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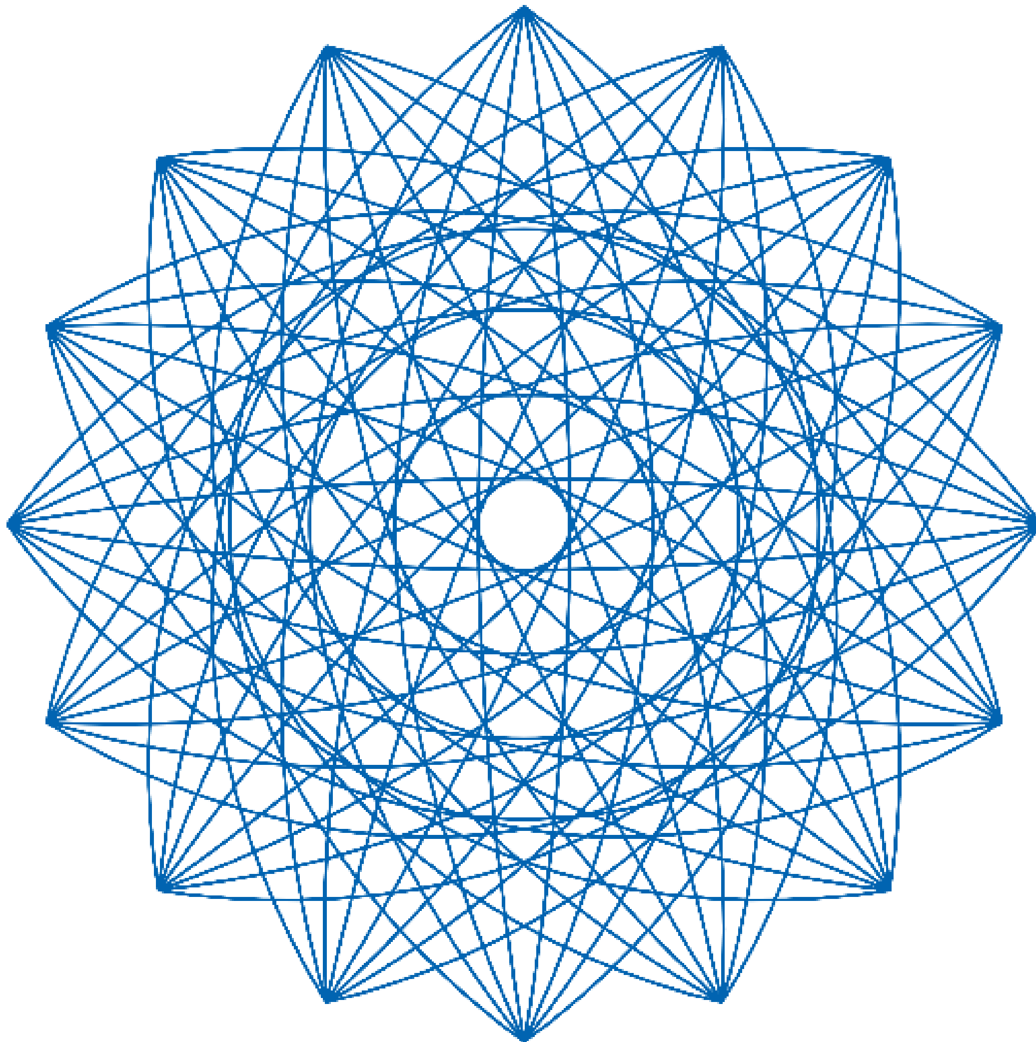

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Half-Yearly Review

At the end of 2018 risk assets were definitely out of favour as we saw equity markets decline, with some moving into “bear market” territory as values fell by over 20%. One of the key drivers of this was the continued rise in interest rates in the US as the Federal Reserve attempted to unwind their Quantitative Easing Programmes.

When the yield on US 10 Year Treasuries topped 3% investors preferences started to change and the attraction of a 3% risk free return was too good an opportunity to miss; this coupled with the fear that rates would continue to rise and stop underpinning the stellar growth in equities of the last ten years - by the end of 2018 the S&P 500 index in the US had lost 12%.

Since then we have seen a strong recovery with the yields on US Treasuries declining and interest rates falling and propelling the S&P 500 to a new high. All this leaves us back where we were a year ago; generally worried about almost every asset class looking over valued and risk is high.

Our last report at the start of the year detailed the risks that existed and how we structured our recommended Model Portfolio’s; including our preferred investments. In this report we are going be building on this information by looking at how we plan our asset allocation and thinking about the effect of potential scenarios on our thesis.

Our Investment Hypothesis

In the current investment climate of ultra-low interest rates, high Government/Corporate Debt levels and relatively benign inflation the value in most asset classes has been squeezed.

The possibility of negative returns from many investments in the coming years is very high.

The future returns that asset classes will achieve will be defined by economic growth, interest rates, inflation and the starting point at which investments are made at.

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Background

Whilst we look at a lot of indicators to help us make investment decisions it is important that we have an overview of what works best in each scenario and how changes in the economy, interest rates and inflation could affect each asset class. The table below from Bridgewater Associates shows historic returns from ssset classes in different scenarios.

Asset Class Returns by Economic Environment

Economic Environment	Asset Class	Average Return (%)
Rising Growth	Equities	13.9
	Commodities	10.2
	TIPS	8.4
	Bonds	1.1
Falling Growth	TIPS	9.4
	Bonds	8.8
	Equities	5.8
	Commodities	1.2
Rising Inflation	TIPS	19.4
	Commodities	11.5
	Equities	5.9
	Bonds	3.9
Falling Inflation	Equities	12.9
	Bonds	7.1
	Commodities	-0.9
	TIPS	-1.4

For the period 1926 to 2010
Source: Bridgewater Associates

Identifying where an investment is made in relation to history is also crucial. Those that have enjoyed above average returns for a prolonged period tend to be ripe for a reversal, whilst the opposite is true of those that have been lagging behind. Ultimately the change in outlook will be driven by investor sentiment as they respond to the changing environment and their risk preferences change.

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Scenario Analysis

Based upon the above information we can then start to construct a simple matrix to look how our portfolios could potentially react to different environments.

		Rising	
	Economy	**Inflation**	**Interest Rates**
Cash	Negative	Negative	Positive
Nominal Bonds	Negative	Negative	Negative
Index Linked Bonds	Positive	Positive	Negative
Equities	Positive	Positive	Negative

		Falling	
	Economy	**Inflation**	**Interest Rates**
Cash	Positive	Positive	Negative
Nominal Bonds	Positive	Positive	Positive
Index Linked Bonds	Positive	Negative	Positive
Equities	Negative	Positive	Positive

Nominal Bonds are Conventional Bonds such as Gilts that offer a fixed rate of interest; the yield and value of this type of Bond will change primarily driven by interest rates and inflation.

Using this matrix helps us to decide what assets we should be considering – here are some examples.

Scenario One – *Interest rates low, economy and inflation rising*

- Negative for Cash
- Negative for Nominal Bonds
- Positive for Index Linked Bonds
- Positive for Equities

Scenario Two – *Interest Rates are high, economy and inflation falling*

- Positive for Cash
- Positive for Nominal Bonds
- Negative for Index Linked Bonds
- Negative for Equities

Whilst this is a good starting point, it does not take account of where the price of an asset is and the future return that you may expect from it. Interest rates could be low with an improving economy and rising inflation but what if equities were at an historic high?

In the UK in the early 70's rising inflation pushed the equity market to a new high; when inflation peaked at 10% and started to fall this helped equities up even further to new all-time highs. However, when inflation then took off again through 1973-1974 it would be disastrous for equities with almost 70% of the value of the UK market wiped out by the start of 1975.

So, we are now armed with an extra layer of protection; understanding where an asset is in relation to its historic price level helps us to understand what to expect in returns in the future. The same is true of any indicator that we look at; is the Economy running starting at a low level and expected to improve or is it above average and a reversal possible? We are not always at the extremes or on the cusp of a change in direction conditions can remain around the mean for prolonged periods.

So, let's look at the US now in detail…….

Current Scenario – *interest rates falling, economy rising and inflation falling*

- Negative for Cash
- Positive for Nominal Bonds
- Mixed for Index Linked Bonds
- Positive for Equities

Whilst this all seems simple it comes with caveats! If we take the US now were see the Economy growing at just over 3.2% almost 1% over its long run average, with inflation at 1.79% around 0.6% below its average. After the interest rate hikes of 2018, we are now seeing benchmark interest rate yields fall.

- Falling interest rates will make cash holdings less attractive unless as a US Investor you were able to "lock in" to higher fixed rates.

- There will be a limit to the returns from Nominal Bonds as interest rates are still relatively close to their all-time lows of 2012 and 2016; when these lows are retested the risk of holding Nominal Bonds will start to rise.

- Index Linked Bonds (TIPS in the US) still have positive yields and whilst this exists, and interest rates continue to fall as with Nominal Bonds it will be beneficial to hold these assets – particularly if the Economy also starts to fall as they continue to perform well. However, if inflation becomes deflation there will be a negative impact on values and they will start to decline.

- Conditions seem tailor made for equities, but the S&P 500 remains at or around all-time highs with returns of over 10% annualised for the last 10 years – a factor that simply cannot be ignored.

This is reflected in our asset allocation for the majority of client portfolios with holdings in US Nominal Bonds 3-4%, US Index Linked Bonds 6-14% and 0% in US Equities.

Asset Allocation – FPW Portfolios

At present we are positioning Portfolios towards an All-Weather strategy with the aim of "sitting on the fence" until some more serious inflexion points are reached. Above we focused on individual markets, but we have to think on a more Global Basis to look for value and diversification. Using the information in the previous section we can look at how changes in scenarios could affect our Portfolios and plan accordingly; also included is a probability column to establish how likely we think the outcome is.

	Probability	Cash	Nominal Bonds	Index Linked Bonds	Equities
Weighting		20-30%	3-4%	6-14%	0-35%
Rising Economy	Low	Negative	Negative	Positive	Positive
Falling Economy	High	Positive	Positive	Positive	Negative
Rising Inflation	Low	Negative	Negative	Positive	Positive
Falling Inflation	High	Positive	Positive	Negative	Positive
Rising Interest Rates	Low	Positive	Negative	Negative	Negative
Falling Interest Rates	Neutral	Negative	Positive	Positive	Positive

It is important to remember that outcomes go hand in hand and; a rising Economy generally leads to rising Inflation followed by a policy response of raising interest rates to cool inflation.

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At the moment our near-term view is that Economic growth could slow and we may see low inflation or in the worst case deflation; this will lead to further interest rate where possible. A recent article in the Financial Times "Negative interest rates take investors into surreal territory" (27th June 2019) provides a great summary of what this means and the implications.

If this happens and continues then we would be in a good position when it comes to asset allocation; but would need to be mindful of how to change our strategy as the situation develops. The following is not a prediction but part of our pre-mortem [1] that helps us consider potential risks what could cause the strategy to fail.

1. Economy weakens Equities decline but positive for Cash, Nominal and Index Linked Bonds

Assets with positive impact	Assets with negative impact
Cash	Equities
Nominal Bonds	
Index Linked Bonds	
Percentage of Portfolio	**Percentage of Portfolio**
29-58%	35%

We are in a strong position with a higher weighting to positive impact assets; the liquidity of cash also allows us to add to equity holdings if the decline is significant enough to offer value.

2. Interest rates (or Quantitative Easing) decline in an effort to improve the Economic environment

Assets with positive impact	Assets with negative impact
Nominal Bonds	Cash
Index Linked Bonds	
Equities	
Percentage of Portfolio	**Percentage of Portfolio**
9-53%	20-30%

[1] A pre-mortem is an assessment of a project assuming its failure; based on this assumption we then try to use hindsight to work backward and consider what could have made the project fail. In a study by the University of Colorado increases the ability to correctly identify reasons for future outcomes by 30%.

Again, we remain in a strong position with falling interest rates benefiting Bonds and Equities; Cash whilst generating little in the way of returns at least should not lose value.

Whilst this stage may initially be beneficial to Index Linked Bonds and Equities if they rally strongly but we see little in the way of Economic improvement or rising inflation consideration would need to be given to taking profits for these assets as a deflationary environment would turn negative.

3. Falling inflation – in this stage if we see deflation then Cash and Nominal Bonds will be the assets to hold and should have been bolstered by the reduction in Index Linked Bonds and Equities at stage two.

If this all plays out in this order then we may get to a new inflexion point where the cycle restarts and the strategy changes focus – the Economy is at a low level and will improve, Inflation will be low but will return to normal levels and finally Equities will have declined substantially, falling out of favour with investors and offer value.

So what could go wrong with our strategy?

What would happen in this alternative environment?

- If we see the Economy improve, and inflation rises then Index Linked Bonds and Equities would do well; both of which we hold in reasonable proportions.

- Rising interest rates are the biggest risk to portfolios and would impact negatively on three out of four asset classes; we currently view this as the least likely event but cash holdings would provide protection and we would need to reduce Bond holdings.

- The status quo of modest growth, low interest rates and benign inflation continues then cash will be a drag on performance but Nominal Bonds, Index Linked Bonds and Equities should result in a reasonable rate of return.

It is a fact that...

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"Humans are incorrigibly inconsistent in making summary judgements of complex information." 2

Technology has increased the availability of information, and data, in turn this increases the amount we try to take in and process. The mental short cuts that the Human Brain has developed over the years to make quick decisions works against us. Having a clear, consistent approach and trying to develop systems to avoid the errors and biases that we all have improves our chances of success.

Model Portfolio Assets Performance 2019

The table below details the year to date returns of assets that we hold in model portfolios – the amounts vary depending on risk profile.

Sector	Fund	Return in 2019
Nominal Bonds	Vanguard US Government Bond Index	3.96%
Index Linked Bonds	Capital Gearing Dollar (GBP Hedged)	5.96%
	iShares $ TIPS ETF	7.51%
	Royal London Index	8.61%
Equities	Finsbury Growth & Income Trust	22.72%
	LF Morant Wright Nippon Yield	5.99%
	Orbis Global Equity Standard	6.75%
	Troy Trojan	8.36%
	Scottish Oriental Smaller Companies	7.87%
	Utilico Emerging Markets	15.61%
	Veritas China	10.05%
Multi-Asset Funds	Capital Gearing Trust	6.30%
	RIT Capital Trust	4.88%
	Ruffer Investment Company	6.12%
Absolute Return	Premier Multi Asset Absolute Return	3.97%
Alternatives	ETFS Physical Gold $	9.08%
	Montlake Dunn WMA Institutional	8.16%
	Pershing Square Holdings	42.57%
	Third Point Offshore	11.29%
	Woodford Patient Capital	-14.79%

The percentages held in your portfolio will vary and returns are dependent on when assets were purchased.

[2] Thinking Fast & Slow – Daniel Kahneman 2011

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So far, the only negative has been Woodford Patient Capital; the Trust has suffered significantly since the well documented suspension of the Woodford Equity Income fund in the last month.

However, given the relatively small holding in even the most aggressive investors model portfolio this has thankfully not had a huge impact on overall returns. For more information on this holding please follow the link to our recent article posted on our website - Woodford Patient Capital 4th June 2019.

We hope that this article provides you with an insight into our process and that in turn this gives you confidence that we remain well positioned for what the currently extremely difficult investment climate may throw at us in the coming months and years.