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How do you incorporate unprecedented events such as geopolitics and climate change into models?

Speaker Participants

Frances Donald
Frances Donald, Global Chief Economist and Strategist, Manulife Investment Management

Eric Menzer
Head of Advisory Solutions, Multi-Asset Solutions Team (MAST), Manulife Investment Management

Leslie Brophy
Assistant Vice President, Head of Investment and Head of Sales, Manulife Private Wealth

Sean Lasko
Senior Investment Counsellor, Manulife Private Wealth

Presentation

Frances Donald
Global Chief Economist and Strategist, Manulife Investment Management

No, we don't try to forecast geopolitical events. What we do is we listen to the best geopolitical experts and then we apply probabilities based on those geopolitical experts that come in. We use a lot of scenario analysis. So, we construct scenarios and then we apply them as shocks to our portfolio. And what's sometimes surprising, and we do this too in our quarterly process, sometimes you think something would be massively important and it turns out not to be, at least not in a more than 12-month scenario.

ESG, I do have a paper on the Manulife website called Applying or Using the ESG Lens with Macro. And we've done a lot of work in this area to try to get a sense of what is the delta. So, what we came to see by applying all these shocks, we look at all of the experts in this area, we apply them to our models, and what we know is that when you have increased severity and frequency of weather events, it's inflationary. We've all seen with our eyes what wildfires have done in this country. It destroyed supply. It burnt down buildings. It meant we had less to be productive with. That's inflationary. It means we're working with less in general.

Flooding is, and a lot of weather events is pushing up food prices. That's not something interest rates can deal with, but it impacts households and consumers. Because when oil prices and food prices rise, we don't eat less or drive less. I mean, you sometimes see shifts. For example, one of my favorite leading indicators of a recession is peanut butter sales. Because we see that people actually start shifting out of proteins like meat proteins towards things like peanut butter. So, you do see some of that moving. But we know that these events that you're all describing, they all have one underlying characteristic, and the magnitude will change based on the scenario we correct, but they're all inflationary. They'll increase prices and lower growth.

So this is why, in general, when we look at these environments, we have to question if all of these new events that are coming forward increase prices, but they're not related to interest rates, how does the relationship between interest rates and inflation change? And a lot of the way we used to do a lot of long-term capital markets assumptions is we would basically apply this very strong relationship between if inflation goes up, interest rates go up. But now we question that relationship exactly because of these things.

Now, the magnitude of which, we could go for lunch and I could walk you through the umpteen scenarios that we go through, but there is a mechanical way in which we do this, and then there's a layer of subjectivity. But what we never do is try to predict what the geopolitical event will be. We just look at a variety of things.

Eric Menzer
Head of Advisory Solutions, Multi-Asset Solutions Team (MAST), Manulife Investment Management

In terms of like the 80-20 rule, 80 percent of the of what we think the risks are versus the other 20, which is out there, the most important thing is, is as you're crafting or developing, constructing a portfolio, is to go through stress testing. So I highly encourage everybody, if you haven't done it broadly speaking, understand how your portfolio can react under different scenarios in a different environment.

So we have various types of tools that we use to put our clients' portfolios through it and say, okay, what happens in a GFC, what happens in a tech bubble, what happens in various scenarios, so we can understand, yeah, one, we're going to put some probabilities to the likelihood of directionally of those events potentially happen, but we want to know what that tail risk is going to be. Should there be a shock, what does that – how is that going to impact? And frankly, when you're having conversations with clients, can you withstand that shock? Do you have the willingness and ability to take the risk to handle that shock if it comes to pass?

But I think, you know, knowledge is power and I would say, you know, having a broad spectrum of kind of shock or scenario testing on the portfolio is very important.

Sean Lasko
Senior Investment Counsellor, Manulife Private Wealth

And part of the reason, to go off what Eric just said, why we include real assets and a large portion of our clients' portfolios for when we go through those difficult time periods. So last year when we had a bear market in the United States, Eric is the Lead Portfolio Manager for the Manulife Real Asset Fund, and I believe that was up 10 percent last year.

Eric Menzer
Head of Advisory Solutions, Multi-Asset Solutions Team (MAST), Manulife Investment Management

10-75.

Sean Lasko
Senior Investment Counsellor, Manulife Private Wealth

10-75. So, it helps soften the blow.

Eric Menzer
Head of Advisory Solutions, Multi-Asset Solutions Team (MAST), Manulife Investment Management

Don't short me 75 basis points.

Frances Donald
Global Chief Economist and Strategist, Manulife Investment Management

Yeah.

Sean Lasko
Senior Investment Counsellor, Manulife Private Wealth

Now this year is a little bit different. We have stock markets in the black, but we have real assets essentially flat on the year. And, you know, I don't want to say that's exactly what we want to happen, but when we build portfolios, we want to have assets that are non-correlated, that move in different directions at different times, and that's exactly the type of approach that Eric's Real Asset Fund brings to the table at Manulife Private Wealth.

Leslie Brophy
Assistant Vice President, Head of Investment and Head of Sales, Manulife Private Wealth

And you speak to one of the key tenets of investment management, portfolio management anyway, which is asset allocation. You want to make sure that you're not putting all your money into one specific asset class or in one specific country either.

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