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Beyond COVID-19: Forces that May Shape Long-Term Investing over the Next Decade

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The key structure of challenges facing long-term investors in the coming years are, number one, the emergence of China as a political, economic and financial superpower. Number two, the low interest rate environment, and to what extent this low interest rate environment will persist for a number of years. And number three, climate change, climate risk and what impact it would have on long term investing.

The integration of China into the global economy and global capital markets has so far been relatively smooth, gradual and deliberate. The Chinese authorities have liberalized the regulatory framework in China and have allowed international investors to invest in Chinese equities and Chinese bonds. However, recently we have seen, of course, some tension in trade and the trade conflict between the United States and China, and this could affect capital markets and global investing in a negative way in the future.

The second important structural change that is affecting global investing is the low interest rate environment. I have been working in financial services for just over 20 years, and over this period, very often investors have wondered about inflation and interest rates starting to increase, and we haven't seen that over that period. And I think investors are gradually coming to the realization that growth, inflation and interest rates may remain low for a prolonged period of time in the coming years. That's very much the case for developed markets, of course. Recent examples like Turkey and Argentina have demonstrated that in emerging markets, interest rates and inflation can rise quite fast. Now, a persistent low interest rate environment has some very profound implications for global investing and for the ability of institutions, pension funds, charities, foundations, sovereign wealth funds to meet long term liabilities. Certainly for fixed income instruments denominated in euro, in Japanese yen, in Swiss franc, a large proportion of those fixed income instruments are currently trading at negative yields. That's pretty severe. That basically means just to spell it out, that if you buy those instruments and hold them to maturity, you're guaranteed a loss, at least in nominal terms. So you can imagine the challenges that this low and negative interest rate environment poses for long term investors, particularly institutional investors that have long term liabilities. This low interest rate environment also has implications for the pricing of other asset classes, such as public equities, private equities, real estate. The big challenge, the big question for investors in those other asset classes is to what extent low or negative interest rates justify higher valuations in those other asset classes or not.

Now the third main structural change that is affecting long-term investing and will continue to do so for the years and possibly decades to come is climate change and climate risk. There are two key issues related to climate change and climate risk. One is how do we translate climate risk into an impact for different markets, segments and asset classes? What does it mean for the pricing of oil stocks, energy stocks, but also for the pricing of alternative energy providers? So clearly there are opportunities as well as risks related to climate change. So that's one issue. The second and probably even more challenging issue related to climate risk is to what extent climate risk is already priced in in the valuations and the prices of different segments, different markets and different sectors?

Brexit and the trade conflict between the United States and China affect capital markets and long term investing, global investing in a number of ways, specifically in three ways. First of all, they affect sentiment. Secondly, they affect fundamentals, and thirdly, they could affect capital flows. So let's take each of those in turn. We've seen that announcements by the trade negotiators, for example, in the US China trade discussions, or even tweets by President Trump can affect sentiment in the market, and we can see equity markets rallying or declining based on those announcements and the sentiment around the trade conflict. More importantly, the trade conflict could have pretty severe implications for economic growth and also for earnings growth. So if corporate earnings are reduced or cannot rise as fast as previously anticipated because of additional tariffs associated with the trade conflict, clearly that will have a huge impact on investment portfolios. Finally, the trade conflict could potentially spill over into other areas if we see either the United States, China, or other governments around the world start to impose investment restrictions on institutions based in their jurisdiction. For example, the United States may start to impose restrictions on how US institutions can deploy capital and whether they can invest in Chinese securities. These types of restrictions, if they were to be introduced, could also have a very severe impact, and they would restrict the ability that investors have today to seek opportunities and spread risk across borders.

It still makes sense to classify markets into developed and emerging. We were commissioned by the Norway Ministry of Finance recently to conduct a study looking at global investing, and one of the main conclusions of that study was that equity markets around the world cluster based on two dimensions. They cluster based on economic development on one hand and on geographical location on the other hand. What that means in practice is that our research has demonstrated that, first of all, correlations clustering exists within the developed market universe and also within the emerging market universe. That doesn't mean that emerging markets behave the same way, but they are a distinct yet diverse segment. And then when you examine, for instance, developed markets, you can very clearly see that the three main geographical regions, North America, EMEA, and Asia Pacific form distinct clusters with higher correlations within those clusters and lower correlations across those segments. So that's one of the key reasons why the classification of markets into emerging and developed still very much makes sense and is relevant and appropriate.

Markets have actually become slightly less concentrated compared to 20 years ago. If you look at equity markets in the late nineties during the dotcom bubble and you compare levels of concentration back then with the level of concentration we have today, actually markets look less concentrated today. However, equity markets have become slightly more concentrated over the last five years or so. So looking at 2013 versus 2018, for example, you would observe that concentration levels have gone up, especially in the US equity market and in the China market. And a lot of that increase in

concentration we've seen recently is related to the dominant role that a handful of technology companies have nowadays in the US and in China. Very often we hear the acronym FAANG. This acronym is slightly arbitrary, but it does capture the phenomenon quite well. FAANG stands for Facebook, Apple, Amazon, Netflix, and Google. This handful of large mega caps technology stocks in the US actually account for more than 10% of the US equity market. And then we have a similar phenomenon in China where Baidu, Alibaba, Tencent, they're known as the BATs, the BAT stocks, they actually account, those three stocks account for more than 30% of the Chinese equity market. So clearly, we've seen some increase in concentration associated with the dominant role that these large technology stocks play nowadays in markets. Now an international investor or an institution, how can they deal with these issues? How can they manage concentration risk? One of the best ways to do that is to actually use a global policy benchmark that covers all geographical and size segments. We have seen through our research that actually if you were to omit, for example, emerging markets, or if you were to omit small capitalization stocks from your global policy benchmarks, that would have pretty severe implications for the risk, the performance, and also the characteristics of your equity portfolio. So it is very much appropriate and has been best practice for institutional investors to use a global policy benchmark that includes all geographical segments, the Americas, EMEA, Asia Pacific, developed markets, emerging markets as well, and also all size segments, large, mid, and small capitalization stocks. That doesn't imply, of course, that every institution investor should invest across all of these segments at all times. But the important point here is that any decision to overweight or underweight any of those segments, emerging markets, small cap stocks and so on, should be a conscious investment decision, very much founded on investment beliefs and analysis. The starting point, the global policy benchmark, should really cover all geographical and size segments. And that is a very good way to actually address and manage concentration risks in equity markets.

Financial markets in the short term are buffeted by noise. So over relatively small investors horizon a day or a week, a month, or even up to a year. News and news flow can affect prices and prices can vary according to news flow. Some of those news will have a long term impact on markets, some of those news may just be transient and have a short term impact. Our research shows that for horizons, investment horizons up to a year, up to 50% of performance and returns can be attributed, associated to price changes. However, as your investment horizon goes up, as we invest over horizons of 5, 10 or even 20 years, when you look at 20 year horizons, the research that we've done shows that actually more than 90% of performance and risk can be attributed to the fundamentals, specifically dividend yield and dividend growth. So to what extent starting valuations are low or high, and then to what extent dividends, earnings, income grows over a long horizon. Those are really the factors that have a very important impact on long term performance.

When MSCI launched the emerging markets index more than 30 years ago, in the late 80s, emerging markets only made up about 1% of global equity markets. The weight of emerging markets today is around 12%. So obviously, the weight of these markets in global indices and global equity portfolios has gone up quite dramatically. But actually, there's another statistic that I think illustrates even better how the role of emerging markets has changed and has increased dramatically over the last few years. So when we look at global corporate revenues and examine where they come from, back in 2003, our research has indicated that in 2003, less than 10% of global corporate revenues came from emerging markets. 15 years later, in 2018, actually more than 40% of global company revenues come from emerging markets. So clearly, the 12% weight that emerging markets have in the ACWI IMI Index of MSCI somewhat understates their economic importance. If you look at where companies derive revenues, where they sell their products and services, well, more than 40% of those company revenues

of companies listed anywhere in the world do come from emerging markets. So on one hand, the 12% weight that emerging markets have in global industries understates their importance, on the other hand, obviously, investors need to be aware that even if they're not directly exposed to companies listed in emerging markets, simply by holding developed market stocks that now sell a lot of their products to emerging markets, they still have substantial economic exposure to emerging markets. So I think these are important portfolio characteristics that investors need to be aware of, monitor, and manage.

A number of topics that we've been discussing with institutions over the last few years remain relevant today, global investing, the emergence of China, factor investing, using factors to understand the risk and performance characteristics of portfolios. However, there is one topic that obviously we've been discussing, but it has gained much more importance recently and that's the integration of environmental, social, and governance criteria into the investment process. And we very much see institutions today looking at ESG sustainability, climate change, climate risk as very, very important dimensions of their investment process.

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