fpw FINANCIAL PLANNING WALES

Chartered Financial Planners

EST. 1999

YOUR LIFE. YOUR FINANCES

Investor Education

www.financialplanningwales.co.uk

fpw

Introduction

We all know that 2020 for nearly everyone has been a period unlike anything that we have lived through before; however, for investors – other than the first months of the year - there has been a disconnect between what has been happening in the “real” World and the generally positive results that most asset classes have delivered.

Looking back at our last few Annual Reviews the recurring theme has been acknowledging the risk from unknown threats at a time when many asset class prices are at or near all-time highs and traditional “safe-havens” such as cash are offering returns less than inflation. This situation remains unchanged and the need to tread carefully whilst also being pragmatic and looking for opportunities means that we continue to rely heavily on our tried and tested process.

In this report we will look more closely at how some of the assets that we have recommended have performed, and then at those that we have recommended for the future. We will also examine the importance of a clearly defined and well communicated process in achieving objectives and analysing performance.

Returns in 2020

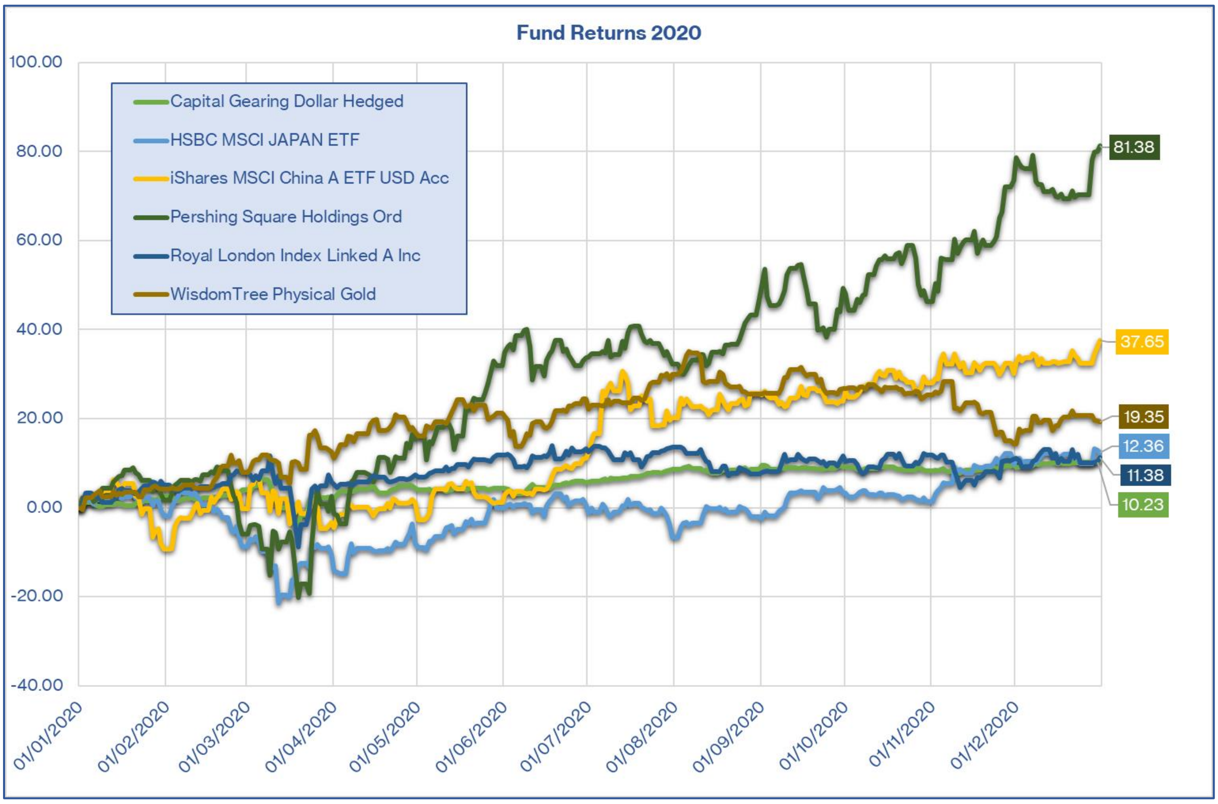
After the initial negative reaction by markets to the spread of COVID-19, that included one of the fastest bear markets and subsequent recoveries in history asset classes by and large have performed well. The table below shows that from a selection of assets in 2020 only five (in red) performed worse than their long-term averages; three (in blue) had performed at or near their long-term averages and six (in green) had, performed better.

Name	2020 Return	5 Year Annualised Return	10 Year Annualised Return	15 Year Annualised Return
UK Bank Base Rate	0.21	0.45	0.47	1.36
UK Gilts	8.27	5.47	5.47	5.26
US Treasuries	4.88	5.45	4.84	5.71
UK Index Linked Gilts	11.01	8.43	7.92	7.29
US Treasury Inflation Protected Securities	8.09	6.90	5.39	6.02
Global Stock Market	11.67	9.48	8.39	4.98
UK Stock Market	-9.82	5.14	5.57	5.42
US Stock Market	14.74	16.97	15.44	11.56
Europe Ex-UK Stock Market	-0.38	3.38	4.37	1.82
Japan Stock Market	18.34	12.62	9.21	6.14
Pacific Ex-Japan Stock Market	-2.73	3.88	2.54	2.53
Emerging Markets Stock Market	11.93	14.46	5.18	8.68
Gold	20.58	14.02	4.32	10.69
Commodities	-6.48	1.39	-5.79	-3.65

For someone arriving on planet Earth at the end of 2020 and looking at investment market returns they would no doubt be astonished that we were in the throes of a Global Pandemic that had not only led to significant deaths but had also shut whole economies and led to huge increases in the level of unemployment.

In our view the cause of this is liquidity; the vast sums of money that Governments and Central Banks have unleashed to support economies has simply accelerated a trend that started in the Financial Crisis. Ultra-low interest rates and every new announcement that fiscal and monetary support is continuing is music to the ears of most asset classes.

These positive returns have been replicated across many of funds that we have recommended within client portfolio's; below are some of the stand-out performances that we have seen in 2020.



There have of course been some detractors from performances, but few have been negative and most have produced the reasonable rates of return we would like to see around the 5-7% mark – which is reflected in the overall performance of most portfolios. We also hold assets that we have recommended for the future that have yet to deliver the returns that we hope for and have seen from the long-term recommendations in the chart.

If we look at the outcomes for portfolios and most of the funds that we have selected, it is easy to say in hindsight that we have done reasonably well; we could after the event also question why we did not invest more heavily in a fund such as Pershing Square.

This is where analysis of our process comes in; we have – I hope – always been very clear about the approach that we take and why; this ex-ante thinking means that we will always tell you why we are following a certain strategy and what we hope will happen.

Whilst investors frequently, and quite rightly, judge recommendations on the result of net return after tax and costs it is crucial to understand how these returns have been generated – we could after all have been selecting funds at random and just got lucky!

There is a well know saying that investments can take the escalator up and the elevator down; and with asset classes becoming increasingly correlated there is a risk that all of them could fall in unison. It is because of this that we use a well-diversified portfolio and risk management tools with the aim of providing consistent rather than spectacular returns.

Below is a table of returns from 1st January 2020 to 31st March 2020 that shows how these risk management tools worked in a bear market with our diversified model portfolios suffering nowhere near the declines of major equity markets.

Investment Name	Cumulative Return
FTSE Act UK Gilts All Stocks TR	6.32%
FPW Defensive Fund	-4.33%
FPW Cautious Fund	-6.12%
FPW Balanced Fund	-7.28%
TOPIX TR JPY	-11.22%
S&P 500 TR USD	-14.10%
FTSE World TR GBP	-16.14%
FTSE All-Share TR GBP	-25.13%

We believe in protecting investors from major declines is just as important as achieving returns as invariably poor decisions are made at extremes; if things are bad, investors can panic and feel compelled to sell which is often the worst decision to make. There is also the benefit of not losing; without the need to recoup losses investors are not required to take on unnecessary risk in the future simply to break even.

New Investments and Our Thinking

In this section we will look at an investment we added to portfolio's during last year (Blackrock Energy & Resources) and one area that we have just recommended including in portfolio – UK Equities.

Blackrock Energy & Resources Investment Trust

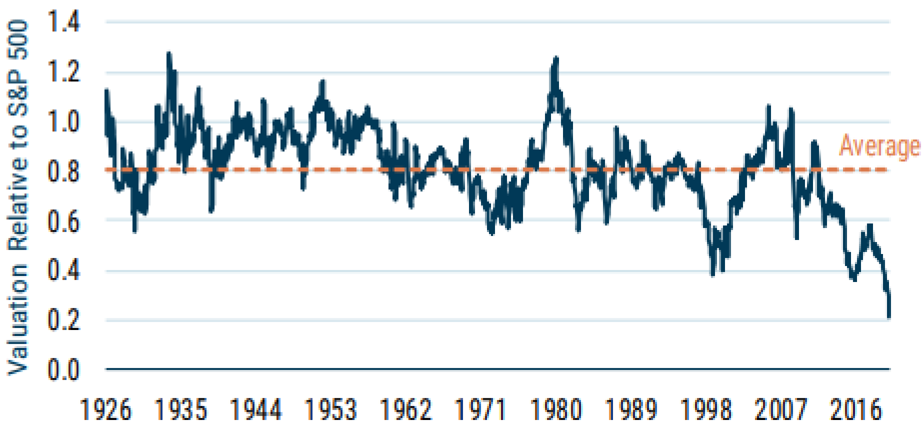
In early 2020 we had been keeping a close eye on the resources sector; research from several sources has shown that: -

- Resource Stocks have gone from cheaper to cheaper and we appear to be at a low in the commodity price cycle as over supply has pushed down prices; this has been accentuated by COVID-19 and a 70% fall in oil prices following the dispute between OPEC and Russia.

- In the US the valuation of energy and metals companies were at historic lows in comparison to the value the broader stock market.

EXHIBIT 2: VALUATIONS ARE AT HISTORIC LOWS

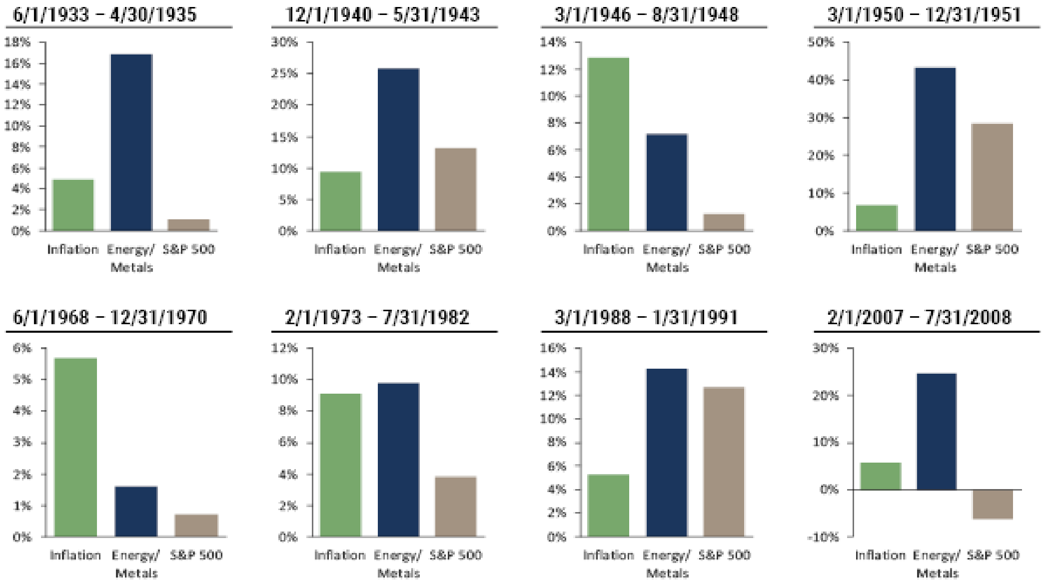
Valuation of Energy and Metals Companies Relative to the S&P 500



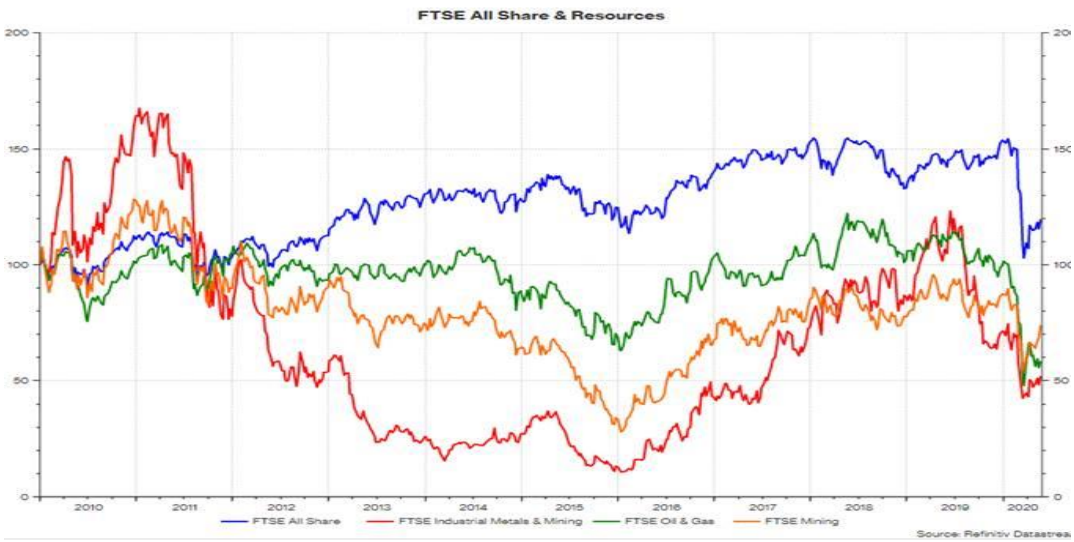
As of 3/31/20 | Source: S&P, MSCI, Moodys, GMO
Valuation metric is a combination of P/E (Normalized Historical Earnings), Price to Book Value, and Dividend Yield.

- Prices of these types of shares had also been driven down by ESG (Environmental, Social & Governance) investing trends as investors flocked to renewable energy investment. This ignores that fact that the Global Economy relies on extractive industries, as does Clean Energy (solar power needs silver and many renewable sources require rare earth metals).

- Long term our view is that inflation will ultimately return and holding resources stocks is a hedge against inflation that has worked very well in the past; the graphs from GMO below show how the sector has outperformed the broader market in the US in periods of above average inflation.



- In the UK a similar situation has developed with Industrial Metal & Mining Firms and Oil & Gas Companies returning 50% less that the FTSE-All Share over the last decade; highlighting investors aversion to the sector and suggesting value that would mean the risk-reward trade off is favourable.



- Not only did these sectors look under valued they had an attractive dividend yield – even as Shell cut their dividend for the first time since WWII in April this year.

- Many of these "old fashioned" firms are transitioning to renewable energy with commitments to cut carbon emissions and reliance on fossil fuels.

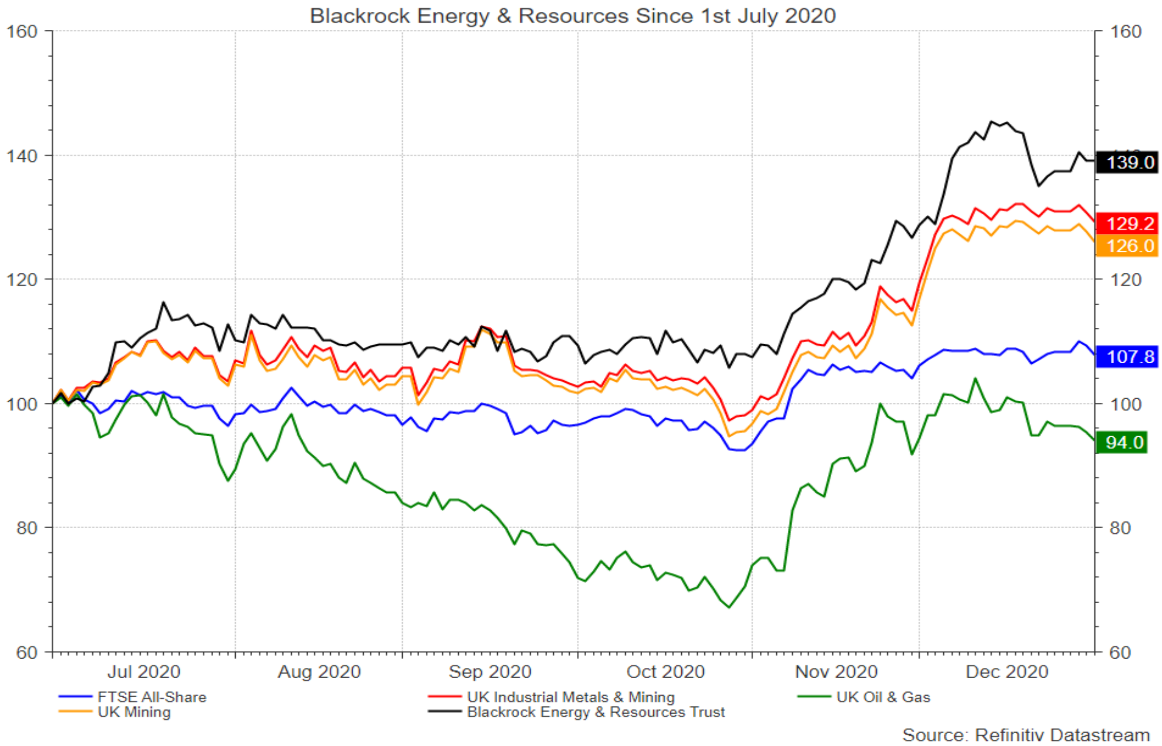
We decided to access this idea through Blackrock Energy & Resources Investment Trust for several reasons: -

- The discount to net asse value was over 10%

- Income was high – a yield of 5.7% - with the Board committed to dividends that it stated would be maintained from revenue reserves if necessary

- Access to a wide range of well known firms that have weathered downturns before and survived – BHP Billiton, Total, Shell, BP Group and Rio Tinto providing access to the different sectors we were interested in.

The results from this so far have been extremely positive as the Trust returned 39% over the second half of 2020 – better than the FTSE All-Share and each of the individual sectors; whilst it is still early days results so far have been encouraging.



We hope that the above provides a strong demonstration of our process and how we develop a thesis; it is important to remember that not all these strategies play out as you imagine, and we have had our share of failures.

Woodford Patient Capital seemed the ultimate "value" buy yet despite numerous attempts to improve performance including a change of name and manager; looking back at this our process at the time was correct but we failed to recognise the power of the sentiment that would keep driving prices down. Once the popularity of the star Manager waned and question marks were raised on all parts of the business and his dealings the investment was tarnished – probably irrevocably.

The fact is that we cannot remove investment risk completely and some recommendations will simply not work out for any number of reasons; however, if we can win more that we lose and ensure that the potential pay offs are worth the risk then long-term consistency should follow.

Buying British!

At present it is probably very easy to find a whole page full of reasons against investing in the United Kingdom – believe me we have tried the exercise and here are some of the results!

- Poor response to COVID Pandemic with high death rates, accentuated by political divisions at many levels from local Councils to Devolved Nations.

- Service orientated economy with many of these businesses now closed.

- Rising unemployment to levels not seen since the early 1990's.

- 20% decline in GDP in the second quarter.

- A weak currency with Sterling rooted at lows since 2016.

- The unknown of exiting from the EU – what will happen?

- A stock market dominated by "old" industry such as financials, pharmaceuticals, and Oil & Gas and no high-flying technology firms such as Amazon or Zoom, that have flourished in the conditions of the pandemic as the trend to automation and digitisation has accelerated.

These negatives have been at the forefront of UK Retail investor's minds as the Investment Association reported that the worst selling fund sector in October was the UK

Equity Income and November saw £425m withdrawn from funds in the UK All Companies Sector.

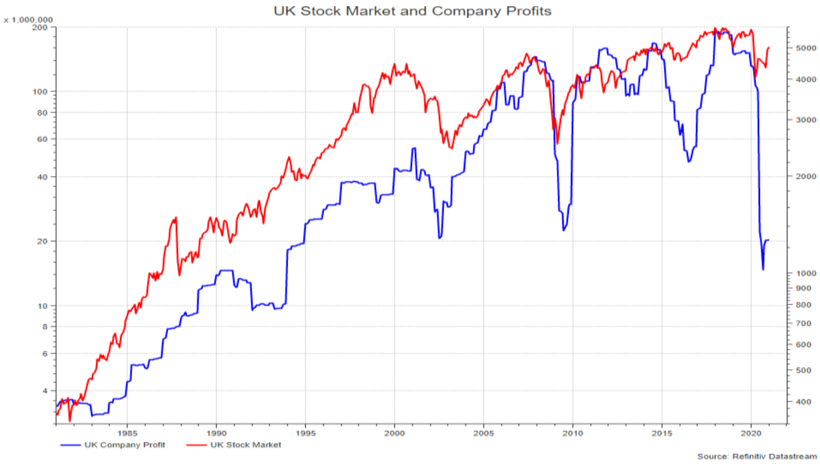
We cannot ignore all the negatives, those are facts, but we can look to see if the evidence tells us something else and whether the fact UK Equities are lagging most other regions for a good reason, or do they have the potential to change direction and improve?

- From a valuation perspective, UK equities are cheap compared to other Developed Markets using the Cyclically Adjusted PE Ratio (in fact so cheap they will make up part of our Value Strategy in 2021).

Country	CAPE
Singapore	12.5
Spain	13.6
U.K.	14
Austria	14
Hong Kong	15
Norway	16.4
Korea	17.3
Israel	18.2
Portugal	18.5
Germany	18.7
Australia	18.9
Italy	19.8
Belgium	20.4
France	20.7
Japan	21.6
Canada	21.8
Sweden	22.9
Finland	25.1
Switzerland	26.2
Netherlands	27.9
New Zealand	31.8
U.S.	34.6
Ireland	36.3
Denmark	39.7

- They offer an attractive dividend yield, which whilst low is higher than many other regions. UK Equities have also underperformed relative to Global Equities; the last time it was this bad was in the 1970's; and they have also performed worse than Gilts and Gold in recent times.

- Company profits in the UK hit all time lows this year, but are they set to recover as on previous occasions such as 2002 and 2009? They could of course fall lower but they have already declined by record levels. A recovery in profits will make UK stocks look even cheaper and attract investors.



- Should vaccines prove successful enough to allow restrictions to be lifted in the coming months there is likely to be significant spending as people return to the hospitality sector and retail sector as well enjoying travel again.

- What if leaving the EU proves to be beneficial? We hear lots of stories about the negative impacts but what if we gain greater control and beneficial trade deals with new markets improve the financial position of the UK?

- As we have already mentioned there is a huge disconnect between economics and investing at present; whilst Central Banks and Governments continue to stand behind businesses and pump liquidity into the financial system there is no reason that equities cannot go even higher – even those that we consider over valued on more traditional measures. It man no longer matter to stocks how negative economic news is!

- Momentum – one of the key things that we missed with Woodford Patient Capital – is returning to the UK market; in fact, our Momentum Strategy for the UK moved to "buy" at the end of 2020.

Based on these factors we feel that investing in UK equities is currently appropriate and have recommended accessing these via an Exchange Traded Fund (ETF) that tracks the broader market as well as a more selective Investment Trust that focuses on high quality firms with a bias to Consumer Goods and Services. We cannot be certain of success, but by following our process we feel we can say that the risk reward trade-off is more attractive than other Developed Region's Equity Markets.

Process, Process, and Process; But Even then……

Building a repeatable and efficient process not only result in quicker decision making it also helps to remove the chance of errors that can invariably occur because of existing biases or just due to the complexity of the analysis that we are trying to undertake. Clearly documenting a strategy or process is key to evaluating its success and helping it evolve over time to deal with changing conditions or new factors that become important to making any decisions.

Even with a robust process we will never have all the information that is available, there is simply too much to analyse, so we will always be deciding without all the facts. The process is what helps us to make a smarter decision despite incomplete information; being able to judge whether the odds of success are in our favour is the best that we can hope for as cast-iron certainties are unlikely. There is also the risk that things go wrong because of something outside of our control, or an event happening that statistically is very, very rare; but does this mean our decision-making process is flawed?

In Annie Duke's book "Thinking in Bets" (Penguin 2018) she highlights what happened in the NFL to Pete Carroll the coach of the Seattle Seahawks who were beating the New England Patriots by four points with 26 seconds to play in the Super Bowl; they had control of the ball and were one yard from the Patriots end zone with three chances to score. Everyone expected the ball to be handed to the running back but instead Carroll "called a play" telling his quarterback to throw the ball. Later referred to as one of the worst calls in NFL history the ball was intercepted the Patriots scored and won the game; Pete Carroll faced brutal headlines from most of the media. However, a few voices pointed out that it was a good call as an interception was highly unlikely – in that season none of the 66 passes in the same position had been intercepted and in the last 15 seasons only 2% of passes thrown on the one-yard line were intercepted. As the author states: -

"Carroll got unlucky. He had control over the quality of the play-call decision, but not over how it turned out. He made a good quality decision that got a bad result."

"Pete Carrol was the victim of our tendency to equate the quality of a decision with quality of its outcome. Poker players have a word for this 'resulting'. When I started playing poker, more experienced players warned me about the dangers of resulting, cautioning me to resist the temptation to change my strategy just because a few hands didn't turn out well in the short run."

If our process has regularly led us to make successful decisions, we must not let single failures dictate or change our approach. Even with the best process, previous success and experience things do not always work out as we hope; we can just be unlucky or face an outcome that was statistically very, very unlikely.

Conclusion

We hope that you have enjoyed this insight into our approach and some of the factors that we take into consideration when making investment decisions. The last twelve months have been a relatively successful period for portfolios with strong returns well in-excess of inflation.

The returns from several of the assets that we have held for some time, have started to come to fruition as we originally hoped they would and some that we have added only recently, have exceeded the expectations that we had for them in the short term.

Looking forward we hope that our decision process that has led us to add to other holdings – such as the UK – is robust and will ultimately have the positive impact that we hope; although as I hope we have explained how even the best laid plans can fall victim of bad luck.

However, whilst we have enjoyed delivering the good news and keeping you updated with our approach it is somewhat tarnished by the difficulties and very real problems that the pandemic has brought to so many people. We hope that the next few months into Spring will bring with it good news and more optimistic future for all of us.