



## Four Strategies for Navigating the Equity Environment Ahead

Recent market turmoil suggests we could be at a turning point for equities. After several years of high returns and low volatility as the market rebounded off the lows of 2009, supported by unprecedented monetary policies, investors are faced with broadly full valuations, global growth that is still uneven and the prospect of rising rates in the U.S. In this environment we suggest four simple approaches that could enhance returns while potentially reducing risk.



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Mr. Pyne is an executive vice president and product manager in the Newport Beach office, focusing on PIMCO's equity strategies. Prior to joining PIMCO in 2011, he was a managing director and client portfolio manager for fundamental equity at Goldman Sachs Asset Management, serving as a member of the growth team investment committee. Before joining Goldman Sachs in 1997, Mr. Pyne was responsible for product management at Van Kampen Investments. He has 23 years of investment experience and holds an undergraduate degree in business/economics from Wheaton College in Illinois.

Over the secular horizon, the macroeconomic backdrop remains favorable for equities. As the global economy converges to slower but more stable growth, as debt and growth dynamics keep real interest rates low and as inflation remains muted, we expect equities to deliver returns that will exceed other asset classes, such as fixed income.

However, challenges remain. Full valuations coupled with expectations for only moderate growth should lead to returns that are much lower than the past six years. In addition, events this summer, from Greece to falling oil prices to the slowdown in China and concerns about its impact on global growth, underscore that in a fully valued market, unfavorable macro or earnings news can generate volatility.

Many investors have enjoyed the ride over the past few years, as simple exposure to equity beta has been enough to achieve their portfolio return targets. But going forward, in an environment of lower returns and higher volatility, many will need to rethink their approach to equity investing to achieve better outcomes.

There are four strategies we believe are worth considering when navigating the road ahead.

## **1. Enhance your core**

Most investors have strategic allocations to core segments of the global equity market. While constructs may differ, allocations to domestic equities, international equities and emerging markets (or capturing exposure to all of these areas in a global equity strategy) are often the cornerstones of an equity asset allocation in investor portfolios. Given our constructive long-term outlook for equities, we believe investors should maintain core equity exposures but seek the potential for higher returns: Beta alone may no longer be enough.

Seeking higher return potential in a period of higher volatility doesn't necessarily require taking additional risk. In fact, we believe investors should strive to retain many of the key benefits of their core allocations, such as broad diversification and economic representation, while still seeking the opportunity for outperformance.

Strategies designed to provide a more structural source of outperformance, such as smart beta and portable alpha, can help enhance the core. Smart beta strategies offer a third option for investors beyond traditional passive and active equity investing: They seek market outperformance through a systematic approach that breaks the link between price and portfolio weight to capitalize on market inefficiencies. Portable alpha strategies can provide investors with equity market exposure but utilize an independent alpha source, such as an absolute return bond portfolio. This approach, pioneered in our StocksPLUS suite of equity offerings, has earned PIMCO four Lipper awards for Best Group over 3 Years for Large Equity (2013, 2012, 2011, 2010).

## **2. Embrace global**

There are two key elements to going global that investors should consider. First, during the bull market since 2009, when we had a synchronization of global monetary policies and even weak companies had access to low cost financing, there was broad multiple expansion and very little dispersion among stock returns. It was an environment where you could simply own the market as opposed to being selective. But we are already seeing the dynamics shifting: The synchronization is desynchronizing. As the U.S. begins to raise rates, we'll have even more divergent monetary policies across the world. This in turn is likely to create additional currency volatility, supplying an earnings tailwind for some companies and a headwind for others. In addition, the energy revolution has a very different impact on oil companies than on some industrials and consumers. In short, an environment of higher dispersion, of winners and losers, suggests investors would benefit from investing in strategies with the broadest opportunity set that allow managers to identify the best risk/reward opportunity

regardless of company domicile.

Second, and specific to U.S. investors, U.S. equities have significantly outperformed most non-U.S. equities over the past few years, increasing an already prominent home-market bias in investor portfolios. However, outside the U.S., valuations tend to be lower, dividend yields tend to be higher, central banks are still aggressively easing and currency dynamics are helping to underpin a more favorable earnings environment. We believe U.S. investors should consider diversifying their equity exposure by adding or increasing allocations to non-U.S. markets in their portfolios. Additionally, investors should consider currency-hedged strategies to take advantage of a strengthening dollar.

### **3. Seek stable sources of returns**

At their most basic level, equity returns have two components: capital appreciation and dividends. Over the past few years – and in high-returning decades like the 80s and 90s – the contribution from capital appreciation has dominated. This is because these markets were characterized by broad multiple expansion (often driven by declining interest rates) and/or a global economy that provided a tailwind to earnings.

Going forward, with fuller valuations and an economic backdrop that will likely lead to modest earnings growth at best, we could see less capital appreciation. As a result, dividends are likely to make up a greater portion of equity returns. Dividends can be a more stable source of returns, but there's a caveat: stocks that simply offer yield may struggle in a rising rate environment. This reinforces the case for a global dividend portfolio (which can benefit from investing where rates are lowest or decreasing around the world), and a focus on companies growing free cash flow and management committed to dividend growth.

### **4. Reduce downside risk**

As investors are faced with the prospect of heightened volatility, and given the way returns compound over time, protecting on the downside could be a critical contributor to long-term returns. Yes, passive exposure to equity beta has rewarded investors over the past few years, but by definition traditional indexes will capture 100% of negative market performance. How can investors participate in equity markets while mitigating downside risk? Low volatility equity strategies may offer the potential for asymmetric up and down market returns.

Specifically, long/short equity strategies may be a good low volatility solution and effective complement to long-only allocations. Long/short equity strategies have outperformed the equity markets over the past 15-plus years with lower volatility

due to their participation in equity upside while also providing downside risk mitigation. The Dow Jones Credit Suisse Long/Short Equity Index has had annualized returns of 9.11% since 1 January 1994 with a Sharpe ratio, a widely used measure of risk-adjusted return, of 0.69 and a maximum drawdown of 22.0%, compared to the S&P 500, which returned 8.82% with a Sharpe ratio of only 0.41 and a maximum drawdown of 50.9%, as of September 30. We believe a stock-specific approach to long/short equity investing is one of the best ways to seek attractive returns today.

### **Conclusion**

At PIMCO, we expect equities to deliver returns that will likely exceed those of other asset classes over the secular horizon, but we expect those returns to be well below the bull market returns of the last six years. In addition, we expect company results to diverge widely based on company fundamentals, sector dynamics and by the macroeconomic and monetary policy outlook in individual countries. We believe this is not the time to expect market beta alone to give investors satisfactory results as in the recent past, and we see trends that will affect companies and regions in different ways.

That said, there are strategies that may help investors to achieve better results, such as enhancing their core equity portfolio with non-traditional sources of return, embracing a global investment set, seeking more stable sources of return, particularly from dividends, and focusing on downside protection with more flexible approaches.

**Past performance is not a guarantee or a reliable indicator of future results.** Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in **foreign-denominated and/or -domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Entering into **short sales** includes the potential for loss of more money than the actual cost of the investment, and the risk that the third party to the short sale may fail to honor its contract terms, causing a loss to the portfolio. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Dividends** are not guaranteed and are subject to change and/or elimination. **Diversification** does not ensure against loss.

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

Dow Jones Credit Suisse Long Short Equity Index is an asset-weighted hedge fund index derived from the TASS database of more than 5,000 funds. The directional strategy involves equity oriented investing on both the long and short sides of the market. The objective is not to be market neutral. Managers have the ability to shift from the value to growth, from small to medium to large capitalization stocks, and from a net long position to a net short position. Managers may use futures and options to hedge. The focus may be regional, such as long/short U.S. or European equity, or sector specific, such as long and short technology or healthcare stocks. Long/Short equity funds tend to build and hold portfolios that are more concentrated than those traditional stock funds. The S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the Large-Cap segment of the U.S. equities market. It is not possible to invest directly in an unmanaged index.

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