# Slow Rotation



Lars Kreckel, Global Equity Strategist

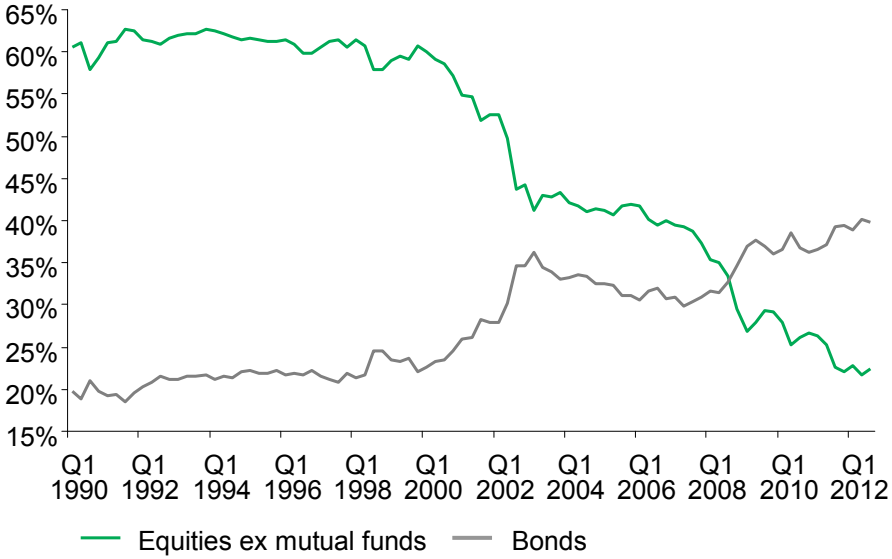
Legal & General
INVESTMENT MANAGEMENT

# Investment overview

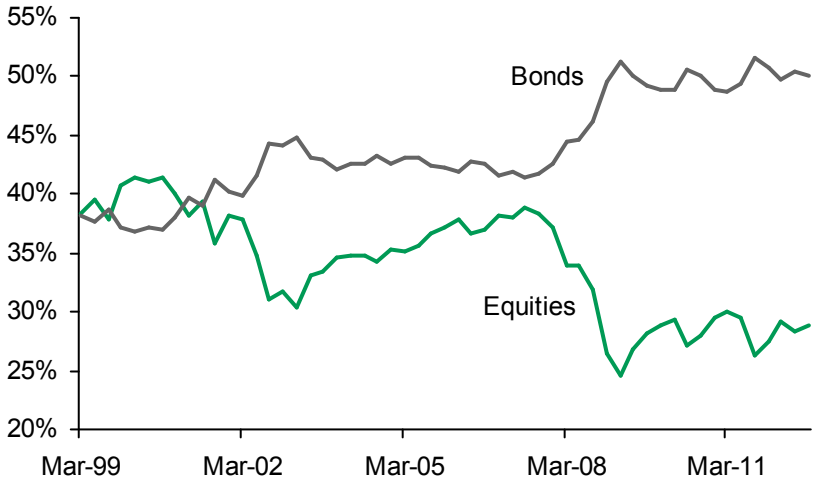
- Great Rotation? More likely a Slow Rotation
- Investors are being *pulled into* equities, but not (yet) *pushed out of* bonds
- At a global level rotation has been out of equities into alternative assets rather than into bonds
- What factors influence asset allocation decisions? Are they changing?
- Mean reversion of extreme relative valuations - yes
- Bad returns (pain) in the asset class of choice – not yet
- Regime change – yes and no
  - fewer tail risks, more inflation, less liquidity, shareholder revival
- Financial repression – no change
- Demographics and regulation – no change

# Rotation…out of equities

UK pension fund asset allocation




G4* pension fund and insurance company asset allocation



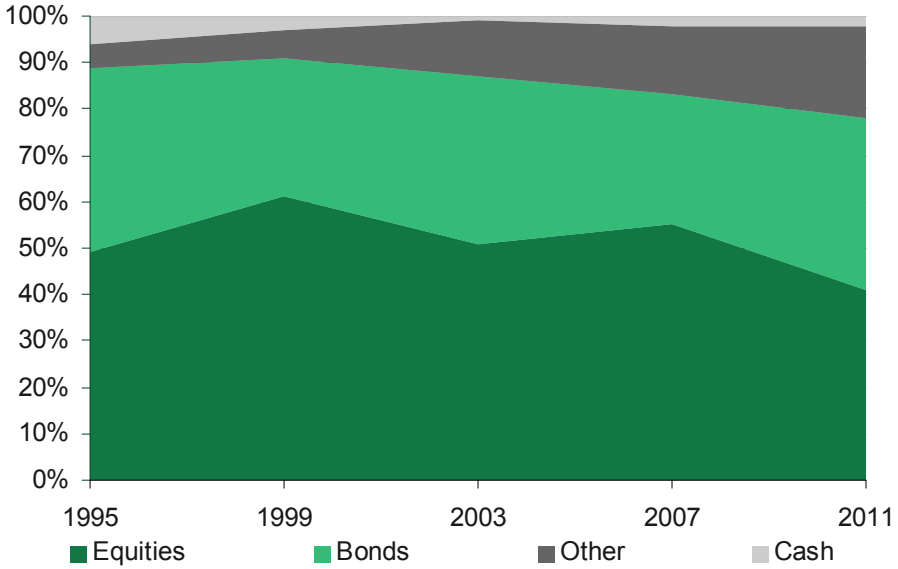

- Allocations have become extremely low in equities and (in some cases) extremely high in bonds
- Since 2000 $575bn has left equities and $950bn flown into bonds
- UK pension fund allocations to equities have fallen from 60% to 25%; bonds have increased from 20% to 40%
- G4* allocations show a similar, although less extreme picture
- Pension fund asset allocations vary widely across countries

* G4 = US, UK, JP, EMU

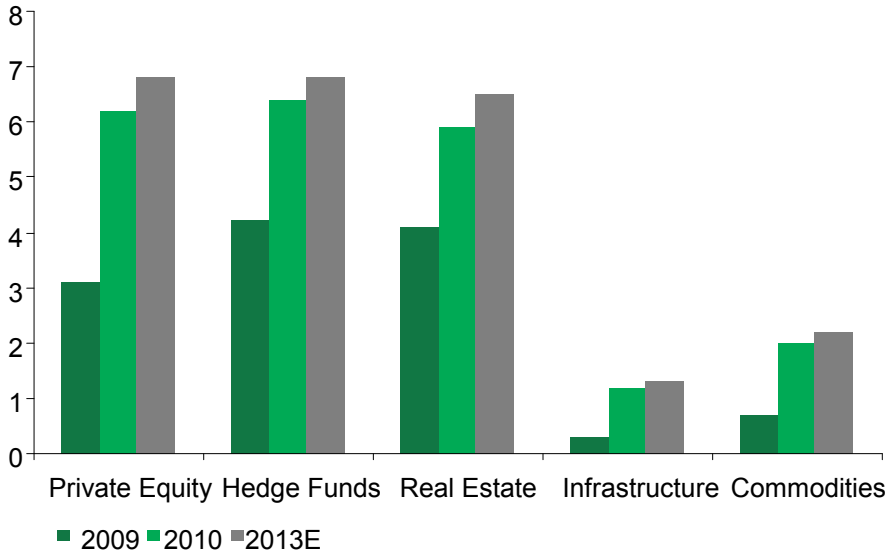
Source: LGIM, Datastream, JPM

# Rotation…into alternative assets

Global* pension asset allocation




% of AUM, global institutional investors



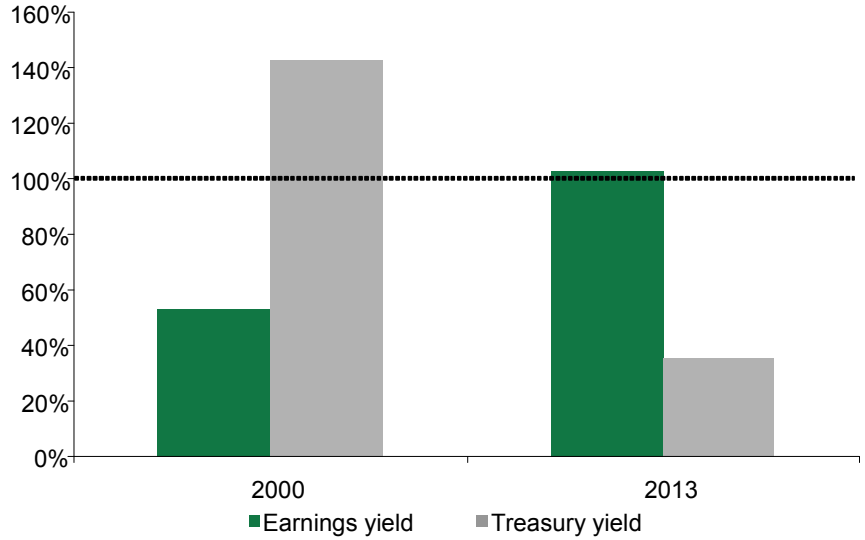

- Global pension asset allocations show the same decline in equity allocations as UK
- But inflows have predominantly been into alternative assets rather than bonds (e.g. private equity, hedge funds, real estate, infrastructure, commodities)
- 'Mainstreaming' of alternative assets seems less vulnerable to mean reversion than overweight bond positions

* Global = SWI, US, UK, AUS, CAN, JP, NL

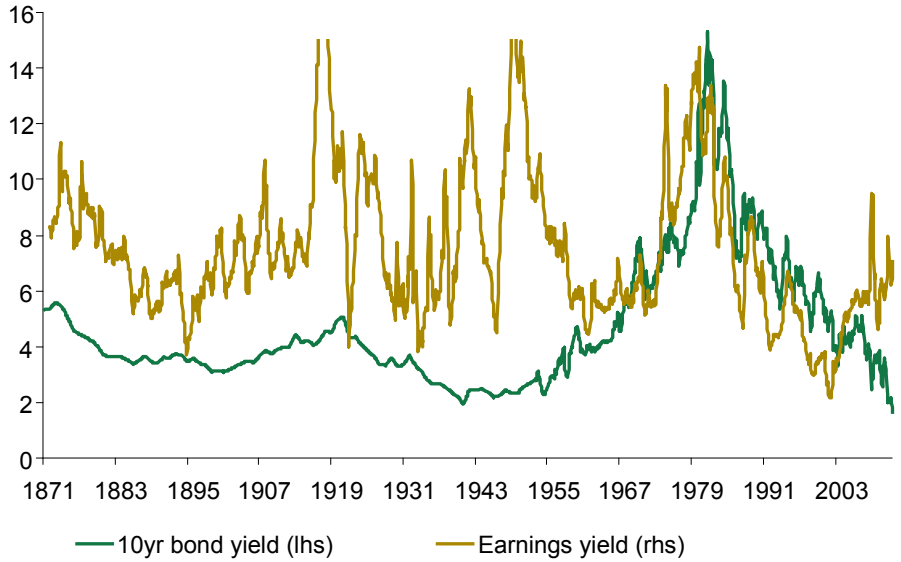
Source: LGIM, Towers Watson, McKinsey

# Trigger 1: extreme valuations GREEN

Yields vs historical average (US, since 1871)




Equity and bond yields (US)

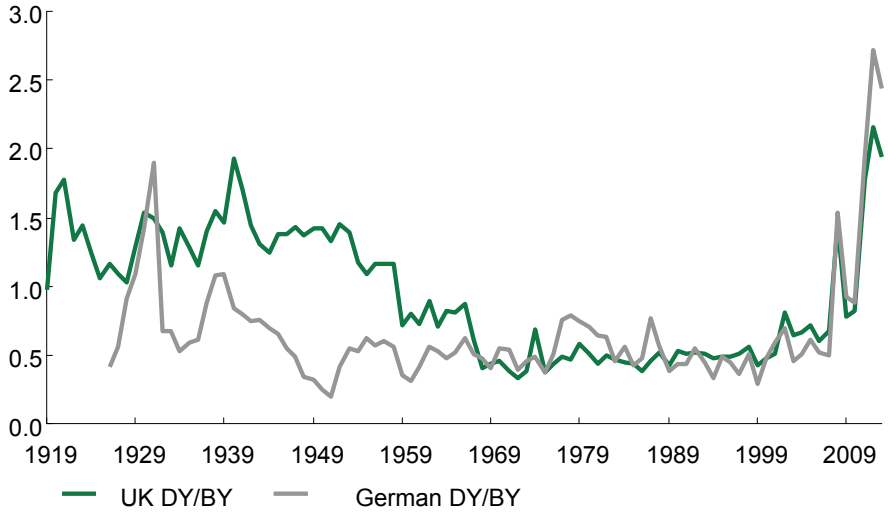



- Equities were at all-time record valuations when rotation began in 2000
  - US PE 30x in 2000, an all-time high and roughly double the long-term average
  - Treasury yields were 40% above the long-term average
- Treasuries are now at all time low yields and yields are about a third of the long-term average -> GREEN
- US equities are roughly in line with long-term valuation averages, many other regions trade below average valuations

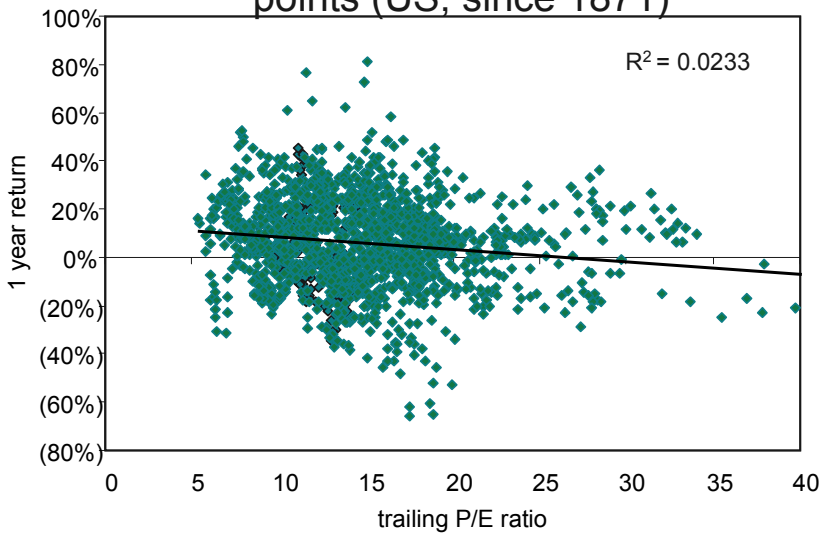
Source: LGIM, Datastream, Robert Shiller

# Trigger 1: extreme valuations GREEN

Dividend yield vs government bond yield




S&P 500 12m return after PE starting points (US, since 1871)

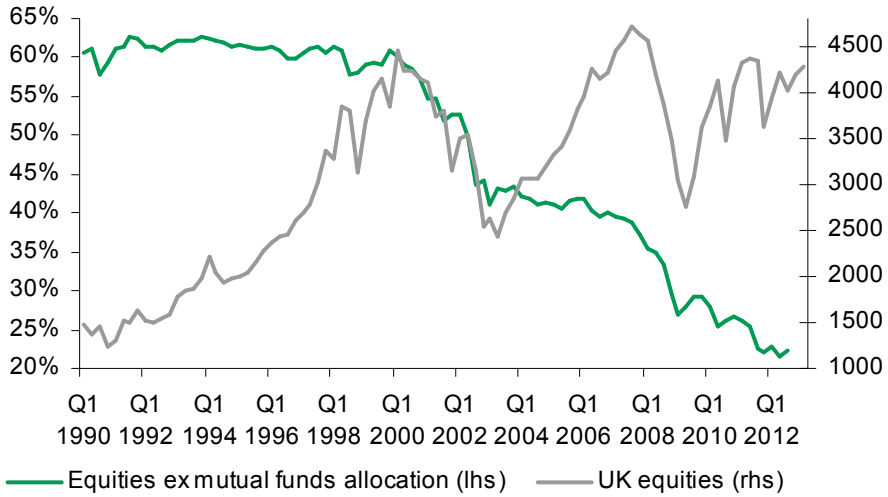



- Valuations have not been reliable catalysts for asset rotation
- The valuation gap was extreme for several years before the 2000 rotation and has been extreme since 2008
- Following valuation gaps would have meant missing out on the 1990's equity bull market
- Valuation is generally not a good timing tool. There is no correlation between PEs and 1yr equity returns

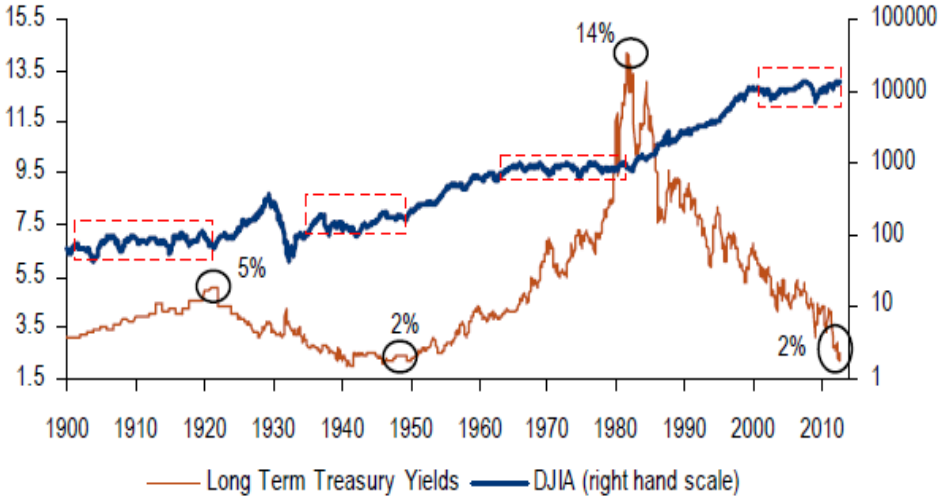
Source: LGIM, Robert Shiller, Citi

# Trigger 2: Bad returns YELLOW

Equity returns and flows




DJ Industrials average and US Treasury yield




- Precedent: rotation out of equities began when equity prices began to fall in 2000
- No sign yet of bond returns turning significantly negative
- But slowing down of returns seems likely given extremely low yields -> YELLOW
- Equities have performed well when rates have normalised in the past

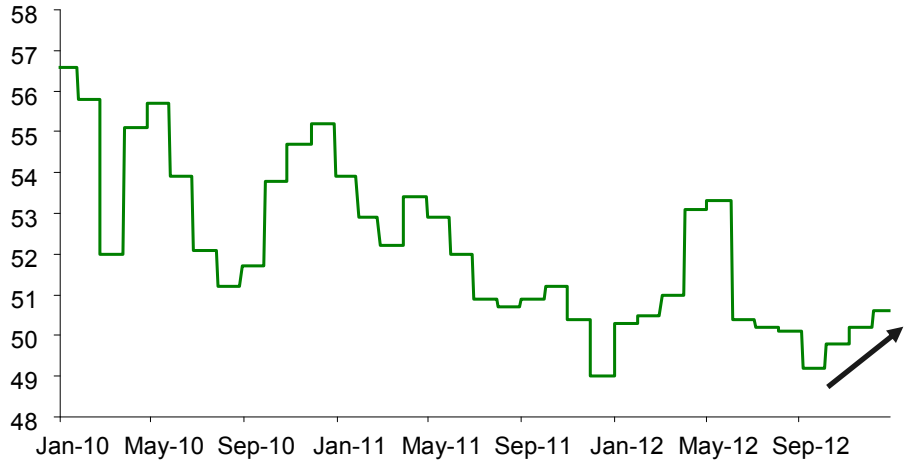
Source: LGIM, Datastream, BAML

# Trigger 3: Regime change – Fewer Risks YELLOW

Periphery risk




China PMI (official)

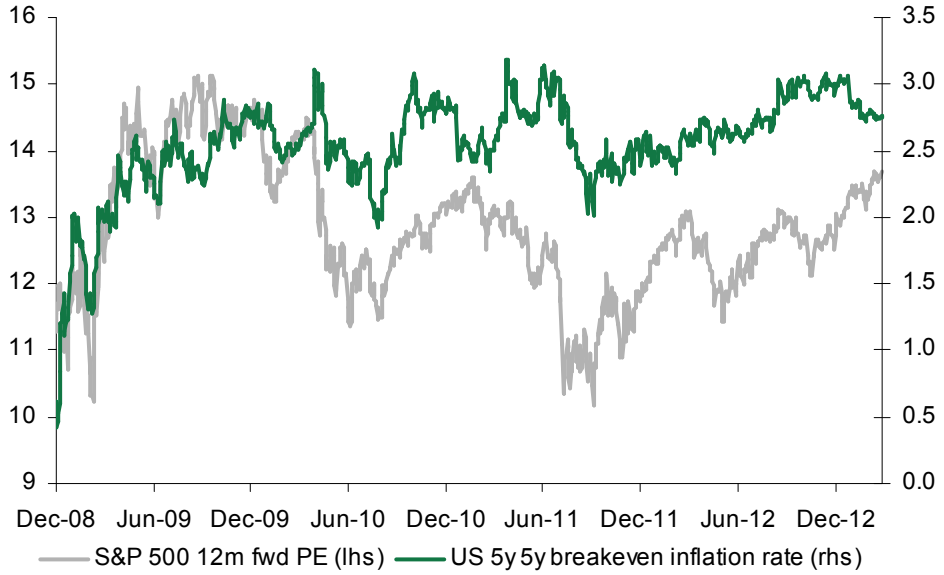



- Risks (or perceptions of risk) have subsided
  - Euro periphery risk, China hard landing, US fiscal crisis
- The reason for an extreme risk-off position with an extreme overweight risk free assets and underweight risky equities no longer exists
- Suggests some 'normalisation' and mean reversion in asset allocation is likely…but what is 'normal' allocation?
- Inertia in asset allocation decisions suggests that unless risks reappear this process could play out for some time -> YELLOW

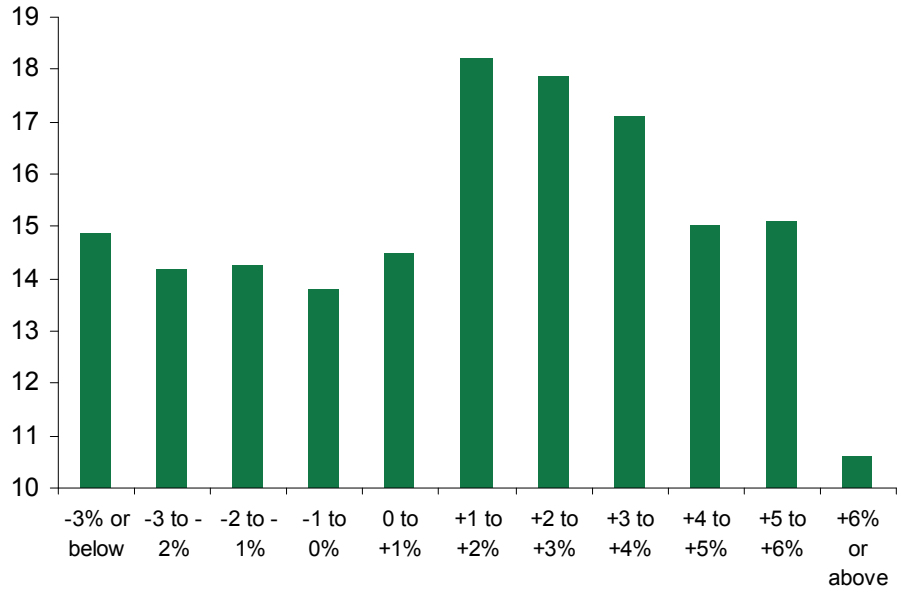
Source: LGIM, Bloomberg

# Trigger 3: Regime change - Inflation YELLOW

Breakeven inflation (US)




S&P 500 PE at different inflation levels (since 1871)

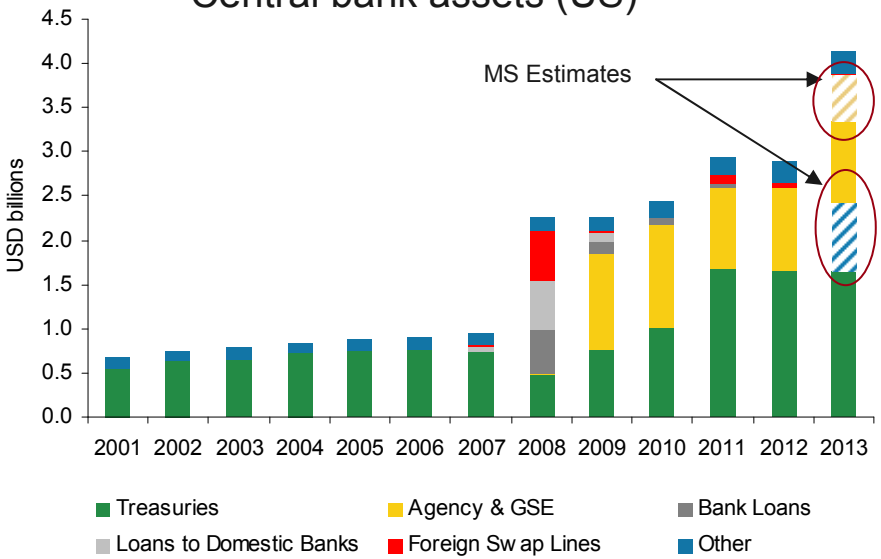



- At record low yields bonds offer no protection against a scenario of rising inflation
- Equities are real assets and offer some protection against inflation
- Earnings rise with inflation and valuations tend to only contract when inflation rises above 4%
- Inflation has the potential to accelerate rotation
- LGIM sees inflation as most likely medium-term scenario, but inflation should remain subdued in the short-term -> YELLOW

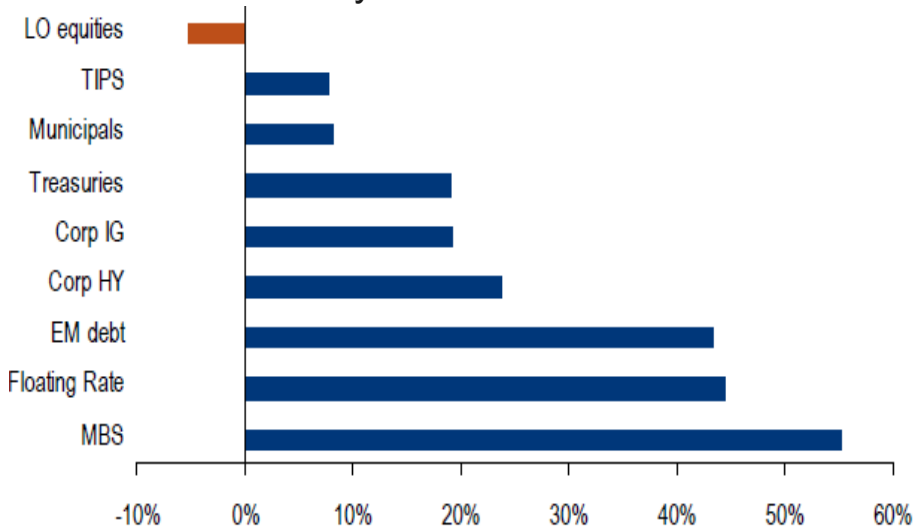
Source: LGIM, Bloomberg, Robert Shiller

# Trigger 3: Regime change – Less liquidity - RED

Central bank assets (US)




Cumulative 3-year fund flows as % AUM

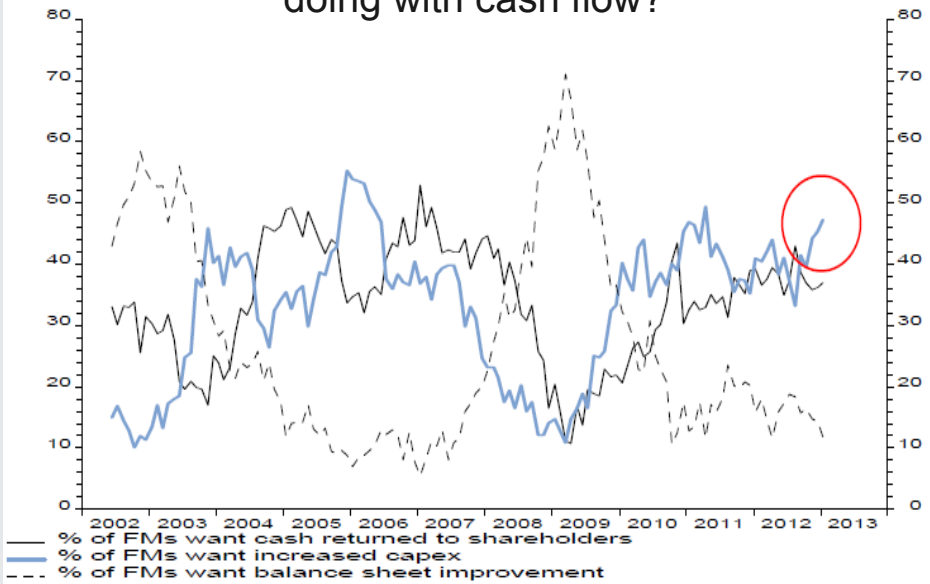



- Central bank liquidity has been one of the main driving forces in financial markets since the financial crisis
- Its withdrawal could trigger a reversal of past trends and potentially trigger market dislocations
- Market reaction to Fed minutes showed sensitivity to CB exit strategies
- Most at risk would be those assets that benefitted the most from the build-up of liquidity: bonds
- No sign yet of imminent exit strategies, quite the opposite with BoJ just joining the QE party -> RED

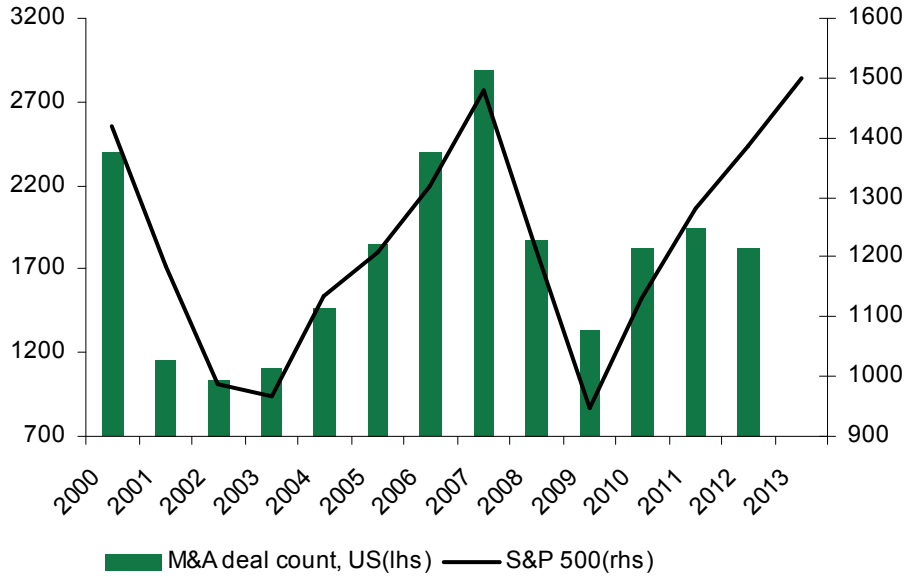
Source: LGIM, MS, BAML

# Trigger 3: Regime change – Shareholder revival YELLOW

What would investors like to see companies doing with cash flow?




M&A activity has been unusually low, but business confidence, the missing ingredient, should improve

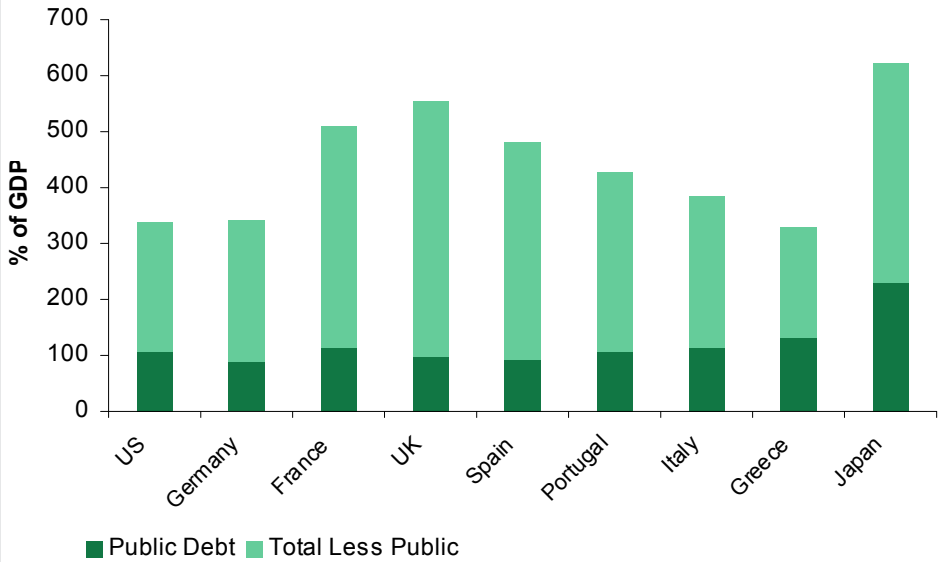



- Re-leveraging ahead?
  - Investor pressure is growing for companies to employ more shareholder-friendly measures: return cash or increase CAPEX rather than improve balance sheets
- Perfect macro environment for M&A - activity likely to pick up
  - all-time low borrowing costs, market appetite for deals, strong equity markets, OK valuations, limited organic growth prospects, LBO equity and finance available
  - Missing ingredient, business confidence, expected to improve in 2013
- It seems likely that companies will increasingly implement shareholder friendly measures, but limited evidence so far -> YELLOW

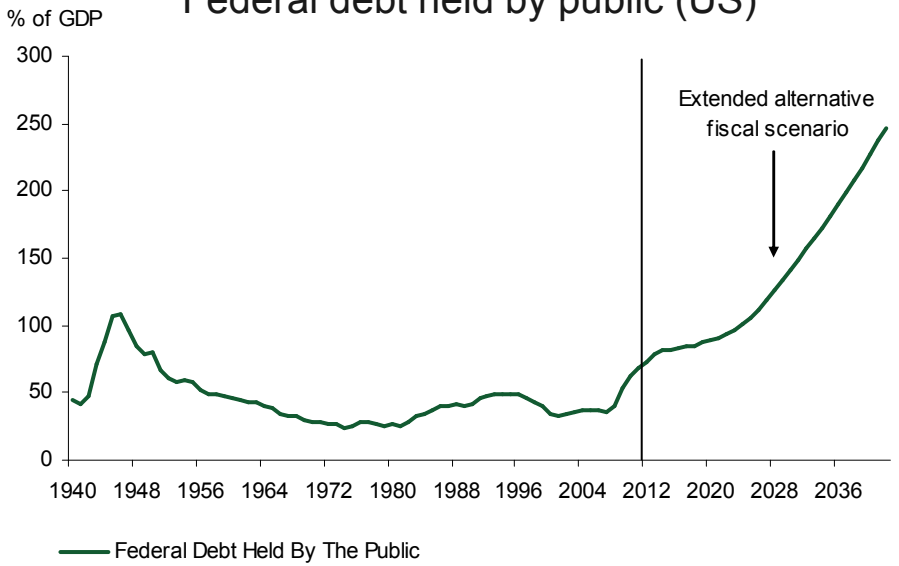
Source: LGIM, BAML, Bloomberg

# Trigger 4: Financial repression RED

Debt outstanding as % of GDP




Federal debt held by public (US)

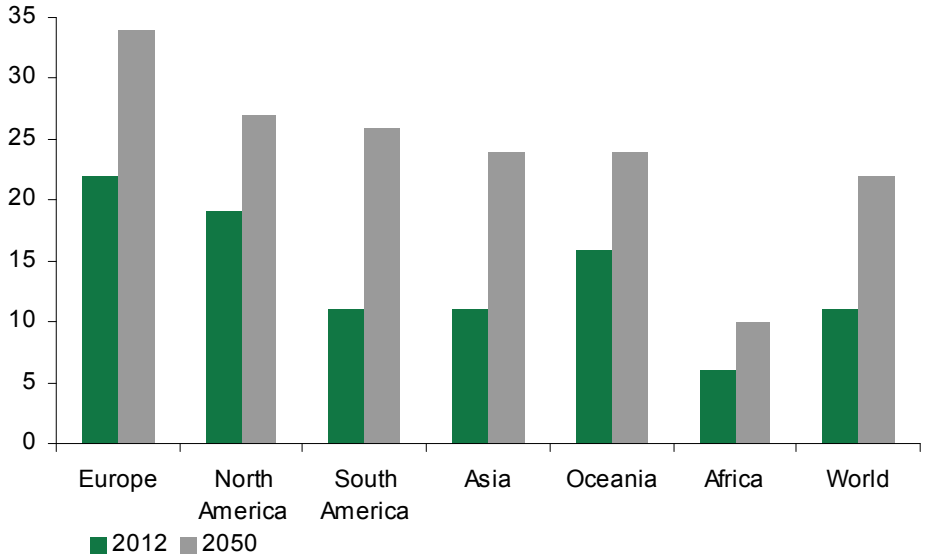



- Both the public and private sectors remain highly levered
- 4 options: with growth unlikely and hard austerity and default politically unacceptable, inflation seems the most realistic path
- If financial repression can keep nominal interest rates low, inflation must not pick up much to achieve negative real interest rates
- Incentives for financial repression are unlikely to decline or disappear -> RED

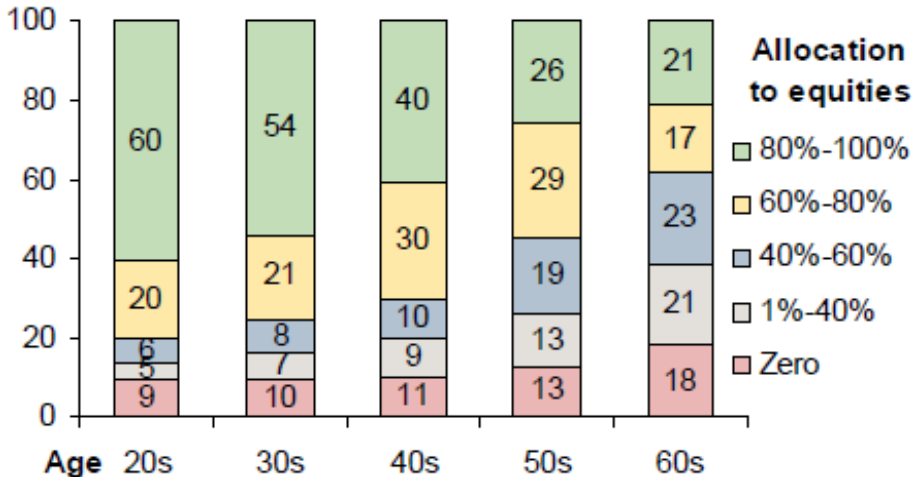
Source: LGIM, MS, CBO

# Trigger 5: Regulation - Demographics RED

% of population over 60




Allocation to equities in US 401(K), % of participants

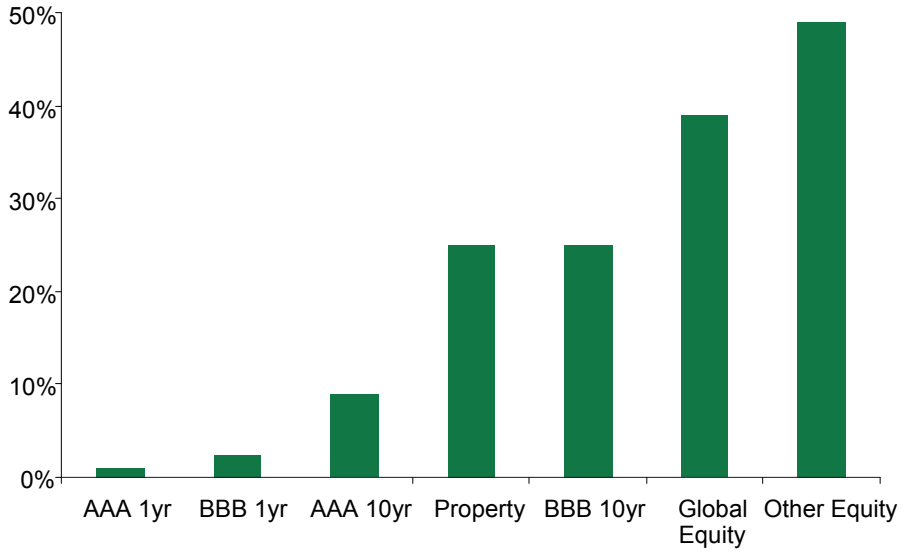



- Over 60's as % of total population will rise ca. 50% by 2050 in developed countries, double in Asia
- Over 60's have the lowest allocation to equities of all age groups
- 'Demography is destiny'
- Demographics will almost certainly remain a factor favouring a greater bond allocation than long-term averages -> RED

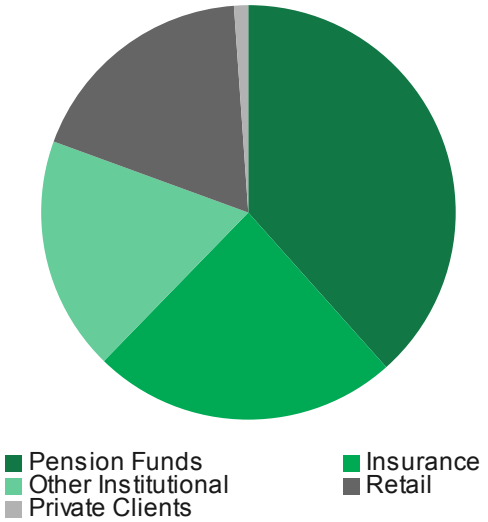
Source: LGIM, UN, CS

# Trigger 5: Regulation – pension and insurance rules RED

Capital charges under Solvency II




Assets managed in the UK by client type (2011)



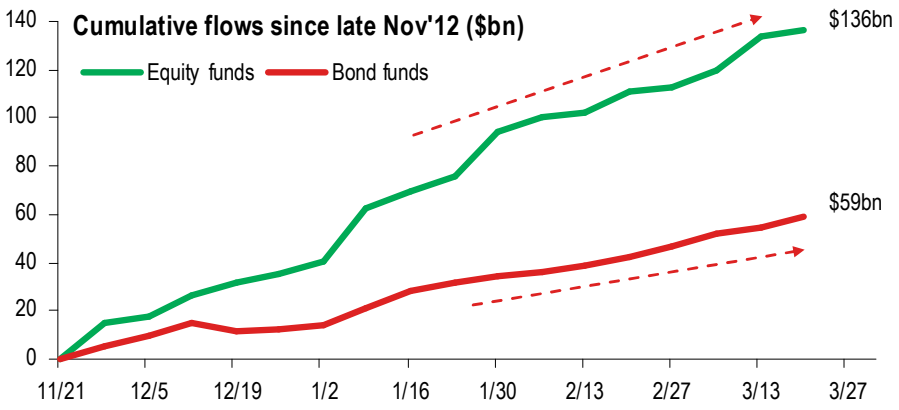

- Insurers and pension funds matter - they account for approx. 60% of European institutional assets (IMF)
- Insurer's equity allocations between 10-20% in most countries. Pension funds between 30-40%
- DB -> DC switch will continue to have a de-risking bias. 55% of global* pension assets are still DB
- High capital charges for equity investments under Solvency II skews asset allocations towards bonds, away from equities
- Regulation often lags market trends
- But: highly leveraged governments have no incentive to decrease the demand for bonds and drive up bond yields

* Global = SWI, US, UK, AUS, CAN, JP, NL

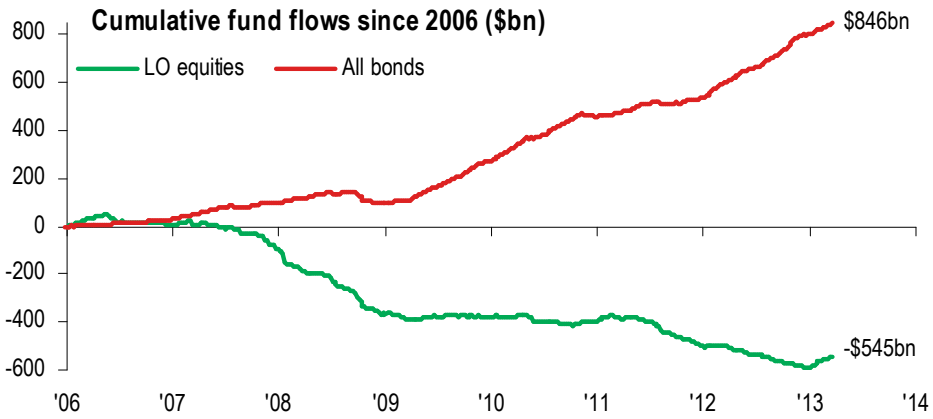
Source: LGIM, IMA

# First signs of rotation

Cumulative flows since late Nov 2012 ($bn)




Cumulative fund flows since 2006 ($bn)



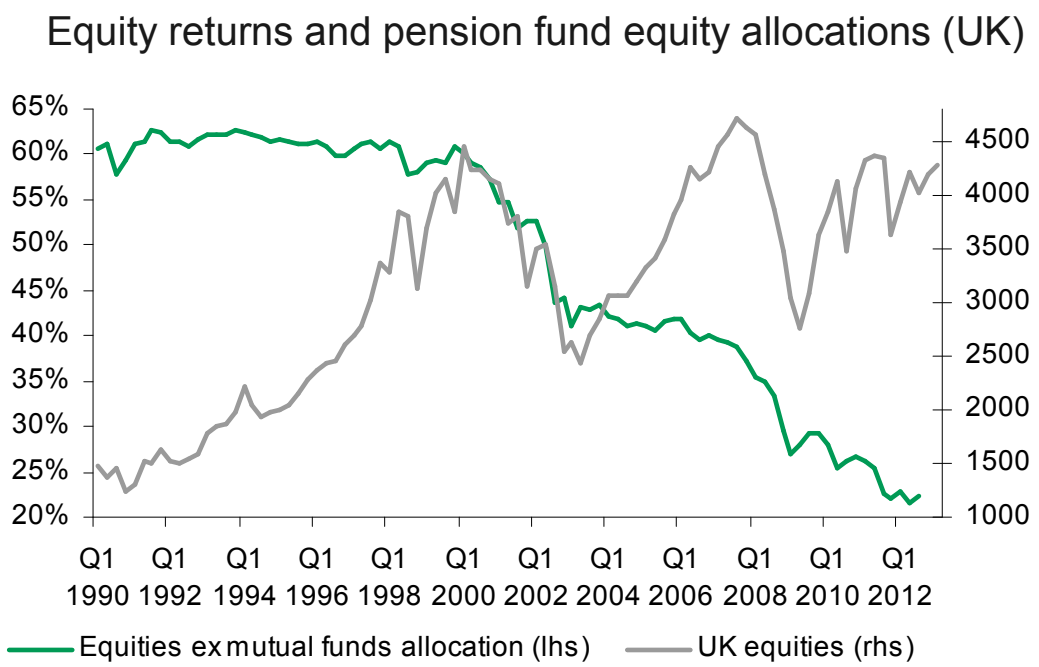

- First signs of investor rotation into equities, but no outflows from bonds yet
- Equity inflows > bond inflows for first time since 2010
- But too early to call a trend. Still small compared with previous pro-bond flows, just from money markets
- More likely a reflection of growing risk appetite than fundamental asset rotation
- The marginal new investment dollar is going to equities rather than bonds

Source: LGIM, BAML

# First signs of rotation - a collection of anecdotal evidence

- Some central banks (e.g. Israel, South Korea, Czech Republic, Japan) have recently increased equity allocations in excess reserves. Excess reserves total > $10tr
- French Strategic Stake Fund shows some insurers are actively looking for ways to increase equity allocations and circumvent Solvency II rules
- Caisse de dépôt will lower its $58.8-billion allocation to fixed income by $7-billion to $8-billion next year [2013] “as a starting point.” (FT)
- GMO, the $104-billion asset manager, said it had “given up” on long-dated sovereign debt
- “No question, the move back into equities is one of the mega trends we witnessed [since] the fourth quarter” (Larry Fink, BlackRock CEO)

# Flows and equities




- There are many good reasons to buy equities, but Great Rotation is not one of them
- Good news: Great Rotation is not required to be optimistic on equities
- Equity rallies have not coincided with increased pension fund equity allocations in the past

Source: LGIM, Datastream

# Conclusion

- ‘Great Rotation’ is a misleading name. A great rotation in relative performance trends is likely, a great rotation of institutional asset allocations is not.
- There is room for slightly higher equity allocations from extreme lows, but pre-2000 asset allocations are not a realistic target
- At a global level rotation has been out of equities into alternative assets rather than into bonds: ‘mainstreaming’ of alternative assets is less vulnerable to mean reversion
- For now, expect ‘Slow Rotation’, a rebalancing of flows rather than a ‘Great Rotation’. The marginal investment dollar is more likely to go into equities than bonds.
- The bull case for equities does not require a ‘Great Rotation’

**Legal & General Investment Management does not provide advice on the suitability of its products or services**

**This document is intended for educational purposes and should not be relied on for any other reason**

Legal & General Investment Management

Authorised and regulated by the Financial Services Authority

One Coleman Street

London

EC2R 5AA