Private Bank

Market Perspectives

September 2020

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Foreword

Fresh highs for US equity indices and gold price in August reflect the mood of financial markets, which frequently remain more beholden to COVID-19 related news than to company fundamentals or geopolitical tensions.

The gold price breached $2,000 an ounce for the first time in August and may have higher to climb. Fears of a second wave of the coronavirus, skyrocketing debt levels and November's US presidential election are among the reasons why demand for the precious metal seems assured. The metal's appeal as a diversifier looks solid. An appropriate weighting in gold allows investors to maintain higher exposure to equities, an asset class that is likely to outperform in the medium term, while hedging downside risk.

The S&P 500 recouped its pandemic-related losses in only five months. While a repeat of March's selloff seems unlikely this year, valuations look elevated. Furthermore, the surge in market valuations has largely been driven by a few growth stocks. More volatility between sector and stock performance seems likely, even if masked somewhat at the index level. Rather than focusing on "growth" or "value" stocks, selecting quality companies, irrespective of industry, remains appealing.

With US equity markets at an all-time high, diversification remains more important than ever. This goes beyond a simple mix of equities and bonds. Indeed, correlations have surged this year as an elevated period of uncertainty took hold. Tighter asset correlations increasingly question the attractions of bonds in multi-asset portfolios, especially with little sign of a sustained upward move in treasury yields. However, bonds remain a key part of a well-diversified portfolio. The addition of corporate bonds and of alternative assets, like gold or hedge funds, can provide additional diversification effects, especially in periods of excessive inflation.

Sustainable investing seems to be coming of age. As geopolitical uncertainty is likely to increase from already high levels in the next few months, a post-pandemic world which strives to be more sustainable seems to be a reasonable conviction to have. More investors are investing in sustainable funds this year. Encouragingly, the funds have outperformed their traditional peers too, reinforcing that trying to make the world a better place can go hand in hand with superior performance.

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Golden opportunity

As the gold price tops $2,000 an ounce for the first time, surging government debt levels, COVID-19 infection risks and November's US presidential election mean that the rally may have more to run.

The gold price has shot up in recent months, gaining an impressive 30% this year in the process. The precious metal hit a record high in August and has traded above the $2,000 an ounce mark for the first time.

Gold, often cited as the ultimate safe-haven asset, seems to be increasingly popular in a progressively uncertain world. Fears of a second wave of the coronavirus, skyrocketing debt levels, November's US presidential election and desire to hedge risk-asset exposure have encouraged investors to boost holdings in the precious metal.

Risk hedge

With the COVID-19 quarantining throwing the global economy into recession, its little surprise that there was an aggressive sell off in risk assets. However, investors have quickly regained their composure on hopes that the most chronic phase of the virus has passed, the easing of containment restrictions will allow economies to recover, supported by overwhelming fiscal and monetary firepower.

The improving sentiment sent stock markets soaring; the S&P 500 is up more than 50% from its March low, in the quickest recorded return to a bull market. Nevertheless, there are still plenty of reasons to remain cautious about the ability of equity markets to maintain the recent momentum. This caution has encouraged investors to hedge their equity positions using Exchange Traded Funds (ETFs).

Gold's reputation as a store of value has also attracted investors who have concerns around currency debasement and future inflation risks. Total gold held by ETFs has risen by 31% this year to 108m ounces.

Low bond yields a boon for gold

While there are many factors that have made gold attractive to investors, its traditional disadvantage is that it's a zero interest-bearing asset. As such, it is often considered a less attractive option compared with sovereign debt that pays a coupon.

> "Total gold held by ETFs has risen by 31% this year"

Nonetheless, the pandemic has encouraged policymakers to adopt an aggressive response. Central banks have cut interest rates and ramped up quantitative easing programmes. These measures have resulted in historically low, and in some cases negative, interest rates.

Some market participants suggest that improving risk sentiment or rising issuance could push bond yields much higher and provide greater competition for gold. We expect risk sentiment to remain brittle and that central banks will continue to accommodate government debt purchases to allow additional borrowing. As a result of the above, yields are likely to stay lower for longer and unlikely to tarnish gold's position as the insurance of choice for many investors.

Weaker US dollar drives international demand

Fluctuations in foreign exchange markets can influence the price of gold. Several US-centric risks, such as its lingering social protests and nearing elections and strategic rivalry with China, helped to push the greenback to a two-year low. A weaker dollar makes gold less expensive for non-dollar dominated buyers and so can boost international demand.

Central bank demand supports prices

Attracted by the desire to diversify away from the US dollar and its liquidity, and lack of default risk, central banks have been one of the most significant buyers of gold over the past decade. The increased demand saw the banks add 650 tonnes of the precious metal in 2019, the second highest level of annual purchases in 50 years and just behind the 2018 level. This has been very supportive of the price.

Emerging markets have led the way, with large purchases made by Turkey, Poland and Russia. Kazakhstan, India and the United Arab Emirates are among other nations to substantially increase their exposure to gold in the past two years.

The economic pressures of dealing with the economic fallout from the pandemic encouraged central banks to ease the pace of their purchases (39% lower year-on-year) in the first half of this year. However, they still accounted for net purchases of 233 tonnes and look set to be net purchasers for the eleventh consecutive year in 2020.

Physical demand down, but not out

While the investment demand for gold has provided a fillip for the price, physical demand was dented by the COVID-19 interruption. Jewellery still accounts for much of the annual demand for gold, with India and China the world's largest markets. Jewellery purchases slumped by 46% in the first six months of the year as quarantined economies, elevated prices and labour market disruption discouraged consumers from buying the precious metal.

Gold's conductive, corrosion resistant and catalytic properties make it a useful component in technological, engineering and environmental applications. That said, the reduction in demand for expensive consumer electronics led to 13% fall in gold used in technology in the first half of the year.

As economic conditions normalise, jewellery and technology demand is expected to recover through the year, albeit at lower levels than before the pandemic. However, more reimposed containment measures or a second wave of infections may slow the recovery period.

Supply growth to eventually catch up

As a commodity, investors need to place close attention to the supply-side of the gold equation. The two major elements responsible for the supply of gold are mine production (75%) and recycling.

Mine production levels have surged over the past ten years, but virus-related disruption reduced supply by 5% in the first half of the year. Elevated prices will encourage capital investment, but the long lead time required to exploit new projects means production levels are usually slow to react to market movements.

Recycling tends to be far more responsive to geopolitical tensions and price changes. However, recycling was also subdued in the six months to June as consumers stayed at home and key recycling centres in the US and Middle East were closed.

Expectations of stabilising economic activity should encourage extraction investment and allow recycling levels to resume a steady long-term upward trend and support future supply growth.

Gold's prospects keep shining

Robust investment demand and recovering physical demand suggests the outlook for gold continues to be positive. The commodity has generated an average return of 11.2% per annum in the ten years to 17 August 2020.

> "The commodity [gold] has generated an average return of 11.2% per annum in the ten years to 17 August 2020"

Gold continues to appeal as a diversification tool within a broader portfolio. An appropriate weighting in gold allows investors to maintain higher exposure to equities, an asset class that is likely to outperform in the medium term, while hedging downside risk.

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Valuing quality stocks

Although choppy markets appear to lie ahead as the pandemic rages on and a US election nears, quality companies seem the investment of choice with supportive central bank policy set to buoy valuations.

It took the S&P 500 only five months to recoup its pandemic-related losses and reach new all-time highs. On the other hand, global economic activity remains considerably below pre-crisis levels. This divergence is unlikely to last forever. However, a sustained, sharp correction may not be on the cards for the time being.

A valuation-driven rebound

While stock prices have swung dramatically between February and August, the same can't be said about earnings expectations. Indeed, 2020 estimates shrank to $122 at their trough in July, from $172 at the beginning of the year (see chart). They stand at $128, having barely moved despite stellar second-quarter results. For 2021, the earnings per share for the S&P 500 are expected to reach $165, broadly in line with the $163 reported in 2019.

With earnings expectations well anchored, the main driver of the stock market's rally has been the expansion of valuation multiples. The S&P 500 is trading at 22 times, on a 12-month forward price-to-earnings ratio basis, significantly above historical averages. Despite equities move higher during earnings season in July and August, this number has been relatively stable as the next four quarters now include a period, between April and June 2021, when consensus expects profits to jump by 40% year-over-year.

All about multiples

While it's fairly easy to rationalise changes in earnings expectations, explaining gyrations in valuation multiples is subject to interpretation. Price-to-earnings ratios typically lead earnings revisions and collapse in anticipation of contracting earnings while expanding ahead of a recovery.

As such, it should not be surprising to see elevated valuation multiples when earnings expectations are depressed and about to be revised higher (see chart, p7). However, as we have established above, the consensus already expects 2021 earnings to be back to 2019 levels, leaving limited room for additional positive revisions.

S&P 500 earnings expectations fail to rebound
US earnings estimates for 2020 and 2021 versus S&P 500 in 2020

Sources: IBES, Refinitiv, Barclays Private Bank. August 2020.

Central banks in control

The reason behind the recent dramatic increase in valuations seems to lie outside of earnings expectations or valuations. But where?

One likely explanation could be the unprecedented injection of liquidity from central banks. While some of the measures announced during the pandemic were solely designed to help financial markets function normally, the ramp up in quantitative easing, coupled with the unconditional

> "The consensus already expects 2021 earnings to be back to 2019 levels, leaving limited room for additional positive revisions"

commitments from the European Central Bank (ECB) and US Federal Reserve (Fed) to do "whatever it takes" to support their economies, have made the institutions buyers of last resort. This has removed some of the risks investors would normally bear, reducing the premium needed to cover these risks and allowing valuations to expand.

Don't fight the Fed still

If central banks' supportive policy actions are indeed responsible for inflating equity valuations, then any sustained and meaningful fall in valuations looks unlikely while liquidity remains plentiful.

With both the Fed and ECB appearing far away from reducing asset purchases, valuations can hold for now, allowing an upward reversion to the mean on the back of gradually recovering earnings. At the same time, markets tend to respond most directly to the flow rather than the stock of monetary easing. With the pace of accommodation likely to slow in coming years, further multiple expansion is improbable.

Choppy sailing

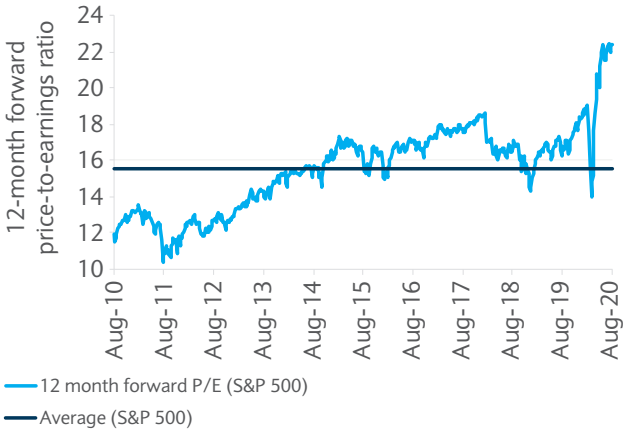
If equity valuations are to hold, a repeat of March's severe selloff is unlikely. Yet, uncertainty remains elevated. Indeed, whether it is US-China trade tensions, the US presidential election or simply the pace of the recovery, the road ahead appears bumpy.

> "Whether it is US-China trade tensions, the US presidential election or simply the pace of the recovery, the road ahead appears bumpy"

As such, we would not dismiss the possibility of a five to ten percent correction, especially should governments fail to maintain a high degree of fiscal support or should a COVID-19 vaccine be elusive this year.

Timing a possible entry point will be difficult if not impossible. This is why staying invested may be an appropriate course of action. However, diversification is likely to be key to successfully navigate equity markets this year.

US equity valuations skyrocket in 2020
S&P 500 twelve-month forward price to earnings ratio and its average since August 2010



Sources: IBES, Refinitiv, Barclays Private Bank. July 2020

Look beneath the surface

Even though, at the index level, price moves should be rather limited, investors should prepare for higher volatility and dispersion at sector and stock levels. In particular, the over dominance of "growth" as an investment style, spearheaded by tech this year, may temporarily come under pressure should the health crisis recede if and when a vaccine becomes available.

Yet, investors should not completely rotate away from growth (technology, internet or healthcare for example) and into value sectors (such as banks or energy). Instead, "quality" remains the main characteristic worth considering when investing, whether its within growth or value.

> "Quality remains the main characteristic worth considering when investing, whether its within growth or value"

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The diversification appeal of bonds

Bond and equity correlations have increased of late. As such, what role can bonds play in diversifying multi-asset portfolios?

Since the peak of the crisis in March this year the US 10-year yield failed three times to change direction: March (resistance 1.2%), June (0.9%), August (0.7%). Given seemingly more encouraging economic data in recent weeks and likelihood of more positive news on the vaccine front (more than 160 vaccines are in development with some at phase three or the approval phase) rates could spike again soon. However, such a move may not lead to a secular move upwards in yields.

We pointed out that more debt in response to the pandemic need not necessarily lead to higher rates, in August's Market Perspectives. Furthermore, our conclusion was that the traditional role that bonds play in 60-40, equity-bond allocation strategies seems more questionable.

The following sections look at the diversification attractions bonds can still provide investors at such challenging times.

Are higher bond-equity correlations a concern?

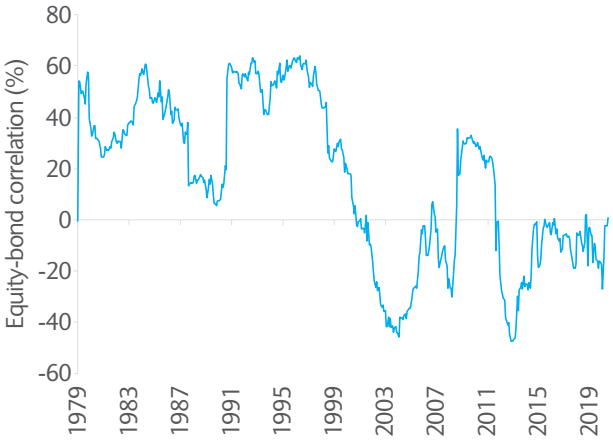
The correlation between bonds and equities has surged this year (see chart). This is a concerning situation given that bonds should ideally have little, or even negative, correlation in order to achieve better diversification effects in portfolios.

But the correlation between equities and bonds has varied substantially from year to year since 1972. The next chart (top left, p9) plots the discrete performance of the US treasury bond index against the performance of the S&P 500 for each year going back to 1972.

The chart shows that a positive correlation between equities and bonds regularly occured in years when both asset classes deliver positive returns (dots on the upper right). Positive correlation in these years should not be a cause for concern.

The left hand segment of the chart is probably more important when looking at equity-bond diversification: as bonds ideally provide positive returns when equities face losses. As confirmed by the blue dots in the left segment except in 1994 (-3.3%) bonds every year delivered positive returns in equity bear markets confirming the theory that in distressed times capital goes into safe-haven bonds.

Equity-bond correlations surge in 2020
Rolling three-year correlation of monthly returns between S&P 500 and US Aggregate Bond Index since 1979



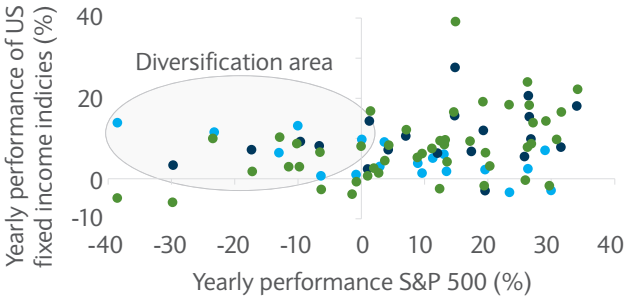
Source: Bloomberg

Safe-haven flows in distressed situations

The light blue dots in the chart show the performance in the years from 2000, when rates rapidly declined towards 4% or lower. As can be seen on the right part of the chart, bond returns, as a result of lower yields, have been significantly lower as a result when comparing to returns when yields were high prior 2000.

Given the low level of yields today it is unlikely that safe-haven bonds provide high returns compared to the past. Still, even in the lower yielding period from 2000 bonds delivered a positive performance during equity bear markets. We believe safe-haven flows into sovereign bonds in times of distress will not disappear in the future.

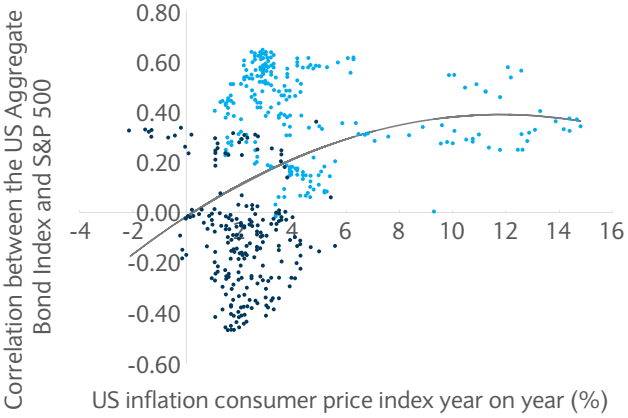
Equity and bond performance by year
S&P 500, US Aggregate Sovereign Bond Index and US corporate bond index performance since 1972



- US Aggregate Sovereign Index vs. S&P 500 from 2000 to 2020
- US Aggregate Sovereign Index vs. S&P 500 from 1973 to 1999
- US Aggregate Corporate Bonds Index vs. S&P 500 from 1973 to 2000

Source: Bloomberg

Equity-bond correlations versus US inflation
Correlation between US Aggregate Bond Index and S&P 500 with US CPI since 1977



Source: Bloomberg

Corporate bonds can help to mitigate lower yields

With yields close to zero, the hedging characteristics of sovereign bonds come at a high cost. Furthermore, the zero mark may act as a lower bound for yields. Corporate bonds do act as a more effective proxy over the longer term in our view.

Investment grade corporate bonds (green dots) produced negative returns in the equity market crashes in 1974 (a time of oil embargoes and the collapse of Bretton Woods) and 2008 (great credit crisis). However, corporate bonds have provided higher returns compared to government bonds throughout the period from 1972, helping to build a bigger cushion over time while performing in years when equity returns were negative in most cases.

Excessive inflation can disrupt the diversification benefits

Years with positive correlation and negative correlation between the equity and bond market were quite balanced in periods of moderate inflation. But the diversification effects seemed not to work in times of very high inflation (see chart, top right). In periods of excessive inflation (higher 5.5% for example) the correlation was always positive which resulted in low or no diversification contribution from bonds.

Bonds retain their appeal

Despite the surge seen in equity-bond correlations this year, bonds are unlikely to lose their diversification benefits. Indeed, the addition of corporate bonds, providing higher income, and of alternative safe-haven assets, like gold, can provide additional diversification effects, especially in periods of excessive inflation.

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The attraction of co-investment funds

For investors looking for exposure to private markets, co-investment funds offer a flexible, diversified portfolio of unlisted investments that can outperform traditional private equity funds.

Co-investment is an investment style in private markets which consists for a fund to acquire a minority investment in companies, alongside lead General Partners (GP). It differs from a traditional private equity (PE) fund as it does not take a controlling stake and therefore the fund does not intend to influence a business' strategy.

As co-investment funds can invest in just one company within a portfolio of companies a specific sponsor holds, it gives the opportunity to invest across a spectrum of strategies, sectors and countries with more flexibility than a more specialised PE fund might.

According to McKinsey, the value of co-investment deals more than doubled between 2012 and 2017, reaching $104bn in 2017. Why has the demand for co-investment grown so much and what are the benefits of this strategy?

Diversification at all levels

Multi-sponsor co-investment funds provide a potentially strong diversification benefit. Contrary to a traditional PE fund, the investment is not deployed along a specific strategy or geography. The investment universe could be as wide as wanted.

The portfolio of companies can be built investing alongside different lead managers and in different strategies, vintages and geographies. Due to this characteristic, a co-investment fund provides diversification in a private market investments programme in a much easier and faster way than allocating to different strategies over time.

It also gives more flexibility in selecting attractive investments as the universe considered is much larger than for traditional funds. And as the fund can be invested in companies at different levels of development, there is the potential to reduce the effective of the so-called J-curve, or the tendency to produce negative returns in the early years of the fund before positive returns kick in as investments mature.

An enhanced investment process

The lower risk from the diversification process is also compounded thanks to an enhanced investment process. Co-investment funds have the opportunity to invest alongside several lead sponsor, which mitigates the risk of one sponsor due diligence being inadequate. Additionally, co-investment funds run their own due-diligence on any company they consider investing in, on top of the initial due-diligence the main sponsor carried before including the company in its portfolio.

Lower fees than usual

All those positive factors are usually delivered at a lower fee than a traditional PE fund would consider. The main sponsor typically does not charge fees to co-investment funds investing alongside them. And as co-investment funds only take minority ownership in companies, the management fee and the carried interest are usually lower than for a traditional fund. As such, average net returns tend to be attractive compared to traditional PE funds.

The diversification advantage, enhanced investment process and more attractive net returns are the main reasons behind the success of co-investment strategies.

Fund selection is paramount

The above fee advantage also highlights the challenges facing investors when choosing co-investment funds. It is a more passive strategy as funds only take a minority stake and do not actively manage the companies they invest in. Finding the right company to invest in alongside a respectable main sponsor is key. And the risk of adverse selection when investing in companies is real — though a recent academic study from researchers at the Technische Universitat Munchen and University of Oxford shows that it might be overstated. For those reasons, choosing well-established co-investment funds with strong links in the industry would likely reduce the risk of such challenges. It would also likely offer better opportunities from lead sponsors, as most of those arise from existing relationships between two funds.

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Getting to the bottom of ESG

The increased popularity of sustainable investing, and its encouraging performance, seen in a period of extreme volatility this year may mark a turning point. But what marks this form of investing out and why should Environmental, Social and Governance (ESG) practices be considered when constructing their portfolios?

As COVID-19 disrupted markets in the first few months of the year, billions of dollars flew out of conventional funds. In contrast, those targeting positive environmental and social outcomes kept attracting converts. For instance, investors allocated $45.6bn to sustainable-focused funds in the first three months of the year, when global outflows reached $384.7bn for the overall fund universe.

At the same time, sustainable strategies predominantly outperformed during this period (see chart). Separate analysis found that the majority sustainable indices outperformed their broad market peers.

Adding value

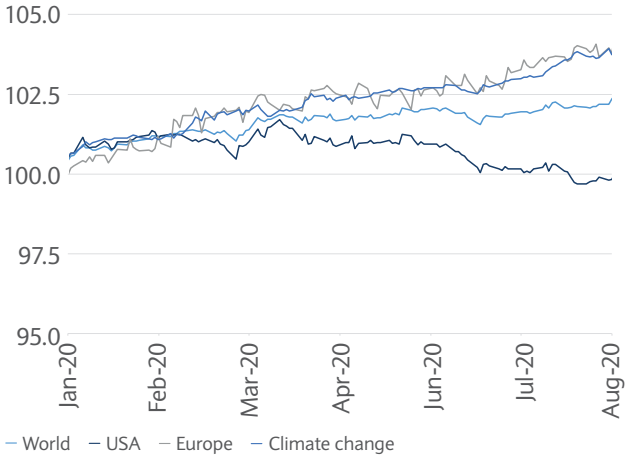
Underlying the increased capital inflows and favourable investment returns to sustainable-focused funds is a growing realisation of the value of sustainable strategies and the consideration of companies with strong ESG practices. Sustainability is becoming a key driver for financial returns. Companies with more effective operating practices may be more likely to create value and perform better in the long run.

Various research shows that companies that are environmentally conscious, are socially responsible and uphold good governance tend to have higher profitability and valuations with less market sensitivity and lower tail risk than other companies. Alongside financial strength, arguably companies with a more flexible approach to production, human capital practices and corporate governance may be able to better navigate volatile periods than those that don't.

When examining performance, better sustainability practices, management of ESG risk and forward-looking opportunities often account for much of the added performance attributed to sustainability investing. As more non-financial information is reported by companies, investors should be better positioned to identify more resilient and effective companies during the crisis.

ESG assets outperform in 2020

The relative performance of the ESG Leaders index against the World, USA, Europe and Climate change MSCI indices in 2020



Source: Bloomberg, MSCI, Barclays

"As more non-financial information is reported by companies, investors should be better positioned to identify more resilient and effective companies during the crisis"

ESG data and ratings

Signatories of the UN sponsored Principles of Responsible Investment, which covers $90 trillion of assets, commit to take into account companies' operating practices – including environmental, social and governance – in their investment decisions.

Environmental, Social, Governance (ESG)

- Environmental considerations relate to the quality and functioning of the natural environment and natural systems
- Social considerations relate to the rights, well-being and interests of people and communities
- Governance considerations relate to the governance practices of companies and other investee entities.

Environment	Social	Governance
Carbon emissions	Labour management	Corporate governance
Energy efficiency	Diversity and discirimination	Business ethics
Natural resource use	Working conditions	Anti-competitive practices
Hazardous waste management	Employee safety	Corruption and instability
Recycled material use	Product safety	Anti-bribery policy
Clean technology	Fair trade products	Anti-money laundering policy
Green buildings	Advertising ethics	Compensation disclosure
Biodiversity programmes	Human rights policy	Gender diversity of board

The core premise is that by considering ESG factors, an investor can take account of a broader set of data and so can make a better judgement about the financial performance and longer term value of a company (see table). In essence, ESG credentials aren't only an important source of information, but can also help identify material financial risks that could affect the reason for investing in a company or group of companies.

To support these assessments, data firms and ratings agencies collect and report on ESG data, which focuses primarily on how a company operates. The comprehensive set of raw data points is based on publicly available sources such as annual reports, company websites, sustainability reports or contributed by surveys.

Once audited and standardised, this data can help to reveal the impact that companies are making in absolute terms (such as carbon emissions generated), or relative to peers (perhaps for gender diversity of a board make-up relative to peers).

Armed with awareness

Data providers play an important role in the investment process by gathering and assessing information about companies' ESG practices and then scoring those companies accordingly. The development of such ratings systems has helped the growth of sustainable investing by helping investors to conduct due diligence.

As data providers generally develop their own sourcing, research and scoring methodologies, the rating for a company can vary across different providers. These differing methodologies also have implications for investors. In choosing a particular provider, investors are, essentially, aligning themselves with that provider's ESG investment philosophy in terms of data acquisition and methodology – including materiality, aggregation and weighting.

The lack of standardisation and transparency is driven partially by data quality – the lifeblood of investment analysis. Many agree that consistency and comparability in the availability of data across companies are essential elements of an effective data set. Yet, companies that wish to report on their ESG credentials have a myriad frameworks to choose from. The most commonly cited frameworks are:

- The Sustainability Accounting Standards Board (SASB)
- Recommendations of the Task Force for Climate-Related Financial Disclosures (TCFD)
- Global Reporting Initiative (GRI)
- UN Sustainable Development Goals (SDGs)

Finding a standardised solution

Investors would prefer the same metrics across all companies for ease of comparability, as well as to establish benchmarks and find trends. From a company's perspective, a likely preferred framework would be one that can be used as a consistent and repeatable framework. One that can take account of investor priorities and the transparency and accountability that regulators expect from companies in the long term.

With sustainable investing becoming more popular, solutions and new approaches are being adopted. In response to the variation across some ratings, investors may attempt to identify the 'best' among the providers, use an aggregate score based on a number of providers or develop their own set of metrics. Some, in addition to the level of ESG scores, explicitly incorporate the dispersion in the ratings into their investment processes. On the standardisation and transparency side, guidance from investors and regulators on their preferred method is increasing with various parties pushing to standardised ESG reporting.

Despite the shortcomings in standardisation and transparency in providers' data collection and scoring methodologies, these providers have made valuable contributions in advancing ESG investing globally. Investors who understand some of the limitations of this data, could learn to manage and mitigate key risks and opportunities better.

ESG and portfolio construction

With the attractions of sustainable investing seemingly on the rise, more investors appear to be using environmental, social, and governance data and ratings to inform their decision-making.

ESG integration into the investment process allows investors to understand the complexities of identifying associated risks and opportunities. As such, investors can position themselves to manage the risks and opportunities associated with these new paradigms.

Even though the use of ESG data and ratings is still in its infancy, and the concept of sustainability is by nature a fluid one; the underlying premise is that investment decisions should factor in the impact of how companies operate. The benefit of using ESG criteria to determine the security and value of investments are now widely acknowledged.

"ESG integration can be valuable both financially, to protect and grow capital, and to make a positive contribution to the world through sustainable value creation"

Still, the usual caveats for performance must be acknowledged. There are various routes to integrate ESG factors to enhance investment decision-making, with increased depth and sophistication. It is also important to note that just as financial data is not perfect, non-financial data will never be so either. Furthermore, not all sustainable investors use the same approach, or have the same skills, resources or senior buy-in and support to make integration core to the investment philosophy.

Making a positive difference

For all the difficulties, ESG integration equips investors with more tools that can be used to build portfolios that beyond aiming to be profitable in the long-term, may help make a positive difference to the world.

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Alpha hunters love dispersion

After the spike at the outset of the pandemic, US equity correlations have trended down. Coupled with increasing performance dispersion, this creates many opportunities for skilled stock pickers. But, are equities still attractive for alpha hunters?

Stock prices often plummet in a crisis, with equity volatility and correlations abruptly spiking and being elevated for some time. Market selloffs are frequently driven by macroeconomic news and sentiment. Fundamentals can often be of secondary importance. Many investors can become defensive and ditch equities in favour of risk-off investments, such as government bonds and gold. High equity correlations and low cross-sectional performance dispersion then make stock selection very difficult.

However, after the initial reaction, a new wave of optimism can set in. Although some sectors might be more macro-driven and attractive on an aggregate level, many stock pickers tend to take a more nuanced research approach. As correlations start reverting to their pre-crisis levels and performance dispersion increases, "alpha hunters" swiftly leave their pit boxes and rejoin the "beta grazers".

The above scenario occurred earlier this year. The initial equities slump of almost 40% saw the VIX volatility index, or the "fear gauge", surge to 80 points from 20 and US equity correlations hit 0.7 from 0.2. All stocks moved in sync, making it difficult to have high conviction calls on single names. In subsequent months, stocks rallied and risk metrics fell (albeit remaining somewhat elevated, historically speaking). In turn, a wider distribution of returns has aided stock pickers.

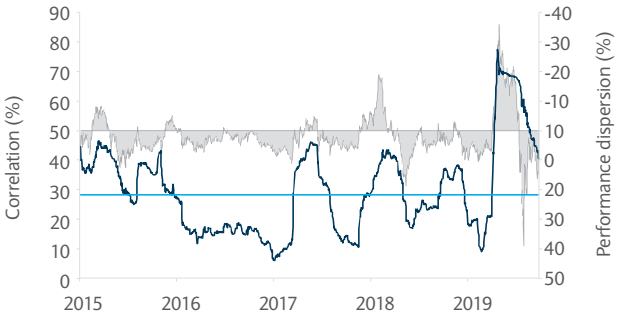
The big picture remains supportive

The chart shows the S&P 500 over the last five years. Initially, three-month rolling pairwise correlations and realised returns are considered. This shows the aggregate dynamic cross-sectional properties of correlations and return dispersion.

The measures that are particularly relevant for our analysis are the location (median) and dispersion (revealing the interquartile range, defined as the difference in returns between the 75th and 25th percentile) of equity returns.

Median correlation and performance for S&P 500 stocks

The trend in median three-month rolling correlations and performance of daily stock returns since August 2015

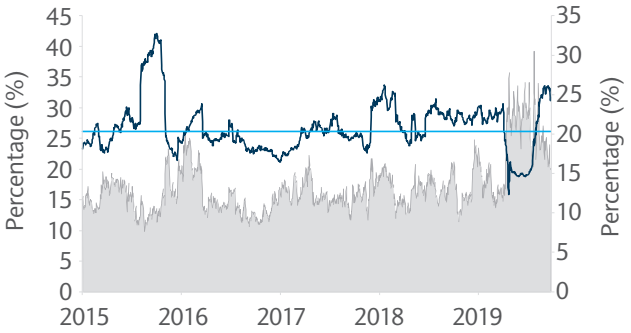


Source: Bloomberg

The three-month rolling correlations and realised returns reveal that stock-picking opportunities have much improved since March. The median correlation is around 0.4, down from 0.7 at its peak but above the five-year average of around 0.3. The median three-month realised return has surged to around 10% from -35% in the same five-month period.

Similarly, correlation dispersion and performance dispersion (see chart, to left, on p15) have widened since March. Recently, the dispersion has somewhat retracted of late. Although it is tempting to conclude that as a result there are fewer opportunities for stock pickers, it is worth investigating each sector too.

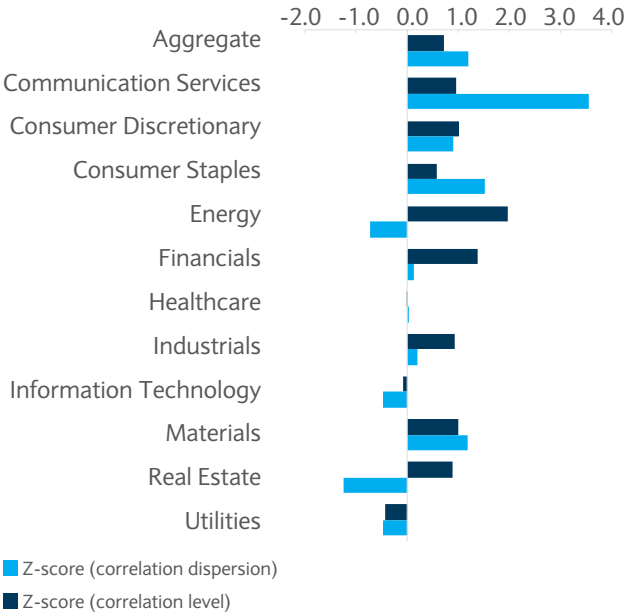
S&P 500 correlation dispersion and performance dispersion
Median three-month rolling correlation dispersion and daily performance dispersion since August 2015



3 month rolling performance dispersion (RHS)
3 month rolling correlation dispersion
Median correlation dispersion

Source: Bloomberg

Median correlation and correlation dispersion for the stocks in S&P 500 index and its eleven sectors
Current z-scores of three-month rolling median correlation and correlation dispersion of daily stock returns since August 2015 based on their sector classification



Eleven shades of S&P 500

To further analyse US equity returns, stocks are grouped by sectors using the same quantitative procedure as in the previous section. Sectors with elevated, but downward-trending, correlations and wide dispersion of returns and correlation should offer the best alpha-generating opportunities.

The bar chart shows that almost all sectors still have elevated correlations relative to the last five years (or a z-score above zero). Utilities appear to be an outlier, their median intra-sector correlation is the highest (irrespectively of the market environment). Healthcare and information technology have returned to their median five-year levels. Given recent fast-paced changes within these two sectors, it is not surprising they have adjusted more quickly than others. Communication services, consumer discretionary and staples, industrials and materials are in the "sweet spot" for stock picking. Energy and real estate lag and appear to be more macro-driven.

Alpha opportunities here to stay

Uncertainty has reached new levels this year. Many risks still lurk – the pandemic and geopolitical tensions being the most acute ones. Historically elevated equity valuations, amid currents favouring deglobalisation, are worrying. Nevertheless, the US outlook appeared solid before the COVID-19 outbreak and the country's infection trend has been healthier since June, despite local spikes in some states.

Unprecedented, generous fiscal policy stimuli around the globe have brought some peace of mind to investors. Perhaps most importantly, containment measures could be paving the way for new secular trends and have accelerated some trends in many industries.

Overall, bouts of volatility are to be expected this year, especially on COVID-19 vaccine developments, Brexit trade negotiations, the US presidential election and US-Sino relations. However, unless there is another major external shock, it is unlikely that correlations will revisit those seen in March.

Divergence between sector and stock returns, including those within sectors, seems likely. Irreversible long-term trends, potential inefficiencies and asymmetries caused by swift and massive fiscal injections, central banks pumping more liquidity into markets and growing spreads in fundamental measures (such as corporate debt, valuation, margins and supply chain robustness) all look favourable signals for alpha hunters.

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Back to school investment lessons

As the summer holiday season heads towards its end for many, certain investment behaviours are worth bearing in mind ahead of what may be an eventful end to 2020.

Back to it

September marks the return to school for many in the northern hemisphere after the summer holiday provided a chance to unwind and switch off, despite the pandemic interfering with life. While a break can help to recharge the batteries, it can take time to get back into the routine and relearn old habits.

With the rest of 2020 likely to be eventful, this article provides a refresher on what good investment discipline looks like. Significant events that lie ahead this year include the US presidential election and the Brexit trade negotiations. Both are likely to affect markets against the backdrop of a pandemic about which much still remains unknown. This will provide both risks and opportunities for investors.

As the impact of COVID-19 reverberated through financial markets, we shone a spotlight on the behavioural challenges to investing to help investors in these testing times. This article brings some of these key points together, to help investors try to best navigate the rest of the year.

What are your goals?

Finances and investments are in many cases the facilitators of many aspects of our lives. A first step may be to review your finances and ensure that they are aligned with your objectives, both for the investments themselves and the reason for seeking to protect and grow wealth. A clarity in your holistic objectives, agreed with or communicated to a trusted adviser, can make it easier to align investment decisions with it.

Have a plan

Having a goal in mind is important, but having a specific plan helps with achieving it. Even better is a plan that sets out the actions to be taken in the case of different eventualities and one that is designed in a way that makes the plan drawer accountable.

A good investment plan may include rules and timelines for getting invested. A plan can be particularly useful when taking actions during difficult market conditions, when investing can become difficult emotionally. In these situations, the natural tendency can be to take actions which provide short-term comfort, potentially at the expense of long-term returns, like selling out or reducing risk in the midst of a downturn.

Prepare for the unexpected

The sharp rally seen in equities and credit since March might suggest that a V-shaped recovery is fully priced into the market. At these levels, the market leaves little cushion for negative surprises. Investment processes and portfolios should always be prepared for negative shocks, because swings in sentiment, and market moves themselves, can occur extremely quickly. This was demonstrated perfectly earlier this year with the speed at which markets unravelled and then rebounded.

The outlook certainly seems more uncertain given so much of the virus and its consequences remain to be seen. Rather than making the world more uncertain, unexpected events show us how uncertain the world already was. While there are degrees of confidence in the likelihood of events occurring, the reality is that there are no crystal balls in investing.

A good way to prepare for the unexpected is by following a robust investment process. One that leads to a diversified portfolio geared for the long term, investing in quality assets and built to perform across different market conditions. Putting in place a process which is resilient in the face of changing conditions is the best protection and should make it easier to stay invested and reap the benefits of time in the market.

Recognise your biases and emotions

Periods of market turbulence and downturns can induce stress in an investor, perhaps leading to poor long-term decision-making. It is when markets look most precarious that our behavioural proclivities can lead us astray.

Periodically reviewing past decision-making objectively to assess the quality of decisions made, and ways to refine them, can be an important first step to improving them. Building a process which is systematic and is built around identified biases can help to reduce the impact of said biases. Delegating decision-making to experts with tried and tested processes and good track records may be advisable.

Be patient

Time in the market is usually far better than trying to time the market. While active management can help to maximise investment returns, behavioural studies show that investors may harm performance through overtrading.

To increase the likelihood of success when investing, it can make sense to follow a robust process which strikes a balance between long-term thinking, to generate the core investment returns, and the more reactive and opportunistic short-term tweaks, to maximise overall returns. This can help temper a tendency to act during emotive market events where a fear of doing nothing can induce actions more harmful than staying with the status quo.

See beyond

When an event occurs which is vivid and affects us personally we understandably attach great significance to it. This is an evolutionary trait which was designed to protect us from predators; in the face of uncertainty we use rules of thumb (heuristics) which have provided us with rapid and effective decision making throughout our evolution.

Unfortunately, this can lead to biased decisions if information which is more vivid and easily recalled is overweighed at the expense of other information. There is a risk that investors focus fully on the post-pandemic recovery and give less attention to events such as US-China trade tensions and the upcoming US elections and Brexit trading relationship.

For those seeking to protect and grow their wealth, active investment strategies that focus on quality and the potential winners coming out of the COVID-19 crisis appear to offer much hope. While 2020 is proving to be an unprecedented year, for economies and financial markets, every year provides risks but also opportunities to be capitalised on by investors looking beyond the headlines.

"Every year provides risks but also opportunities to be capitalised on by investors looking beyond the headlines"

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Multi-asset portfolio allocation

Barclays Private Bank discusses asset allocation views within the context of a multi-asset class portfolio. Our views elsewhere in the publication are absolute and within the context of each asset class.

Cash and short duration bonds: neutral

- On the back of increased fears over a wider spread of the COVID-19 virus globally, a preference for higher quality and liquid opportunities – which translates into our positioning in short duration bonds – is maintained.

- Although real interest rates remain negative in most jurisdictions, a neutral conviction in the asset class seems to make sense from a risk management perspective.

Fixed income: neutral

Only modest opportunities are likely in fixed income given market dynamics. Although sovereign rates appear less attractive in the context of low yields, they offer protection in very weak economic environments. For this reason, a small overweight is maintained in developed market government bonds.

In credit, the higher quality segment most appeals. But as spreads have recovered remarkably from their highs back in March, our risk budget is likely to be allocated in the equity space. In high yield, selection is key. We prefer high yield, and emerging market (EM) hard currency debt over EM local currency debt considering the risk facing their economies and currencies.

- Developed market government bonds: high conviction
  - Developed market government bonds worldwide have been losing their appeal as rates edge down amid softening economic growth, lower inflation expectations and unprecedented liquidity injections from major central banks. However, we see the asset class as a diversifier and maintain our holding to a small overweight.

  - Although US dollar real rates remain at historically low levels, they are still marginally more attractive relative to the other developed market bond markets. Amid the COVID-19 outbreak and more active central bank behaviour, UK and European bonds have somewhat synchronised with US rates. However, depressed yields make it difficult to find both markets attractive, apart from in respect of managing portfolio risk.

- Investment grade bonds: neutral
  - A large contraction in the economy and earnings will likely lead to a substantial increase in leverage ratios and a higher risk of downgrades; specifically among BBB-rated bonds.

  - As spreads are now back to tight levels, selection will be key.

  - Notwithstanding volatility in the short to medium term as a result of COVID-19 and increasing fears over a second wave of infections, a neutral stance to the asset class is maintained as more spread volatility is likely.

- High yield bonds: neutral
  - Amid the market turmoil, spreads widened to historically elevated levels before retracing. However, we remain wary of the impact of lower oil prices on energy-related names and the broader economic impact of the COVID-19 pandemic.

  - The economic effects of the coronavirus outbreak have significantly increased the risk of default. That risk increases the longer the pandemic continues, subduing economic activity.

  - Back in April, our position in the asset class was increased twice, closing a long-held large underweight. The rationale was to take advantage of wide spreads by historical standards, suggesting potential attractive returns. While high yield bonds have recovered well, with rising default rates, taking risks in equities seems preferable.

- Emerging market bonds: low conviction
  - Emerging market hard currency debt is preferred to local currency debt considering the risk facing the respective economies and currencies.

- Many EM economies run high debt deficits, low currency reserves and potentially lack capacity to deal with the COVID-19 crisis. The recovery from the pandemic differs within EM and is mostly linked to the infection rates, with Latin America, South Africa, Israel, the Philippines and India under pressure.

- However, the US Federal Reserve's dovish stance should continue to provide some relief to the largely dollar-denominated emerging market debt market.

- Although corporate fundamentals are now less robust and default rates are gradually rising, the majority of EM central banks have helped issuers with more accommodative monetary policies. With rising COVID-19 infections starting to affect EM economies and forex, a more cautious stance is taken on local currency debt.

- Given downside risks from geopolitical issues, a low conviction is kept for the asset class as margin pressure may increase in the current volatile environment.

Equities: high conviction

Portfolios have been positioned in high quality, conservatively capitalised businesses for the longer term. While we remain positive on prospects for stocks over this period, the near-term view has been clouded by the growing risks to the global economy.

Regionally, we see more compelling opportunities in developed market equities, where we maintain high conviction, while being neutral on emerging market equities from a risk budgeting perspective. However, not all emerging markets are created equally and so warrant selectivity, with Asia appearing to provide a broader opportunity set than elsewhere.

- Developed market equities: high conviction
- The impact of the pandemic, and related widespread business shutdowns, means that there is very little visibility on near-term revenue and earnings numbers for the market.

- Earnings look set to fall substantially in 2020 but the market is likely to focus on 2021 and beyond to price in a recovery.

- Further out, market events have created an opportunity for those willing to take a longer term view and be selective.

- The rapid and sizeable response of central banks and governments to events means that policy should be favourable when a recovery takes hold.

- Most importantly, active management and selective stock picking of companies with strong balance sheets is favoured. We focus on businesses with high cash returns on capital, with conservative capital structures and ideally an ability to reinvest cash in future growth at equally high rates of return. The US tends to offer us more opportunities to invest in such businesses, meaning that North America remains the largest geographical weighting within the equity allocation.

- Emerging market equities: neutral
  - Emerging markets have suffered from country specific risks and slowdown in the region, particularly after the COVID-19 outbreak.

  - While the region may suffer significantly for the pandemic in the short term (especially Latin America), a secular shift from investment to consumption should support growth over the medium term.

  - Furthermore, the region should benefit from the benign rate environment.

  - While markets appear increasingly cautious, emerging market equities should benefit from attractive valuations. Persisting with a neutral stance, our position in the asset class was increased in March after the virus-induced sell-off.

Other assets: low conviction

Alternative asset classes will continue to diversify our portfolio, but are not expected to be the main drivers of returns. Gold is set to benefit from its status as a safe-haven asset, and for this reason we maintained our allocation to the asset class. Conversely, real estate and alternative trading strategies are underpinned by a weak investment case.

- Commodities: high conviction
  - The sole exposure within commodities continues to be our position in gold.

  - In light of increasing headwinds for the global economy and despite gold reaching an all-time high in August, value persists in gold compared to other commodities. This allocation is seen as complementary to the other risk-mitigating assets in the portfolio.

  - The asset class has little appeal outside of precious metals and our risk budget can be better deployed elsewhere.

- Real estate: low conviction
  - Real estate should continue to provide mild diversification benefits, helped by loose monetary policy. That said, a low conviction to the asset class reflects structural headwinds, such as the shift to online retailing, and the higher leverage in the sector.

- Alternative trading strategies: low conviction
  - The low conviction in alternatives reflects their high expense and a lack of investment opportunities in the space. However, strategies that have low correlations to equity markets, such as merger arbitrage, appear preferable.

  - Indeed, conviction towards the asset class was further reduced recently, preferring to move into cash and to increase high yield to neutral, where better opportunities exist. Nonetheless, sudden spikes in volatility, which are likely to materialise more often in a volatile environment, may lift the asset class at least in the short term.

Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk.

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