Break from tradition - seeking alternative sources of return

Caught between rock-bottom bond yields and high equity valuations? We think it's time for investors to break from tradition to deliver long-term returns.

To do this, we believe investors need diversification and should consider seeking alternative sources of return – some new and different ideas for a changing investment landscape.

Below, we share three investment themes we have implemented within the L&G Multi-Index funds to seek to generate extra sources of return.

Forestry

We define investment in forestry as investing into timberland companies, which own forests and the associated lands as their main assets. As such, the success of these companies depends on their ability to manage their resources in a sustainable way.

Forestry, like infrastructure and global property, is a 'real asset', therefore provides us with an actual asset underlying the cashflow stream. Forestry is a naturally produced commodity that can be harvested and sold, which makes it very interesting, in our view.

Why we invest:

The value of timber grows over time, independent of economic cycles, as the trees grow larger in size and number. This independence from the economic cycle, and dependence on time, gives the asset class a unique trait compared with other alternatives.

Forestry has historically had a low correlation to equities, which means it could provide much-needed diversification to a portfolio. Over the longer term it behaves more like the underlying asset – wood – which tends to be pro-cyclical as demand rises when there's an increase in housebuilding activity.

As there is a natural alignment between forest care and a timberland's success, we believe forestry can be an attractive opportunity for investors seeking to reflect environmental, social and governance considerations. It is also another way the asset class brings diversification, by providing a positive climate tilt compared to traditional asset classes.

How we invest:

There are several ways to invest in forestry, however we have been investing directly in timberland companies since 2020. This means we can be very selective to ensure we're picking the right companies in our aim to deliver long-term returns. For example, we exclude companies that only lease their land. We believe owning the property that produces trees gives us more confidence on the longevity of the investment.

Forestry has performed very well since we invested due to the increase in DIY and home improvement activity as economies went into lockdown. We have also seen global shortages in lumber as economies reopen, which is now boosting prices.

Bond diversifiers

Sovereign bonds have traditionally been viewed as a 'safe haven' asset by investors attracted to their income-generation and risk-mitigation qualities. But the role of these bonds in investment portfolios has come under increasing scrutiny in this low-yielding environment.

However, we believe it would be unwise to write-off all bonds as there are still some countries that can potentially provide an attractive level of protection. In our Multi-Index funds, we hold Australian, New Zealand, Chinese and South Korean government bonds.

Why we invest:

Quite simply, because these bonds currently offer higher yields and steeper curves than the traditional 'go to' bonds, including UK gilts and core-European bonds.

It is also worth noting that many of these regions are currently behind on their COVID-19 vaccination programmes relative to other countries, with the threat of the Delta variant looming. If further lockdowns are required in these regions, we expect to see their yields falling from current levels and therefore we should benefit from relative gains compared to other developed markets.

How we invest:

We first invested in Australian, New Zealand and South Korean bonds in early 2020, and gained exposure to Chinese bonds via the L&G ESG China CNY Bond UCITS ETF in April.

Key risk
The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested. It should be noted that diversification is no guarantee against a loss in a declining market.

Recovery trades

Recovery or reopening trades are equity plays we make to seek to benefit from the ongoing economic recovery. As things are fast-changing, this means we hold a variety of investments within this theme, from autos and US small caps, to Japanese railways and travel & leisure stocks.

This is not an alternative asset class (for the most part), but an alternative investment theme that we monitor and evolve constantly to remain appropriately exposed as markets change.

Why we invest:

During the initial stage of the pandemic, we recognised that some assets were unloved and therefore cheap but had the potential to catch up with the broad market and do well at different points in the economic recovery. We believed investing early while these stocks were still 'laggards' would provide us with a tailwind.

As this is a long-term theme that is not tied to a particular asset class, there is flexibility and it also helps us diversify our return stream and spread the risk across different sectors.

How we invest:

From May 2020, we bought or increased exposure to cyclical areas such as European autos, European value and US small-cap equities. As these investments started to outperform, we had to pivot to stay ahead of markets. So we started to sell or trim these positions towards the end of 2020, but kept our full position in European value as we believe we can still benefit from this exposure in this stage of the recovery.

As part of this ongoing theme, in December 2020 we added an exposure to Japanese railways stocks. We already held a positive view on listed infrastructure and see this as an attractive way to express this view further. We believed these stocks would benefit from normalisation in 2021 as people return to work in offices.

We also added European travel & leisure stocks to the basket in February 2021. Despite lockdown rules being lifted around the world, travel & leisure equities are still heavily disliked which makes them quite attractive in our view.

Our positions in European travel & leisure and Japanese railway stocks are currently very sensitive to reopening news flow, and as the recovery continues to unfold we will look for a good time to trim or exit these positions as we did with earlier investments aligned with this theme.

We believe diversification is a key differentiator for our Multi-Index funds. This is why we stress the importance of seeking alternative sources of return, especially at times when equity valuations are high and traditional bond yields are low. We believe holding a wider range of asset classes also brings genuine innovation of investment ideas and strategy, which can positively affect long-term returns.

While we may only hold what appears to be a small allocation to each individual investment mentioned above, when you add all of these holdings together with our other active positions, they add up to 30-40% of the portfolios' asset allocations, which shows our conviction to genuinely active asset allocation.

To find out more about how the Multi-Index funds are positioned or how they are performing, please visit: Multi-Index funds | Investment strategy | LGIM Financial Adviser

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.

There is no guarantee that any forecasts made will come to pass. Past performance is not a guide to the future.

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