MERCER

Rebalancing in troubled markets

Guidelines for investors

March 2020

Recent developments

Last week, the World Health Organization declared COVID-19 a global pandemic. As the number of cases continues to grow, governments and health services around the world are scrambling to contain the spread of the virus. Tragically, the death toll also is continuing to rise, and we express our greatest sympathies to everyone directly or indirectly affected by these events.

The economic damage resulting from business disruption has been severe and material uncertainty remains. A global recession now appears likely. The depth and shape of recovery depend on how quickly the outbreak can be brought under control. One of the most striking fallouts has been the combination of a supply-side shock and a demand-side shock leading to a collapse in oil prices. This resulted when Saudi Arabia increased production just as countries began to ground flights, and commuting as well as other forms of travel significantly declined.[1]

This has not escaped the markets. A downward trend that began around February 12, 2020, culminated in what has already been dubbed "Black Thursday" on March 12 — the worst one-day equity market crash since Black Monday in October of 1987. Following a recovery the following day, equity markets crashed by even more on March 16.

Portfolio implications and call for action

Since the end of 2019,[2] risk assets have taken a substantial hit, whereas safer assets have performed well, as expected in such an environment. Rising credit spreads, especially for lower-rated credit, more than offset the fall in global yields, leading to losses across the growth fixed income spectrum.

[1] On the one hand, low oil prices can act as a stimulus, as energy accounts for a large chunk of household expenses. On the other hand, high concentration of energy and equipment suppliers at lower-rated segments of the bond market (high yield) creates the vicious cycle of rising defaults resulting in significant market stress. This makes refinancing more difficult and leads to further defaults. As with the collapse in oil prices during 2015 and 2016, reductions in jobs and investments by energy companies could more than offset any stimulatory impact of low oil prices, given the economic clout of shale gas in the US.

[2] This paper was written in March 2020 during the COVID-19-related market selloff.

Asset class performance in the recent market can divided into four general categories:

1. Equity securities across all markets have declined dramatically in value, becoming a much smaller portion of investor portfolios.

2. Defensive fixed income securities such as US Treasury have increased in the low single digits amid falling yields, whereas investment-grade credit has been mostly flat to slightly down.

3. Riskier fixed income, such as high yield and emerging markets debt, has seen losses amid rising spreads, though not as much as equities. Most balanced fixed income portfolios have therefore become a greater proportion of total investment programs.

4. Alternative investments, such as real estate and private markets, which are not marked to market daily, may have changed very little in value and have probably grown to be a more significant portion of the investment program. Generalizations about diversified alternatives or other multi-asset strategies, whose performance in these markets has varied considerably, are more difficult.

Market movements alone would have altered a simple 60% global equity/40% government bond portfolio to about 52% equity/48% bonds over the first quarter of 2020.[3] This is a significant deviation from the target allocation in a very short time, skirting or breaching the asset allocation tolerance ranges in many investment policies.

Mercer recommends that clients consider rebalancing their exposure at least halfway back to their targets, to the extent possible.

Rebalancing can potentially enhance return, but most importantly, it is a risk-control measure. Markets will ultimately touch bottom and rebound, and in the absence of rebalancing, it would be difficult for the portfolio to keep up with a policy benchmark and recover lost value.

Below, we discuss issues that might arise in the process of executing this important investment risk-control activity.

[3] Quarter to date as the paper was published on March 17, 2020

Investment policy considerations

An investment policy statement (IPS) generally provides an asset allocation range for each asset class around a target determined during the strategic asset allocation process. These ranges ensure that the actual asset allocation does not significantly drift such that the targeted return and risk profile differs from the long-term profile. When an asset class moves outside the specified range, it causes the expected return and/or risk of the portfolio to differ meaningfully from the strategic intentions of the portfolio.

The adoption of an IPS imposes a fiduciary obligation to maintain the investment structure in a manner consistent with the terms of the IPS. Best practice requires periodic rebalancing toward asset allocation targets. Actual allocations moving outside the maximum and minimum ranges should be addressed promptly unless otherwise provided for in the IPS.

Mercer believes adhering to established asset allocation targets and ranges is good governance, benefiting the portfolio's long-term return and risk profile. However, it is essential to measure the desire to rebalance the portfolio against the cost and risk involved.

Situation-specific considerations (COVID-19 market sell-off)

Generally, rebalancing involves moving money from overweighted to underweighted asset classes or channeling cash flows such as contributions and disinvestments accordingly. The current market environment introduces several additional considerations to this normally routine process, which requires more portfolio-specific analysis than usual. Thus, we recommend considering only rebalancing halfway to target for now.

Unlike in 2008, the structure of the financial system has held up reasonably well so far. There are no widespread doubts about the stability of banks, and central banks have acted quickly to provide liquidity, even if it is not yet clear how effective this may be. Central banks and policymakers today are in greater alignment and have committed to stand by with monetary and fiscal stimulus actions. However, even amid all those efforts, considerable liquidity swings have occurred between different instruments (cash versus synthetic; index versus single name) as investors have been crowding into the most liquid instruments. Markets have gone through fundamental changes since 2008 (such as banks no longer being the primary liquidity provider) that are only now being tested under severe market stress. While some crisis indicators have not moved nearly as much as in 2008 (such as spreads in foreign exchange swaps), other indicators are notably worse than in 2008 (such as liquidity in Treasury markets).

We have observed trading challenges in fixed income markets, with significant expansions in bid ask spreads and difficulty in trading both Treasury and corporate securities.

Lower liquidity leads to higher trading costs (due to higher spread), which can make transactions prohibitive. Patience is required to manage through this risk, as liquidity fluctuates continually. Investors should monitor **market liquidity conditions daily especially in bond markets – as well as in the particular instruments they may want to trade.**

There are no obvious signs of a fundamental credit crunch yet. However, there is mounting evidence of companies in severely affected sectors, such as energy, scrambling to extend short-term credit lines. Although an over-leveraged financial system does not seem to be the problem this time, certain sectors or companies are highly leveraged.

Unlike in 2008, a significant portion (though not all) of the market decline is driven by uncertainty, not fundamentals. We do not yet know what the full extent of the pandemic will be or which companies it will affect over the long term. The main concern is an escalation in the US and the impact of enforced lockdown measures like those seen in Italy and China. This would likely inflict a deep wound on global markets given the sheer market capitalization of the US.

Rebalancing is not about market timing.[4] Markets may continue to fall, and rebalancing could result in buying into falling markets before they recover. This would hurt portfolio performance over the short term, and potentially even the long term, depending on how long it takes markets to recover. This is the main reason we deem rebalancing halfway to target to be most prudent for now. Consider another rebalancing exercise when there is more clarity.

To demonstrate the impact of partial rebalancing in a bear market, we analyzed the performance of a simple 60% equity/40% bonds portfolio during the global financial crisis from the outset of the crisis in September 2008 to five years later. We considered three approaches:

1) Buy-and-hold; that is, no rebalancing
2) Rebalance to target if allocations breached a +/-5% range limit
3) Rebalance halfway to target if allocations breached a +/-5% range limit

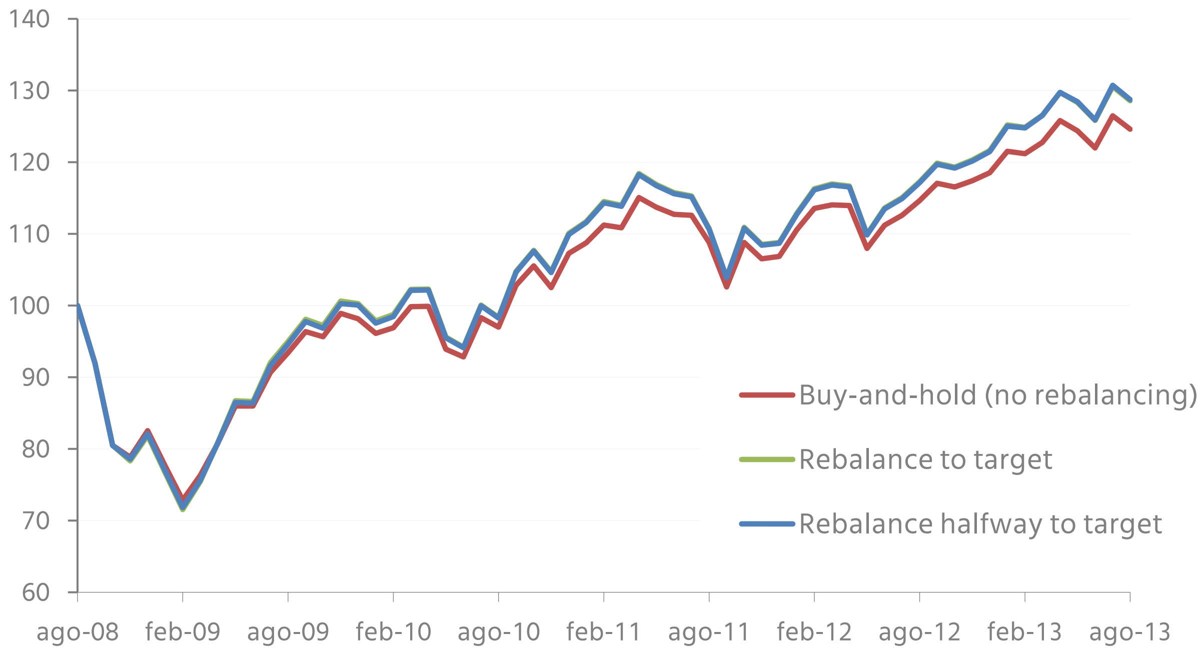
Transaction costs of 10 bps were assumed in rebalancing.

---

[4] For actively managed funds, it may be possible to time the market, such as buying sectors or companies deemed oversold and thus particularly well-positioned for the eventual rebound. Rebalancing portfolios that have exposure to actively managed funds will ensure that the portfolio will fully benefit.

Figure 1 shows the resulting performance. The rebalanced portfolios would have underperformed the buy-and-hold portfolio to the bottom of the market in March 2009 as a result of "catching falling knives." However, they would then have outperformed in the subsequent recovery. The fully rebalanced and halfway-rebalanced portfolios outperform the buy-and-hold portfolio by a cumulative 3% over this period, since they are better positioned for the rebound in equities.

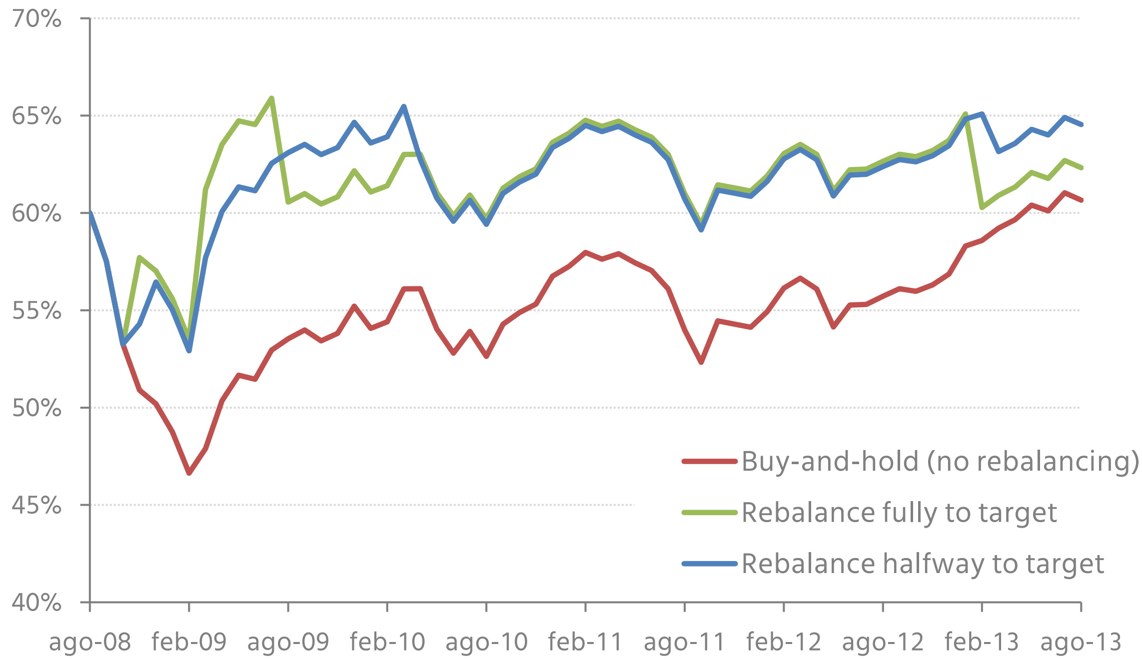
Figure 1. Cumulative performance commencing at 100 at August 31, 2008



Source: Thomson Reuters Datastream, Mercer analysis. MSCI World and Bloomberg Barclays Global Aggregate used as proxies for equities and bonds. Dates shown are end of months. Rebalancing to target and rebalancing halfway have been moving very closely relative to each other and are therefore undistinguishable in the chart.
For illustrative purposes only. Past performance is no guarantee of future results.

Figure 2 shows the allocations over time. In March 2009, when stock markets touched bottom, the buy-and-hold portfolio would have held 47% equities and 53% bonds, compared to the fully and halfway rebalanced portfolios, with 57% equities and 43% bonds at the same time.

Figure 2. Allocation to equities commencing at 60% at August 31, 2008



Source: Thomson Reuters Datastream, Mercer analysis. MSCI World and Bloomberg Barclays Global Aggregate used as proxies for equities and bonds. Dates shown are end of months.
For illustrative purposes only. Past performance is no guarantee of future results.

Fully and halfway rebalanced portfolios outperformed the buy-and-hold portfolio equally over the period. This means that either would have worked equally well with the benefit of hindsight. However, as the period ahead may differ from 2008, we suggest rebalancing halfway, as we cannot rule out a prolonged "falling-knife" period, whereas there seem to be no greater long-term rewards in rebalancing fully (relative to rebalancing halfway).

For portfolios with a private markets or real estate allocation, the lack of market pricing on these investments means that the carrying value of the investment is likely to be high relative to publicly traded securities (equities, bonds and REITs). For this reason, these investments will appear overweight relative to other asset classes. However, they are not liquid investments and likely cannot be easily sold for rebalancing. Furthermore, their valuations could fall upon appraisal. For rebalancing, such allocations should be considered fixed, with only the prorated liquid part of the portfolio being rebalanced toward the strategic benchmark.

We recommend factoring any plans to develop strategic positioning over time into the rebalancing process. For instance, for investors who wish to reduce equity exposure over time, either for de-risking reasons or to improve diversification from equity risk, market movements may allow them to make that strategic move more quickly. Rather than rebalancing the equity position, it may be an opportunity to increase the allocation to other liquid parts of the growth portfolio that have also fallen recently. For instance, credit spreads have recently widened significantly; investors looking to increase credit exposure could use this as an opportunity to invest at what appear to be reasonable prices.

A single solution will not be suitable in all situations. Each organization's return goals and risk tolerance must be taken into account. Rebalancing is intended to moderate risk and maintain the expected return profile. In this environment, however, it is critical to weigh the costs of rebalancing with the potential impact on the long-term structure. For example, if the only overweight asset class is real estate or private markets, which are expensive to sell and potentially difficult to replace, the benefit of rebalancing may be limited.

What process should investors follow?

1. Investors should assess whether the current environment has altered their organization's risk profile in a way that warrants revising the current asset allocation targets.

2. Review the actual allocation of the portfolio against targets, identifying any asset classes that are currently outside their target range.

3. Determine the target for rebalancing, including whether the objective is to rebalance to target or to take a position within the target range.

4. Review future cash flow projections and ensure that cash for three to six months is available in a liquid form. Relative to asset allocation targets, any cash that needs to be set aside should be considered part of the defensive fixed income allocation.

5. Those who invest in private markets should allow for sufficient cover for drawdowns (cash calls). Private market programs often use realizations (cash distributions) from mature funds to fund drawdowns on newer funds. Distributions may come in lower than expected in these market conditions, although cash calls tend to decrease in times of crisis as well.

6. If policy permits, deploy or source cash flows to or from the portfolio in a manner that moves the fund toward its target allocation.

7. Monitor the liquidity of each asset class that is outside its target range, determining whether it is sufficient to rebalance that asset class for a reasonable cost just before the transaction. Investors must evaluate the relationship between the benefit of a rebalancing action and the cost.

8. If liquidity is low and trading costs high, look for the most cost-effective means of achieving the rebalancing. Derivatives are a viable approach to rebalance exposures for some investors. For many investors, patience will be the most effective approach, coordinating with fund managers to sell and buy as opportunities permit.

9. Where rebalancing is impractical, investors should document the reasons for delay and plan to revisit the topic. Review the IPS to be sure it includes language permitting such a delay or action.

Investors should work with their consultants on this process, both to ensure compliance with any applicable fiduciary guidelines and to take advantage of market opportunities.

For further information, please visit
www.mercer.ca

Join the conversation
@MercerCanada   Mercer Canada

MERCER

Important notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications. This does not constitute an offer to purchase or sell any securities. The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

Information contained herein may have been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential, or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Pension & Investments rankings are based on survey responses from responding firms. Mercer may calculate worldwide assets under advisement and worldwide assets under management differently than other responding firms. The assets under advisement data (AUA Data) reported here include aggregated assets under advisement for Mercer (Canada) Limited, Mercer Global Investments Canada Limited, and their affiliated companies globally (Mercer). The AUA Data have been derived from a variety of sources, including, but not limited to, third-party custodians or investment managers, regulatory filings, and client self-reported data. Mercer has not independently verified the AUA Data. Where available, the AUA Data are provided as the date indicated (the Reporting Date). To the extent information was not available as of the Reporting Date; information from a date closest in time to the Reporting Date, which may be of a date more recent in time than the Reporting Date, was included in the AUA Data. The AUA Data include assets of clients that have engaged Mercer to provide project-based services within the 12-month period ending on the Reporting Date. The assets under management data (the AUM Data) reported here include aggregated assets for which Mercer Global Investments Canada Limited and their global affiliates provide discretionary investment management services as of the dates indicated.

Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited. Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.