Episode 10: Interest Rates and Portfolio Construction

Lukasz de Pourbaix - Lonsec and **Hamish Fitzsimons - Alliance Bernstein** discuss the following points

- How are you changing portfolios in response to rising inflation and interest rates?
- Now that bond yields are over 3% are you reconsidering adding to fixed income in portfolios?
- What other asset classes do you like in this environment?
- Is it too late to sell long duration assets now or switch out of high growth managers?
- How do you see rising inflation impacting equity markets?
- What parts of the equity market do you prefer in an environment of rising rates and high inflation?
- What sectors do you see as potential offering inflation protection?

Moderated by **David McDonald, CFA IMAP Investment Specialist**

Transcription

David McDonald - IMAP

Okay, all right welcome to this podcast in the IMAP independent thought series joining me today to discuss interest rates and portfolio construction.

I have **Lukasz de Pourbaix - Lonsec** who is an Executive Director and CIO **of Lonsec Investment Solutions** and **Hamish Fitzsimons** who is a portfolio manager with **Alliance Bernstein** welcome gentlemen now you know I think we're all aware of the current environment high inflation rising interest rates. We've seen the US Fed has put rates up and suggest that it's going to continue to do so in perhaps a quite an aggressive way. We've got 5% plus inflation locally and the RBA started rate hikes. So it's certainly front and center of a lot of people's minds. Perhaps Lukasz de Pourbaix - Lonsec if we can start with you. Just. Wanted to ask you how is Lonsec looking at asset allocation in this environment and how are you positioning portfolios at the moment?

Lukasz de Pourbaix - Lonsec

Yeah, look the current environment. It. It certainly is keeping us focused in terms of as allocation. It's worthwhile just recapping I guess where we've come from in terms of our allocation because they give you a bit of a sense of what we're doing so we've been for some time overweight growth assets so equities and so forth underweight fixed income and cash and look that that positioning has worked really well for the last. , several years as we've seen equity markets. Obviously do very well fuelled by lower interest rates fuelled by, central bank support in the form of all of those things have really been positive for risk assets now as we've seen interest rates. . The prospect of interest rates going up and then we have subsequently seen that go up and also the inflationary pressures for the last sort of six months effectively we've been tapering some of our equity exposure and really sort of where we've been more towards a neutral. Position, but where we have been allocating more assets from an as allocation perspective in things like real assets so things like listed infrastructure and property we have continued to be underweight fixed income. , ah. Albeit where we are at the moment is with bond yields going up. , you know fixed income is starting actually to pay something where you know we've been at pretty much Zero for many years so we're not there yet, but we are looking at some of those fixed income assets.

Lukasz de Pourbaix - Lonsec

Ah, guess the main sort of thing is we think a lot of the action is going to be from a bottom-up perspective. So from an asset allocation perspective I think the easy money has been made. We've probably been more heading towards a more neutral allocation and more focused. From a bottom-up perspective is where do you have some of those tilts.

For example, you know within fixed income having more floating rate exposure as an example and in the rising interest rate environment that should hold up well having a look at things like inflation link bonds. For example. And then within some of the other asset classes things like commodities. So it's probably fair to say the asset location causes.

It's been difficult but I think it's sort of the shift is now really more from that sub asset class perspective and a bottom-up perspective and that's where we've been focused.

David McDonald - IMAP

Thanks Lukasz de Pourbaix - Lonsec …Yes, there is a lot we can draw out of that when can talk about some of the specifics you mentioned and maybe just initially as well Hamish Fitzsimons - Alliance Bernstein .?

You know Lukasz de Pourbaix - Lonsec mentioned that they'd been overweight equities for quite a long time and I think. People had seen the benefits of of growth in the low interest rate environment. So as an equity portfolio manager. What's your view on the broader equity markets at the moment? Do you have a positive outlook?

Hamish Fitzsimons - Alliance Bernstein

Sure look I think it's hard to have a broadly positive outlook I would sort of None Lukasz de Pourbaix - Lonsec 's point around. There's a lot of bottom up that's going to go on here in that the environment we're in is going to create quite Stark winners and losers. And rising inflation rising input costs rising interest rates. They're very negative for some companies but for other companies are extremely positive. So I think you've got to be really careful to differentiate between the 2 and just buying everything is is not the right answer at this point in time.

I mean just and look I just want to make the general overall point in that if you if you go back through the major things that have made the stock market go down in the last sort of 80 years if you choose the things that have made the stock market go down more than 20% yeah, since 1940 inflation is the worst right? Inflation outbreaks in 1974 1982 and 1995 the average pullback of the market was close to 40%. That's worse than wars that's worse than asset bubbles I mean having said that we're having worse right now.

David McDonald - IMAP

Are there many bad things happening?

Hamish Fitzsimons - Alliance Bernstein

Yeah, a lot of the bad things. A lot of the things that causes markets to go really badly are happening simultaneously but I want to point out that inflation is very bad.

So I think the general theory of just being inequity broadly is a tough one. But I would differentiate within that and just to call out a couple of examples. I mean if you're in supermarkets right now and I'll pick an individual stock and say Coles that their margin is yeah through the whole of covid with sales up sales down costs up cost down online up online down has been 4% plus or None their ability to control the margins. Fantastic so input price inflation for them is just more sales because they will just maintain a 4% margin increase their price that the consumer is going to kind of see and continue to grow their profits.

David McDonald - IMAP

Yeah, right.

Hamish Fitzsimons - Alliance Bernstein

Their input costs go up and they don't have the ability to pass it on to customers and it just crunches their margin. So yeah, another example, yeah APA pipelines they have inflation explicitly built into the revenue of their of their contracts. So, if inflation goes up their customers paid them more money so they actually once again benefit. From inflation, so I just think you've got to be really careful about picking those ones who have thought about inflation or have the ability to deal with inflation and those who don't.

David McDonald - IMAP

Yeah, right? Okay what you have mentioned Hamish Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein is interesting. You know you talked about times that equities have fallen by more than 20% and that you know inflation is one of the risks there and I guess maybe more a question for Lukasz de Pourbaix - Lonsec but USA markets more or less achieved that year to date that 20% fall less so here in Australia but does that change your outlook you know are we getting to a stage where you would reconsider equities or you still have ah a reasonably negative outlook.

Lukasz de Pourbaix - Lonsec

Yeah, None of the things I mean we do look at is obvious evaluations and we recently just reran our models to sort of look at you know, post the most recent pullback and interestingly even though we've had that that pullback.

You know we probably wouldn't be in the camp where us equities necessarily look cheap as yet. , probably the one asset class that it sort of stands out I guess in that sort of cheaper territory are emerging markets but we all know some of the challenges. particularly China. With their sort of heavy handed sort of covid policy lockdowns and so forth like there's some real sort of issues in in that market at the moment.

So despite it being cheap. We haven't been allocating more to emerging markets. But in terms of us equities. Yes, we've had a pullback but you know we're still not seeing you know. And the same with Aussie equities. We're not sort of so seeing the broader sectors necessarily in cheap, , ah territory and I think the interesting thing will be to see what happens to pes more generally and usually in in sort of inflationary environments you do see a bit of a rerating in terms of sort of longer PE's look like and so you might say a bit more pressure coming down on PE's but look we certainly don't think we're there in terms of I guess upweighting growth assets at this stage I think the market is still sort of look.

The next six months in our view is just going to be a bit of of the market trying to find itself. There'll be a lot more volatility. You know one of one of the plausible things we may see is we may see rates go up. , you know over the sort of six months but then plateau out and potentially even reverse so. A lot of moving parts. So I guess with that in mind we've sort of said, let's sort of neutralize some of our allocations over the next six months let's reckon on that bottom up, , angle because. Yeah I think I think what we've seen at the moment you know you've seen a couple of dead cat bounces as well. In terms of the market in the us , look at I think the next six months is just going to be more volatility rather than sort of you know it's not going to be in in my mind I don't think it's going to be like this v-shaped recovery that we saw When we have that covid the covid sort of bounce a couple of years ago

David McDonald - IMAP

Okay and just within that I suppose in terms of managers looking at managers and allocating to managers. Are you looking for a value tilt. Are you staying away from the high growth managers still in in this environment.

Lukasz de Pourbaix - Lonsec

Yes look I think it's an interesting one, I mean one of the things we do look at is what are the different factor exposures within our portfolio. So you know your value your growth you call it all those sort of things and ah you know and certainly when we sort of saw that rotation. We had another good look at you know. Are we overexposed to any single factor particularly growth and you know the growth factor and so look our portfolios have been fairly balanced, and we have had exposure to really contrarian value managers for some time and you know that's sort of been a drag on the portfolio. But now you know they've made it back in spades in in recent months. So I'd probably be cautious about just sort of flipping from one style to another style because even on the growth side, you know a lot of those. You've got a lot of quality companies.

There's nothing wrong with a lot of those companies so necessarily crystallizing. Ah the losses is probably not ah not a prudent thing. Interesting thing is value tends to is very much a long term factor as we've seen you, you can be under underwater for a long time and then you get it all back in a very short period of time so yes, we do have some value have we been massively tilting towards value. No, but we have been very sort of prudent in terms of understanding what our factor exposure is but it's probably fair to say we've been fairly diversified over time and look. We know that there's different parts of the fire are going to work in different cycles. So We're not necessarily trying to time you know now's value now's growth or which of a slot.

David McDonald - IMAP

Okay

Hamish Fitzsimons - Alliance Bernstein

If I could just comment on that I think having been in equities funds management for a while I've been in a number of conversations with people over the years which say what? what is value and yeah is it price earnings is a price book. Is it price to free cash flow is it a variety of other things. So I think and I think. What our analysis would sort of show within that is that in in pullbacks the type the type of value that you want is price to free cash flow cash is what matters when the markets are going down price to book is not necessarily a helpful factor when markets are going down. So, I think you've got to be careful when you're talking about value and what type of value do you mean.

David McDonald - IMAP

Yeah, and I guess from your earlier comments Hamish Fitzsimons - Alliance Bernstein . It's you know you're looking for companies and sectors where there's inflation protection is an important factor.

Hamish Fitzsimons - Alliance Bernstein

Yes that's right, and when we when we look at that I mean there's a couple of source sectors I'd call out broadly

I mean Gold is an interesting one I think in the middle ground of inflation gold can do poorly or badly , poorly or well. But when inflation gets extreme Gold does. Well so it's like a tail a tail hedge so you don't want to have your whole portfolio in gold. But you want to think about it as a tail risk hedge some of the healthcare companies in particular have extremely strong pricing Power and Dominant Market positions. Demand is not going to go down for their products particularly so they can that they're not going to be affected too dramatically by what's going on.

In fact, some of them will benefit from the research you know a lot of them are struggling. For example, you know Resmed who make the sleep apnoea devices are struggling to get chips right now. Because the consumer is hot. They're all going into iPhone all this Stuff. So Some of that stuff's going to free up and actually help them on the other side of things and you know they could sell every they can sell every product they make for whatever price they want right now that is can't make enough right and that's not going to really change but they'll be able to make more in the future. insurance companies.

I high rates help insurance companies if you if you can price if you can price for the inflation which a lot of the Australians can and globally insurance markets are very strong for price. Yeah, because they invest a lot of their money in fixed income which used to be a tough thing to do whereas now, you're getting a decent yield So That's helping returns on Insurance. Infrastructure. We talked about some of them have explicit inflation links and the consumer staples. We talked about so within you know there's some in in each of those categories that aren't going to work but within those categories are the ones who are more likely to win in different inflation situations.

Lukasz de Pourbaix - Lonsec

I Think just the interesting one on the inflation argent at the moment is it is you know, still a lot a lot of it is still supply side driven I mean you know and so one of the one of the questions we've been asking ourselves is you know? Okay, you can raise interest rates but how effective when you know a lot of the pressures are due to you know it? you know I mean the transitory argents sort of you know that's the no-no at the moment like that's sort of not the main narrative but the reality is when you know you've got shipping containers stuck on the coast in China, you know that's still driving a lot of the inflationary pressures combined with the conflict in in in Ukraine where we've seen you know some of the commodity prices.

You know, wheat. Sunflower oil all of these things ramp up in price. So, it's an interesting one and so I think that's the sort of conundrum for the central banks at the moment is you know you've got a very blunt tool in terms of interest rates and the other one is obviously tapering quantitative tapering but

To what degree that you know that that will be effective. It's to pull the Jury's out and the other thing is I mean it's that careful sort of balancing act between sort of hosing down inflation and then you know your killing growth.

31:53.51

David McDonald - IMAP

Yes absolutely as you say Lukasz de Pourbaix - Lonsec , you know, that putting rates up 5000 basis points isn't going to solve the chip shortage or the bring the wheat back out of Ukraine at the moment etc.

Lukasz de Pourbaix - Lonsec

Indeed.

Hamish Fitzsimons - Alliance Bernstein

I did read the article yesterday where someone pointed out that the USA fed has engineered a soft landing 2 out of the last ten times so let's not be too optimistic about their ability to time this right?

And I think we've seen that in the last six to eight weeks in that a lot of the major research houses like Goldman Sachs and Morgan Stanley have started to be much more strident about the fact that 2023 is most likely a recession year for the US like the probabilities have been going up quite dramatically.

David McDonald - IMAP

Yes

Hamish Fitzsimons - Alliance Bernstein

So no-ones saying 100% but they're sort of getting to “more likely than not” territory.

David McDonald - IMAP

Yes, and to move on Lukasz de Pourbaix - Lonsec you mentioned commodities earlier I know as something that you saw is interesting and Hamish Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein has mentioned gold just wondered how you're seeing that area. Are you allocating to commodities at the moment?

I mean obviously a lot of the bulks and they all have gone up a lot already.

Lukasz de Pourbaix - Lonsec

Yes they have so there's probably 2 sort of main angles that we've been allocating.

I mean structurally obviously the Aussie market compared to say the us market is you know we're very sort of resource materials. Heavy. So structurally I guess Aussie equities do provide you some exposure to those parts of the markets but outside of that we have had an allocation to gold for a long time, and that allocation is I guess been a pro-longed one as a sort of flight to safety agent.

So you know whenever we've had that sort of real sell off gold tends to tended to sort of be that sort of safe harbour, but the none one which when we allocated a few years ago was this sort of prospect of inflation and you know that at some stage the other side of QE. You know as we see that coming off, our thought is that there's going to be sort of potentially issues there. So probably gold has been our main exposure in terms of that sort of commodities.

David McDonald - IMAP

Right.

Lukasz de Pourbaix - Lonsec

The other sort of peripheral ways we have accessed it is via some of the alternative managers that have some exposure to some of the other commodities. But that's been our main exposure.

David McDonald - IMAP

Okay, and you also mentioned real assets property infrastructure and so on and I know Hamish Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein has talked about infrastructure within the equity context is that the sectors that you still see as doing well in this environment with inflation particularly.

Lukasz de Pourbaix - Lonsec

Yeah, look I mean I think from a capital perspective and our main exposure has been via the listed market because that's sort of the universe we play in I mean as Hamish Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein mentioned some of those structure assets do have Cpi linked sort of. Income streams attached to them so that they can provide from an income perspective. Some certainly some levels of protection but at the same time look if you get you know they are also sensitive to interest rates so you can see this sort of from a capital perspective. You know if we saw that inflation really kick up then you know you could get a bit of downside. We've probably had our sort of why max exposure in terms of that and while it still sort of shows us up as being an attractive on our models we probably wouldn't be at to looking to further increase that we're already sort of overweight.

David McDonald - IMAP

Okay I guess the bit left field maybe 1 asset class. We haven't mentioned which has got a lot of attention in the last year or so and certainly I think advisors get a lot of questions about is crypto.

Is that something you either of you have considered. Do you think it's a real asset class or not?

Lukasz de Pourbaix - Lonsec

Look we've looked at it close simply because a lot of Advisors. Do ask about it. So we've done a bit of work and I guess where we've done a bit of the work is to look at what are the characteristics of Crypto. , you know so look based on historical data. It does have some and when I say crypto I'm talking about the main like bitcoin For example, so it does exhibit some interesting characteristics. , this sort of idiosyncratic risk profile that it sort of does to a portfolio. You know it does show a sort of a symmetric return and profile but look it's very volatile so you know we certainly wouldn't be looking to allocate to crypto sort of anytime soon. But it is a. It's an emerging area and I think from our perspective you've at least got to be aware of it and try to understand it, because you know where it ends Up. We don't know but it does have some interesting Characteristics. So and the sell off is probably a good thing right?

David McDonald - IMAP

Yes sure.

Lukasz de Pourbaix - Lonsec

Because it like anything it cleans out a lot of the one a lot of the hot money and two sort of a lot of the sort of you know Coins will probably have got no future but it's still too early in our mind. But. Again, as the world is looking for. You know, diversifying assets and so forth. That's you've at least got to have a look.

David McDonald - IMAP

Yeah I guess it hasn't really played that diversifying role in the last few months as you said has it.

Lukasz de Pourbaix - Lonsec

I think that's the other thing is like there's no yeah, the market's been interesting in that and it be interesting to hear Hamish Fitzsimons - Alliance Bernstein 's view on this from an equity perspective because look there's been nowhere really to hide right? I mean unless you've been holding cash but you know it's been. It's been a really broad selloff I mean.

Hamish Fitzsimons - Alliance Bernstein

Beat Beaters high.

Lukasz de Pourbaix - Lonsec

Apart from some of the commodity plays and so forth and some of the funs as well. But it's been pretty indiscriminate and any risk asset is yeah they've all sold off and you know crypto like these sort of amplified high vol risk assets. That's obviously sold off quite a bit.

Hamish Fitzsimons - Alliance Bernstein

If I could chip in on the cryptos in that you know I'm a financials person by history to some extent and look I I just wanted to point out that that they sort of exist outside the regulatory net at the moment I mean we have tax authorities. Securities regulation authorities anti-money laundering authorities and prudential supervisors none of whom are involved in this market. But if they're going to play the role that the people who ah bullish on them are going to think they're going to play all of those authorities are going to have to. Get a really hard look at them and get into them and it hasn't happened yet in any jurisdiction really and just I just point out. There's been None or two instances where regulators have had a little bit of ah, a faint in their direction. I think if you look back at the big pullbacks that that that cryptos had.

Hamish Fitzsimons - Alliance Bernstein

In the last five years 2 of them were caused by the Chinese regulators going. We're not going to accept this anymore and bitcoin just halved like within two weeks that's just 1 regulator making one statement. Yes, whereas we've got all these regulators across all these major jurisdictions who are all gradually if this takes off got to pull it within their nets I think there's a long journey to go through before these things become stable investments if I could put it that way.

And I think the day where a major international government accepts bitcoin to pay your tax bill. Be a very strange day I mean kind of kind of countries like to control their own currency and one of the ways they control it is the only way you can pay your tax is in our own currency If You don't pay your tax. We send some people around and they put you in jail right?

It's a very nice way of supporting your currency and I don't see bitcoin having that kind of coercive power any time soon. , so I'm watching with interest but I feel like we're at the beginning of a very long journey at the very least.

David McDonald - IMAP

Yes fair enough look it's been a great discussion I know I'm sort of aware we're pushing towards our time now and I just thank you both for what's been a really great discussion Some very insightful points there. So, it just remains for me to thank Lukasz de Pourbaix - Lonsec de Pourbaix from Lonsec and Hamish Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein Fitzsimons - Alliance Bernstein Fitzsimmons from Alliance Bernstein for taking part in our podcast.

Lastly a reminder that we do have some upcoming IMAP events. The week beginning Monday 23rd of May 2022 we have a webinar series which is entitled transforming advice into wealth management with three 1 hour sessions at noon on Monday Wednesday and Friday and you can find more about those on our website.

Also registration now open for our advisor conferences which are being held mid-June 2022 in Sydney Brisbane and Melbourne and registration is open for those which we have called advice in action again, you can find more on our website **https://imap.as.au** Thank you