The soundtrack of the pandemic: ‘Birdsong and protest’

Cooper Abbott: There are two primary factors by which the asset management industry will be judged:

- How well are we generating returns for our investors?
- The concept that we need to deliver results in a way that makes society and markets better.

We will be doing this against a backdrop of unprecedented uncertainty amidst a pandemic, with a huge human toll as well as massive economic dislocations.

A key question is the environmental and societal contribution of investments and the way we use our positions and the power of capital to help influence these.

It has certainly been the opposite of a ‘silent spring.’ If we were to consider what the soundtrack thus far of the pandemic has been, I would describe it on one hand as birdsong – as economies have slowed down, as pollution has decreased, as we’ve seen the impact of the quarantine at a personal level. And on the other side has been protest – global responses to issues around justice, inclusion, race, opportunity, and respect.

So between “birdsong and protest” I think we have an environment where people are seeing real implications for what’s going on … and are also able to reconsider the current design. We’ve seen the decline in pollution. We’ve seen the city streets that have been given back to pedestrians. Work outside the office is proving to be effective. Yet the segmentation by employment and socio-economic levels is also highlighted: Not everyone can work from home; we see the vital role that “essential workers” play in society. There is frustration about fairness, economic opportunity, and questions about how “the economy” works for all people.

It will be difficult to put the genie back in the bottle. These are scenarios that are going to raise thoughtful challenges going forward, because people have started to see the direct impact of a different – if very extreme – take on the economy.

How do we incorporate that backdrop in our investments? We’ve seen a growing emphasis on the societal component of ESG (environmental, social, and governance), issues of justice, issues of structural design. For the sake of long-term returns and economic sustainability, these really do need to be addressed. Getting these right can help compound returns for the full system. And we, given our position in the capital markets and as investors, can be uniquely positioned to help address them.
Investors anticipate lower future returns

IPE: What are your thoughts on expectations for returns?

Abbott: The feedback we’ve gotten from clients and from consultants in the U.S., in Europe and the U.K., in Asia, and Australia, is that they are anticipating we really have reached the "end of easy." The factors that have driven returns in the past decade will not necessarily drive the next decade, and pensions are anticipating a period of lower growth, more challenging returns, and that traditional asset allocations could be quite pressured. So I think there's definitely the expectation for lower returns and it being more challenging to achieve them.

We’re hearing some clients talk about the role of fixed income – both in terms of income and as correlation position in portfolio allocations.

Others are looking at more unconstrained approaches to fixed income. These can take strategic, opportunistic advantage of dislocations and continue to actively adapt to new realities in fixed income through positioning across a broad range of sectors -- a pure alpha approach. Some pensions are exploring whether equity dividends can be a supplement on the income front. They are really looking across correlations, across industries, to understand where you can get the real diversification benefits.

IPE: Most respondents to our survey are in line with it being harder to get returns. But about one in five appear to be more optimistic. Does that surprise you?

Abbott: There's always reason to be optimistic. I do think there are whole new economies and industries that are being created. A lot of the discussion we've had in the conference thus far is around ESG, and I think there are real opportunities, particularly as the focus shifts from risk protection, and particularly as new industries get created and new opportunities get dissected.

There's also plenty of new industries out there to think about. Business models are changing. The pandemic is pulling some of the digitization forward, in my opinion.

To put the question of optimism – which to my mind is a perspective on the ability to adaptively change – in broad perspective, look at the power of ideas with leverage. In 1975, more than 80% of the S&P 500's value was in tangible assets – plant, equipment, physical “stuff” that you could locate and touch. Now, tangible assets are less than 20% of the value. Most of the value is in assets that have no physical substance. Business models, patents, franchises, relationships – ideas.

This has major implications on firms’ ability to evolve on environmental impacts. And it also has important societal implications in terms of who is currently able to participate in these kinds of domains.

The good news in all of that is that we have the ability, we have the mind power, and the approaches to collaboration to help achieve these goals. I’m confident that while it will be more challenging, we can still get the results together.
Active management and diversification

**IPE:** In the last decade, if I’d just invested in a classic 60-40 equity-bond portfolio that happened to be passive, that would have served me pretty well. Now we’re looking at pretty high equity valuations, Treasury yields are pretty low, so I’m looking at equities and bonds in a different way. Are we seeing a rethinking of the classic frameworks of asset allocation?

**Abbott:** I would caution that when one is in the midst of a unique circumstance – like we are right now, with the pandemic – there is a tendency to say “everything has changed, we are in a completely different world.”

Some things are certainly going to be different, but I would still think about the longer term. I do believe that bonds have a role to play in a portfolio, although right now there are real questions. Where does the yield curve go from here? Where is the lower bound? How to think about increasing fiscal factors in addition to monetary ones?

What, by the way, is the role of inflation – which is something we haven’t really seen in a generation? Managing fixed income in a declining rate environment is quite different from a level or rising rate environment. So what does this look like going forward? All fair questions.

One of the things our current situation – the pandemic and a recession we were somewhat due for in any case – is setting up is the concept that indexing certainly has its place, but you really are starting to see separations between companies, between business models and between the credit quality and the ability to pay for bonds.

Part of it is a regional component as the pandemic has influenced different areas in different ways. The pandemic has clearly influenced industries in different ways. I think within individual companies it is a real opportunity to distinguish between business models that have the wherewithal to take advantage of the current moment but also to build and to provide some of that elusive growth going forward. I think it’s a real opportunity if you have the research capability to identify some of these winners and losers, particularly in an environment where traditional economic data is going to be very fuzzy and not going to give you a lot of insight.

**IPE:** What is the case for active? Some people will say I’m still investing for the long term. Passive have served me well. What reasons other than research capability and sectoral changes can you give for investors to put greater faith in active?

**Abbott:** I think passive certainly has its role. And that over the past decade, passive results have been driven by a handful of companies and some specific tailwinds coming out of the Global Financial Crisis, its own self-perpetuating growth, and momentum.

I also believe that “passive investing” is something of an oxymoron.

The opportunity in active is a couple fold. One is to identify companies that have longer-term prospects that can do better than the broad indexes. Ultimately it’s a market of stocks as opposed to a stock market. Depending on the characteristics of returns, active management can also bring a risk-reduction focus, and in a lower-rate environment where you can have a very long investment horizon, the sequence of those returns is still very important.
There are certain asset classes that I think are not well suited for passive investments: typically the small- and mid-cap asset space on the equity side. I think fixed income indexes are not particularly indicative of the full opportunity set. I think you want to pick your places and points.

If we look at research capability, which I still believe is ultimately crucial when you are evaluating the capital markets, it has declined, making in-house research capabilities even more valuable. In a number of ways we are watching a systemic de-industrialization of research. We've seen it on the sell side – MiFID II I think has inadvertently contributed to that – but we're also seeing it on the buy side where there are fewer asset managers, there are mergers that are taking a lot of research capacity out of the equation.

And this decrease in research and active management is happening at a point in the cycle where I think that these become particularly valuable to have. It's both less prevalent, and so I think more valuable by its scarcity factor, but also where we are in the cycle – the ability to distinguish companies is uniquely important at this moment.

**Is Growth vs. Value still relevant?**

**IPE:** Regarding “Value vs. Growth” has something broken down in traditional diversification and reversion to the mean, or is this an inflection point in terms of how we look at Growth?

**Abbott:** The Value/Growth "style battle" has been going on for an awfully long time. There are reasonable arguments that the environment for Growth's outperformance could be changing – yet in a slower growth economy, that is not necessarily a given. The cycles may be longer, and when they do start to end, they may tend to be more extreme.

One of the questions I would ask is how is value being defined? Traditional definitions could use a bit of a dusting off I think. And I think it matters a lot whether you are talking about "upper-case V" Value, or the practice of identifying companies worth more than their current price, "lower-case v": that kind of investing will not go out of fashion.

There are certainly companies, a Washington-based PC software and technology giant, for example, which for many years was a "Growth" stock. It is in many ways now "Value" in terms of its almost utility-like characteristics, but it’s able to address different markets in terms of its digital approach as opposed to some of the "traditional Value" companies that might be more old economy or industrial in nature.

I think the concept of "lower case v" value – investing in companies that are below their intrinsic value – I don't think that has died at all, and I think active can be a very aggressive way to implement that. But I would say the "capital V" where you are looking at energy companies, business models that have difficulty scaling, things of that nature – there have been some secular trends that are contributing to this dynamic.
How ESG investing is ‘double or triple active’

IPE: At Carillon Tower, what’s your take on ESG?

Abbott: ESG is an opportunity to be double or triple active. This is an area I believe is uniquely suited to research capabilities – because real evaluation is not as simple as a single score or letter grade. A company’s involvement in environmental, social, and economic ecosystems is complex, and the best way to evaluate material impacts is to consider a multi-dimensional, research-based approach.

If you have that research capability, you can talk about the company not in isolation and not as a stereotype. You can really understand how that company positions in the broader industry, what its supply chains are like, how it compares to peers, but also – and quite importantly – how it’s changing over time.

There is a concern in my mind to greenwashing, where people are treating ESG as simply a marketing aspect – you put the stamp on the product and you push it out the same way the industry has done too many times in the past. I think it can be something much deeper.

Part of the dynamic here is: What is real change? Research on the companies, the management teams, the business models and seeing how those are evolving lets you fashion an informed, fact-based opinion. A manager can work with a client to help develop and implement an approach to the multidimensional aspects of ESG. There’s no one simple score that will capture this.

When I think double and triple active, I think of another aspect of ESG investing, and that is to be an advocate for change. To use the power of capital – in conjunction with your client! – to raise questions of business management. To recognize that equity is ownership, and management teams and boards serve at the pleasure of the owners of the company. And as owners there are reasonable questions you can ask about how business practices enhance the longevity of a business.

IPE: Our attendees surveyed view ESG overwhelmingly as risk-reduction. Can you comment on whether that surprises?

Abbott: The survey results are perhaps not surprising. I think that is where we are in the current evolution of ESG – risk reduction. Don’t pollute, be a good neighbor, have good business practices around your governance.

And I think that is a good starting point! Of course, I think the potential is much greater. And that is to look at companies, identify them relatively early in the cycle, that have the ability to be transformative. I think the return opportunity for companies that are being efficient utilizers of resources, who have a motivated workforce, who have a buyer base that supports what they do, that should not be underestimated. I also think the evolution and rate of industrial change that we’re going to see going forward really is going to be epic.
Just to look at one case that I think people are familiar with, the electrification of vehicles. The typical internal combustion engine vehicle has something on the order of 2000 moving parts; EV's have about 20.

Or take another around the theme of electrical power. There is a lot of interesting thinking about renewable energy and increasingly attractive un-subsidized costs. New solar, wind, hydro, geothermal capacity coming on line. What sometimes gets left out of the equation is the fact that – no matter what the source – about 60% of power generated is lost. Completely not used. Increasing efficiencies, smart distribution grids – just to name a few ideas – can have very, very meaningful environmental and economic impacts.

The ability to change some of these industrial verticals is going to be significant.

And investors who are ahead of the curve can participate not just in a risk-reduction aspect but also a business-growth and capital appreciation.

Read more about the survey at IPE’s Summer Pensions Congress 2020.

About Carillon Tower Advisers

Carillon Tower Advisers is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates – ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments), and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. Carillon Tower believes providing a lineup of institutional-class portfolio managers, spanning a wide range of disciplines and investing vehicles, is the best way to help investors seek their long-term financial goals.

1MiFID II (Markets in Financial Instruments Directive) is a package of European Union legislative reforms to the financial industry introduced in January 2018.

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The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 75% of the investable U.S. equity market.