– preparing for the road ahead

We live in an uncertain world which is undergoing fast and sometimes unforeseen changes. Being better prepared for the unexpected can help a pension scheme ride out this uncertainty. By constructing a portfolio that focuses on what may happen in the future rather than what has happened in the past, a pension scheme is more likely to stay on the road and reach its final destination.

## What's around the next corner?

Like it or not, we live in increasingly uncertain times.

Who would have guessed that Donald Trump would become the next US president? Or that the UK would decide to leave the EU? With political unrest growing across Europe and the Chinese economy facing a sharp slowdown, the road ahead for the global economy has never been so unclear.

Despite this uncertainty, markets have proved surprisingly resilient and remain at record highs. But is there an accident just waiting to happen around the corner?

Since the financial crisis of 2008, supportive global central bank policies have certainly helped fuel asset prices to their current highs. However, with many of these policies close to their limits and others beginning to reverse course, one wonders whether we have reached the top of the mountain.

## An unhealthy reliance on the past

In today's uncertain world, one would think that most pension scheme portfolios were diversified enough to ride out any bumps in the road. But, for many, this couldn't be further from the truth.

Over recent years, it's fair to say that many have tried to diversify away from the traditional 60/40 equities/bonds approach by adding other assets such as credit and property. However, while this may look good on paper, this supposed diversity has led many into a false sense of security.

The problem is that – like trying to drive a car forwards whilst looking through the rearview mirror - these asset allocations are typically based on traditional models that rely too much on historical data.

## Why is this a problem?

Firstly, these models assume that historical asset class relationships, such as equities and bonds tending to move in opposite directions, remain stable. They don't consider that during times of market stress, when diversification is most needed, these relationships tend to break down and everything falls at once.

The risk of a serious accident is never far away.

In addition, this unhealthy reliance on historical data leads to the assumption that assets that have performed well in the past will continue to perform well in the future. This leads to allocations skewed towards assets that have outperformed in the past – during an environment where economic growth has been robust.

Given that economic growth is one of the fundamental drivers of asset class returns, these allocations effectively represent a significant bet that the global economy will continue to grow at this pace in future.

Taken together, if the world were to enter another downturn, portfolios based on this traditional approach may be exposed to such significant asset price falls that many would struggle to ever recover. See Figure 1 overleaf.

Surely there is a better way to manage a portfolio? One that can help it traverse a variety of terrains and not just a flat race track.

## An eye on the road ahead

A forward looking scenario-based approach can help better prepare pension funds for the winding road ahead.

At the heart of this approach is the consideration of what will drive asset returns in the future rather than what drove them in the past. It's more about understanding how these assets are driven by underlying economic factors, such as growth and inflation, rather than historical relationships.

Such an approach takes into consideration how different assets perform across various economic scenarios. A focus on what could happen in the most unlikely scenarios is particularly important as these events will typically have the largest impact on the portfolio.

By considering this, many investors begin to see the benefits of holding assets that they may have never once considered.

For instance, assets principally designed to perform well in a stressed market or recessionary environment become more desirable in a portfolio. This could include equity downside protection strategies which only lose small amounts in other scenarios or even gold which typically sees high demand in a downturn as investors seek its perceived safe store of value.

Armed with this new scenario way of thinking, an investor is primed to build a more robust portfolio that is better prepared for the unexpected. ▶

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By proactively avoiding large shocks to the portfolio, the scheme is more likely to reach its final destination

For example, by developing a view on the likelihood of how the world will develop in years to come, one can start to think about how to allocate to assets that are expected to outperform in these different scenarios. Figuring out the size of these allocations is not an exact science and the impact of asset price valuations also needs to be taken into consideration. But it does make an investor consider what could happen in the worst possible outcome and what could be done to protect against this.

Over time, this scenario-based approach also encourages pro-active adjustments to the asset holdings as and when the outlook changes. This helps to ensure the portfolio is ideally positioned for those times when you leave the motorway and move onto the winding country lanes.

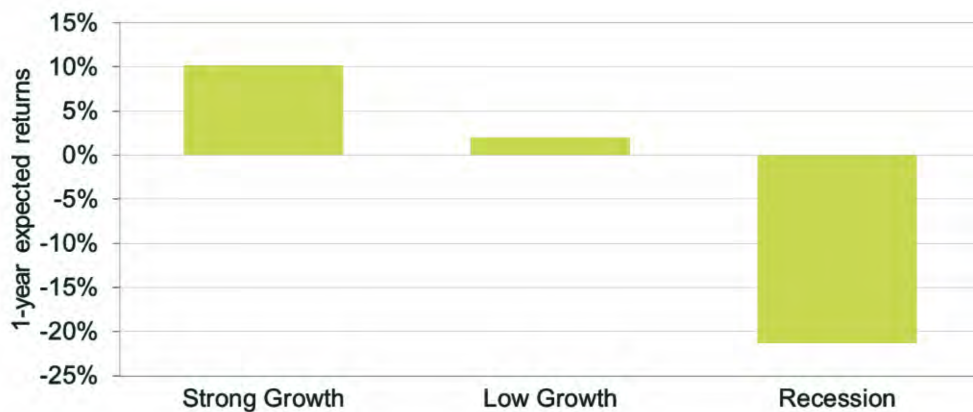
As seen in Figure 2 below, analysing the impact of different allocations under different events can provide a much greater understanding of how the journey will be in the future. Greater clarity can be achieved as to the potential gains and losses, meaning that trade-offs can be made. By proactively avoiding large shocks to the portfolio, the scheme is more likely to reach its final destination.

## Better prepared for the journey

The truth is that no one knows for certain what the future may hold. But being prepared for the unexpected can help a pension fund better meet its goals over the longer term.

In these more uncertain times, a scenario-based approach to portfolio construction can help you better avoid any accidents along the way. While it doesn't guarantee returns, it can deliver true diversity that can help deliver more predictable results in this increasingly uncertain world.

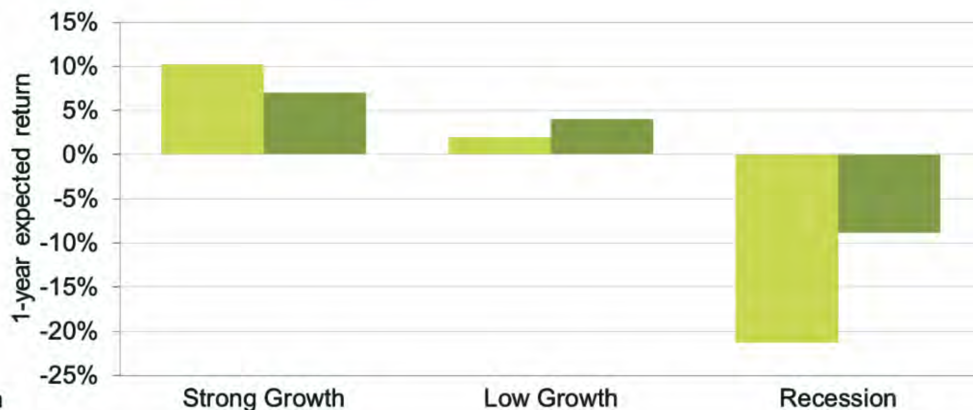
*Figure 1:* **Impact of a more traditional approach**




Historical approach

*Source: Cardano*

*Figure 2:* **Impact of using a scenario-based approach**




Historical approach

Forward looking approach

*Source: Cardano*