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Investing Against the Possibility of Regime Change

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During a trip to London to meet with our new colleagues at QMA Wadhwani, I was caught in a traffic delay arising from protests by the environmentalist organization, Extinction Rebellion. Held across the centre of London for 10 days, the protests advocated a new paradigm for global energy production and for capitalism more broadly. The delay gave me the opportunity to catch up on recent industry developments in the U.S. One, in particular, caught my eye—a new U.S. government executive order instructing the U.S. Department of Labor (which regulates U.S. pension plans subject to ERISA) to consider whether ESG is affecting energy investment and, more specifically, whether proxy voting guidance needs to be amended presumably because it is undermining policies to encourage investment in the energy sector.

As a keen student of irony (it's the British sense of humor), I was struck by the juxtaposition of passionate protests to highlight the risks presented by climate change with concerns that ESG could curtail investment in traditional energy infrastructure. As the traffic crawled forward, I reflected that the divergent politics about climate change raise a difficult question. How should investors, and particularly fiduciaries, deal with the possibility of regime change?

First, I should elaborate on what I mean by "regime change." I am referencing the idea that there is a secular shift in the investment or economic environment that prevents investors from extrapolating from the past or, at least, the recent past. So, for example, we can interpret ESG as a regime change because for most of investment history, this was not a factor in the minds of investors. Moreover, no attention was paid to corporate externalities, such as CO2 emissions. However, I would argue that, given the sharp focus on these issues globally, whatever one's own beliefs, it's necessary to accept that the investment environment for energy companies is likely to be different going forward than it has for most of their history. I would support this premise by pointing out that many of the energy companies themselves are behaving differently.

Let's pick a different example. As I have remarked before, there is compelling empirical evidence that quantitative easing (QE) has significantly affected investor behavior and investment outcomes. As such, I would argue that QE itself represented a regime change. The question for investors today is whether the *withdrawal* of QE also will generate a regime change of its own. If the answer is "Yes," we should attach much less weight to investment outcomes during the QE period. It's certainly plausible that if the introduction of QE had such an effect, its withdrawal could have an opposite impact.

The boundaries of regime change, however, may be neither discrete nor easily observed, and "This time is different" has been applied on many occasions to what were, in fact, passing phases. At the height of the late 1990s tech bubble, for example, I remember well the justification for stratospheric valuations, which was that technology was revolutionizing the world and that the value managers were dinosaurs. Of course, I also remember vividly how badly it went for those clients who shifted their portfolios on the belief that a new era had arrived. As it turned out, value managers, who had to stick it out through some very tough periods, were ultimately well rewarded. Take heed, growth managers in 2019!

So how should an investor respond to the possibility of a regime change? I believe the first step is to isolate the argument and consider the basis for the regime change on its own merits. That will at least increase the chances of separating a real "this-time-is-different" environment from what is simply a cyclical phenomenon. However, it will not always be possible to differentiate structural from cyclical change, so the investor will inevitably need to accept an element of uncertainty about whether a major secular shift is really happening.

The next step is to try to determine appropriate responses to these alternate possibilities. My recommendation would be to think about them as discrete scenarios. There are no shortcuts for this, but I would offer a couple of observations:

- In framing potential actions and outcomes in a given regime-change scenario, it's important to try to step away from the mindset that was useful during the period prior to the regime change. For example, extrapolating from pre-ESG market forces or stock returns to a post-ESG environment will be of limited use. More critically, if you are weighing whether QE was a regime change that has now ended, you need to go back to the pre-QE period to consider what future returns might look like. Usually the worst mistake an investor can make is to jump on a cyclical train just before it reaches its turning point, however seductive those recent returns may seem. If that's one scenario in your analysis, make sure your assumed returns factor in the full damage that could occur if that train does in fact go full circle. This approach would have prevented some of the worst mistakes in the tech bubble, for example, by highlighting just how expensive a shift back to value could prove for those contemplating a late move to growth.

- Now each of us as individual investors can simply choose a scenario in which to believe and back it 100%, should we so desire. However, I would argue that life as a fiduciary is much more complex, because it will be difficult to be 100% confident about any scenario, and part of being a prudent fiduciary should be to reflect on both possibilities here. Because it's unlikely you can adopt a strategy that will succeed in both scenarios, you will need to consider the probability of each working and the likely impact of being right or wrong in each. In an ideal world, you would find a strategy that perhaps prevents large losses if your choice of scenario proves incorrect but allows you to win big if your preferred scenario plays out. A more realistic strategy, of course, is one that contains the damage from the wrong choice at the cost of more modest returns should your choice prove correct.

Let me finish by applying this logic to my initial examples. As I mentioned earlier, it's highly likely that investment outcomes for carbon emitters will be different going forward than they were in the past. Of course, that's not certain, and even if you accept it's going to be different going forward, you'd want to determine whether regime change had already been assimilated into the companies' stock prices. Assuming you concluded the regime had not yet fully shifted, the optimal course would be to position yourself in such a way that you would be on the right side of the risks if regime change is, indeed, occurring, but where you would not see an appreciable change in your expected return if regime change failed to materialize. To me, this would be the most prudent course for a fiduciary, and I look forward, perhaps through rose-tinted spectacles, to seeing the U.S. Labor Department reflect that in its forthcoming guidance.

With respect to QE, I think a case can be made that both the introduction and withdrawal of QE constitute regime change. I don't think anyone can say that with complete certainty, so it makes sense to model both scenarios. So, for example, if I were looking at diversification strategies, I would separate their history into two categories—the pre-QE period and the QE era—and assess the effectiveness of the diversification strategies during each time period. I can then look at potential outcomes of each strategy to try to generate an overall picture of what the strategies' impact might be on investment performance. I would certainly give at least a 50% weight (and arguably quite a bit more) to the pre-QE version. As I've proposed before, I would move beyond the "usual suspects"—stocks and bonds—when executing your diversification strategy, particularly if you've decided regime change is a real possibility. A more expansive diversification strategy—one that includes commodities, managed futures and other alternatives to conventional assets—might better serve you as you wrestle with the additional uncertainty a regime change, such as the end of QE, might bring.

As I emerged from my reverie, the traffic had lifted, and I reached our office. My only regret was that I hadn't had more time to extend my thinking to reflect on the particular challenges and dangers of accommodating regime changes in a passive approach. But, then again, I'll have something to focus on during the next traffic jam!

Andrew Dyson

NOTES TO DISCLOSURE

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