What We Are Hearing And Seeing

Envestnet | PMC (PMC) performs the research and due diligence that drives the selection of asset managers on the Envestnet platform. This gives PMC tremendous visibility and insight into the broadest possible range of asset managers and investment types.

Our daily commutes to the office, Starbucks coffee runs, and adhoc team discussions have changed to a remote work environment. However, the roles and responsibilities of Envestnet | PMC's research team hasn't. PMC's analyst team, consisting of 28 members, is divided among four teams: Equity, Fixed Income, Liquid Alternatives, and Multi-Asset. Here is what the team is hearing and seeing in their discussions with some of the world's top asset managers.

Dan Homan

The Curious Case of China

Despite substantial impairment to the national economy from COVID-19 during the first quarter, the impact on Chinese equity markets was relatively mild. Due to the government's draconian response to the virus, manufacturing activity dropped to levels even lower than during the height of the 2008-2009 Global Financial Crisis, and GDP estimates are among the worst in modern history. However, China was the best-performing country in the MSCI EM Index, down only 10.22%. This compares to the broader MSCI EM Index, which declined 23.60%, and to the MSCI EM ex China Index, which plummeted 30.62%. Further, the MSCI EAFE Index, the broad developed market index, fell 22.83%, while the S&P 500 Index dropped 19.60%. Europe and the US certainly have had their difficulty in dealing with the virus and its fallout. But the question remains: If China was the first country affected, why did their markets hold up so well throughout the entire quarter?

First, we need to look at the construction of the MSCI China Index, which is incredibly top heavy—so much so that two companies make up 31.90% of the index. Those two companies are Alibaba and Tencent, both of which are positioned not only to survive a lockdown, but to thrive. Alibaba is much like Amazon in the US, an online marketplace where people can shop remotely. For obvious reasons, Alibaba's business model is durable during a lockdown. Tencent is a mobile gaming and social media company that also is in a position to benefit from a stay-at-home order. When nearly a third of the MSCI China Index would see a windfall from the current conditions while most of the traditional economy suffers, it's easy to see how the index performed so well on a relative basis.

Although the first quarter's market performance is a bit of an anomaly, it is worth looking to China to see what a recovery might look like, considering it is two months ahead of the rest of the world in dealing with the virus. The government enacted severe policies to curb the spread of the virus, and it appears it has succeeded, with few new cases in the last couple of weeks, according to government data. Examining preliminary economic activity data shows life is returning to a somewhat normal state. Traffic congestion is back to near 2019 levels, daily coal consumption is only 9% behind its 2019 level, and steel demand returned to last year's weekly level. Certainly, China has a long way to go to fully recover, as does the rest of the world's economy. Rarely would we point to China as a beacon of hope, but in these uncertain days, it appears as though it is emerging from a strict lockdown, with its economy on the path to some semblance of normalcy.

Ed Zablan

What Happened to My "Safe" Fixed Income Allocation?

During the volatile first quarter, 90% of active intermediate core and core plus managers failed to keep pace with the 3.15% return of the Bloomberg Barclays US Aggregate Index, with nearly half of these managers producing negative returns. Liquidity constraints and redemptions certainly played a role. However, in reviewing the first-quarter performance of active fixed income managers, it is important to step back and look at both the composition of the index and the market forces that have skewed its sector allocation and duration profile since the 2008-2009 Global Financial Crisis.

The Federal Reserve's low interest rate policy over the past decade has led to an extension of the benchmark's duration, which now stands at more than 5.5 years. Additionally, roughly 40% of the index comprises U.S. Treasury and Agency debt. Adding in Agency MBS, which typically trade at a modest spread above Treasurys, results in slightly more than two-thirds of the index allocated to low-yielding, government-related securities, many of which have maturities beyond 20 years.

To exploit this undesirable index construction, active fixed income managers are equipped to construct their portfolios by modulating their duration and expressing their views through over- and underweights to various sectors. In addition, most active fixed income managers invest not only in the five bond market segments that constitute the Aggregate, but also in other types of fixed income instruments, ranging from high yield bonds to emerging markets debt. Using areas of the market not included in the benchmark expands the opportunity set to provide diverse sources of alpha, higher absolute returns, and better diversification. This approach typically results in outperformance in the vast majority of flat and up markets, but can lead to underperformance during periods of market stress, such as the most recent quarter or during the 2008-2009 Global Financial Crisis. However, these bouts of underperformance are typically short-lived and, similar to the sharp rebound in 2009, more than 75% of active managers are outperforming the Aggregate's 1.02% quarter-to-date return (through April 14).

For many of the same reasons, investors considering passive exposure to fixed income using the Aggregate as a proxy for the asset class may want to rethink their approach. In addition to a high allocation to lower-yielding, longer-duration securities, the low financing costs of the most recent economic expansion paved the way for a surge in the number of outstanding BBB-rated corporate bonds. These lowest-rated investment grade securities now comprise more than half of the investment grade corporate bond universe, and because of the index construction methodology, passive investing actually allocates more money to the most heavily indebted entities. Finally, as the Aggregate excludes more than half of the total investable fixed income universe, investors who are passively tracking the index miss out on nearly $21 trillion of investment opportunities. The bottom line is that the ability of active managers to rotate freely and respond to credit market trends provides a key advantage over passive portfolios, especially during a market recovery.

Monica Sengelmann

Stick to the Process

During the impressive 11-year bull run since the 2008-2009 Global Financial Crisis, it became difficult to differentiate among good managers and great managers, as a rising tide tended to lift all boats. However, volatility returned with a bang in 2020, and it is during these uncertain times that following a structured and repeatable process is even more important than ever.

Following a process helps avoid one of the biggest pitfalls in investing: behavioral biases. Overcoming these biases and investing without emotion is a difficult task, especially in the face of fear. But sticking to a process and following guidelines allows a manager to use their strengths to take advantage of opportunities in the market and avoid undue risks.

Team experience is another important characteristic PMC emphasizes in our manager selection process, and we find it shines through during periods of market turmoil. Managers who have been through multiple market cycles have a unique perspective into how markets react during times of stress. They can leverage this experience as a guide through the next period of market dislocation. This, combined with a deep familiarity with their investment process, can create a powerful combination that leads to alpha generation over time.

As a research team, we are keenly focused on picking great managers. We, too, stick to a process when choosing these managers. And we expect this focus and discipline will be rewarded over the long term.

Ling-Wei Hew

Expectations of Active Management

The broad notion that active management should have better weathered recent volatility is a vast generalization that needs to be peeled back layer by layer. Within multiasset fund strategist portfolios, active management takes on a variety of forms—passive asset allocation decisions among actively managed funds, active allocation decisions among passive funds, or a mix of any or all of the above. Rather than following an overly simple and prescriptive approach to evaluating the success or failure of active management in navigating this market volatility, we consider the following in our active versus passive debates.

First, the market sell-off was extremely swift. Active management often has been touted as superior to passive management due to its ability to be flexible and nimble. Although this might be the case, a swift sell-off was hardly anticipated by subscribers to either philosophy, and any ensuing portfolio changes are unlikely to manifest in performance results after just a few weeks. Second, consider the mandate of the active manager. Many actively managed strategies have a long-term outlook and were positioned for a market downturn due to heightened valuations, particularly within domestic equities. They were not positioned for a sudden global pandemic, which disproportionately took down emerging markets, small-cap, and value-oriented equities more than their developed, large-cap, and growth-oriented counterparts. Finally, it is important to remember that the opportunity for active management to shine is predicated on a discernable and systematic divergence of returns across asset types. Although the long-term implications of the global pandemic may pave the way for this, it is too soon to tell whether favorable bets have been a result of skill or luck.

The resounding response from all of our strategist managers, whether they use a pure active, passive, or mixed approach to investing, is that this is the time for investors to stay focused on long-term goals and let the investment process they subscribed to do its job. The evaluation and success of active management cannot be analyzed through one quarter. Volatility, particularly as a result of a global pandemic, does have severe market and economic implications, but a significant portion of that is fear, and it will subside at some point.

Frank Wei

Will Managed Futures Continue to Deliver?

Although stock markets fell sharply during the first quarter of 2020 due to the COVID-19 pandemic, liquid alternative strategies held up relatively well. The HFRX Global Hedge Fund Index, a proxy for liquid alternatives, declined just 6.9% vs. the 19.6% drop of the S&P 500 Index for the first quarter. This was expected to be, as most liquid alternative strategies structurally have low beta to equity markets (they rise less in up markets and fall less in down markets). Managed futures was one of the few liquid alternative categories that registered a positive return, gaining 2.3% for the quarter (using the SG Trend Index as a proxy).

Most managed futures strategies are trend-following strategies, and their investment philosophy is simple: long markets with positive momentum and short markets with negative momentum. They seek opportunities across global equity, fixed income, currency, and commodity markets, and tend to do well during market crisis periods when more compelling momentum opportunities, with defined and persistent trends, exist. For example, during the first quarter, they benefited from sharply lower Treasury yields and plunging energy prices.

Will managed futures continue to deliver? Although it ultimately depends on how well managed futures managers execute their strategies, the current market environment is favorable for trend following. We are likely in the relatively early phases of the COVID-19 pandemic and are facing an unprecedented market crisis environment that neither investors nor regulators have ever experienced before. As the pandemic unfolds, market volatility should remain elevated, and the greater the market volatility, the more opportunities will be available for managed futures managers to exploit. Additionally, the current market crisis requires more government intervention than do typical recessions. We already have seen massive government stimulus, and more is likely to come. Although stimulus helps stabilize markets, it also makes markets less efficient and distorts asset pricing, creating more trend/momentum opportunities for managed futures managers. For example, OPEC's artificially propping up energy prices will only extend their long-term downward trend, which managed futures managers can capitalize on. As the COVID-19 pandemic continues to wreak havoc on human life, the economy, and traditional investment markets, it also highlights the diversifying role alternatives can play within investors' portfolios.