have increased significantly. Elsewhere, we have seen credit spreads widen whilst rates rise – a r*everse* of the negative correlation pattern we would normally expect to see. As such, its difficult to find opportunities in fixed income because the traditional sources of return and defence i.e. credit and interest rates, are both falling.

Investors need to innovate

To navigate these market changes we suggest three actions: (1) seek new risk premia unrelated to credit and interest rates, (2) identify strategies that thrive in volatile environments and (3) embrace active management. The fixed income market is diverse and other risk premia are available. Convertible arbitrage offers credit risk which works better in volatile markets than traditional credit. Segments of the mortgage market can offer high quality securities that benefit from longevity risk or prepayment risk. We also believe volatility is an excellent source of diversification, especially today. Select “long volatility” strategies, when expertly managed, hedge away broad market risk so that investors are left only with exposure to the market’s expectation of volatility. With a negative correlation to risk assets, this type of strategy makes for a very strong diversifier against the drawdown risk, for example. Overall, they are very different to credit management strategies and are a rare breed, with few experts who can execute the strategy successfully.

Lastly, alpha and active management is more important now than ever. In an environment where all asset classes are under pressure, the value dynamic strategies and active strategies that can take advantage of volatility are essential.

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or

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