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INVESTMENT INSIGHT | 03/16

# Were January & February *really* that bad?

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As we wrote in our recent note, *(Un)happy New Year*, 2016 got off to a torrid start. Uncertainty regarding the outlook for U.S. interest rates (following December's 0.25% rise) and a plunging oil price was compounded by the Chinese authorities' decision to accelerate the devaluation of their currency. In what was a poorly communicated message, the authorities' inept response to managing Chinese equity market volatility only served to exacerbate concerns regarding the strength of the Chinese economy and more importantly, the ability of policy makers to handle its obvious slowdown – let alone the capital outflows from the country.

**As a result, major equity and commodity markets sank in January**

- The benchmark global equities index, the MSCI World Ex Australia (Hedged) Index fell by -5.36%.
- The S&P 500 (United States), S&P/ASX 200 Accumulation Index (Australia), MSCI Europe Ex U.K. and MSCI Japan all dropped by between -5.00% and -7.64% in local currency terms.
- China, as represented by the CSI 300, was down more than 21%, making the -5.22% local currency return of the MSCI Emerging Markets Index seem even more remarkable.
- Oil, often considered the barometer of global economic growth, was at one point down 25% *for the month alone.*

**A European and Japanese 'bear market' in February (technically)**

By mid-February, key European and Japanese equity indices had fallen into a bear market i.e. a drop of more than 20%, in the *eleven weeks* since 01 December 2015, following the Japanese Central Bank's surprise decision to take official interest rates negative.

Investors further positioned for an announcement of additional support from the European Central Bank (which was duly delivered in March), including the further cutting of official cash rates – which were already negative. Whilst the move to negative interest rates is designed to encourage lending and boost growth (and inflation) in the economy, negative interest rates make it harder for banks to make money from lending, bringing the profitability of some European banks into question.

**Emerging market and high yield bonds were not spared**

It wasn't just equity markets that suffered. Credit spreads[1] in Emerging Market Debt (i.e. the debt of Emerging Market sovereign nations) increased to levels not seen since the GFC, in fear of an Emerging Market currency crisis induced by rising U.S. interest rates.

Similarly, U.S. High Yield Credit spreads blew out as the collapsing oil price raised the risk of increasing defaults. With a bond's price having an 'inverse relationship' with its implied yield, all things being equal, the increase in yield resulted in significant losses, leading to a flight to safety toward higher quality issuers.

[1] This relates to the difference in yield between two bonds that are identical in all respects (e.g. maturity, fixed/floating payments) except for creditworthiness. Generally, this refers to the premium that a bond investor expects to receive over the 'risk-free' benchmark (e.g. a treasury bond, which is considered 'risk free') for investing in a lower quality security – the higher the spread, the more risky the investment, all things being equal.

### At the February lows…

- The MSCI World Ex Australia (Hedged) Index had fallen -12.54% since the start of the calendar year.
- Oil remained under pressure, whilst gold, often thought of as the ultimate store of value in uncertain times, rallied strongly.
- The VIX, the so called "fear index", spiked to levels typically seen in the depths of the European Crisis of 2011. Worse, media sentiment during this period would have you believe that the sky was falling in.
- The U.S. Dollar and Japanese Yen strengthened, consistent with a flight to safety, with the latter's performance particularly impressive given the unprecedented moves by the Japanese Central Bank to cut official interest rates negative.

### Comments from the U.S. Fed chair drove a market rebound

Markets turned, following Janet Yellen's comments stating that financial conditions "have become less supportive of growth". The comments eased concerns that the U.S. Federal Reserve would raise rates throughout 2016 as much as was first expected. Such is the dependency on Central Banker rhetoric in the current environment that markets rallied strongly into month-end, largely reversing the losses seen earlier in the month.

### And so, with all of this fear and negativity, what was the actual impact on the Ibbotson portfolios?

Whilst we are certainly mindful of current events, being long-term investors means that we tend not to get caught up in the month-to-month vagaries of markets. Nonetheless, the performance of our portfolios in the face of the extremely challenging market conditions in early 2016 serves as a prudent example of our long-term valuation driven process at work, incorporating fundamental research and Dynamic Asset Allocation.

**Ibbotson Diversified Trust Monthly Performance (Net)**

| | Conservative | Balanced | Growth | High Growth | High Growth Plus |
|---|---|---|---|---|---|
| **January 2016** | -0.20% | -0.54% | -0.85% | -1.02% | -1.19% |
| **February 2016** | -0.06% | -0.31% | -0.48% | -0.70% | -0.62% |

To be clear, any period that results in a loss of investor capital is a disappointing result but in the context of the broader market volatility and drawdowns, the portfolios have performed exceptionally well.

Importantly, whilst January and February's performance detracted slightly from returns, longer term numbers remain well ahead of the portfolios' CPI + objectives:

**Ibbotson Diversified Trust Performance p.a. (Net) – as at 29 February 2016**

| | Conservative | Balanced | Growth | High Growth | High Growth Plus |
|---|---|---|---|---|---|
| **3 Year Ibbotson Diversified Trust** | 5.08% | 6.69% | 8.03% | 8.62% | 9.44% |
| **3 Year CPI + Objective** | 3.00% | 4.50% | 5.50% | 6.50% | 7.00% |
| **5 Year Ibbotson Diversified Trust** | 5.50% | 6.58% | 7.37% | 7.63% | 8.09% |
| **5 Year CPI + Objective** | 3.10% | 4.60% | 5.60% | 6.60% | 7.10% |

**There are three key reasons why the portfolios performed relatively well in this period of market instability:**

I. **The portfolios are currently holding elevated levels of cash,** which buffered them from the heightened volatility. Ibbotson had been progressively increasing the cash levels within the portfolios for well over a year, in recognition of a number of key asset classes becoming increasingly expensive (and offering negative forecast returns).

Clients may recall that markets got off to a bumper start in 2015. Our local market raced towards 6,000 (CBA hit $95!!), buoyed by a 0.25% interest rate cut in February. Elsewhere, confirmation of European quantitative easing saw European equities hit an all-time high, while European bonds also rallied strongly. As valuations peaked in April 2015, so too did our cash allocations, as we further reduced exposure to risk assets and sought to preserve capital in an expensive market. What followed was two quarters of turbulence, with equity markets tumbling, firstly as Greece was nearly expelled from the Eurozone in June/July 2015 and then as Chinese equity markets shuddered in August 2015, in what was a pre-cursor to the events of January and February this year.

Whilst we did add cash back to the market selectively in the fourth quarter, most notably into Australian and certain Emerging Market equities (Taiwan & South Korea) and International bonds as valuations became more compelling, the portfolios still maintained higher levels of cash than normal as we headed into 2016. As such, when the volatility hit, the portfolios were well positioned. In this regard, whilst the timing and catalyst of this pullback were a surprise, the ultimate outcome was not.

**And this is the point** – it's not always possible to determine what the catalyst will be to bring about a correction in expensive asset classes – it could be a change in the macroeconomic environment, such as interest rate rises in the U.S.; it could be a geo-political event; or it could simply be that the marginal buyer of the asset class has dried up and once the momentum falls away, the fair value of the investment is exposed. Regardless of the trigger, we believe that over time, valuations and fundamentals will win out and asset prices will ultimately return to their fair value.

Importantly though, increasing our allocations to cash when we did, allowed us to take advantage of investment opportunities as they arose from February's weakness, for instance, we broadly increased our allocations to growth assets, whilst the wider spreads supported increasing allocations to fixed income, for the more defensive portfolios.

II. **The portfolios are very well diversified** – whilst equities suffered, fixed income assets for example, enjoyed a very strong start to the year in response to declining interest rate expectations and an investor flight to safety.

III. **We are invested in assets that we consider to be attractively priced** and so we would expect them to have more limited downside compared to more expensive asset classes. This was certainly true in the recent period of weakness. Even the High Growth and High Growth Plus portfolios, for example, which are predominantly invested in growth assets, significantly outperformed the major equity indices.

However, this highlights an interesting point – **whilst the portfolios have in general, delivered superior risk-adjusted returns across all key time frames**, this is not to say that they will never have periods of negative returns. They may well of course, but our expectation is that by investing in attractively priced assets, we have a greater margin of safety than what those investing in expensive asset classes would have, which should limit our downside.

In addition, we would expect our portfolios to bounce back well, once the period of fear and volatility passes, as investors renew their focus on more reasonably priced assets. This is evidenced in the February numbers with returns for all portfolios being flat to slightly negative (versus for comparison, the MSCI World Ex Australia (Hedged) Index which finished down -1.39%, for the month) and is further supported by the provisional data for March (to date) returns, which suggests that the portfolios have again performed relatively well. In fact, gross quarter-to-date returns are broadly flat, an extraordinary result when you consider where markets have been during the quarter.

**In conclusion**

Ibbotson's long-term valuation driven asset allocation approach continues to provide a structured and rigorous framework for navigating the recent market conditions that have been plagued by market noise and emotion. Whilst we can't always tell when these periods of fear and irrationality will subside, Ibbotson's disciplined investment approach means we can objectively measure the valuations of assets based on a fundamental understanding of the cash flows before, during and after these periods, and make rational investment decisions accordingly.

We continue to expect ongoing volatility in markets, particularly given the divergent nature of Central Bank policy. In view of this, and in acknowledgement of certain asset classes remaining over-valued, we maintain higher levels of cash in wait for more compelling investment opportunities. Nonetheless, we believe that the portfolios remain well positioned to achieve their longer term objectives.

For further information on investment management products and services, please contact our Distribution Team on +61 2 9276 4550 or email AUDistribution@ibbotson.com

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