



The Next Five Years?

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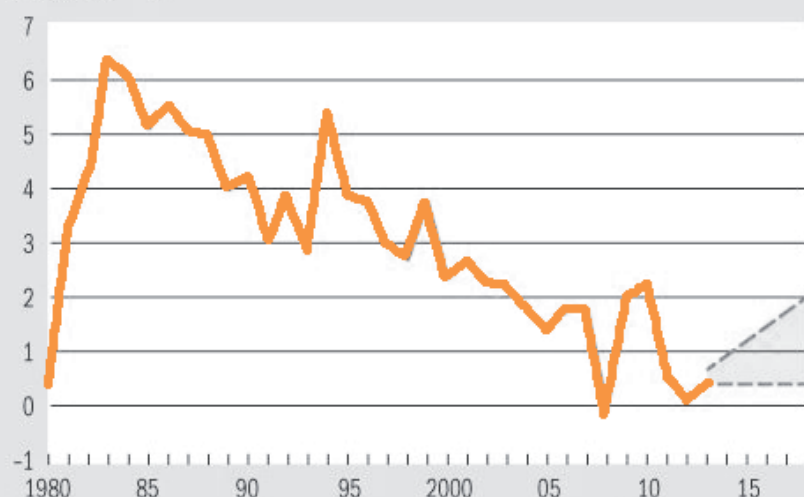
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The IMF in its recent World Economic Outlook investigated global real interest rates. There were a series of interesting findings. Globalisation has integrated finance. We no longer see the huge divergence we were used to in individual region rates. More and more, rates respond to common influences.

The IMF also highlighted the steep decline in both short and long term global real interest rates (see graph). Factors at play here have been changes in both monetary and fiscal policy as well as changes in portfolio allocation (such as pension funds seeking to match liabilities) and changes in saver preferences in Emerging Markets.

The IMF projects global long-term interest rates to remain low, in the range of 0.5–2.0 percent.

(index, 2007 = 0)



Global long-term interest rates

However the truly critical question is how long interest rates may stay at these low levels. The IMF believes that while global rates may be expected to rise somewhat in the medium term, this will only be moderate. The report suggests that real interest rates are to remain relatively low even when economies recover and output gaps have been closed. This is because factors such as stronger financial regulation, portfolio shifts and long lasting impacts of the financial crisis are likely to persist rather than reverse. Structural factors may outweigh cyclical trends.

While no time line is given, the IMF suggest real rates will remain on average at just over 1% out to at least 2018. As the Financial Times says “this is not a short-term story”.

This is not a short-term story

This is perhaps the critical take-away from the research. According to the report we are not looking at a “bounce-back” to anything like pre-crisis interest rates. As the IMF notes:

“Pension funds, insurance companies that provide defined benefits and savers in general may suffer from a prolonged period of continued low real interest rates.”

In this light, Endowments or Charities looking to plan income and expenditures over the next 5 years will have to grapple with the prospect of looking beyond bonds or cash deposits (of any maturity) to meet their goals.

In running the rule over other asset classes there are several features to bear in mind:

- Property is probably still well placed in the investment cycle but selectivity as regards the underlying exposure is key
- Alternative assets such as private equity or infrastructure may offer potential, but will come with long lock-in periods.
- So-called absolute return funds have often failed to beat cash returns but more crucially have suffered severe draw-downs in value just when they should have played a risk-dampening role, for example in May 2013.

So where do Equities fit?

Developed market equities are a highly liquid asset which will benefit from the healing of global economies that policy makers are intent on achieving over the next 3-5 years. But they are volatile.

Can we manage that? Our strong view at Appian is yes - and in two key ways. Firstly, by combining an equity allocation in a truly dynamic way with other desired assets such as property, forestry, commodities, credit etc. It is essential to be dynamic in this allocation and not slave to any benchmark or peer group average. “Managed” pension funds provided little comfort to Irish investors in the dark days of 2008 with an average decline in the region of 35%.

Secondly, by being very selective in the type of equities in the portfolio. Riskier stocks don't necessarily mean better long term returns. In fact the opposite is true. More volatile portfolios tend to get hit excessively on the downside and don't make it back on the upside. What tends to happen is that when higher expectations, that may have driven a stock forward, don't get met, the fall from grace is severe.

Positioning yourself in the stocks which display lower levels of volatility significantly enhances return. The table below shows how over the past 28 years the most volatile 20% (quintile) of the global equity market gave the worst returns while low volatility names did better.

Quintiles	Volatility	Returns
Low Volatility (Q5)	11.00%	11.60%
Quintile 4	14.00%	11.60%
Quintile 3	15.40%	10.60%
FTSE World	15.80%	10.00%
Quintile 2	17.50%	9.80%
High Volatility (Q1)	25.20%	7.80%

The superior performance of low volatility equities stems from their ability to protect in times of market stress. For instance, low volatility stocks performed significantly better than broad market indices in the market melt-down of 2008.

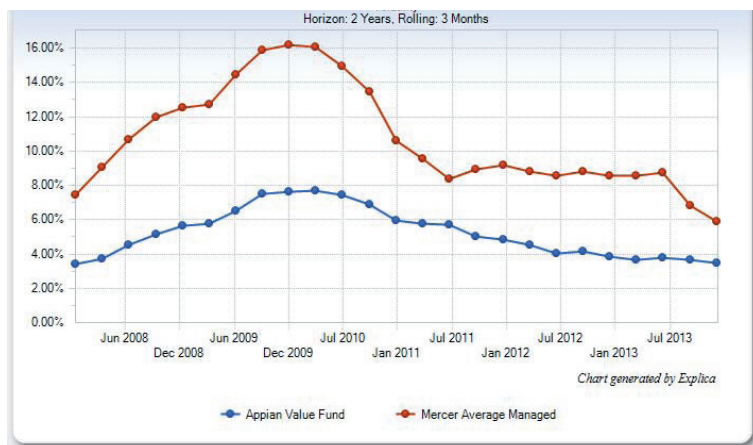
Our experience at Appian mirrors this. In our equity portfolios we don't set out to target volatility levels but as a consequence of the discipline we apply in our stock selection, our equity portfolios display significantly lower volatility than market indices and have seen much lower drawdowns as a result. We look to invest in companies generating strong cash flow off solid balance sheets which can pay out solid dividends that are sustainable and growing. We believe in the power of compounding solid returns through time rather than "hitting the lights out" in any one year.

Low volatility works

And it works.



Appian Value Fund: A Smoother Profile



At consistently lower volatility

As the World Economic Report suggests, we may be in a low interest rate regime for a considerable time. This poses challenges for treasurers, bursars pension trustees etc. who need to generate income but have a clear risk budget.

One solution could be a truly dynamic multi-asset approach that is anchored by a low volatility equity allocation.

Sources:

IMF World Economic Report April 2014

Martin Wolf Financial Times May 6 2014

FTSE World Index/Blackrock



To discuss any of this further please contact:

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