DISCUSSING ASSET ALLOCATION, ACTIVE VS. PASSIVE AND JAPAN

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Last week on our podcast, I had the opportunity to speak with Bill Stone, the global chief investment strategist for PNC Asset Management, and Jesper Koll, CEO of WisdomTree Japan. Our discussion focused on markets, Fed policy and building global portfolios, with a particular focus on Japan in the second half of the conversation with Jesper.

- With Stone, we talked about how his asset allocation strategy at PNC Asset Management is to carve up active/passive/factor portfolios using a roughly one-third allocation to each as a way of targeting equity exposure. Within the active group, he's looking for high-conviction managers who can add value and pairing them with factor approaches and pure beta in a way that minimizes tracking error from benchmarks. His factor approach tries to tilt to rewarded factors such as value investing and quality investing.
- In today's market environment, Stone's team is favoring value-oriented strategies, in part due to a belief the financial sector run-up has room to go with a steep yield curve.
- Stone's team has even been looking at factor strategies applied to the alternatives market. We discussed various alternatives such as commodities and managed futures, and why Stone's team is moving from pure commodities exposures to managed futures that incorporate a trend element for commodities.

On Japan, Jesper discussed:

- For monetary policy, the Bank of Japan (BOJ) has been sticking with its zero interest rate cap all the way down to the 10-year maturity on its yield curve, and the BOJ is going to remain steadfast in this policy. We saw this divergence in policies recently with a global yield pickup led out of Europe, but 10-year Japanese bond yields stayed at just 10 basis points (bps).
- Jesper believes the policy is working. He sees bank credit growth accelerating. Last year bank lending growth was running at 2% to 2.25%, while this year Jesper sees it growing at 3.25% to 3.5%. He sees the banks as strong, well-capitalized and ready to lend with a pickup in demand for credit.
- Japanese prime minister Shinzo Abe's popularity is declining. Jesper attributes this decline to Abe's desire to make changes to the Japanese constitution and not to his economic policy decisions. We expect to see a change in his cabinet in the coming few weeks and a renewed focus on the economics side. Jesper is confident the team around Abe sees this as a wake-up call for new initiatives on deregulation and privatization.

- Japanese banks benefiting from being the largest lender outside China into countries in the Association of South East Asian Nations.
- Jesper talked about the performance of Japanese small caps versus large caps as one sign of the endogenous demand happening in the local economy—over the last five years, Japanese small caps have been beating large caps by over 5 percentage points per year, which translates to very large gains over large caps. Jesper believes Japan is in a demographic sweet spot because purchasing powers and income are growing. The quality of jobs is improving with a move toward full-time jobs and wage growth. Starting salaries for university graduates increased around 6% this year, while total wage growth was 1.5%. This does not sound like a lot, but after decades of declining wage growth, this is a big deal. And it's concentrated in the younger population.

It was a pleasure talking to both Bill Stone and Jesper Koll, and we thank them for participating. To listen to the full broadcast, you can click below.

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DEFINITIONS

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Basis point : 1/100th of 1 percent.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.