European fund selectors look at absolute return, active and unconstrained products

The first survey of MondoInvestor on the investors of the Old Continent also unveils a clear preference for equity investments in the Asia Pacific region

by Valerio Magni

Issues posing the greatest risks for European fund selectors' portfolios	
Trade wars	71.2%
Economic recession or slowdown in the U.S.	55.8%
Political events in the EU	46.2%
Economic recession or slowdown in Europe	40.4%
Economic slowdown in China	34.6%
Inflation	19.2%
Equity volatility	19.2%
Changes in ECB monetary policy	19.2%
Credit volatility	15.4%
US dollar weakening	13.5%
US dollar strenghtening	9.6%
Middle East or Far East tensions rising	5.8%
Deflation	1.9%

Fund selectors chose the three most relevant risks for their portfolios. Data based on a survey conducted in July and August 2018, 52 fund selectors answered. Source: MondoInvestor

In all of Europe, as already noted in Italy, investment professionals will first increase their allocations in absolute return funds, followed in their preferences by active long-only and unconstrained ones. Speaking of asset classes, on the other hand, the most popular are the emerging Asia Pacific and Japan equities, with a rather clear indication also in favor of an increase in the share of cash and short term holdings in the portfolio. In fact, the Brexit process is very frightening, so much so that the fund selectors will stay away from investments in the United Kingdom. No surprise, however, for what concerns events that could have a negative impact on portfolios: trade wars intimidate everyone, as well as the possible slowdown in US economic growth or political tensions in Europe. These are some of the results of a survey conducted by MondoInvestor, which for the first time involved 52 professionals in the selection of funds in Europe, from Portugal to Russia, Italy excluded. 54% of them work for asset managers, 18% for advisors, 12% for family offices, 10% for wealth advisor and 6% for private banking.

Asia Pacific in the forefront

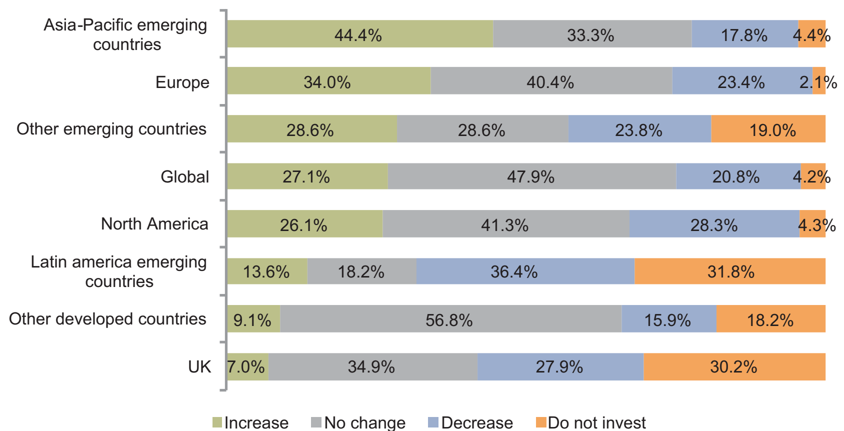
European fund selectors, consulted during the summer, indicated a clear preference for equity investments in the Asia Pacific area, both in emerging countries and, to a lesser extent, in Japan. The difference between the indications for an increase in the allocation and a decrease, in fact, is equal to 42% for the emerging Asia Pacific and to 28% for the Land of the Rising Sun (*see table on page 4*). Furthermore, 41.2% of European fund selectors will increase their share of cash in portfolios and only 7.8% will decrease it. "We believe in Asian Emerging markets, where almost half the world's population is located across India, China and the Asean region", **Pierre Theron**, Principal at Erlen Street says. "Generally", Theron continues, "with young, increasingly well-educated populations, with a strong motivation to improve their standard and quality of life, this region is undoubtedly the world's growth engine of the future. These markets have their own risk and volatility profiles but are, long term, the most exciting markets". Fourth and fifth place, in terms of preferences, for emerging corporate bonds and US inflation linked bonds. The difference between the indications in favor of an increase and those of a decrease is greater than 20% also for equity Europe, European inflation linked bonds and emerging government bonds in local currency. For what concerns US equities, the view is quite controversial: 32.7% of the fund selectors want to add, 25% to reduce. **Bernardo Silveira Godinho**, Head of Capital Markets, Banco Privado Atlantico Europe explains that, in general, the "equity allocation is stable. We welcome the current drawdown as a healthy thing, as it might increase the longevity of the current bull market. However, we are a bit suspicious of the earnings expectations, especially for US equities". For what concerns fixed income, instead, it seems that the only interesting are those on emerging bonds and inflation linked securities. "I wouldn't put that as strongly", **Dimitris Dalipis**, Head of Fixed Income at Alpha Trust observes. "You can find interesting investments in many parts of fixed income space", he adds. "But we cannot overlook the fact of course that the best days are most probably behind us in this asset class as a whole. Monetary

Investments for the coming 12 months	Increase	No change	Decrease	Do not invest
Asia-Pacific emerging countries equity	50.0%	32.0%	8.0%	10.0%
Cash and other short term securities	41.2%	41.2%	7.8%	9.8%
EU equity	34.6%	50.0%	13.5%	1.9%
North America equity	32.7%	38.5%	25.0%	3.8%
US sovereign bonds	30.6%	26.5%	14.3%	28.6%
Emerging markets corporate bonds	30.6%	44.9%	4.1%	20.4%
Japanese equity	30.0%	44.0%	2.0%	24.0%
Emerging sovereign bonds in hard currency	26.5%	34.7%	10.2%	28.6%
Emerging sovereign bonds in local currency	24.5%	36.7%	4.1%	34.7%
US inflation-linked bonds	24.5%	18.4%	2.0%	55.1%
EU inflation-linked bonds	20.4%	30.6%	0.0%	49.0%
Other developed countries equity	20.0%	66.0%	2.0%	12.0%
US Corporate high yields bonds	20.0%	36.0%	14.0%	30.0%
Real estate	20.0%	36.0%	2.0%	42.0%
Commodity (ex gold)	18.0%	44.0%	2.0%	36.0%
US Corporate non financial inv. grade bonds	16.0%	42.0%	18.0%	24.0%
Other credit	16.0%	30.0%	8.0%	46.0%
Gold	16.0%	42.0%	4.0%	38.0%
UK equity	14.0%	32.0%	32.0%	22.0%
European Corporate high yields bonds	14.0%	50.0%	20.0%	16.0%
Non-core Europe sovereign bonds	12.2%	32.7%	18.4%	36.7%
European financial bonds	12.2%	53.1%	6.1%	28.6%
Core Europe sovereign bonds	10.2%	32.7%	24.5%	32.7%
US financial bonds	10.2%	49.0%	0.0%	40.8%
Latin america emerging countries equity	10.0%	34.0%	28.0%	28.0%
European Corporate non financial i.g. bonds	10.0%	44.0%	22.0%	24.0%
UK inflation-linked bonds	6.1%	14.3%	6.1%	73.5%
UK sovereign bonds	4.1%	20.4%	14.3%	61.2%
Cryptocurrencies	2.0%	4.0%	2.0%	92.0%

Data based on a survey conducted in July and August 2018, 52 fund selectors answered. Source: MondoInvestor

policy is not going to be as supportive and yields fail in many cases to provide the needed cushion or a meaningful return even. Nevertheless, as I mentioned, even in a negative environment there are always opportunities or left-over pockets of value to be found, so in general we tend to favor flexible strategies in fixed income", Dalipis says. Silveira Godinho agrees with him: "Since our asset base in mainly EUR based, we have preferred global unconstrained fixed income allocations for a number of years. Tactically, we believe that EM bonds (local and hard currency) offer the best risk return profile, but the looming trade war and the USD strength will probably keep this space under pressure. We have also been analyzing short term high yield as a possible candidate for our portfolios", Silveira Godinho argues. Going back to the survey and looking at indications for a decrease in allocation, equities of the emerging countries of South America and Great Britain will likely suffer outflows, according to the statements of investment professionals, as well as the bonds of core countries of Europe and European non-financial companies. Assuming a different perspective and speaking of allocation looking at the risk of the portfolio, the indications do not change. European fund selectors have shown their intention to increase the risky allocation to the Asia Pacific region (*see chart 1 page 5*), especially with regard to equity, while on duration the vision is more conservative, and to stay far from South America and Great Britain. In other geographical areas, however, the sentiment is more neutral, even if the intention to reduce the risk with regard to creditworthiness and the duration of the bond portfolio emerges. This observation applies especially to the United States, where fund selectors will limit positions in the most fragile segments of credit. Trade wars are the event that has the greatest potential to damage the portfolios of the fund selectors, so much so that 71.2% have indicated it (*see table on page 3*). "We are especially concerned with the trade war, since all parties involved will likely be losers", Silveira Godinho says. "The stakes are high especially for China and consequentially for emerging markets, since the growth slowdown might be more pronounced going forward. We are also monitoring the Fed activity with a special interest, since higher rates might be a contributing factor for the end of the current bull market", Silveira Godinho adds. According to the survey, in fact, there are concerns about a possible slowdown in the US economy (55.8%), political tensions in Europe (46.2%) and a slowdown in the European economy (40.4%). Deflation, on the contrary, does not seem to

WILL YOU INCREASE, MAINTAIN OR DECREASE THE FOLLOWING PORTFOLIO RISKS IN THE NEXT 12 MONTHS?



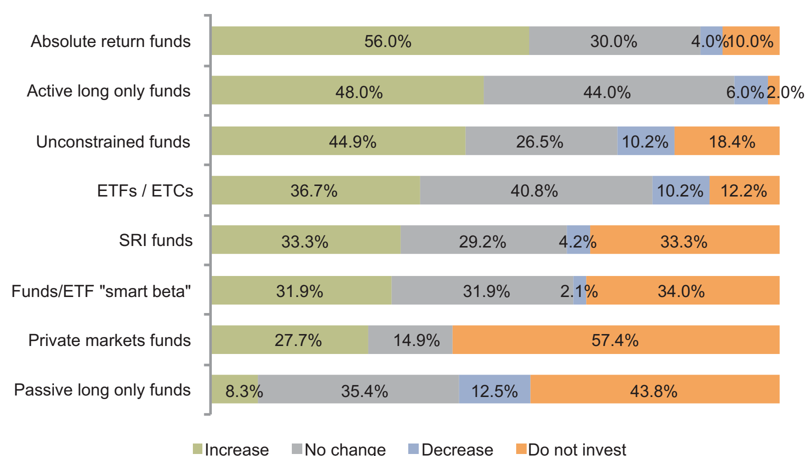
Data based on a survey conducted in July and August 2018, 52 fund selectors answered. Source: MondoInvestor — chart 1

worry any more, as do geopolitical tensions in the Far East and the strength or weakness of the US dollar. "Politics and emotion are our main concerns", Theron explains. "The political and geopolitical risks are clear as we watch the USA and China, and also Russia, work in their own unique ways to increase their global strength and influence, but we currently take some comfort in the fact that President Trump wants a strong economy and a rising stock market, and President Xi has great ambitions for China to be an economic powerhouse with an increasingly wealthy population. Emotion, on the other hand is more dangerous for the markets. As we have seen sporadically over the last few weeks, when enough investors believe that "the longest bull run in history" must end, it will. Despite the fact that this statistic, on its own, is totally irrelevant, we are closely watching emotional indicators as they, more than anything fundamental, are likely to drive any market correction in the short term", Theron argues. "We have long entered a period when describing risks takes up more time (or space in case of trying to sum those up in a piece of paper) as new sources of risk emerge with increasing frequency", Dalipis observes. "Overall", he continues, "one has to follow geopolitical developments closely as trade war worries and higher political risk in many parts of the world can have serious repercussions for all markets (FX markets included). Developments in Italy and the tensions over its proposed budget, tensions between the US and China, tensions between US and Turkey, the situation in Argentina are few of those risks that have manifested themselves recently and can still be with us in the following months. Second in our list is the less accommodative monetary policy particularly from the Federal Reserve as tighter financial conditions have the potential to indeed cause disruptive portfolio adjustments and sharp exchange movements (as the IMF also acknowledges in its latest report). Finally market valuations are another cause of concern for us as, in some cases at least, there seems to be little room for error in the pricing of some markets or individual securities", Dalipis concludes.

Absolute, active and unconstrained

If instead of the asset classes, we look at the fund selector preferences in terms of types of funds, the choice goes, first of all, to absolute return products (*see chart 2 page 6*). These were indicated by 56% of the professionals who responded to the survey, followed by active long-only funds (48% of indications for an increase in the allocation), and by unconstrained funds (44.9%). The ETFs are in fourth place in the preferences, even if 36.7% of the positive indications are reduced by a 10.2% of

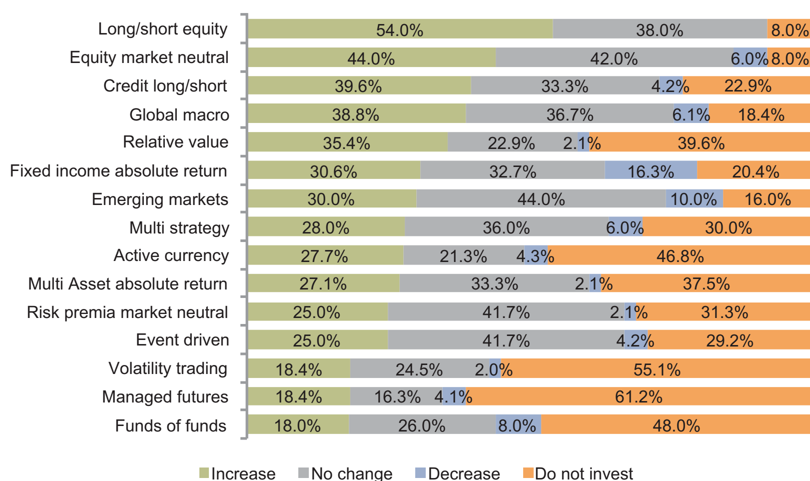
WILL YOU INCREASE, DECREASE OR MAINTAIN THE FOLLOWING FUNDS IN THE NEXT 6 TO 12 MONTHS?



Data based on a survey conducted in July and August 2018, 52 fund selectors answered. Source: MondoInvestor — chart 2

indications for a decrease in the allocation. "We prefer allocating to active managers over passive, because we have some reservations regarding ETPs, especially in the fixed income space", Silveira Godinho says. "Regarding absolute return", he adds, "we believe that they should play an important role in a portfolio. Besides the reduction in volatility and directionality, they should provide an uncorrelated source of return to the portfolio". Dalipis is more dubious about absolute return products: "Regarding absolute return funds I must say that ourselves are more skeptical compared to the results of your survey. That is not to say that there are no good managers out there with interesting strategies or that they don't have their own appeal as an investment. But we believe that it is difficult to distinguish among them and it's tough to incorporate within your own investment strategy given the "black box" nature of many of them. Furthermore", Dalipis adds, "it has been shown that many strategies only work and perform until they don't basically and the "absolute" part of their return target can be debatable. Many funds aim to perform in all market conditions but this has been shown to be tough to accomplish in practice as the sector has had many accidents in the past. On the other hand we do indeed prefer active products over passive investments at the moment as we are more concerned about the downside of riskier markets and we prefer to choose suitably skilled managers and strategies than simply buy an index. However, passive investments always have their use and the choice really comes down to what kind of markets we are talking about and what kind of purpose the particular investment aims to serve in the portfolio", Dalipis observes. Theron too prefers active over passive in the current environment: "While most active managers have clearly struggled to beat their benchmarks during the recent bull market, we expect that well managed active funds should outperform passive investments over the coming months. We are entering a period where risk-aware active stock picking should be able to help reduce the pain of any correction and, more importantly, well-structured hedge funds should be able to benefit from any correction. As risk averse investors, we also actively seek out exceptional absolute return and unconstrained products because such funds have the potential to be good all-weather products. However", Theron says, "we are conscious of the unique risks of such strategies, such as over-diversification and the lack of adequate understanding of individual markets to effectively evaluate and anticipate local risks and opportunities. Hence, our aim is to find managers

WILL YOU INCREASE, DECREASE OR MAINTAIN THE FOLLOWING ABSOLUTE RETURN STRATEGIES IN THE NEXT 6 TO 12 MONTHS?



Data based on a survey conducted in July and August 2018, 52 fund selectors answered. Source: MondoInvestor

chart 3

that demonstrate that they are able to overcome these particular challenges", Theron argues. Going back to the survey, the indications are also positive for SRI and smart beta funds, they are neutral for long-only passive funds, while less than half of fund-selectors look at private markets. Among the absolute return funds, intended here as liquid alternative funds, the preferred strategies for an increase in the allocation are those of the Long/short equity type, indicated by 54% of the fund selectors, followed by Equity market neutral, Credit long/short and Global macro products (*see chart 3*). None of the typical strategies of alternative liquid funds have received negative net indications, consequently the sector should continue to register positive flows of investments, if the sentiment of the fund selectors questioned by the survey should be confirmed. In terms of active strategies that are typical of the long-only world, fundraising professionals particularly favor specialized products in Europe. In particular, the choices to increase the allocation will fall on the "value" European equity funds, which reach the top in the preferences along with the small and mid-cap equity funds. They are followed by large-cap Europe equity funds, while the "growth" US equity, Emerging small/mid-cap and the US large-cap stocks are expected to register outflows over the next few months. Among the private market funds, even if little used, the indications from those who use them go for an increase in the allocation in private equity funds, followed by other real assets and infrastructure. The positive indications in favor of renewable energy, private debt and venture capital are lower. In the survey, the theme of sustainable investment was also addressed. At the request to indicate which, among the typical strategies of SRI funds, were preferred, 55.8% of the fund selectors indicated both the sustainability themed, and impact investing. The best-in-class selection (44.2%), engagement and voting (26.9%), sector exclusions (23.1%) and screening based on adherence to international agreements (21.2%) follow. Finally, the survey also investigated the attitude of fund selectors towards smart beta strategies. The professionals who will increase the weight in the portfolio will look, first of all, to multi-factor approaches, indicated by 44.2% of the sample. The following are, among the preferences, the strategies based on fundamentals (36.5%) and those based on quality and momentum (both equal to 32.7%). Value and size approaches are also appreciated (30.8% both), while risk weighted (19.2%), dividend (11.5%) and equal weighted (9.6%) strategies will be more neglected.