NATIXIS
GLOBAL ASSET MANAGEMENT

Riding the aftershock

Wholesale portfolio managers anticipate volatility and opportunity

Wholesale portfolio managers anticipate geopolitics, market volatility and interest rates will pose the greatest challenges to meeting their top investment objective in 2017: delivering higher risk-adjusted returns.

After a year of political volatility that brought Brexit, a Trump presidency, the resignation of Italian Prime Minister Renzi and the impeachment of both Dilma Rousseff in Brazil and Park Geun-hye in Korea, the 200 professionals responsible for investment strategy and construction of model portfolios at private banks, wealth managers and insurance platforms, are anticipating significant aftershocks as populist platforms gain momentum in anticipation of national elections in France and Germany.

While geopolitical instability fuels speculation on market volatility, the risks are compounded by the persistence of low interest rates globally. For the better part of a decade, low rates have frustrated professionals in their search for yield. For some, the problem is likely to continue unabated as central banks in Europe and Asia struggle to scale their asset purchase programs. For others, interest rate risk is a likely concern as the Fed gradually increases rates in the U.S., which could potentially put downward pressure on bond values.

A time for active management and alternative investments

If wholesale portfolio managers see the potential for increased market volatility, their views on active management provide a strong indication of how they may seek to capitalize on the opportunities volatile times offer. To navigate a riskier market, they say they will look to apply a one-two punch of active management and alternative investments.

- Eight in ten (79%) wholesale portfolio managers say the current investment environment favors active managers.
- Three-quarters (74%) say it's essential to invest in alternatives to diversify portfolio risk.

Delving into their specific views on risk, asset allocation, and market performance, survey results show that wholesale portfolio managers are resetting strategy to ensure they are positioned for volatile and uncertain markets.

Political volatility raises the specter of market volatility

Much like the market panic after the U.K.'s Brexit vote, markets have presented brief and infrequent periods of volatility over the past seven years. But now geopolitics and economics are converging to make volatility a top risk concern for the next 12 months.

In the political realm, 2016's Brexit vote and a Trump election represent the forces of change that contribute to speculation for greater market volatility. Both events are converging as immigration and jobs fuel the populist candidacies of Marine Le Pen in France and Frauke Petry in Germany, leading to speculation of increased market volatility.

Prospects of populist tremors in elections across Europe, coupled with Britain's plan for invoking Article 50 and early missteps by the Trump administration, do little to quell volatility concerns. But where the impact of results of the U.S. election weighed on the minds of institutional decision makers in a separate survey, wholesale portfolio managers may be more market-focused, citing a slowdown in China as another source of volatility.

Monetary policy continues to dominate economic concerns. While central banks have kept interest rates artificially low for the better part of a decade, change is in the wind, at least in the U.S., as the Fed raises interest rates.

Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research in October and November of 2016. Survey included 500 institutional decision makers and 200 wholesale portfolio managers in 31 countries.

All investing, including Active Management, involves risk including risk of loss. Alternative investments involve unique risks that may be different than those associated with traditional investments, including illiquidity and the potential for amplified losses or gains. Investors should fully understand the risks associated with any investment prior to investing.

From this perspective, volatility may be the byproduct of markets perceiving that central banks are no longer delivering the Yellen/Bernanke "put option" on assets, which has given the impression that ultra-accommodative policy provides downside protection.

Institutional investor view[1]:

Top sources of volatility for 2017	
Geopolitical Risk	65%
U.S. Election	38%
Interest Rates	37%

Wholesale portfolio manager view:

Top sources of volatility for 2017	
Geopolitical Events	63%
Interest Rates	49%
China Market Woes	36%

A shift from a policy-driven market to one driven by earnings may present prospects for asset growth, but wholesale portfolio managers are likely to pursue the opportunity with informed caution. They cite delivering high risk-adjusted returns (36%) and managing volatility (18%) as more important priorities than growing capital (16%).

Where the risks lie

Among the key risks facing professional buyers, the low yield environment ranks highest with 77% of respondents citing it as a key risk management concern. Low interest rates have left many to pursue much-needed yield with investments in riskier assets, turning to high-yield sectors to boost performance. While this may help address immediate needs for income, eight in ten respondents worry investors may be taking on too much risk in pursuit of yield.

Divergent monetary policy may also factor into risk management concerns, with 61% of respondents saying interest rates pose a risk in 2017. With the potential for rate increases, at least in the U.S., the potential for decreasing bond values will be a critical consideration in portfolio plans.

Top risk management concerns	
Low yield environment	77%
Interest rates	61%
Inflation	39%

The regulatory environment presents another set of problems to be managed by wholesale portfolio managers. Three-quarters of those surveyed believe that solvency and liquidity requirements may create too much of a bias for short-term horizons and highly liquid investments.

All of these factors will come into play for wholesale portfolio managers in 2017 as they look to address their biggest challenges. Two-thirds say they are challenged to effectively balance growth objectives with short-term liquidity needs – a problem that can limit their options in portfolio construction. For 59%, the problem is further compounded by the difficulties of getting a consolidated view of portfolio risks.

Risk, returns and resetting expectations

Under the specter of increased volatility, it appears that many wholesale portfolio managers may be ready to hit the reset button on investment strategy. When asked about their ability to address market risks, only 49% said they believe their peers are prepared to meet the challenge. Where they may have once relied heavily on diversification to manage risk, 49% believe that it alone cannot provide adequate downside protection.

Concerns about market performance are leading many to revisit return expectations, even though 78% of wholesale portfolio managers believe their firm's return assumptions are realistically achievable. But confidence may not be as strong as it seems on the surface. Seven in ten (68%) also say their firms will reduce return expectations in the next 12 months. Managing expectations will be critical in what appears to be a high risk market as six in ten say they are willing to underperform their peers in order to ensure downside protection for their portfolios.

Strategies for the next wave

From generating returns, to managing volatility, to addressing low yields, wholesale portfolio managers are presented with a wide range of investment challenges. We see that they will respond with a renewed emphasis on active management, increased use of alternative investments and more intensive efforts to diversify fixed-income holdings.

A market for active managers

Higher levels of market volatility are likely to result in greater dispersion[2] in equity returns, an environment in which wholesale portfolio managers believe active management will stand out. More than nine out of ten (95%) of those surveyed choose active management over passive investments for generating alpha.[3] They also believe active management is better suited to a wide range of critical portfolio functions than passive strategies.

1 Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research in October and November 2016. Survey included 500 institutional investors in 31 countries.

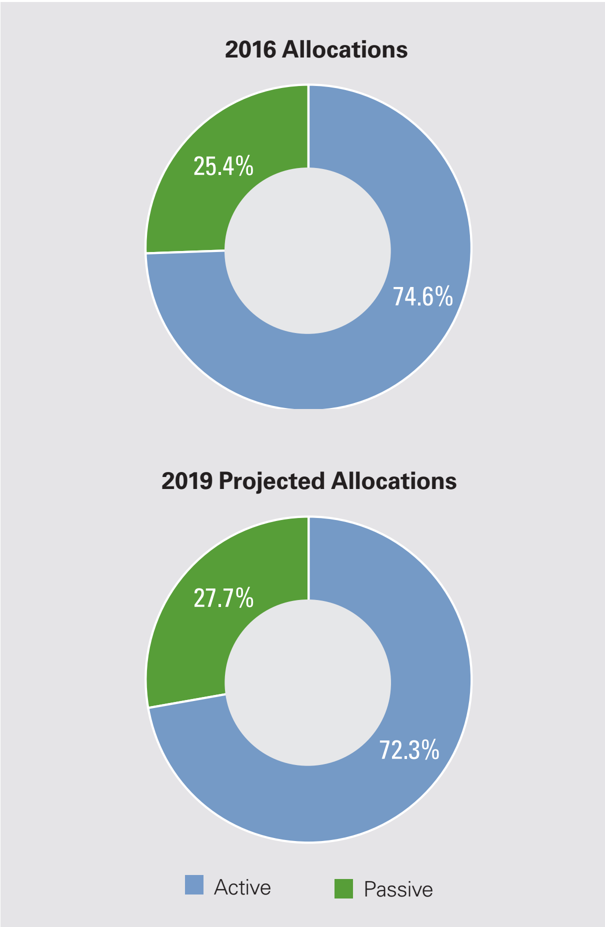
2 Dispersion refers to the variability of returns among individual indexes and stocks within each index.

3 Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of systematic market risk. There is no guarantee that any investment will generate alpha.

Diversification does not guarantee a profit or protect against a loss.

When it comes to meeting their number one investment goal of delivering higher risk-adjusted returns, nearly three-quarters (73%) of wholesale portfolio managers say actively managed strategies can give them a much-needed edge. Given the potential for greater volatility, active management will also factor into investment plans as 63% say it is better suited to taking advantage of short-term market movements.

Active management is also the preferred route to gaining exposure to non-correlated asset classes (74%), accessing emerging markets (77%), generating stable income (66%), and implementing environmental, social and governance strategies within portfolios (79%). Wholesale portfolio managers give an advantage to passive investments in only one area – minimizing fees. Given the outlook for increased volatility and potentially greater dispersion, wholesale portfolio managers plan to add less than 2% to their passive allocations over the next three years.



A word of caution on passive investments

Over the past decade accommodative monetary policy had an equalizing effect on equity markets, keeping dispersion low and equally rewarding the companies with middling results alongside companies that could demonstrate meaningful earnings growth. In the midst of this environment, individual investors have increasingly turned to index-based strategies for market returns, but wholesale portfolio managers believe investors may be turning a blind eye to risks presented by index strategies.

Eight in ten of those in our survey say investors have a false sense of security about passive investments. The same number also believe individuals are unaware of the risks associated with passive investing. Their suspicions are confirmed in results from our 2016 Global Survey of Individual Investors[4] in which 60% of investors say index investments are less risky and 60% believe passive will protect them on the downside. In essence the professionals offer these investors a reminder on the physics of indexing: you may get positive returns when markets are up, but you will also get losses when markets are down.

One explanation for these misperceptions: 91% of wholesale portfolio managers say investors are too focused on short-term results.

A twofold role for alternatives: seeking diversification and performance

Given the prospects for increased volatility, diversification will become a critical, yet difficult, objective for wholesale portfolio managers. But where traditional strategy might normally call for increased bond allocations to provide ballast in portfolios, low yields and prospects for rate increases in the U.S. may prevent this conventional approach from delivering the desired results.

Eight in ten (82%) wholesale portfolio managers say they need to replace traditional diversification and portfolio construction techniques to achieve results. As a result, alternative investments have become a more critical part of the equation for wholesale portfolio managers. In looking at the choices they have for portfolio construction, seven in ten (69%) say traditional asset classes are too highly correlated to provide distinct sources of return, while three-quarters say it is essential to invest in alternatives to diversify portfolio risks.

While diversification and risk management weigh heavily in the decision to up allocations to alternative investments, wholesale portfolio managers see the potential for additional benefits. More than half (54%) also say it is essential to invest in alternatives in order to outperform the broad market. Even though 64% believe a lack of liquidity can limit their allocations to alternatives, more than half say their firm is embracing illiquid assets more now than three years ago. In accepting the liquidity trade-off, six in ten (63%) say the potential returns of these assets make them worth the risk.

Managing portfolio risk

Beyond diversification, asset allocation and manager selection, wholesale portfolio managers have a range of techniques and tools at their disposal for managing risk.

4 Natixis Global Asset Management, Global Survey of Individual Investors conducted by CoreData Research, February-March 2016. Survey included 7,100 investors from 22 countries.

Most frequently, survey respondents say they will look at diversifying across sectors (87%), risk budgeting (82%) and currency hedging (72%) to better manage portfolio risks. They also cite increased use of alternative investments (66%), smart beta[5] strategies (63%) and deploying ESG[6] strategies (43%) as effective solutions for managing risk. As expected in the current environment, only 28% believe increasing the use of fixed-income is effective at this time.

One particular area where respondents show they must be resourceful in managing risk is in how they address the challenges presented by today's low yield environment. Wholesale portfolio managers are deploying a range of strategies to better position portfolios for this reality.

Managing fixed-income risks

While four in ten are diversifying holdings by region, we see that 36% are also reducing their fixed-income exposures. In keeping with the move to non-correlated assets, 34% also say they are increasing their use of alternative investments. Some (31%) say they will take on more risk to pursue yield by increasing exposure to credit within their portfolio, while others (30%) may be taking a more defensive posture by holding on to large cash positions.

Market outlook for 2017

Overall, we find that while wholesale portfolio managers anticipate greater volatility in the year ahead, they are not shying away from risk, which is reflected in their market outlook and asset allocation calls.

Equities

The consensus view among wholesale portfolio managers is that emerging market stocks will shine in 2017, with 47% projecting this as the bright spot among equity sectors. In pursuing emerging market opportunities, wholesale portfolio managers look to Asia ex-Japan to provide the best performance in 2017. But investing in this sector is not without its challenges, as 44% say political and social risks present the biggest obstacles they have encountered within emerging markets.

On the downside, 40% predict that U.S. stocks will be a disappointment, but this sentiment could change in the wake of the so-called "Trump Bump," which has driven the Dow Jones Industrial Average to a record 20,000 after the election and after our polling was completed.

Fixed-income

Concerns over low rates dominate wholesale portfolio managers' expectations for fixed-income performance in 2017, with the largest number of respondents (47%) calling for a credit play with high-yield bonds to pay off. This is a clear example of how the pursuit of yield is likely to impact risk budgets as wholesale portfolio managers go further out on the risk spectrum to generate performance from their fixed-income allocations.

It is also clear that central bank policies hold particular sway in the allocation process as 57% of wholesale portfolio managers call for government bonds to be a disappointment in the fixed-income universe.

Alternative investments

The challenge to deliver returns from traditional assets is not limited to bonds, a trend that is clearly represented in wholesale portfolio managers' views on alternative investments. Overall they favor private equity (25%) as the bright spot within the alternatives realm, showing they are willing to go to private markets for what public securities fail to deliver. Coming in a close second are commodities (23%), a call in line with expectations for growth to come in emerging markets. Wholesale portfolio managers share a clear consensus view on the assets they think will disappoint: real estate (32%) and hedge funds (27%).

Allocation calls

Although they anticipate volatile markets ahead, wholesale portfolio managers do not anticipate commensurate swings in portfolio allocations. Instead they are more likely to trim positions where they see performance lacking and reallocate to assets that can provide a counterweight. A projected -3% cut in fixed-income allocations demonstrates the widest movement in allocation calls and is a clear reflection of the challenges presented by the low-yield environment. These assets will be reallocated equally to equities (+1.6) and alternatives (+1.5). These small moves suggest much of the risk management regimes have been worked out over the course of the past decade and moves planned in 2017 are more likely fine-tuning investment strategy.

Riding the aftershock

After a year of surprises in 2016, it seems as though wholesale portfolio managers across the globe are waiting for the other shoe to drop in 2017. But their anticipation is not filled with anxiety. Instead, they have embraced the uncertainty and come to terms with the risks. Their response will be measured and focus on risk-managed solutions for generating long-term growth.

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5 Smart beta refers to an investment style where the manager passively follows an index designed to take advantage of perceived systematic biases or inefficiencies in the market.

6 ESG investing focuses on investments in companies that relate to certain sustainable development themes and demonstrate adherence to environmental, social and governance (ESG) practices, therefore the universe of investments may be reduced. A security may be sold when it could be disadvantageous to do so or forgo opportunities in certain companies, industries, sectors or countries. This could have a negative impact on performance depending on whether such investments are in or out of favor.

Smart beta and ESG strategies involve risk, including risk of loss.

PROGRAM OVERVIEW

About the Durable Portfolio Construction® Research Center

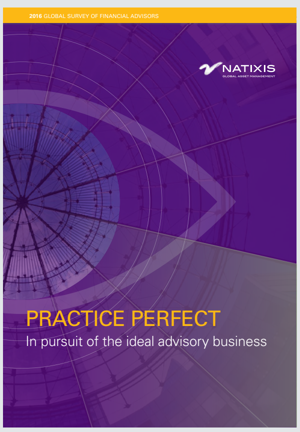
Investing can be complicated: Event risk is greater and more frequent. Volatility is persistent despite market gains. And investment products are more complex. These factors and others weigh on the psyche of investors and shape their attitudes and perceptions, which ultimately influence their investment decisions. Through the Durable Portfolio Construction Research Center, Natixis Global Asset Management conducts research with investors around the globe to gain an understanding of their feelings about risk, their attitudes toward the markets and their perceptions of investing.

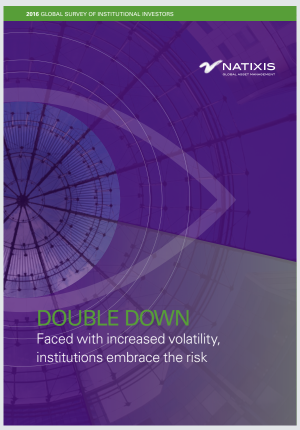
Research agenda

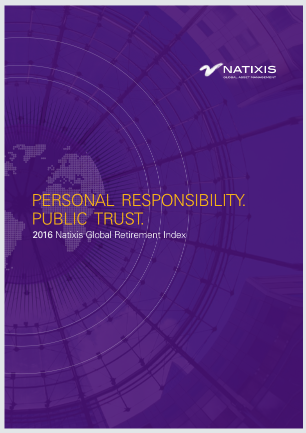
Our annual research program offers insights into the perceptions and motivations of individuals, institutions and financial advisors around the globe and looks at financial, economic and public policy factors that shape retirement globally with:

- **Global Survey of Individual Investors** – reaches out to 7,100 investors in 22 countries.
- **Global Survey of Financial Advisors** – reaches out to 2,550 advisors in 15 countries.
- **Global Survey of Institutional Investors** – reaches out to 500 institutional investors in 31 countries.
- **Natixis Global Retirement Index** – provides insight into the environment for retirees globally based on 18 economic, regulatory and health factors.

The end result is a comprehensive look into the minds of investors – and the challenges they face as they pursue long-term investment goals.







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