Wealth and Investment
Management

Compass

Q1 2017

Bark versus bite: our key investment themes for 2017

- Leading indicators: no end in sight
- Politics: between a rock and a hard place
- Emerging markets: bottoming out
- Equity sector: reflation trades
- Safe havens: undesired outcomes

New Year, new possibilities with impact investing

Are you happy with your investments?

Still stocks

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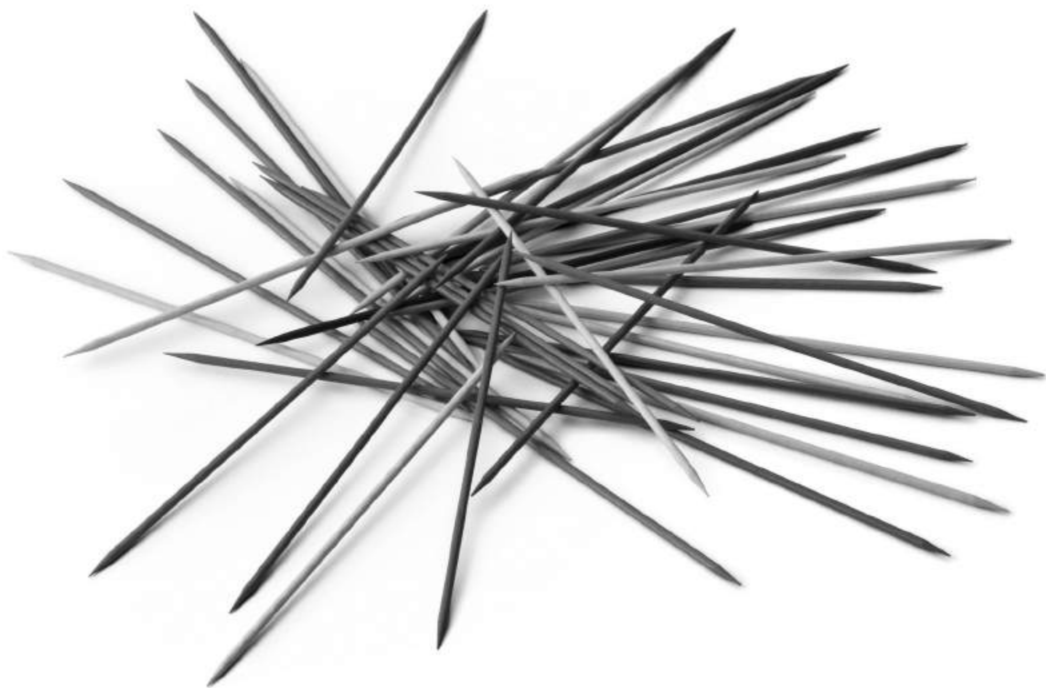

December 2016

Sometimes less is more. In a world of rapidly expanding information overload, the ability to filter out what really matters has become a key competitive advantage. During the past year the political risk that dominated the information flow and narrative turned out to have very limited impact on economies and capital markets, which continued to take their lead from improving fundamentals. Looking into 2017, we continue to rely more on our key fundamental indicators and tune out much of the political concerns. With this approach, we don't see an imminent end to this market cycle and therefore continue to be overweight risk assets.

Any outlook for the new year is supposed to have a list of themes. And we don't want to disappoint you. But, given that we believe that the real value is not in long lists, but in the filtering of this information, this edition of Compass has a shorter and hopefully more focused list.

The first theme is that that we currently don't see an end to this economic and market cycle. This view is formed by the signals from the five key filters or indicators we use to monitor the probability of the end of the cycle being around the corner. These indicators are based on theory and have statistical support. But we still overlay them with experienced judgement, especially during unusual price episodes, be it oil or interest rates. You can find more details about our indicators in the Investment Strategy section.

The second theme is political risk, with a focus on Europe. After the Italian 'No' vote to constitutional reform, the focus has been shifting to the Netherlands, France and Germany. Our view is that these political events will have a very limited impact on economies and markets. Only a Marine Le Pen victory in France would seriously rock the boat and we put a low probability on that outcome.

The third theme is emerging market assets which we think will recover on the back of healthier growth and protectionist fears receding, as the Trump administration tones down campaign trail rhetoric. Our fourth theme is equity sector reflation trades, focusing on the importance of the yield curve for banks. And our fifth and final theme is about the safe haven investments, in case we are wrong or the world changes.

Next, we cover impact investing, an area where we see considerable interest and where we think you can combine having a positive impact on society with attractive financial returns. Companies with high ESG standards (environmental, social and governance) are usually well-run with less headline risk and higher-quality return streams. Following this section, we focus on the behavioural aspects of assessing your investment results at year-end and longer time periods, and provide an update on our tactical positioning.

Finally, some thoughts on the negative bias we have seen for some time in markets, where many investors have been overly concerned and sometimes acted unnecessarily on perceived risks. Being sceptical and focusing on what can go wrong is often viewed as being analytical and well-informed. This bias became more accentuated after the Global Financial Crisis in 2008-09, when shell-shocked investors found themselves in the uncomfortable position of having to stretch for yield and risk in a low-return environment. This increased the demand for downside protection, ideally without having to give up much return. However, many of these 'hedges' or insurance solutions turned out to be costly and less affordable when returns were lower.

The best way to approach this challenge is to try to be symmetrical, to be equally sceptical against both bullish and bearish ideas. We also have to try to avoid being embarrassed when we change our minds, as long as it is based on unbiased analysis. Another important point is to create the room to act 'counter-cyclically' – to buy low during crises and sell high during good times – thereby improving the scope to add value over time. To be able to do this, we have to make sure clients clearly understand, and are comfortable with, the risk levels we are targeting. Finally, don't forget that the most cost-efficient defence against bad outcomes is diversification.

With a non-biased attitude – trying to avoid being too negative or positive – we should be able to increase the chances of a Happy New Year.

As always, we hope you enjoy this edition of Compass and we welcome any feedback on the content.

Warmest regards,

Arne Hassel

Arne Hassel
CIO, Global Investments and Solutions

Bark versus bite: our key investment themes for 2017

The alleged popular backlash against globalisation has shown a bark worse than its bite so far. Highly evolved constitutional defences have helped, as has an increasingly robust business cycle. Of course, there may be more of a 'bite' to come in the year ahead, as Article 50 is finally invoked in the UK, President Trump gets his feet under the Oval Office desk and European voters get a few more chances to illustrate their discontent.

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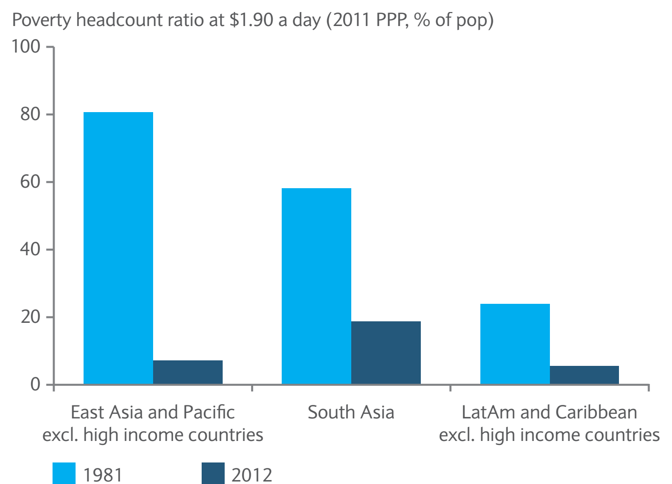
However, our view remains that much like this year; politics will create plenty of lurid headlines, but it will be the underlying fundamentals of the economy that matter most for investments. The influence of the political backdrop on those fundamentals will likely remain hotly debated, but marginal in most cases.

We remain wary of this anti-globalisation/end-of-liberal consensus theme that is attracting so much comment at the moment. The world tends to be messier than the commentators trying to impose such epic all-explaining themes on our ever-changing times will allow for. Some have already pointed out that the average income of President-elect Trump supporters actually sits above those who supported Hillary Clinton[1]. Meanwhile, the strongest predictors of voter behaviour in both the UK's referendum on its EU membership and the US presidential election have not been income, but education level, ethnicity and age[2]. In our opinion, the liberal economic world order is likely too well-established to meaningfully reverse in the next few years. Economic self-interest and constitutional safeguards will likely keep the world economy on the well-trodden path that has coincided with decisively less global inter-country inequality, poverty and violence over the last half-century (Figures 1 and 2). This does not mean that we do not take some of the political promises to unravel these regimes seriously. Quite the reverse – if we did see protectionism raise its ugly head again, there would likely need to be material changes to our recommended asset allocation as we incorporated a dramatically increased probability of an imminent US and global recession.

FIGURE 1: Global poverty



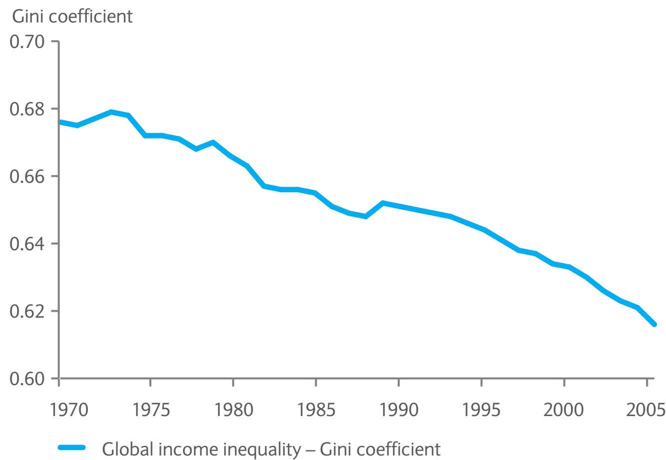
Source: Datastream, Barclays

For the moment, we remain focused on the prospects for global economic growth and inflation as the primary inputs into our investment thinking. On the indicators that we look at, the next global recession does not yet look imminent. For the moment, our five preferred indicators (explored in further detail in one of the short essays below) continue to point to global economic growth

[1] Explaining nationalist political views: The case of Donald Trump – Rothwell, Gallup, September 2016
[2] It's NOT the economy, stupid: Brexit as a story of personal values – Kaufmann, July 2016

remaining above stall speed and inflation bouncing back. With regards to the latter, it now seems a little more plausible to imagine inflation loitering above-trend in the US and UK, with wages and import prices now among the indicators suggesting as much. If President-elect Trump gets to enact his full stated agenda, then inflation forecasts will likely have to rise substantially again. As discussed in In Focus – Trick or Treat?, we choose to withhold judgement for now, and focus primarily on the economic forces already in motion.

FIGURE 2: Global income inequality



Source: Parametric estimations of the world distribution of income – Sala-i-Martin, Pinkovskiy, October 2009

All in all, the world looks like it will continue to reward portfolios slanted towards equities at the expense of bonds. There will come a time to change that stance, but that moment does not look imminent to us yet. In the short essays that follow, we explore some of the things to think about for the year ahead. The list is neither definitive nor exhaustive, but should help illustrate some of the thinking behind our current tactical asset allocation.

5 key takeaways

- Our five preferred indicators continue to point to the economic cycle having further to run – stocks to continue to outperform bonds
- Politics to continue to offer more bark than bite for capital markets investors – European equities to outperform, but nervous European equity investors should retain unhedged exposure to US companies
- Emerging Markets Equities to outperform in spite of protectionist noises emanating from the developed world
- For equity sector strategy, focus on areas most likely to benefit from underestimated prospects for growth and inflation – banks, industrials and technology
- A diversified portfolio will still be your best defence against unforeseen equity downdrafts

Investment theme #1

Leading indicators: no end in sight

The value destruction that characterised 2007/08 has persuaded many that it is more important to focus on missing the bad times, rather than being invested through the good. The post-war period tells us this is patently not true.

Nonetheless, there are five indicators that we continue to watch very carefully for any signs that the cycle end is close. Below, we explore what the five indicators currently tell us and why we value their input. It is worth remembering that none of these is infallible – all require interpretation and context, much as the last few years has proved with reference to the many leading indicators warped by lower commodity prices, unconventional monetary policy and near-zero interest rates.

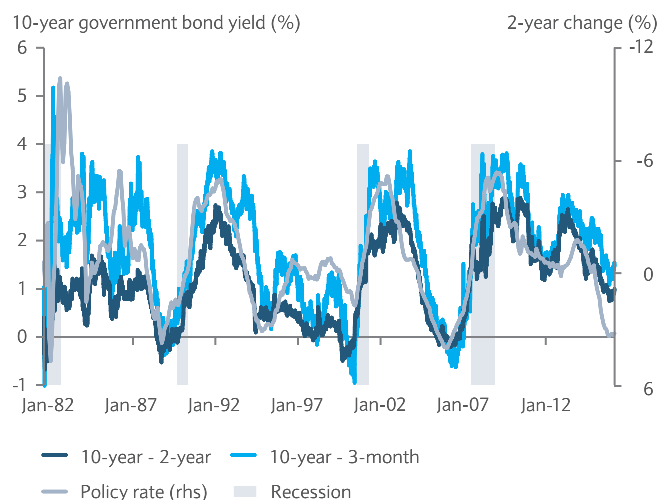
1. **ISM surveys** (Figure 3): the ISM manufacturing survey remains the longest-running and most trusted cyclical lead indicator. Earlier work on the ISM surveys with regards to forecasting GDP suggested over 60% of the moves in GDP can be explained by the ISM surveys[3]. The plunge in oil prices clearly impaired the reliability of the ISM Manufacturing earlier in the year, but both manufacturing and services surveys now sit at levels consistent with trend economic growth.

FIGURE 3: US ISM Manufacturing Index and GDP growth

Source: Datastream, Barclays

2. **Yield curve** (Figure 4): in the post-war period, an inverting yield curve (2-year yield moving higher than 10-year yield) has preceded every single recession. There has been one false positive in 1967, where a credit crunch but no recession materialised. However, in all other cases, the economy had slipped into recession in less than 12 months after the signal had been given. Many worry about the massive central bank bond purchase programmes and near-zero short-term rates distorting this signal, and have made some attempts to compensate[4]. The level of the yield curve is currently consistent with no imminent US recession.

FIGURE 4: US yield curve

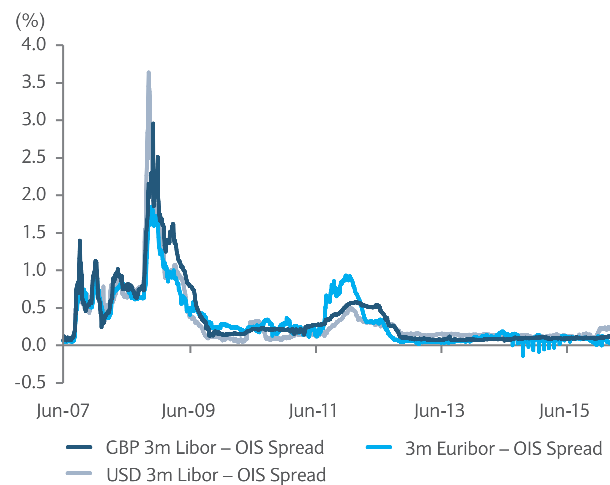


Source: Datastream, FRB Atlanta, Barclays

[3] In Focus, A tale of two indicators, 15 January 2016
[4] The Yield Curve as a Leading Indicator – FRB New York, Wu-Xia Shadow Federal Funds Rate – FRB Atlanta

3. European interbank rates and credit default swap (CDS) spreads (Figure 5): it remains hard to have a fully-fledged banking crisis without it showing up in either CDS or interbank lending rates. The latter should represent the liquidity situation within the banking sector, while the former tends to reflect balance sheet quality fairly accurately[5].

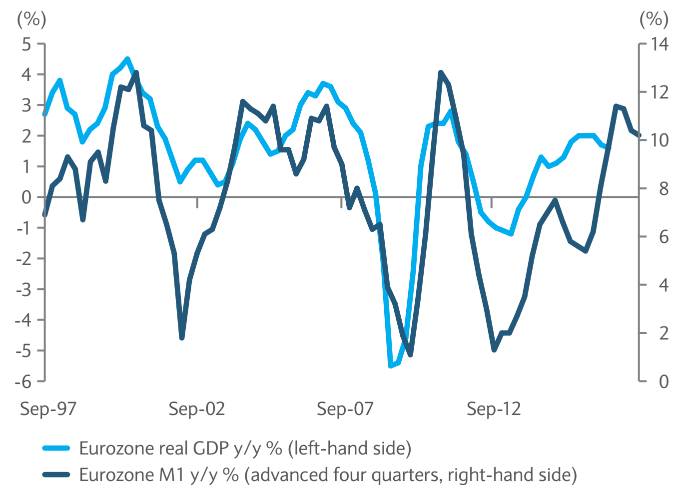
FIGURE 5: Interbank spreads



Source: Datastream, Barclays

4. Narrow money (M1) growth (Figure 6): the ECB's very thorough study of the relationship between M1 growth and recessions, suggest that when M1 growth moderates to zero year-on-year or below, a recession has tended to come within 18 months[6]. One possible reason for this is that M1 holdings are related to actual spending, since they are mostly money balances held for transactional purposes. A deceleration in M1 likely signals a slowdown in spending and economic activity. Right now, M1 growth is not at levels that are consistent with any alarm.

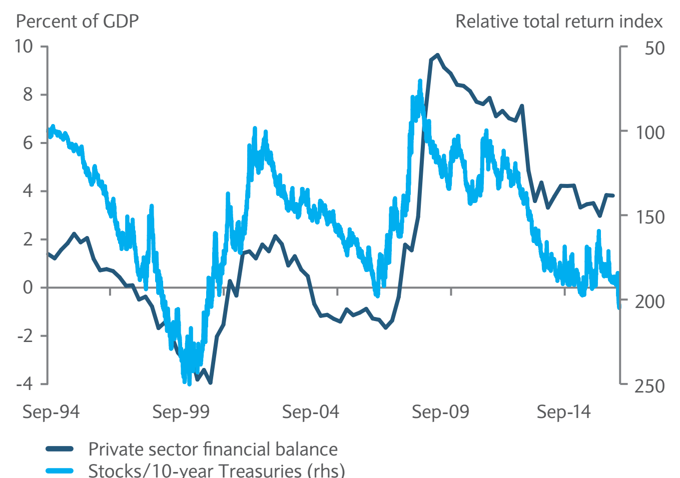
FIGURE 6: Eurozone GDP and money supply growth



Source: Datastream, Barclays

5. Private sector balance (Figure 7): this is a representation of private sector free cash flows, aggregating cash flow from the corporate sector and incomes from households, and detracting inventories and residential investment respectively[7]. The last two recessions have seen the private sector balance retreat into deficit. On its own this doesn't have to be a sinister phenomenon, though in concert with other indicators could be seen to be an approximation of the level of private sector exuberance. Current levels indicate further to run in this economic cycle.

FIGURE 7: Private sector financial balance



Source: Datastream, Barclays

[5] Are CDS spreads a good proxy of bank risk? – Chiaramonte, Casu, August 2010
[6] Stylised facts of money and credit over the business cycle – ECB, October 2013
[7] The Private Sector Deficit Meets the GSFCI: A Financial Balances Model of the US Economy – Hatzius, September 2003

Investment theme #2

Politics: between a rock and a hard place

The 2017 political calendar looks to be overflowing with things to worry about. Will it be the Scylla of a Geert Wilders led Dutch parliament in March or the Charybdis of a Marine Le Pen presidency in May? German elections later in the year will surely show a large part of the electorate expressing their dissatisfaction with the status quo, while more Italian elections are never far away.

However, 2016 has amply demonstrated that changes in the political discourse can make for fascinating editorials, but may not have predictable or, more importantly, durable investment ramifications. We expect this to remain the case in 2017. For Europe in particular, we take comfort in the fact that the constitutional backdrop in many countries has evolved specifically to mute the influence of the extreme ends of the political spectrum in the post-war period[8].

For France, the fact that Francois Fillon is now installed as the centre right candidate for next year's elections in May increases our belief that Marine Le Pen will be defeated by an electoral system designed to safeguard the influence of the political centre ground. She may well make it into the second round, but we would expect sufficient numbers of the moderate left to turn out in support for Francois Fillon, so continuing to keep the Front Nationale in abeyance.

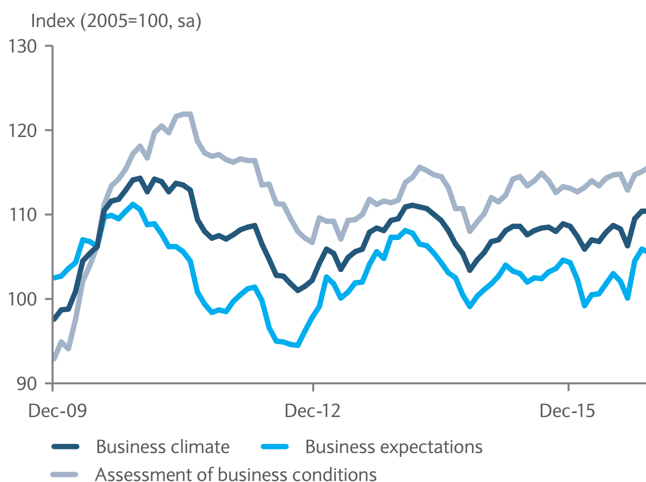
Meanwhile, the far-right politician, Geert Wilders of the Freedom party, could well be the next elected leader of Holland. However, for the Dutch to be able to hold a referendum on an international treaty, he would need to assemble a parliamentary supermajority to approve the necessary constitutional change[9] – something that we see as far less likely.

Germany's 'Alternative fur Deutschland' (AfD) has seen its support rise in the wake of the surge in Syrian immigration. However, we think AfD will manage to attain representation but not material influence in the German political set-up. Current opinion polls put the AfD support in the low teens in percentage terms, with no party signalling any willingness to cooperate with it to form a coalition.

Following its referendum on constitutional reform, Italy is now in political limbo, something that the economy is not unfamiliar with in the post-war period. While we suspect that the economy will remain a source of some disappointment through 2017, we do not see an increased probability of an Italian exit from the euro, particularly while the constitution remains almost perfectly bicameral.

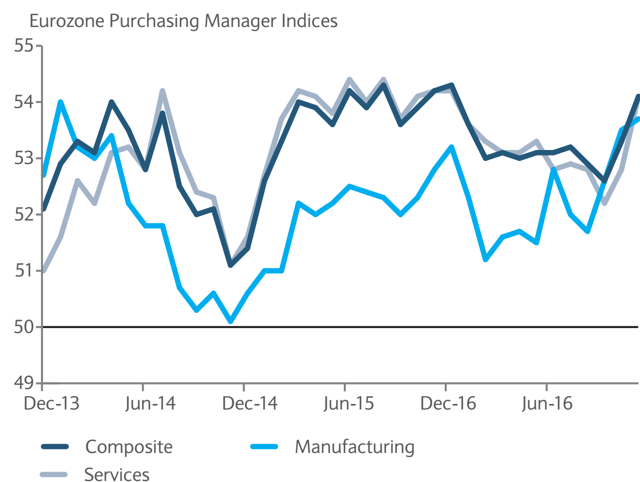
There will be plenty of ugly headlines and concerned talking heads, however we would still urge investors to focus on the underlying fundamentals of the economies in question. In Europe, the latest reading of our most trusted cyclical lead indicators suggest that the region's economic prospects remain more or less healthy (Figures 8 and 9). Outside of the base effects from previous declines in energy prices, inflationary forces remain benign. However, we suspect that the peak of deflation fears and monetary extremism for this cycle has now passed. This supports an overweight position in continental European stocks. For those European investors more nervous of less benign outcomes in the above-mentioned political events, but keen to stay invested in equities, we would suggest holding unhedged exposure in US equities.

FIGURE 8: German IFO survey



Source: Datastream, Barclays

FIGURE 9: Eurozone PMIs



Source: Datastream, Barclays

[8] Moderating Political Extremism: Single vs. Dual Ballot Elections – Bordignon, Tabellini, April 2008
[9] EU referenda beyond the UK: unlikely for now – Barclays Live, July 2016

Investment theme #3

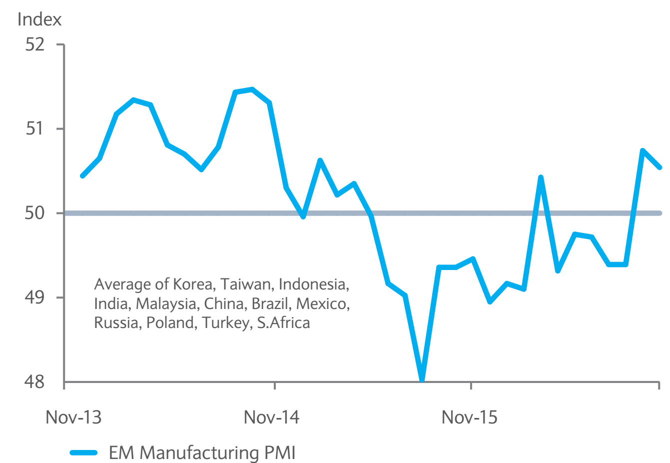
Emerging markets: bottoming out

Emerging markets (EM) assets have suffered in the wake of Donald Trump's election victory on fears of an impending return to the disasters of protectionism. We have argued at length that a combination of constitutional restraints and economic self-interest should help mellow his various, fluid and sometimes contradictory campaign trail promises. Admittedly, the president does have more unilateral power on trade. Various acts, ranging from the Trading with the Enemy Act of 1917 to the Trade Act of 1974[10], allow the president to bypass Congress' constitutional power to 'regulate commerce with foreign nations'. However, as we've mentioned in In Focus – Trick or Treat?, the fledgling make-up of his administration indicates a less controversial trade posture. We believe that now is a good time to be tactically increasing our exposure to EM equities.

While much of the recent debate has centred on political risk, EM macro fundamentals have shown signs of mild improvement, with business confidence finding a floor (Figure 10). EM-DM (developed markets) growth differentials have also shown signs of bottoming, arresting a falling trend that has been in place since the Great Recession (Figure 11). Stabilising demand from China and recovering commodity prices have helped EM exports. Meanwhile, moderating inflationary pressures in many EM economies have allowed the respective central banks to pursue looser monetary policy. For now, China remains low down our global list of concerns – traditional heavy industries are struggling and private sector investment remains weak; however, we remain confident of the government's ability to contain any systemic risks for the moment.

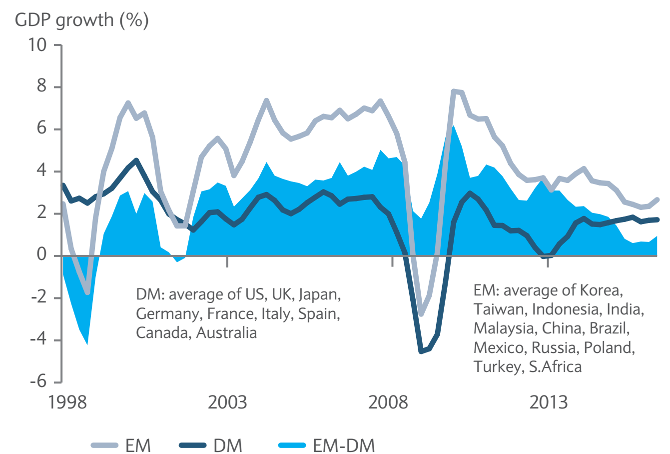
Our more positive view on the commodity complex, primarily oil, should continue to translate into a more hospitable backdrop for the various oil exporting economies, including Russia, Brazil and Mexico. The prospects for a widespread balance of payments problem and fiscal deterioration in such countries should recede accordingly.

FIGURE 10: EM PMIs



Source: Datastream, Barclays

FIGURE 11: EM-DM growth differentials



Source: Datastream, Barclays

As discussed in In Focus - Emerging Markets: Building a framework, EM asset returns are closely correlated to a handful of global macro factors such as the US dollar, US Treasury yields, oil prices, and DM equities. We currently see further upside to DM equities given the prospects for continued global economic growth. We hold a moderately positive outlook on oil as supply/demand imbalances work themselves out. However, we think that Treasury yields have more room to rise as the incoming inflation data strengthens. On balance, these inputs, alongside a neutral to mildly positive view on the dollar, suggest a moderately positive tactical outlook for EM asset returns.

Within EM, it is still to Asia that we would steer portfolio exposure. There is certainly excitement to be had in some of the more heavily beaten-up areas of the last five years. However, our convictions are highest in the regions with the most credible macroeconomic policies, where structural growth and governance are strongest and markets are most liquid and diversified. EM Asia is the region that still most readily ticks all of these boxes for us. Brighter prospects for global trade are no doubt important here, but not inconsistent with our view that the US consumer – the global economic actor where trends in global trade are most often catalysed historically – remains in good and improving health.

[10] Assessing Trade Agendas in the US Presidential Campaign (Chapter 1) – Noland, Hufbauer, Robinson, Moran, September 2016

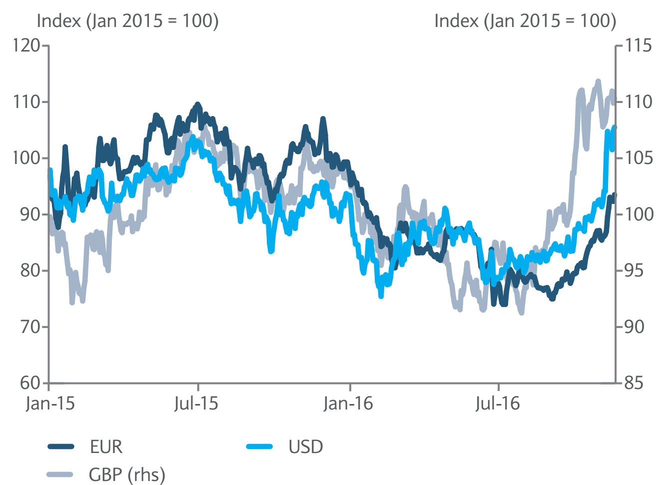
Investment theme #4

Equity sector strategy: reflation trades

A turbulent period for bond investors, amidst returning inflation and fears/hopes of an inflationary incoming US administration, has proven a boon for some of the more cyclical areas of the equity market. Banking, industrial and technology stocks are part of the driving force that has taken the US stock market to fresh all-time highs. Few details on policy and implementation have emerged from a still inchoate Trump administration. Whether President-elect Trump can, or even wants to, keep his promises and threats, and how far-reaching the resultant policies are, depends in large part on Congress.

Nevertheless, the case for leaning equity portfolios to the more cyclically sensitive areas of the market, even after the recent sharp rally, remains powerful. The base effect driven bounce in inflation data has helped to reverse overly-pessimistic assumptions on long-term inflation since the summer (Figure 12). Meanwhile, a less historically remarkable term premium should start to emerge in bonds as developed world central bankers take their feet slowly off the monetary pedal over the next few years. This, in turn, should relieve some of the strain on bank net interest margins, providing much needed succour to a still widely distrusted sector. Meanwhile, we see a rising yield curve as indicative of improving expectations for growth, something echoed by the ISM, and other manufacturing surveys. Such improving confidence is also consistent with higher earnings expectations, particularly from the more economically-sensitive areas of the stock market.

FIGURE 12: Inflation expectations



Source: Barclays

For banks specifically, loan growth and credit quality have been solid in the developed world, with loans to households now growing at a stable pace (Figure 13). The clearest investment case for banks remains the US segment, where inflation expectations are most credibly rising amidst rising wages. The case for European banks is obviously more cluttered, with a more questionable backdrop for growth and inflation and a structurally more concerning non-performing loan backdrop. However, the potential upside is likely greater too given depressed valuations. The valuation upside is admittedly less obvious for the likes of technology and industrials, but, as noted above, we see market-beating returns spurred primarily by above-average earnings growth in these areas.

FIGURE 13: US credit growth

Source: Datastream, Barclays

This reflation trade predates President-elect Trump's surprise election win and does not rely on some of his more growth-friendly policies making it through Congress. We see yield curves continuing to rise and steepen as the forces of growth and inflation in both the US and world economy prove themselves less structurally absent than widely feared.

With banks at the epicenter of the last, harrowing, recession, they were always likely to be the last sector to recover. The macroeconomic environment has not been helpful, with slow growth leaving flat bond yield curves and central bankers desperately experimenting with negative deposit rates. However, the above-mentioned more helpful economic backdrop is likely to scoop up some of the more cyclical areas of the market with banks. For this reason we advise clients to lean equity exposure in portfolios towards financials, technology and industrials.

Investment theme #5

Safe haven assets: undesired outcomes

As we have repeatedly emphasised in the past, growth is the norm - most years world output grows because of the simple interaction between new technology and the learning curve. The inference is that we need to find good reasons for positioning against that trend, with investors usually being better off with exposures supported by continued growth. Broadly speaking, history is on the side of the optimists, and that means investors are best served in the long term by tilting their portfolios towards risk assets such as equities, rather than traditional safe haven assets.

For now, our preferred indicators are telling us that the end of the cycle isn't imminent. Until they start flashing amber, the Tactical Asset Allocation Committee sees no reason to deviate from its current stance with an overweight in risk assets. This is further compounded by our concern that one of the most popular safe havens, government bonds, may be offering a period of return-free risk rather than risk-free return. However, the global economy is vastly complex, and we know far less than we imagine. We may be wrong about the near-term prospects for the economy – models can be mis-specified, and unforeseen risks may erupt without warning.

By spreading investments across a range of assets with varying degrees of sensitivity to the economy, we attempt to insulate our portfolios against unforeseen and undesirable outcomes. Comments about portfolio diversification broadly revolve around two broad asset classes – equities and fixed income. In reality, portfolios have a wider set of asset classes to choose from, not to mention that sub-asset classes (e.g. Emerging Markets Equities, Investment Grade Bonds etc.) have different risk characteristics as well. Having a wider opportunity set allows portfolios to reduce their allocations to Developed Government Bonds without having to sacrifice diversification. Figures 14 and 15 illustrate this nicely – when equities have performed poorly, it isn't just Developed Government Bonds that outperform, other asset classes such as Alternative Trading Strategies (ATS) and investment grade credit tend to do well too.

FIGURE 14: Asset class performance during developed market equity drawdowns

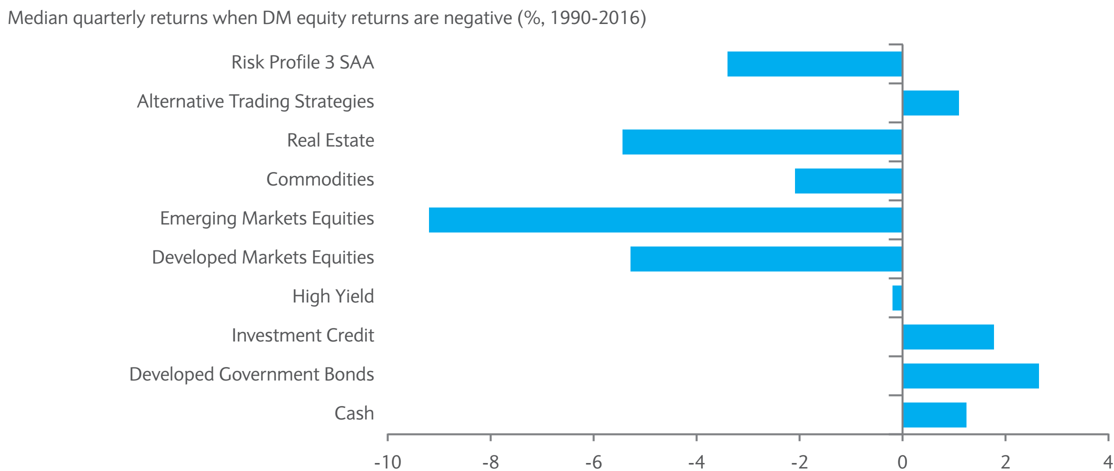
Q1 1990	Q3 1990	Q3 1998	Q3 2001	Q2 2002	Q3 2002	Q1 2008	Q1 2009	Q2 2010	Q3 2011
5.28%	44.45%	5.86%	3.25%	3.26%	4.88%	9.68%	2.85%	2.46%	3.96%
3.53%	9.35%	3.91%	3.16%	2.65%	4.65%	3.04%	2.07%	1.88%	0.90%
0.87%	3.81%	2.02%	2.73%	1.35%	4.14%	1.40%	0.83%	0.09%	0.14%
0.15%	1.67%	0.23%	1.43%	1.04%	0.98%	-0.28%	0.18%	-0.53%	-5.21%
-0.70%	1.41%	-6.88%	-4.01%	-1.96%	-0.18%	-1.42%	-0.11%	-2.87%	-6.50%
-2.19%	-8.72%	-8.31%	-9.36%	-5.28%	-1.64%	-2.33%	-1.66%	-3.29%	-8.66%
-7.24%	-10.73%	-11.67%	-9.68%	-6.67%	-9.32%	-4.38%	-4.55%	-5.42%	-9.25%
-9.18%	-22.91%	-12.36%	-13.44%	-7.56%	-12.07%	-5.72%	-4.68%	-6.63%	-14.10%
-16.19%	-23.91%	-13.59%	-17.81%	-14.86%	-18.21%	-9.00%	-10.26%	-6.90%	-14.94%
-18.63%	-23.96%	-23.43%	-24.81%	-15.50%	-20.20%	-10.93%	-20.83%	-11.27%	-20.23%

Cash and Short-maturity Bonds
Developed Government Bonds
Investment Grade Bonds
High Yield & Emerging Markets Bonds
Developed Markets Equities
Emerging Markets Equities
Commodities
Real Estate
Alternative Trading Strategies
Risk Profile 3 SAA

Source: Barclays

Past performance does not guarantee future results.

FIGURE 15: Median asset class performance during DM equity drawdowns



Source: Barclays

Past performance does not guarantee future results.

Accordingly, portfolio diversification shouldn't be viewed in terms of a simplified bi-allocation between equities and fixed income, but rather in terms of its beta, or the portfolio's overall relationship to equity markets and fixed income. Within our client portfolios, the presence of safe havens and other diversifying assets, plus the proportions in which we own them, have been successful in restraining that beta in both good and bad times. In the current environment we still see Cash and Short-Maturity Bonds as the most reliable nominal safe haven, providing liquid and stable ballast in portfolios. We augment this stable, but low returning core safe haven, with some government bonds, investment grade credit, and alternative assets with a negative beta to equity markets. At some stage, government bond yields may return to levels that start to offer the kind of real returns and nominal stability that we would demand of a safe haven asset. Until then, investors will have to continue to look to the less traditional asset classes to provide the same valuable service.

Beta

An indication of whether an investment is more or less volatile than the market. In general, a beta less than 1 indicates that the investment is less volatile than the market, while a beta more than 1 indicates that the investment is more volatile than the market.

New Year, new possibilities with impact investing

As investors, we are always mindful of the financial returns of our investments. But how many of us consider the social and environmental impact of those investments? And how that impact can affect our financial aims?

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Historically, most investors haven't been aware or interested in how their investment capital has been used – just that it produced the expected return. However, considering the impact of an investment can be material to its value.

For example, investors tend to become very cognisant after a scandal causes a material drop in their investment's value – as we've seen in the recent past for energy, textile, or auto companies. Consider, for example, the effect on your portfolio's value if part of it had been allocated to the coal industry. According to Bloomberg, due to the issue of stranded assets (assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities), "more than half the assets in the global coal industry are now held by companies that are either in bankruptcy proceedings or don't earn enough money to pay their interest bills.[1]" Clearly, the industry's impact in terms of climate change has had an influence on companies' valuations.

> Investing with dual aims – financial returns and societal impact – is the purpose of impact investing.

On a more positive note, investors are increasingly allocating capital to initiatives seeking to address societal challenges such as climate change, ageing populations, structural unemployment, and chronic diseases. The UN Sustainable Development Goals, which committed 193 countries to social, environmental and economic targets for global development, is estimated to require another $2.5 trillion, in developing countries alone, to deliver on their commitments[2]. Here, investors have an opportunity to grow their assets while generating impact by supporting solutions to the world's most pressing problems.

These are some of the new approaches which, by factoring impact considerations into investing, can benefit an investor's portfolio.

Latent demand

Although arguably the concept of impact investing has been around for a long time, the term was only coined at a meeting convened by the Rockefeller Foundation ten years ago. Since then, it has been gaining increased visibility and interest amongst governments, companies, philanthropic organisations, financial institutions, investors, academia and the media.

Having observed the concept during its early years, we decided to delve deeper into the topic in 2015 with those we see as the key participants – investors. Our Behavioural Finance team conducted research with around 2,000 individuals about their attitudes and activity in impact investing. Among many intriguing insights, we found that 56% of investors were interested in impact investing but only 9% had actually made any impact investments.

5 key takeaways

- Impact investing is intentionally investing to generate financial returns and societal impact to protect and grow assets and to make a positive contribution to our world
- In-house research covering 2,000 individuals showed that 56% of investors were interested in impact investing
- Partly driven by the UN Sustainable Development Goals, there are increasing flows of capital into initiatives seeking to address societal challenges such as climate change, ageing populations, structural unemployment, and chronic diseases
- Impact investing does not mean having to give up financial returns
- Impact investing offers investors new possibilities for their capital and can add value to investment portfolios

[1] https://www.bloomberg.com/gadfly/articles/2016-05-10/coal-s-stranded-assets#footnote-1462855087374
[2] http://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=194

If a majority of investors are interested, it is unclear why so few are involved. We spoke further with those who were active, and those who were not, as well as the leading experts in the field.

What we've realised is fairly simple. As a nascent and rapidly evolving field, it can be difficult to understand and access the market. Moreover, impact investing is frequently confused with other related alternative approaches such as ethical investing, socially responsible investing (SRI), sustainable investing, social investment, etc.

So, while many investors want to get involved, a lack of time, familiarity and support has been creating a 'latent demand' to participate.

Providing clarity

Given our role as proactive partners to our clients, it became a natural extension for us to support clients to consider how to bring impact into their portfolios. With sponsorship from our Social Innovation Facility[3], we've been able to commit to this journey over the next several years and support the industry as it matures and reaches the mainstream.

As we have already begun to build our presence and capabilities this year, it seems a good time to share some of the insights and ideas that we've developed; while also dispelling a few of the myths and misunderstandings which frequently arise when investors first learn about impact investing.

Myths & misconceptions #1: Impact investing requires giving up financial returns

The first, and most frequent, misunderstanding is that you have to sacrifice returns to have an impact.

Consider institutional investors active in impact investing who, as part of the Global Impact Investing Network (GIIN), annually complete a member survey. For those investors targeting market rate returns, they reported 9% of their investments were underperforming, whereas 66% were in line with expectations, and 25% were outperforming.

There are, however, investments that explicitly target lower returns than other comparable investments. Although this is not an attribute of all impact investments, in these cases, it is the investor's choice whether or not they choose to invest.

As a starting point, we consider impact investing as:

"Investing to intentionally generate financial returns and societal impact - to protect and grow your assets, and to make a positive contribution to our world."

One of the key terms in this view is the 'intention'. Impact investments need to have an eye on both the financial return and societal impact. This is not philanthropy – investors are seeking financial returns for the capital at risk. Neither is this just an investment which happens to have an impact – the intention from the outset must be to seek a positive social or environmental impact.

Linked with the intention to make an impact, these investments also seek to measure the outcomes they achieve. Given the early stage of the industry, providing good quality data is one of the most challenging elements of investing for impact. However, given the efforts in this area and increased investor demands, we expect significant improvements in the coming years.

We would also highlight how impact investing can add financial value to investment portfolios, i.e. "protect and grow your assets". This could be through incorporating additional considerations into the investment process to select more viable long-term investments, or finding new investment opportunities where organisations are generating innovative commercial solutions to social and environmental challenges.

[3] http://www.media.barclays.co.uk/video/?id=165573-1465392
[4] https://thegiin.org/knowledge/publication/annualsurvey2016

Myths & misconceptions #2: Impact investing is a separate asset class or allocation

Impact investments are fundamentally investments but are not themselves a distinct asset class. As options for impact investments exist across most asset classes, an investor would not need to allocate a separate portion of their portfolio to impact investments. Rather, they would look at how many of their investments include impact considerations in their investment approach.

To provide an example, an investor would not have a portfolio made up of 40% equity, 40% fixed income, and 20% impact investments. Why not? Imagine if the investor wanted the 20% of impact investments to be in 'green bonds', which are fixed income investments where the proceeds are applied specifically to environmental projects. Because green bonds are fundamentally fixed income investments, the 20% impact investment is really an additional 20% allocation to the existing debt allocation in the portfolio.

While today it may not always be possible for every investment in an investor's portfolio to be an impact investment, we expect this will be feasible over time. Already, some leading impact investors in a network called 'Toniic' have deployed $1.1 billion into what they call 100% 'Impact Portfolios', where they have found investments they consider impactful across all asset classes in their portfolios.[5]

Choosing to make an impact

As we approach the start of a new year, now may be an ideal time to consider whether impact investing is relevant for you by considering whether you have a preference for:

- Preventing your capital from funding companies/investments that potentially harm people and/or the planet
- Allocating your capital to companies operating effectively and generating positive societal outcomes
- Using your capital to target pressing social and environmental issues, particularly causes that are personally important to you

Overall, impact investing offers investors new possibilities for their capital. As a recent and evolving field of investing, we expect some challenges to be addressed now while others lie ahead. We will continue to provide more insights to clarify and help investors to navigate this field. In the end, we believe the true potential of impact investing is to enable every investor's portfolio to perform, and have the power to benefit wider society and the environment.

Myths & misconceptions #3: Impact investing is private equity investing in early stage businesses

The most visible and recognisable form of impact investing has been providing financing to early stage businesses addressing social and environmental challenges, often in developing countries. These are critical and ambitious organisations that often lead the innovation around finding solutions with commercial business models.

However, they are not the only impact investment option or way to invest for impact. For example, we believe that it is possible to incorporate impact in investment decision-making when selecting publicly-listed companies which issue stocks and bonds. These organisations generate an impact, which is often significant, in how they operate and in the goods/services they provide.

We recognise that investing in these more established organisations may not have the same additional effect as funding a start-up, and it may not be as easy to directly measure the impact of these investments. However, for many investors, these investments are accessible or appropriate for their circumstances, and can be made in line with the intention to invest for impact.

Additionally, investing in listed companies with this intention in mind can, in itself, be catalytic insofar as it generates behavioural change amongst businesses, driving them to think about the overall outcomes of their operations beyond the bottom line, the impact they have in the environment and communities, and the role they may want to have in society. This presents an opportunity for positive change and comparable financial returns.

[5] http://www.toniic.com/t100/insights-from-the-frontier-of-impact-investing/

Are you happy with your investments?

The turning of the calendar creates a natural point to reassess how your investment strategy has fared over the past year. For the most part, this can be a reassuring way to understand that you are still on track for whatever investing goals you set for yourself, but it can also be misleading. At this time of year, we should all be careful because our actual investing experience and the memories of our investing experience may not be the same.

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Studies in psychology have shown that our memories can be influenced by a 'peak-end' rule. This leads to the rather bizarre finding that people tend to prefer a more drawn out painful medical procedure, which although painful, ends with a relatively less painful period, as opposed to a shorter procedure which ends with more intense pain.

The peak-end rule

A similar peak-end rule can apply in investing. Investors will recognise that how you achieve your returns matters. Think about two investors, who got exactly the same return over the year. They should both be equally happy, shouldn't they? But what if one of the investors, let's call her Mrs. Peak, had a strong rise to the middle of the year followed by some losses from that peak just before year-end. The other investor, let's call him Mr. Trough, lost some money early in the year and then recovered to end with a gain. The peak-end rule would suggest that Mr. Trough is a happier investor than Mrs. Peak. After all, Mr. Trough's end point was also his peak (Figure 1).

As we come to the end of the year, each investor's experience will be different depending on their asset allocation. However, for many investors, 2016 may well have felt more like Mr. Trough's experience. Stock markets on both sides of the Atlantic have reacted better than widely feared to this year's political surprises and the weakness in sterling further boosted returns from globally diversified portfolios for sterling denominated investors.

The peak–end rule

A psychological event in which people judge an experience largely based on how they felt at the end and if this was its peak (i.e. its most intense point), rather than based on the total sum or average of every moment of the experience.

The story at the end of any given year could be very different though and you should recognise that any year could feel much like Mrs. Peak's experience. It is unlikely that the arbitrary point created by a new year, or receiving your latest statement, will also be when your portfolio is at a peak. This leads to an almost perpetual sense of dissatisfaction with the investing experience caused by our memories of events anchoring us to peaks along the way.

It's all in the timing…

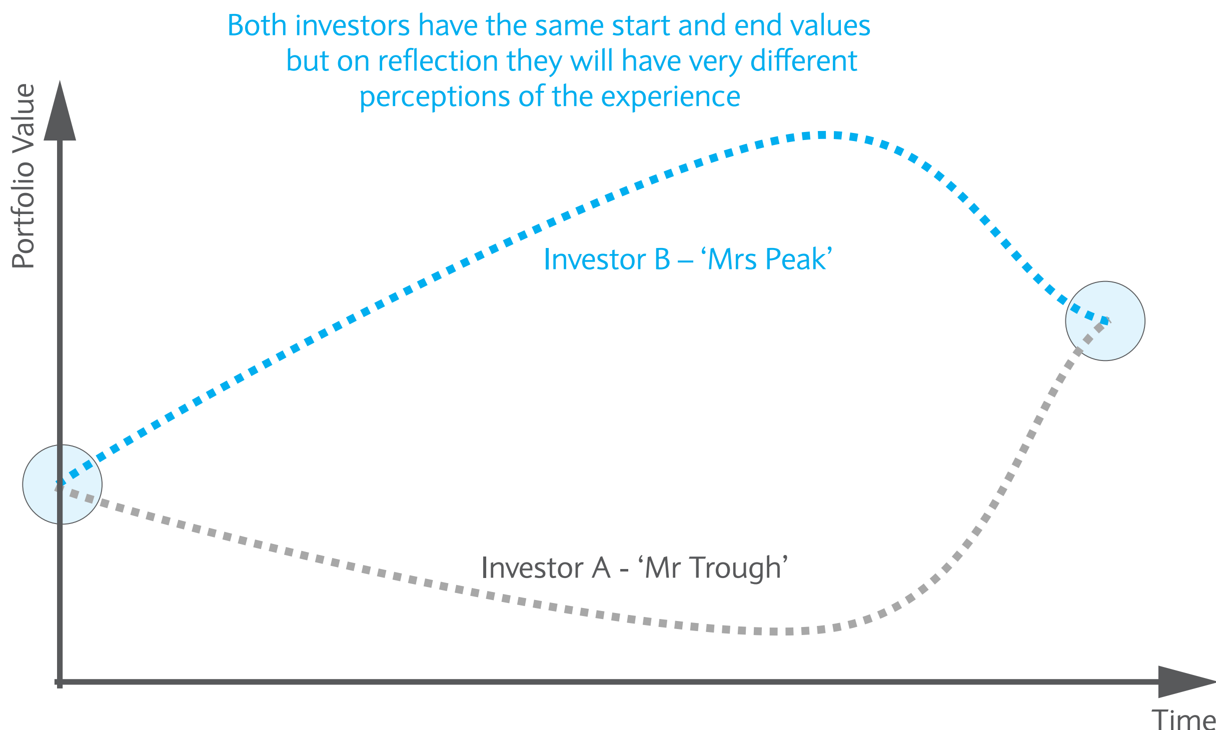
The way to overcome this behavioural trap is to recognise when discrete time periods of performance are influencing your experience. Most of us are aware that a year-to-date performance number is fairly meaningless at the end of the first trading week of the year.

5 key takeaways

- At this time of year, we should all be careful because our actual investing experience and the memories of our investing experience may not be the same
- Studies in psychology have shown that our memories can be influenced by a 'peak-end' rule
- It is unlikely that the arbitrary point created by a new year will also be when your portfolio is at a peak – this leads to an almost perpetual sense of dissatisfaction with the investing experience caused by our memories of events anchoring us to peaks along the way
- Calendar years are a natural way to frame performance, but you should be careful to look across a number of years to get a better sense of the average level of risk and return within your portfolio
- Long-term investors in a globally diversified portfolio have taken the first steps to investing success simply by getting invested

However, for the long-term investor who has a multi-year investment objective, it is just as meaningless in the last trading week of the year. Calendar years are a natural way to frame performance, but you should be careful to look across a number of years to get a better sense of the average level of risk and return within your portfolio.

Figure 1: Which investor is happiest at the end?



Conclusion

As we enter 2017 our behavioural perspective remains unaltered – risks that we know about will either disappear or become certainties, and new risks that we haven't even contemplated will become apparent. Remember, it is because of these risks that you are investing and not despite these risks. Long-term investors in a globally diversified portfolio have taken the first steps to investing success simply by getting invested. There may well be times when your resolve is tested and staying invested feels uncomfortable. In these periods, managing your short-term emotional state may dominate your desire for long-term returns. The bias to take action will be tempting but can also be destructive. Rebalancing your portfolio in these periods can provide emotional comfort from taking control of the situation and also enforces good portfolio discipline.

Finally, the peak-end rule is reinforced by news headlines of markets reaching new highs and of the days when commentators squawk of the billions being wiped off the value of investments. These headlines seldom match the experience of a diversified investor but can provide a salient memory which affects your satisfaction. Focus on what matters – reaching your investing goals and objectives.

The view from the Tactical Allocation Committee

Still stocks

We expect the world economy will continue to grow at above stall speed and see the cycle end as a relatively distant prospect. Here, we explain our current thinking behind our recommended tactical positioning. We still see investors being best served by leaning portfolios towards developed equities, and in the US and Europe ex-UK in particular.

We maintain a Strategic Asset Allocation for five risk profiles, based on our outlook for each asset class. Our Tactical Allocation Committee (TAC), made up of our senior investment strategists and portfolio managers, regularly assesses the need for tactical adjustments to those allocations, based on our shorter-term (three to six month) outlook. Here, we share our latest thinking on our key tactical tilts.

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Equities	
OW	Developed Markets Equities • The prospects for US consumption remain well-founded on a robust jobs backdrop, characterised by more visibly rising wages, which in turn is helping the appetite for credit to continue to recover • The negative hit from oil prices on associated corporate earnings is fading as is the headwind to profits from the previous ascent of the US dollar • US operating earnings have now made it back into positive territory year-on-year following the now almost complete US Q3 earnings season • Within the developed world, our preferred markets remain the US, Europe ex-UK and UK in roughly that order • For the US, we are not expecting further gains to come from multiple expansion, but from continuing earnings and dividend growth • For our overweight position in Continental European equities, much depends on the performance of the embattled banking sector where we expect a more helpful yield curve to continue to alleviate some of the more apocalyptic concerns • Our more positive outlook for oil prices is part of the reason that we have turned more positive on large cap UK equities
OW	Emerging Markets Equities • We moved our recommended tactical position in Emerging Markets Equities up to overweight from neutral in November • The emerging markets business cycle is bottoming, as evidenced by business confidence surveys and trade data • Trade data has collapsed and recovered in value terms due to commodity price swings, but the latest round of business confidence surveys have seen a sizeable rebound • US consumption also looks healthy, with wages now more visibly picking up and credit provision following suit • The fundamental macroeconomic backdrop has turned more positive for emerging markets corporate profitability • Asia remains our preferred region, with Korea, Taiwan and China (offshore) our highest conviction country views on a strategic basis

Bonds	
OW	High Yield & Emerging Markets Bonds • Earlier in the summer we moved from a tactical underweight to overweight position in High Yield and Emerging Markets Bonds by adding to Global High Yield • This was funded by moving from a tactical overweight to neutral position in Cash & Short-Maturity Bonds • Given our more sanguine take on the various risks to global growth and inflation, yields on junk credit look attractive on a risk-reward basis • We have more recently neutralised our earlier underweight position in local currency Emerging Markets Bonds, again using Cash & Short-Maturity Bonds
UW	Cash & Short-Maturity Bonds • While Cash continues to play a pivotal portfolio insulation role, the rising appeal from Emerging Markets Equities has led the Tactical Asset Allocation Committee to deploy our cash holdings into the latter, bringing our position in Cash & Short-Maturity Bonds from neutral to underweight
UW	Developed Government Bonds • Nominal yields offered by large chunks of the government bond universe are still negligible, even after the fairly dramatic sell-off seen since the summer • Our view remains that such valuations underestimate the underlying inflationary pressures within the US economy in particular – something that incoming inflation data pays some testament to • For us, the level of (returns insensitive) central bank ownership probably suggests that the bond market will remain more or less orderly and may lag a pick-up in inflation • Our continuing small strategic and tactical allocation to the area indicates that higher real returns lie elsewhere
UW	Investment Grade Bonds • The spread of investment grade credit over government bond yields has held more or less firm amidst the above-mentioned correction • Nominal yields in high quality corporate credit remain low in absolute terms and may make the job of those trying to make positive real returns difficult

Alternatives	
N	Commodities • We closed our long-held underweight in the commodity complex in May • US monetary normalisation will likely provide a headwind, but the stabilisation in Chinese growth looks sufficient to offset this for the moment • Investors are likely best served by tilting their commodity exposure towards oil and away from gold where possible, with the latter still particularly vulnerable to further US interest rate rises • We see oil prices continuing to drift higher over the coming 12 – 18 months as the market's worst fears on China fail to materialise and a smaller than suspected surplus is worked through
N	Real Estate • Recent volatility has served as a timely reminder of the importance of maintaining a diversified portfolio with the ability to weather a number of market environments, and we continue to encourage clients to ensure that they maintain a neutral strategic weight to Real Estate.
UW	Alternative Trading Strategies • We shifted our previous tactical underweight in Commodities to Alternative Trading Strategies (ATS), primarily due to the difference in volatilities for the two asset classes • There is less risk being underweight the lower volatility ATS in the current market environment in our opinion • Regulation and lower leverage leave this diversifying asset class without much tactical appeal at the moment

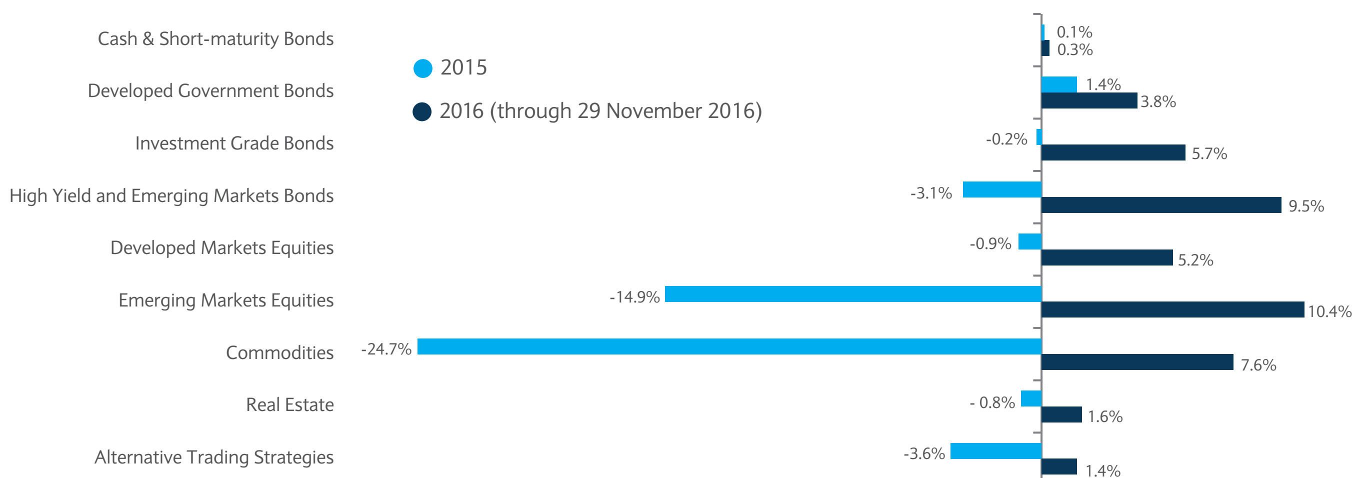
Key
OW Overweight **UW** Underweight **N** Neutral

Figure 1: Tactical asset allocation (TAA) tilts and strategic asset allocation (SAA) benchmark (moderate risk profile)

	Expected 10Yr Returns	SAA Profile 3	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight	
Cash & Short Maturity Bonds	2.0%	6%						Decreased on 23 November: counterpart to increased weighting in Emerging Markets Equities
Developed Government Bonds	1.9%	5%						Central bank buying and falling supply offset by high valuations and likely recovery in risk appetite
Investment Grade Bonds	2.8%	11%						Very expensive: little spread compression left to go for, prefer lower-tier 2 banks and insurers. Weighting has been decreased on 13 October
High Yield & Emerging Markets Bonds	5.1%	12%						Expensive, but part of the higher yielding asset classes that should benefit from the reasonably benign global environment. Weighting has been increased slightly on 13 October
Developed Markets Equities	8.0%	38%						Quoted corporate sector remains cash generative and well capitalised. The European equity exposure that was removed as a precautionary measure ahead of the UK's referendum has been added back and some exposure has been shifted from Japan to UK
Emerging Markets Equities	10.2%	8%						As of 23 November, we have increased this to an overweight, as the fundamental macroeconomic backdrop has turned more positive for emerging markets economies, based on the latest PMI and trade data
Commodities	4.6%	4%						We closed our long held underweight in the commodity complex as of 13 May. US monetary normalisation will likely provide a headwind, but the bounce in China's property market indicators look sufficient to offset this
Real Estate	7.6%	5%						Recent volatility has served as a timely reminder of the importance of maintaining a diversified portfolio
Alternative Trading Strategies	3.8%	11%						The previous underweight in Commodities was shifted to Alternative Trading Strategies on 13 May. Regulation and lower leverage leave this diversifying asset class without tactical appeal

We use qualitative descriptions of our Tactical positions relative to their Strategic benchmarks, ranging from 'strongly underweight' to 'strongly overweight'. This is a shift away from the percentage-based reporting method we used in the past. Our Strategic Asset Allocation (SAA) models offer a mix of assets that over a full business cycle will, in our view, provide the most desirable mix of return and risk at a given level of Risk Tolerance. They are reviewed annually to reflect new information and our evolving outlook. Our Tactical Asset Allocation (TAA) tilts these SAA views to reflect our shorter-term cyclical views. Source: Barclays

FIGURE 2: Total returns across key asset classes

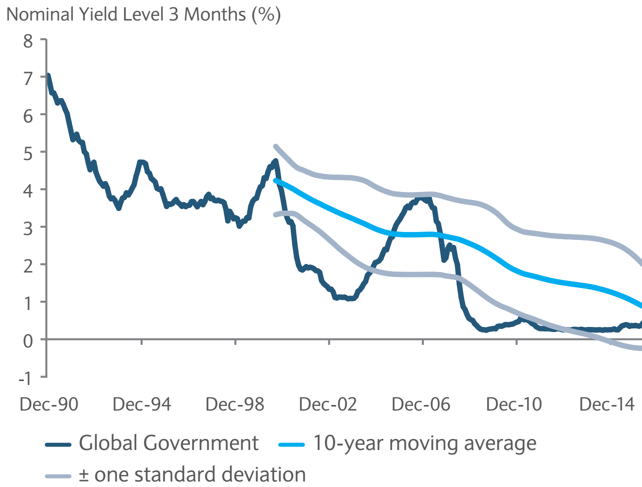


Source: FactSet, Barclays. List of indices used: Cash & Short-Maturity Bonds: Barclays US T-Bills (USD); Developed Government Bonds: Barclays Global Treasury (USD Hgd); Investment Grade Bonds: Barclays Global Aggregate – Corporates (USD Hgd); High Yield & Emerging Market Bonds: 40% Barclays Global HY (USD Hgd), 30% Barclays EM Hard Currency Aggregate (USD Hgd), 30% Barclays EM Local Currency Government (USD); Developed Market Equities: MSCI World Net TR (USD); Emerging Market Equities: MSCI EM Net TR (USD); Commodities: Bloomberg Commodity TR (USD); Real Estate: FTSE EPRA/NAREIT Net TR (USD); ATS: HFRX Global Hedge Fund (USD). For a table of historical discrete annual performances, please see Compass Q4 2016.

Past performance does not guarantee future results.

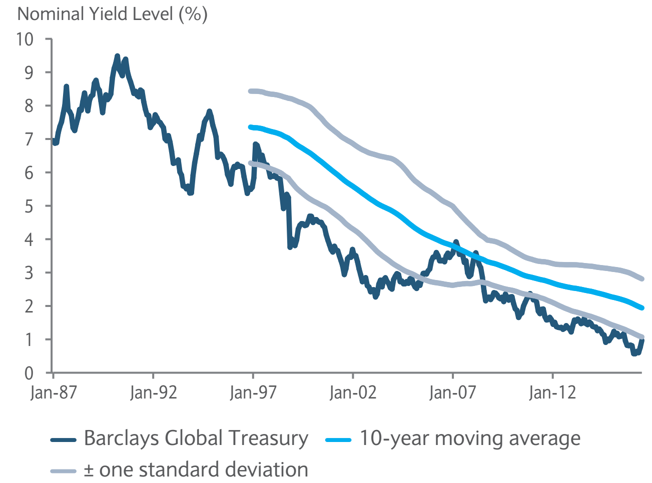
Interest rates, bond yields, and commodity and equity prices in context*

FIGURE 1: Short-term interest rates (global)



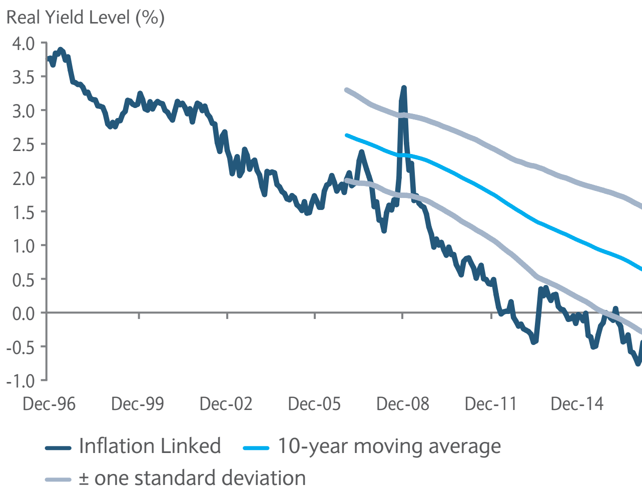
Source: FactSet, Barclays

FIGURE 2: Government bond yields (global)



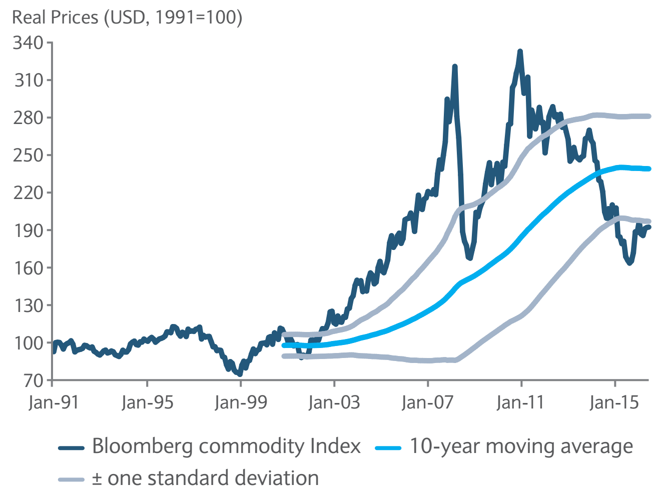
Source: FactSet, Barclays

FIGURE 3: Inflation-linked real bond yields (global)



Source: Bank of America Merrill Lynch, Datastream, FactSet, Barclays

FIGURE 4: Inflation-adjusted spot commodity prices



Source: Datastream, Barclays

FIGURE 5: Government bond yields: selected markets

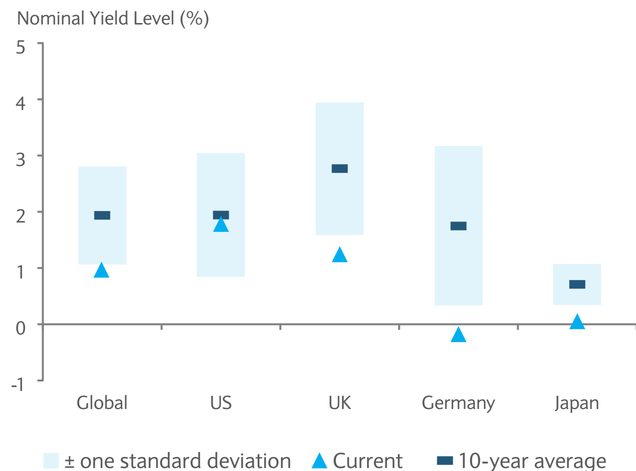
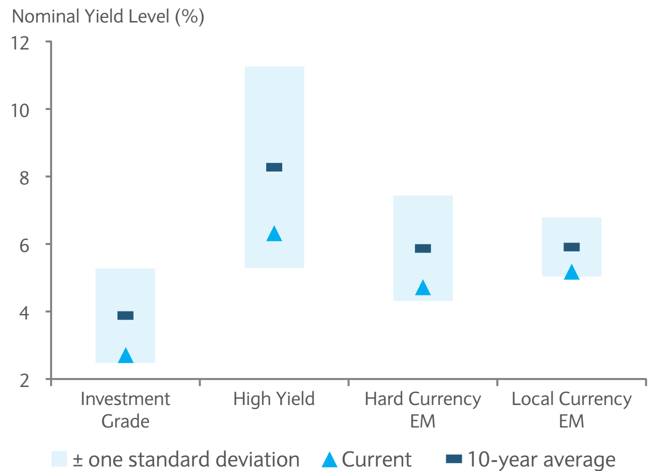


FIGURE 6: Global credit and emerging markets yields



Source for Figures 5-6: FactSet, Barclays

*Monthly data with final data point as of COB 29 November 2016. Past performance does not guarantee future results.

FIGURE 7: Developed stock market, forward PE ratio

FIGURE 8: Emerging stock market, forward PE ratio

FIGURE 9: Developed world dividend and credit yields

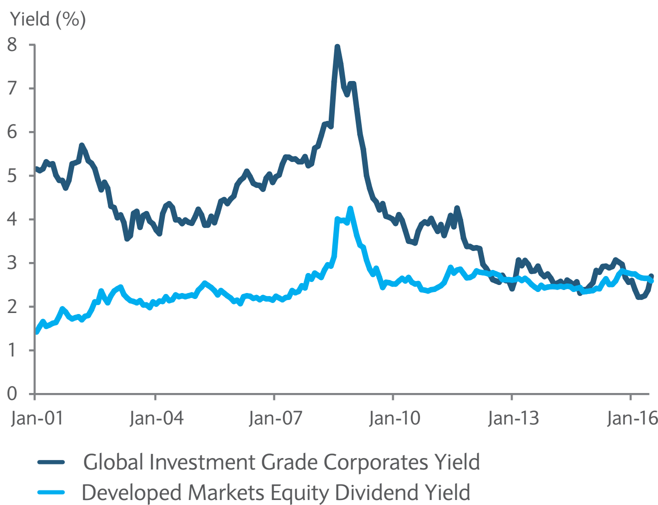


FIGURE 10: Regional quoted-sector profitability

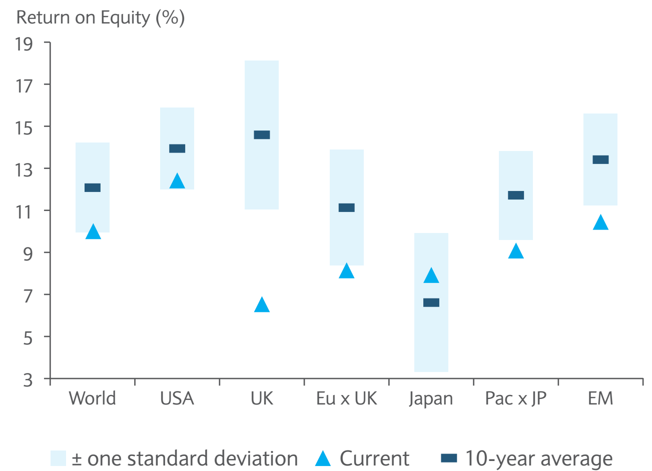


FIGURE 11: Global stock markets: forward PE ratios

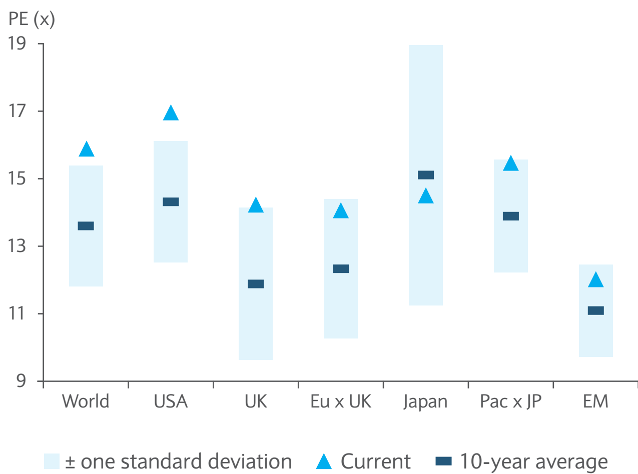
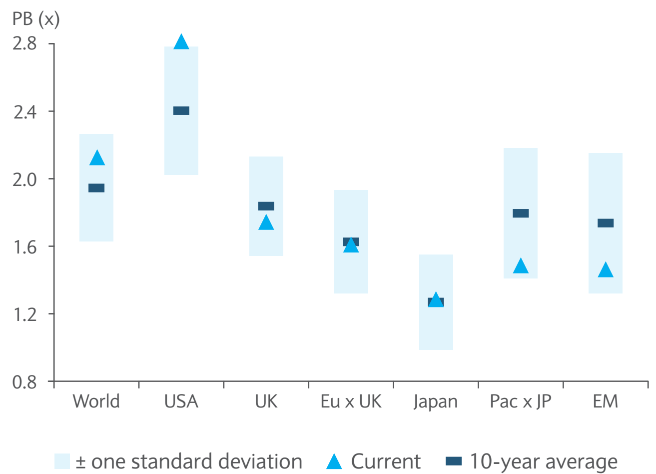


FIGURE 12: Global stock markets: price/book value ratios



All sources on this page: MSCI, IBES, FactSet, Datastream, Barclays.
Past performance does not guarantee future results.

Barclays' key macroeconomic projections

FIGURE 1: Real GDP and consumer prices (% y-o-y)

	Real GDP			Consumer prices		
	2016F	2017F	2018F	2016F	2017F	2018F
Global	3.1	3.5	3.8	1.7	2.3	2.5
Advanced	1.6	1.6	2.0	0.7	1.8	2.1
Emerging	4.3	4.9	5.1	3.2	3.0	3.1
United States	1.6	2.2	2.5	1.3	2.4 ↓	2.8
Euro area	1.6	1.2	1.6	0.2	1.2	1.4
Japan	0.6 ↑	1.2	0.7	-0.3	0.4	1.0
United Kingdom	2.0	0.5	1.5	0.6	2.4	2.1
China	6.7	6.3	6.1	2.0	2.2	2.3
Brazil	-3.6	0.5	1.8	8.8	5.5 ↓	5.3 ↓
India	7.6	7.9	8.0	5.1	4.8	5.3
Russia	-0.5	1.1	1.9	7.1	4.7	4.1

Source: Barclays Research, Global Economics Weekly, 18 November 2016

Note: Arrows appear next to numbers if current forecasts differ from previous week by 0.2pp or more. Weights used for real GDP are based on IMF PPP-based GDP (5yr centred moving averages). Weights used for consumer prices are based on IMF nominal GDP (5yr centred moving averages). Aggregates for CPI exclude Argentina and Venezuela. There can be no guarantees that these projections will be achieved.

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