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Market Insights

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A New Paradigm for Institutional Investing:

Why the Next Few Decades Will Be Different

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Almeida: What's on the minds of institutional investors today?

Hyland: It's an interesting time to be investing. I believe our clients recognize that the next few decades ahead of us are going to be fundamentally different from the past few. We are in a paradigm shift that may require a different mindset. Last year was a market environment that we haven't experienced in decades — over 40 years since the last time both equities and bonds were down in the same year. Given that backdrop, there are a few key trends facing institutional investors.

First, with the markets down across the board in 2022, addressing liquidity needs with lower total values was a challenge. The second trend is the role of fixed income. Bonds are back. Riskless assets, such as Treasuries, are now a competitive asset class. Institutional investors may need to rethink the role of public fixed income in their portfolios and examine their current allocation and its composition. The third trend is managing overallocations to private markets given the current market environment. Staying disciplined and keeping your exposure aligned with your long-term policy is a focus for clients.

Finally, there's the role of active management. Given the changing economic backdrop, the return environment may be more muted going forward. Alpha may become a critical component of your overall total return. In the 13 years leading up to 2022, declining rates created a strong beta environment where a rising tide lifted all boats. Higher rates will likely lead to more volatility and dispersion in markets. Selectivity will be key. Clients' have many alpha levers — regional allocation, sector selection, style selection, security selection and manager selection are different ways to generate alpha in their portfolios. This is an environment where the role of active management matters.

Hyland: It's a tough investing environment: a hot war with Russia, a cold war with China, a climate transition and upward pressures on costs. So hard landing, soft landing or no landing? What should we expect in 2023 and beyond?

Almeida: I'm less worried about GDP growth than about the years of interest rate manipulation. Pushing rates below their natural equilibrium because that's when malinvestment accrues in the economy. People make financial decisions based on distorted signals, and those suboptimal decisions — starting a new product line, moving into a new geography or investing in a SPAC or crypto — get exposed. Over the next 2, 3, 5 or even 10 years, I think investors should be concerned about the things that we can't see. What bad investments did a company make? What impairment do they have on the balance sheet? How much debt did they accrue to make that bad investment? When I think about where we are now, valuations are above average at the very least, companies are overearning and cash flows are too high. I think investors should ask, is this asset good? How much cash flow will the enterprise generate? Am I overpaying or underpaying? That's where I think the focus should be.

I have less conviction on soft or hard landing. I don't think it will matter as much as a company that refinances at 8% but has an ROI of 6%. They're no longer earning their cost of capital. Recession or not, that company won't survive.

Hyland: Over the past 15 years, a backdrop of declining rates, fiscal stimulus and quantitative easing put the world awash in easy money. How do companies adapt to an environment with a higher cost of capital and a tighter credit environment? Many companies will need to roll over their debt. When you look across our platform, how does this impact individual companies? Where are we seeing the risks and opportunities?

Almeida: Over the past 10 years, you had a ton of corporate debt issuance because interest rates were so low and central banks hoped that that capital would be funded into projects, plants, property and equipment to create economic growth, jobs and money velocity. That didn't happen. Instead, you had the greatest profit cycle in US history with the weakest economic growth cycle in 150 years. Instead of capital being put into production, it went into financial gearing. Companies levered up existing income streams. That's why profits are so high and why the equity market responded so well. That's over now. Interest rates are at 4%; we went from quantitative easing to quantitative tapering/tightening, which changes the dynamic. While I don't know how fast or slow, I think companies that are unable to earn their cost of capital will get exposed.

Now, we've outgrown our physical world; we don't have enough green energy assets. Companies are worried about their supply chains. How much mother nature or geopolitical risk do they have? I think that spells a massive shift from increasing dividends and buybacks to reducing greenhouse gases and shoring up supply chains, which requires a tremendous amount of capital, and that comes at the expense of profit margins. We're thinking about who can earn their cost of capital in this kind of environment and who can't. And to your point, where security selection matters, that becomes a big delta. We should see a lot of dispersion in the markets, within and across sectors.

The market will price it in before it becomes tangible. I don't know whether that happens next quarter or in three years. But as we've seen time and time again, markets discount things before they become tangible. You have to be ready beforehand, which goes back to your opening comments about what your clients are telling you — they're worried about liquidity.

Hyland: Do you think the banking crisis could be the beginning of more trouble in the markets? How is our investment team thinking about it?

Almeida: Business cycles don't die of old age. They die because of malinvestment. In the 2000s, too much capital was put into building too many homes financed by large Wall Street banks. That imbalance was corrected in 2008 by a bank solvency problem. Today, banks have a liquidity problem. It's not a systemic banking crisis. However, we do have a fragmented banking system. Because of the artificial interest rate environment, we have excess capacity — over 4,000 US banks. And some do fly too close to the sun, but I don't think all of them do. This is a symptom of the overall environment.

The investment team tends to think about these types of events similarly. How does this change the P&L of the individual business? What are the risks we can see? What are the risks we can't see? How does this impact a model? Is the market over or underdiscounting? While I think we have other problems, it's not an '08 bank crisis.

Hyland: How are we thinking about ChatGPT?

Almeida: Technology is the proverbial S curve. Early disruptors get disrupted along the way. As artificial intelligence grows, it will be difficult if not impossible to know who will hold long-term market share. Instead, we come at it from another angle. What technology or existing services does AI make redundant? That's the risk. For the past 20 years, we've had significant developments in technology, specifically software, but nothing as revolutionary as AI, in my view. In simple terms, this new technology allows the quick adaptation or duplication of coding. Maybe a software company's economic model or value proposition has been selling a code or an algorithm and now AI can accomplish what the code or algorithm can for free or less expensively.

AI data sets are doubling every three months. Compare that to Moore's Law, which basically says the speed of semiconductors double every 18 to 24 months. AI is growing six times faster than Moore's Law, and there are beneficiaries of that fast growth. You need data centers, colocation and tons of equipment. While there are pockets of risk I think we've identified, there are areas of opportunity servicing the AI industry — we call them pickaxes and shovels — that we have exposure to.

Hyland: From a bottom-up perspective, what are the opportunities you see in deglobalization and onshoring?

Almeida: Making sure supply chains are resilient and having our own semiconductor and electric vehicle–making capabilities requires people, parts and goods — a tremendous amount of capex and opex. Capital goods and industrial companies are at the epicenter of that. There seems to be the potential for a new paradigm or market leader, but many of these companies were good businesses to begin with, and we've owned them for a long time. While this may unfold slowly or quickly, it's likely additive to earnings.

Hyland: Earnings are projected to be up for the year. It feels like stock markets have disconnected from the economy. Do you think we'll start to see some earnings degradation?

Almeida: The bond market and central banks are saying something very different from what the equity markets are saying. There's inconsistency, and usually equity markets are late. Companies financed debt at low rates, but now they have to refinance at higher rates. At the same time, they're dealing with rising labor costs and demand for goods is slowing. For some companies, it's happened quickly, as we saw with some apparel manufacturers late this winter. For other companies, it will be slower because of their debt structure and end markets. While I don't know the timing, I do know that the market will price it in before it happens. Usually the equity market is caught offsides but then reacts quickly. Investors have to be ready before it happens, and we've been ready for some time.

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There's more and more evidence of income statement and balance sheet fragility, but people find reasons for dismissing it. I'm not suggesting those reasons aren't valid, but look at the quality of earnings. Generally, as cycles mature, nominal earnings go up and the quality of earnings goes down. Look at the difference between what companies say they're earning and their generally accepted accounting principles (GAAP) earnings. While there's always a difference because of one-off noncash charges, as a cycle ages, malinvestments start to accrue. At the end of 2022, the dispersion was the highest we've seen since 2007. The quality of earnings is poor, and that's a symptom of malinvestment. We need to be thoughtful about that. How this structurally different operating environment will affect profit and loss statements is what matters most. Financial markets are going to have to adjust. Lower profit margins and lower multiples is different from the environment of the past two decades. Strategies that may have worked in the past may not be sufficient over the next 10 years.

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