The materialisation of our investment themes

July 2021

Humility is a good value to live by. It's especially important for investment professionals. Markets have a knack for knocking down those who become a little too sure of themselves. With that context, we're quietly gratified that three themes we previously wrote about over the last financial year have materialised. It means we've been able to make some calls that have benefited clients' portfolios.

We've unpacked the three themes and how we responded in our multi-asset portfolios.

Theme 1: 'Participate and protect'

There were (and are) too many uncertainties to justify taking 'either or' decisions. Obviously, being right would be rewarding. However, being wrong would be costly for clients' portfolios. Humility, and realism, led us towards dual-track 'participate and protect' strategies.

There are still reasons for participating in 'risk' assets, but the reasons have changed as the pandemic has morphed and policy responses evolved. Governments can't keep spending at the pace they've been, and it's harder to justify central banks persisting with emergency policies. In other words, a gentle path towards policy normalisation is called for and economies and markets need to be pushed forward by something other than government and central bank support.

Share markets have rotated from the narrow Technology and Health Care leadership of 2020 to a broader set of winners including cyclicals like Financials and Industrials. Our clients' portfolios have participated in this transition.

On the other hand, share market valuations are elevated reflecting abundant optimism. Inflation risks have reappeared after a decades-long absence. These are reasons for 'protecting.' The negative relationship between bond prices and inflation is well documented. What may be less well understood is the negative relationship between inflation and share market valuations, as measured by the price to earnings ratio[1] (P/E). Our research is not suggesting that inflation is bad for shares, but is bad for P/E ratios – inflation can compress them.

Theme 2: Address inflation risk by accessing assets with variable cash flows

Consumer Price Index (CPI) levels are up, as are inflation expectations. With this as the backdrop, our inclination to favour real cash flows to build inflation hedges (as opposed to taking inflation bets) into the portfolios has been rewarded with strong returns to assets with variable cash flows, like cyclical shares. The threshold issue is whether recent higher inflation readings will be transitory, or prove to be sticky. No doubt some of the reported issues like high US car prices because of semiconductor and chip shortages will be overcome when the supply of those inputs ramps up.

But there are reasons to think that the long-standing disinflationary regime we've become accustomed might be weakening, and maybe, an upturn in inflation is ahead:

- Central banks appear to be changing their function from keeping inflation within their target ranges, to allowing it to breach the top end of their ranges in an attempt to achieve higher 'average' inflation.
- Tight-fisted fiscal hawks are a dying breed as governments are embracing deficit spending.
- Company behaviour post-pandemic looks like leaning more towards local production rather than relying on global supply chains. Think of it as 'just-in-case' local production versus 'just-in-time' global production. It's good from a supply-security perspective, but also likely to be more expensive.

[1] The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its earnings-per-share (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

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- Competition for labour is increasing as immigration is reduced and the cost of off-shoring to developing markets has increased.

Rather than making a binary decision on inflation being transitory or sticky, our approach has been to create inflation hedges implemented at a reasonable price. One of the ways we've done this is to build a customised basket of high-quality mining and energy shares, that we know are sensitive to inflation, and offer a high dividend yield. The basket is then tightly hedged with options over those shares so that even if markets sour, they can, at a minimum, earn the dividend yield and not suffer anything worse than bond-type losses.

Theme 3: Prepared for higher market interest rates

We've been killjoys for a few years, shouting 'interest rates can't keep going lower'. But they have! Belated vindication, of sorts, arrived in the first quarter of 2021 when market interest rates moved higher. This rewarded our bias for keeping portfolio duration low (interest rate risk low) by preferring inflation-linked to nominal bonds.

We've also taken advantage of structural opportunities on offer in markets that can enhance returns. An example being exposure to Chinese shares that pay a guaranteed excess return of over 10% pa, with part of the outperformance used to fund downside protection over what is expected to be a volatile investment.

Portfolio positioning

MLC Inflation Plus portfolio activity this quarter was focused on introducing thematic strategies. As explained earlier they're baskets of high-quality mining and energy companies that act as inflation hedges because their earnings and dividends are sensitive to inflation. We're also wary of the correlation between the Australian dollar (AUD) and global shares shifting over time which we manage with an AUD/US dollar (USD) risk reversal strategy which will increase in value if the AUD rises. We've used this strategy in the past and reinstated it this quarter.

Asset allocation positioning of the **MLC Horizon** portfolios was largely unchanged over the June quarter. However, the following underlying manager changes were made to the fixed income and Australian shares components of the portfolios:

- We appointed Ardea Investment Management as a global absolute return manager, and removed BNP Paribas and Insight. We have strong confidence in Ardea's ability to consistently outperform the cash plus objective of our global absolute return bonds strategy.

- We appointed Macquarie Investment Management as an 'enhanced index' Australian shares manager, and removed Redpoint. We are confident that Macquarie will be able to outperform the market more consistently, through a range of different market conditions, while controlling risk.

Asset allocation positioning of the **MLC Index Plus** portfolios was little changed in the June quarter and the manager changes made to the MLC Horizon portfolios were also made to the MLC Index Plus portfolios.

MLC Horizon and Index Plus portfolios also inherit exposures through their investment in Inflation Plus and a real return strategy, providing important real return exposure and sources of low correlation return streams.

More information on each portfolio's positioning is available in the fund commentaries available on the Fund Profile Tool on https://www.mlc.com.au/fundprofiletool.

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