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Investor Education

Trusting the Process – Half Yearly Review 2020

I have deliberated all day about what to say in our half-yearly report and how to say it; unfortunately, each time I started the content and tone became more and more depressing! Eventually I gave up did some training in my newly established back garden gym and took the dog for a walk – so far this seems to have done the trick and I have adjusted my approach accordingly.

The fact is that there is a lot of depressing news – Covid-19, lockdowns, civil unrest, political point scoring, rising unemployment etc – and we are all constantly reminded of it through 24-hour news or social media. My youngest son, whose 12, has even shown me a post of the similarities between now and dates starting 100 years ago that culminated in the attack on Pearl Harbour! Clearly the tone of what we are all seeing, and hearing has been negative now for some months.

So with this in mind it's time to change the narrative and let you know about the positive things that we have been doing, the plans we have for keeping capital safe and generating some reasonable returns – no matter how modest.

Believing in a Process

There are so many things that are outside of our control when it comes to investment and if we start to try and second guess what might happen or what market participants might do next the odds are against us getting it right.

What we can do though is develop a robust process that uses reliable indicators to help us identify valuation levels; within this framework we can then decide what makes sense in the current climate and whether there are any similarities with what has gone before.

Writing down and following a process helps keep ego's in check and also provides a great record for analysing decisions after the event; as humans we are very adept at embellishing a story in hindsight that makes things a little rosier or removes us from blame.

Keeping a detailed record of decisions, the successes and, just as importantly the failures help create improvement. We will not always be 100% right but we can take steps to help us be more right than wrong and create a credit on the balance sheet.

Over the last year we have been busy working on several projects to improve our process; mainly though writing down our principles and strategies on how we hope to generate reasonable returns whilst maintaining a tight grip on risk management. As you know, our strategy aims to be consistent rather than spectacular and through diversification of how returns are generated we hope to be ready for what the World may throw at us.

Whilst there is a lot of work that goes on behind the scenes in terms of how and what we monitor the basic premise is relatively simple.

By owning a combination of assets and following different return strategies we strive to *create a portfolio that can deal with a variety of scenarios and investment environments. Understanding what drives the returns each of these assets and where they are in relation to history allows us to decide how much to allocate to each at any given point. If an asset is expensive/cheap then it is likely that at some point an event or change in the environment will alter investor sentiment that will make fall/rise in value.*

This may seem like common sense – which we hope it is – but it is the understanding of the environment for asset classes that makes it work effectively. If we are looking at the Stock Market we know from history that monitoring Price Ratios, Dividend Yields, Corporate Profits, Inflation and the Yield from other assets we can form a view as to what is the outlook for a Stock Market. It is even possible to create reasonable forecasts of potential future returns that help provide guidance of what we can expect in the future.

What is the process telling us now?

The holdings that we recommend for each of you are driven by your required rate of return and the amount of risk that you are willing to accept. However, for most we recommend the same holdings across all portfolios; it is the percentage in each asset that changes the risk profile. So, with all that in mind what is going on and what are we going to do?

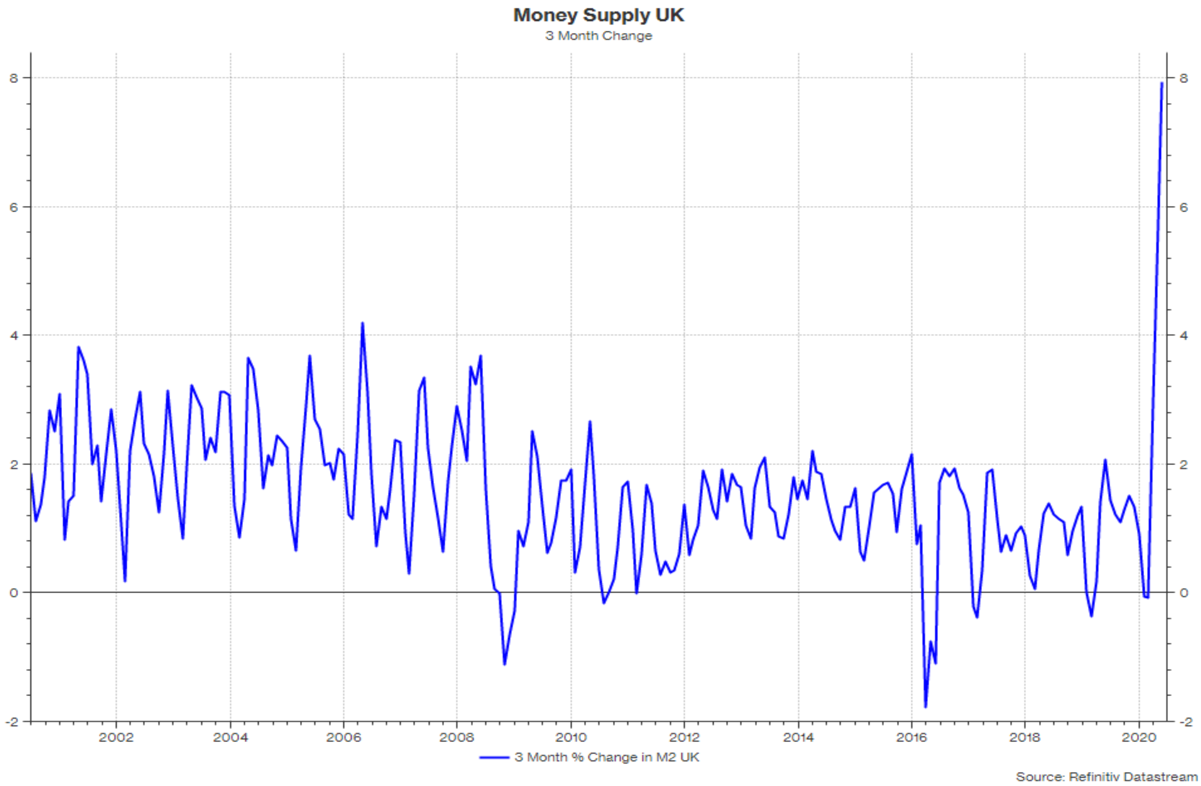
Interest Rates are at all-time lows and Central Banks and Governments continue to provide both Monetary and Fiscal stimulus; the Quantitative Easing programs mean that the Central Bank creates money and buys the debt the Government issues putting capital in the hands of Government to spend and the debt becomes an asset of the Central Bank.

If a country can issue debt in its own currency – as most developed regions can - the Central Bank can print money to buy the Debt the Government issues and they can carry on indefinitely. This was the case in the UK and US in World War II and Japan has been aggressively following the strategy for almost 30 years – their Debt to GDP is over 240% (we are around 100%) and interest rates there have been below 2% since the early 1990's.

Unlike the Financial Crisis when Financial Institutions held on to capital to rebuild their reserves money is now actually going into the pockets of businesses and individuals through Fiscal stimulus that is provided by the Government; this "helicopter money" is provided in the form of furlough payments, grants, and loans.

The best way to see this is the rise in M2 or Money Supply over three months; this figure shows highly liquid cash such as current accounts; below we see how this has increased on a scale almost four fold that of the Financial Crisis.

Figure 1.1 Three Month Change in UK Money Supply (M2)



This has important implications and we need to think how this money will be spent; will individuals reduce debt – the UK has high personal lending levels – and build up reserves to protect against the risk of unemployment? Alternatively, they could well embark on a spending spree and we have already seen a strong rebound in retail sales in the UK through May; with shops reopening we could see this rise further.

Alongside this we would expect Government Budget Deficits to widen as spending outstrips revenues; this coupled with a rise in the supply of money and low interest rates is likely to have a negative impact on the value of a country's currency. The risk is potentially higher for somewhere such as the US where the Dollar is relatively strong in comparison to history.

The result of this makes a strong case for an inflationary environment; something that could be accentuated as firms shorten their supply chains and no longer outsource production to Emerging economies where cheaper labour has kept production costs down.

With rising unemployment and falling GDP it may seem that deflation is more likely than inflation; but Central Banks and Governments are intent on avoiding the deflation that we saw in the Depression in the 1930's. Inflation is also beneficial as it reduces the value of the debt; something that all Countries will hope to do; particularly as the alternative is raising taxes and a more austere environment to repay borrowing – quite frankly that doesn't win elections!

To us it seems likely that whilst we may initially see a deflationary environment followed by one that is more inflationary in the future; whether this is just a little higher than we are used to or more like the "stagflation" of the 1970's when inflation hit double digits and economic growth stalled is unclear. Hopefully, it will be the first as the only way that 1970's inflation was successfully subdued was over 15 years when interest rates were for the most part above 10%.

In an inflationary environment the assets that have historically performed well are Index Linked Gilts (Linkers), US Treasury Inflation Protected Securities (TIPS) and Commodities; for most portfolios we hold a good measure of these using the following strategies.

Index Linked Government Bonds

- These are available in the UK and US with capital and income return linked to inflation.
- We currently prefer US TIPS over UK Linkers given the better yield.
- These have also been working well in the current deflationary environment.

Commodities

- Commodities are sold for the most part in US Dollars $; a strong/weak Dollar has a negative/positive effect on the price. If we expect the Doller to weaken this will be positive for commodities.
- Gold has been a strong performer over the last year and with low interest rates, currency weakness and rising budget deficit the scene looks set for this to continue.

- Gold Mining Stocks perform well if the Gold Price rises; Gold Mining stocks have recently been at levels last seen in 2002-2004 after which they returned almost 600% in response to the strong rise in the price of Gold.

- Silver tends to follow Gold and the price is now significantly lower in comparison to history presenting a real opportunity for gains albeit with some volatility.

- Earlier in the year we saw deflationary concerns coupled with OPEC action against Russia result in negative Oil Prices for the first time ever; whilst current prices have recovered to just over $40 per barrel we are some way off the $80-$100 per barrel that has been the norm in recent years. The result has been devastating for the Oil & Gas Producers with major firms such as BP and Shell falling in value substantially; this sector now starts to offer some interesting opportunities, despite declining dividends.

Other Asset Classes

It is clear to us that on the whole stock markets are unlikely to be near the start of a new Bull market; in fact a case could be made that we are in a shorter term rally of a more long term Bear trend that will lead stocks much lower.

However, given the liquidity injections of capital and the fact that dividends offer positive "real" yields above inflation compared to other asset classes their popularity could continue for some time yet.

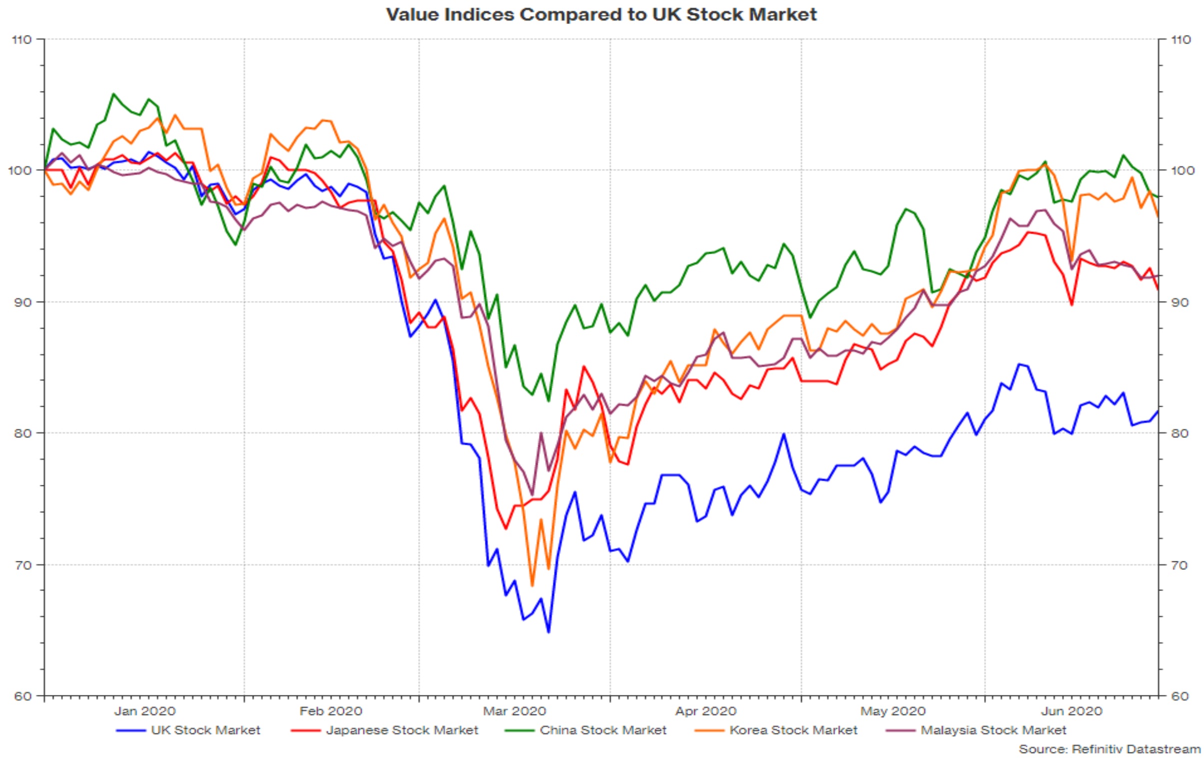
We still view the US as an extremely expensive stock market dominated by a handful of stocks (Facebook, Apple, Amazon, Netflix & Google) and would prefer to avoid investment here. The UK looks to be valued at reasonable levels – but certainly not a generational buying opportunity!

We are relying here on our Momentum strategy to tell us when to get back into these markets and to keep us out whilst risk is high.

The response to Covid-19 in the Far East and selected Emerging Markets has for the most part been superior to many Western Countries and many of them have strong economies with lower levels of debt and a growing consumer base.

These regions stock markets had already been suffering prior to the pandemic, which was reflected in the fact that China, Japan, Korea and Malaysia were identified in our Value screen at the start 2020 – so far despite being in negative territory these are all at least 10% better off than the UK Stock Market

Figure 1.2 Investment in "Value" Indices compared to the UK Stock Market



We always retain a reasonable level of equity exposure through tried and tested funds that hold some World Class companies that we hope will continue to deliver over the long run; we certainly don't want to miss out on those!

Alongside this we also include Multi-Asset Funds with a long track record of capital preservation and consistent returns over 20 years or more that provides portfolios with a solid core. If we add into this Hedge Funds and Trend following strategies that can benefit in declining as well as rising markets then we have a strong combination of possible sources of returns and the diversification that we need to deal with different scenarios.

Hopefully by adopting a clear strategy, that we can convey to you, will provide some reassurance in what is a trying time for all of us; in the meantime we will continue with our endeavours to help you achieve your financial objectives whilst avoiding any sleepless nights.