interview

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Stonehage sees role for long/short strategies with higher volatility ahead

Stonehage Fleming's Bryn Hatty talks about the prospects for family wealth management as markets enter the next leg of the cycle

HedgeNews Africa sits down with Bryn Hatty, chief investment officer South Africa, Stonehage Fleming, one of the world's leading independently owned family offices and the largest in the EMEA region as measured by breadth of services, geographic reach and by assets under management, advice and administration. Stonehage Fleming helps families to manage their wealth and protect their legacies for future generations.

Before joining Stonehage Fleming late last year, Hatty spent almost 13 years at Old Mutual Investments' Customised Solutions boutique (previously known as Absolute Return Investments) as a portfolio manager, and has also worked previously at Investec and Cadiz. He has a BBus Sci Honours (Finance) from the University of Cape Town and is a CA(SA) and CFA charterholder.

As one of the world's leading independently owned family offices, Stonehage Fleming advises on over US$55 billion of assets on behalf of more than 250 families from 11 offices in eight geographies.

Global geopolitical and economic concerns persist, yet markets have made gains so far in 2019. What is your outlook for global markets at present?

BH: Risk assets have registered healthy gains for the year (the MSCI All Country World Index is 16.2% higher in US dollars), despite an escalation in US-China trade tensions and global growth concerns. Central bankers in the US and Europe have reinforced their commitment to prolong the economic cycle, signalling more monetary stimulus in response to softer growth. Global bond yields have collapsed as a result, with US$13 trillion now held in negative-yielding debt (double the amount six months ago).

There are three main reasons for this policy U-turn: a moderation of economic growth, stubbornly low global inflation and heightened trade tensions. Intuitively, equity markets should struggle in this environment, yet have had a stellar six months. Looking forward, there are reasons to be cautious, but we identify fundamental reasons to remain engaged.

Our outlook for risk assets remains constructive and is supported by the combination of a resilient consumer, muted earnings expectations (raising the prospect of positive surprises) and reasonable valuations. Furthermore, we are not seeing typical signs of market complacency. Higher volatility is, however, expected to accompany the next leg of this cycle. Geopolitics, be it trade wars, Brexit or tensions in the Middle East, will continue to test investors' nerves.

With yields now reflecting a recessionary environment, we are negative on government bonds, preferring cash as a diversifying asset. In addition, carefully selected long/short equity strategies should also do well, recognising the potential for higher volatility. We also retain an active allocation in emerging markets' local-currency debt. Equities remain our favoured asset class for capital growth, where our carefully selected managers are finding opportunities across industries and regions.

Bryn Hatty

The South African market has unique concerns. How do you see those playing out for investors?

BH: South African financial markets have had a good year so far; in spite of the negative mood in the country and ongoing weak economic fundamentals. Equity market returns have largely been driven by the large-cap shares with globally diversified earnings rather than the shares that are more exposed to the South African economy.

Over the next quarter, we will hopefully see some concrete plans to resolve the Eskom crisis as well as some progress towards implementing more investment-friendly policies. Ultimately, solid GDP growth is needed to provide South African corporates with the opportunity to grow their earnings base. The South African markets are also impacted by global markets and, in this regard, developments in US monetary policy will be closely watched.

We believe that the local equity market exhibits reasonable value – with some parts looking cheap (a good buying opportunity?) if we can get some improvements in the economy. Locally, we also believe that selected exposure to hedge funds will provide attractive returns as asset dispersions increase and will also provide diversification benefits in the event of a market sell-off.

Passive investments have attracted more attention than active strategies in recent years. Do you see this as a permanent change in investor appetite?

BH: Since the global financial crisis, momentum has been the order of the day – assets have risen and fallen together, largely driven by monetary conditions. As a result, investors haven't been as discerning about whether they were investing in good or poor-quality assets. A momentum-driven market is a difficult investment environment for active managers, which is why there has been such a big move towards indexation, or passive investing.

However, as the economy reaches the end of the expansion phase there is generally increased dispersion in returns between asset classes and within asset classes. This will provide a more favourable alpha-generation environment for active managers. Passive investments are here to stay and investors should be using these strategies in combination with active strategies, but the pendulum has probably swung too far and, after a period of outperformance by active managers, investor appetite will swing back towards active strategies. In addition, many of the passive strategies available to retail investors in South Africa are not that much cheaper than active strategies, which eliminates one of the main selling points of passive strategies.

Are traditional asset classes giving investors the kinds of solutions they need in the current environment?

BH: Largely they do, however we are concerned about the high correlation between asset classes globally as well as the current levels of global bond yields. For a long period now, bonds have been a great diversifier for equity, providing protection during equity-market sell-offs. Government bond yields now reflect an environment characterised by a stagnant global economy with deflationary pressures and this unfavourable dynamic in global bond markets leaves us with an increasing challenge to diversify multi-asset portfolios. Whereas once we could rely on government bonds to appreciate in value during periods of market stress, while still generating a decent real income over time, we cannot say the same today. We believe that cash as well as carefully selected hedge funds provide the best portfolio hedge against negative equity markets.

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What can alternative assets contribute to future-proofed portfolios? And do hedge funds – both local and offshore – have a role to play?

BH: The momentum-driven market that has largely been in place since the Global Financial Crisis has not provided a fertile alpha-generation environment for active managers. We believe that the environment going forward will be much more conducive for active managers, and in particular hedge funds. Hedge funds offer the best current alternative to the traditional portfolio protection role historically provided by global bonds.

We are encouraging our clients to increase exposure to hedge funds at this time. In particular, long/short hedge funds should provide a good risk-adjusted return as markets get more volatile towards the end of this economic cycle. In the longer term, private equity also provides real returns for investors who can commit to the illiquidity required when investing in this asset class.

Do you see pan Africa (ex South Africa) as a worthwhile investment opportunity? And how would you suggest accessing it?

BH: It is probably worthwhile investigating but this is not an area we currently research.

How many of your clients are South African, or have roots in the country? What solutions can you offer South African families?

BH: A reasonable proportion of our global client base is South African or has South African roots, with an invested interest in South Africa e.g. business and properties. South African families have similar concerns to other families globally. In our 2015 *Four Pillars of Capital* report, we found that most families saw their tangible assets as only one part of a broader family legacy.

We identified three main themes from our research. The purpose of wealth, where it is important for a family to agree a collective purpose for their wealth. Defining a collective purpose creates greater alignment within a family to enable better decision-making and reducing the potential conflict. Risks to family wealth - the greatest risks to a family's wealth were internal risks that sit within a family, rather than the more commonly perceived financial risks.

We are increasingly helping families to implement a formal risk-management process to identify, monitor and mitigate these risks. Family governance is important to agree decision-making frameworks when they are matters of principle rather than when it is personal. We help our clients in this regard by reviewing their existing governance framework and identifying potential areas for improvements.

From an investment perspective, they are concerned with risk diversification including the geographic exposure of all their assets, not just their liquid investments. Many of them have significant businesses and other assets in South Africa and therefore will use their liquid investments to get exposure to the other 99% of the global economy.