

A New Management Approach for a New Market Regime

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KEY TAKEAWAYS

- We believe investment professionals should consider modifying their management approach, one that is better suited for a new market regime.
- Why now? The structure of the market has changed, where correlation risks are now higher. Managers should adapt or potentially face suboptimal results.
- The keys are fresh portfolio construction and implementation techniques with an overriding goal of improved risk-adjusted returns.

Today's new interest rate and inflation regime deviates significantly from the past 40 years. As such we believe investment professionals should consider modifying their investment process with unique portfolio construction and implementation techniques discussed in this paper.

The downward interest rate cycle from 1981 – 2021 spurred a massive bull market in bonds. The bad news is that this has now come to a screeching halt and changes everything, as interest rates have risen well above their previous lows, making diversification between stocks and bonds problematic. The good news is that we offer what we believe is a viable solution.

Managing Client Money in a New Market Regime

When investment professionals manage their client's money, diversification of assets is often a primary goal, combined with some element of predictability. We find that high net worth investors in particular like a "smooth ride," with low volatility and the minimization of downside participation. In short, they don't want to lose money. We believe that in order to do this, a flexible weighting between fixed income and equities must be actively managed to deliver meaningful alpha, as opposed to passively generating market beta, with target returns, risk considerations and changes in market regime top of mind.

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One such change in market regime is that we expect is that the correlation between fixed income and equity returns will be much higher than they have been over the past few decades. *Display 1* illustrates the long-term correlation of returns between stocks and bonds, where correlations have risen sharply over the past several years—and where we think they are likely to stay. We expect this to be the case because one of the primary drivers of rising correlations is the interest rate and inflation cycle, and their combined effect on bond returns.

During periods like the late 1940s and into the 1950s, there were policies designed to suppress interest rates and increase nominal GDP in order to pay off the deficit the U.S. accumulated during World War II. As a result, correlations fell during this period. Then in the 1960s and 70s bond yields were allowed to rise and later accelerated when inflation took root. This had the effect of increasing stock and bond return correlations from lower to higher levels across both decades, where the interest rate and inflation cycles were key drivers of that rise.

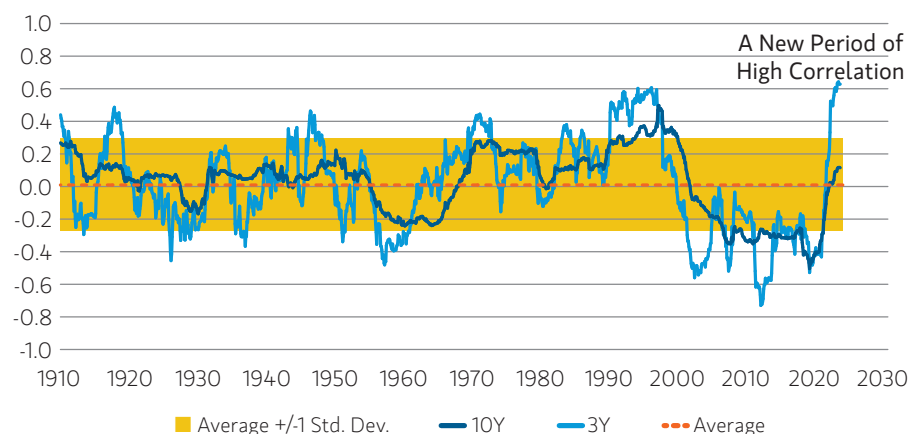
Similarly, correlations declined as interest rates and inflation fell due to globalization policies that began in the late 1990s. Correlations declined further with the introduction of the quantitative easing that greatly suppressed interest rates because of the global financial crisis of 2007-2009. Now that the policies designed to keep interest rates low have lapsed, combined with the fact that inflation has now become a tangible risk, we may likely see these return correlations rise and stay elevated for an extended period. This constitutes a regime change, namely a higher inflation regime alongside higher equity-bond return correlations (*Display 2*).

One of the most important observations from *Display 1* is that it is neither normal—nor common—

DISPLAY 1

Bonds Are Not a Natural Hedge to Equities

High Return Correlations Are Common

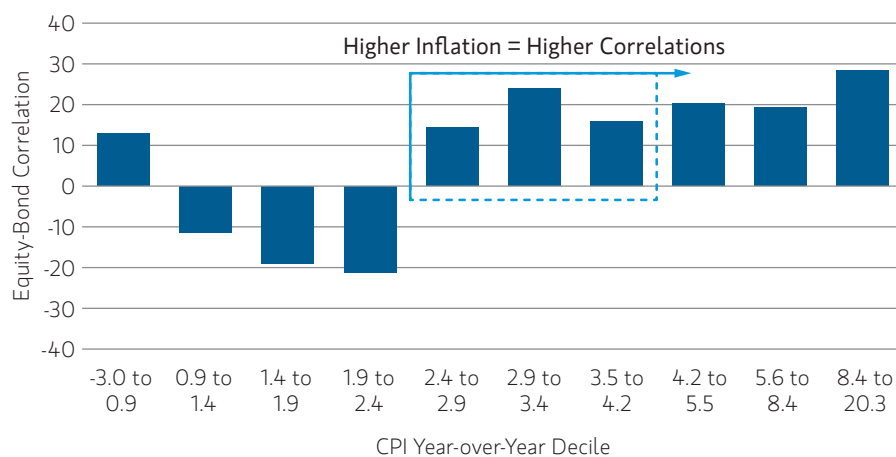


Source: 3-year and 10-year rolling correlations. Shiller, Bloomberg, Macrobond, MSIM. As of September 30, 2024. Bonds are represented by aggregate U.S. Treasury returns sourced from Robert Shiller, "A History of Interest Rates"; equities by the S&P 500. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. Indexes are shown for illustrative purposes only and do not include any expenses, fees or sales charges, which would lower performance. Indexes are unmanaged and should not be considered an investment. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

DISPLAY 2

Inflation Is the Key Driver of Equity-Bond Correlation

S&P 500 and U.S. 10-year Treasury Total Return Correlation by Inflation Decile



Source: MSIM analysis, Bloomberg, FactSet, Haver, GFD. As of March 31, 2024. Equities are represented by S&P 500 Index, bonds by the U.S. 10-Year Treasury. Index definitions can be found in the disclosure section. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

for bonds to be a natural hedge for equities. Instead, their relationship is highly regime-dependent and reliant on exogenous factors like policy and otherwise. Many may think the latest 40-year period is the "way things will continue to be" and that we may eventually revert to the norm of this most recent past.

However, we think differently about this scenario and are looking for innovative investment solutions outside of what may commonly be thought of as the norm. In other words, a greater allocation to bonds may not consistently mean less risk for returns. The balance of risks may likely vary more over time

because bond returns are less stable. This could emerge from a set of parameters in which we see stronger growth that benefits equities, but includes modestly rising inflation that ultimately detracts from bond returns, something which has already started (*Display 3*). Our view is that it requires a recognition of this regime change and the flexibility to make an adjustment to managing money. Why? Mainly because a static balance of equities and bond—e.g., the traditional 60/40 portfolio—may very well be suboptimal when interest rates no longer trend lower.

Now, being active and reducing risk may run counter to each other in the eyes of some investors. However, our analysis reveals that in an environment of changing interest rates, inflation and policy, active management, coupled with an eye toward reducing risk, need not conflict. In fact, we strongly believe they complement each other.

Being Active Also Means Identifying When To Switch Between Regimes

Active management is often thought of as being focused on changing allocations between bonds and equities to reflect a change, or anticipated change, in the markets. Today though, it is thought of differently. We believe being active now means that a manager should change their approach to reflect regime changes.

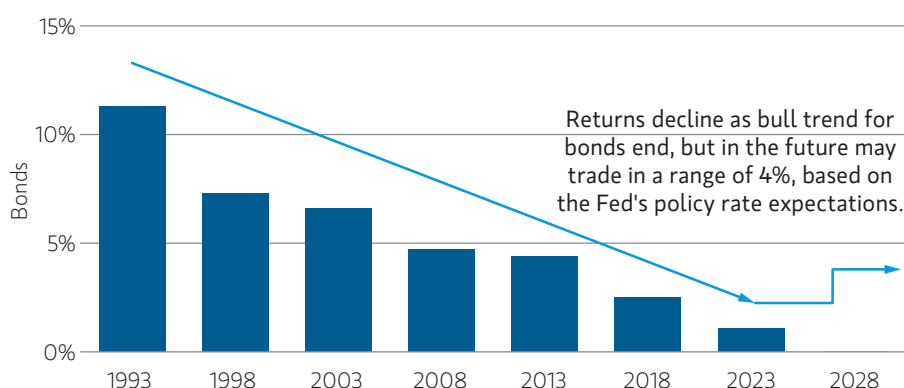
1. RISK CONTROL – VOLATILITY-MANAGED PORTFOLIOS TEND TO PERFORM WELL OVER TIME.

We believe forecasting volatility is an important component of an investment approach, namely understanding the underlying risk of each asset class, and as importantly, the risk relationship between them. Since market volatility is more predictable than directional market changes,

DISPLAY 3

Bond Returns Aren't What They Used To Be

Lower Expected Returns Offer Fewer Diversification Benefits



managing the volatility of returns can create value through increased exposure to compounding and the trending nature of markets.

But understanding the broader volatility characteristics of the total portfolio is an enhancement we employ to provide greater predictability in the potential for downside returns. Lowering this uncertainty is designed to allow for the benefit of compounding returns over time.

It should be noted that actively managing volatility is different from benchmark-driven portfolios. As we see it, actively managing volatility is preferable to benchmark-driven portfolios that rebalance passively based on returns driven by markets. As such, if higher volatility is associated with negative returns, then benchmark portfolios often instead unwittingly increase their allocation to assets with a higher risk profile.

2. REGIME DEPENDENCE – TACTICAL MANAGEMENT IS A REQUIREMENT IN THE CURRENT ENVIRONMENT OF HIGHER RATES, INFLATION AND UNCERTAINTY.

As mentioned, the ability to identify market regimes is critical when

determining whether a volatility or benchmark-based approach may provide better results. The foundation for these two distinct approaches differs based on whether the market is trending, or reverting to a norm.

For example, when rates were low, the market was in a sustained period of low volatility that was predictable and led to periods of trending. When central banks, like the Fed, started to increase rates, we observed movement back to a more uncertain market with a greater propensity for mean reversion.

The point to be made is that the ability to recognize the fluctuations between these two regimes is key to running a successful risk-balanced strategy. Yes, we want to be risk-balanced, but also aware of the importance of benchmarks in strongly reverting periods. Tactical management helps us to both take advantage of opportunities—and avoid risks.

3. IMPLEMENTATION – ACTIVE MANAGEMENT IS A MECHANISM DESIGNED TO DRIVE OUTPERFORMANCE, BUT SHOULD BE DONE IN A SELECTIVE AND INTEGRATED WAY.

Investors often rely on active management to derive alpha (as opposed to beta, which is merely derived from market exposure). In this respect, we have observed positive and persistent alpha in various markets, but it does come with a number of challenges. Specifically, the issue associated with alpha is that it is not made available equally, or efficiently, across all active strategies.

Alpha is commonly derived from pure security selection and market timing. Investors have differing abilities in identifying, and then relying, on these different sources of return. The consistent identification of alpha-based returns involves our use of sophisticated factor models and bottoms-up holdings analysis to assess performance.

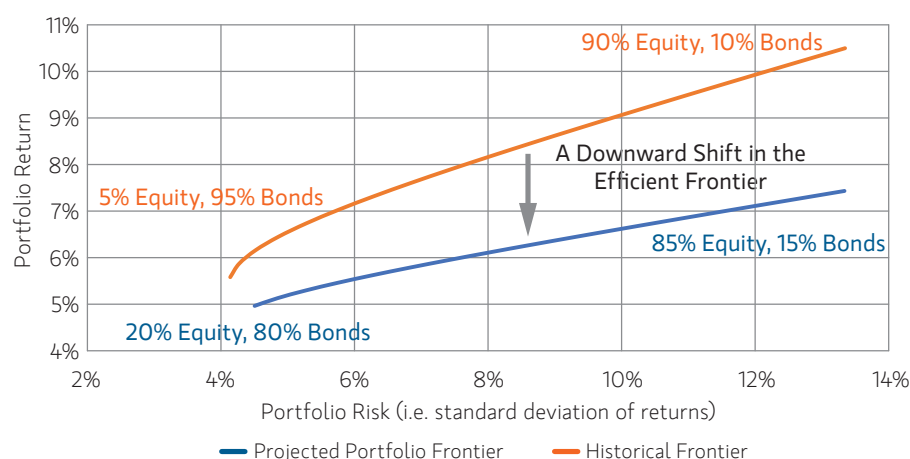
4. PORTFOLIO CONSTRUCTION – COMBINING THESE COMPLEXITIES INTO A PORTFOLIO REQUIRES AN INTEGRATED APPROACH.

The complexity of sources and variation of returns means that the process of building a portfolio must be integrated. The traditional approach to portfolio construction with active managers is to choose managers based on all their sources of return, such that beta is chosen first and alpha then sourced. The consequence here is that less-efficient alpha sources are chosen with little regard for their interaction with each other.

One can do things differently by starting with alpha and recognizing that alpha will bring with it both beta and factor biases. The most efficient alpha source is then constructed in a way designed to maximize areas where alpha can be sourced efficiently, but also leverage the potential benefit of their alpha diversification.

DISPLAY 4

The Downward Shift in the Efficient Frontier Requires a Change in Management Techniques To Achieve Target Returns



Source: Bloomberg, MSIM Capital Markets Group. As of March 31, 2024. Bonds are represented by the Bloomberg U.S. Aggregate Bond Index; equities are represented by the S&P 500 Index. Historical Frontier covers period from February 1988 – March 2024. Projected frontier is an illustration based on PSG's long term CMA assumptions. Index definitions can be found in the disclosure section. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

Markets have three degrees of freedom: they can trend higher, trend lower or move sideways. Said differently, either a market is trending or reverting to the mean. Many strategies are designed rigidly to perform better in one environment or the other. We feel it is best to have an approach designed to take advantage of the opportunities of both regimes. In the end, the choice is not either/or, but both.

Understand that one regime is not necessarily better than the other. Instead, the ability to be flexible and reposition between regimes may be optimal and produce better results over time. Skill is required to identify which regime the markets are in or, as importantly, heading into. For example one can amplify the momentum characteristics of a strategy when the market is trending, but then

can also adjust in a mean-reverting regime when markets are trendless.

Conclusion

As markets evolve, investment professionals must evolve with them and consider elements of a modified management approach better suited for a new market regime. We believe the efficient frontier, which illustrates the relationship between risk and return, has shifted down and toward the right, making it harder to achieve the same risk-adjusted returns experienced from 1988 – March 2024 (Display 4).

The structure of the market has changed, where correlation risks are now higher. Investment professionals should adapt or potentially face suboptimal results. In our mind, the keys are a fresh look at portfolio construction and implementation techniques with an overriding goal of improved risk-adjusted returns.

Risk Considerations

There is no assurance that the strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology** and assumptions regarding the underlying portfolios may be incorrect in light of actual market conditions and the portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in ETFs and other investment funds, the portfolio absorbs both its own expenses and those of the ETFs and investment funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of leverage may increase volatility in the Portfolio. **Diversification** does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

DEFINITIONS

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy.

The **Bloomberg U.S. Aggregate Bond Index** is an index comprised of approximately 6,000 publicly traded bonds including United States government, mortgage-backed, corporate and Yankee bonds with an average maturity of approximately 10 years.

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