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# Investment Update

Autumn 2015

## Brighter times ahead

**Not all doom and gloom**

**Top of the podium for UK**

**Market indices – not always what they seem**

# Overview

This summer has certainly been a challenging one for world stockmarkets: concerns over Chinese growth, falls in commodity prices and an imminent shift in US interest rate policy have all collided to create an environment of heightened uncertainty, volatility and risk aversion.

Mark Robinson
Director
Chief Investment Officer

Whilst it is disappointing to have given back some of this year's earlier hard-fought gains, losses have generally been contained through varying degrees of active management, asset diversification and avoidance of problem areas, depending on clients' risk appetite. Furthermore, and as this review will go on to note, falls in some well-known stockmarket indices have been magnified by their 'exposure' to certain heavily impacted sectors or individual companies, and paint a somewhat misleading and perhaps overly pessimistic picture of the investment world, and the actual outcome for most investors. The current volatility could continue into the final quarter, and perhaps beyond that, but there are equally some very solid reasons to suggest that markets have overreacted, as they often do, to the current uncertainty and that brighter market influences, of which there are several, could emerge from the shadows quite soon.

As we enter the final quarter of the year, the risks and opportunities are finely balanced. There is still a risk that the broad global economic growth momentum that has been building this year, principally in the US and Europe, begins to stall and deflationary concerns re-emerge. There is also the risk of policy error by the Fed in particular, with Chinese growth concerns and the markets' recent reaction causing them to dither at a time when a small tap on the brakes would otherwise be eminently sensible. But the summer correction in equity markets is beginning to look like an over-reaction, particularly in markets and sectors which are less susceptible to a Chinese slowdown or more immune to (or indeed beneficiaries of) a sustained drop in energy and commodity prices. So, investors need to be careful not to be overly consumed by the negativity emanating from Asia and emerging markets: we should keep in focus the solid growth emanating from the US, the turnaround in Europe, improved business and consumer confidence, acceptable valuations and corporate earnings growth, and the continued stimulatory backdrop of low interest rates and inflation, all of which should be positive influences well into 2016.

Mark Robinson
1 October 2015

# Not all doom and gloom

With all the headlines currently surrounding China's growth and associated contagion within emerging markets, it is quite easy to lose sight of some encouraging news building in western economies. America's economy has rebounded strongly after a weak start to the year and latest figures suggest growth by the mid-year point had recovered to an annualised rate approaching 4%.

When viewed from a domestic perspective, the US seems to be out of the direct firing line and quite far from an economy caught in the crosshairs of China and broader emerging market contagion.

Admittedly, there are significant challenges in certain sectors, most notably those which are directly hit by the fall in the oil price or whose exports are dependent upon strong emerging market demand. But it appears that any weaknesses in the manufacturing side of the economy are being more than offset by the strength in services and non-manufacturing components.

This distinction partly explains the US Federal Reserve's indecisiveness on raising interest rates: it can see the momentum building in jobs, wages and business confidence, but is also alert to parts of the economy where growth is quite fragile or impaired, and the instability in confidence that too early a rate rise might bring. The Fed needs to be careful, though, in letting market noise and external factors interfere too much with its decision-making process – postponing the first rate hike for too long might require a more acute policy adjustment as the US economy gains momentum.

# Top of the podium for UK

It would be remiss not to mention the established recovery in the UK economy which, according to latest figures has been confirmed as being the strongest amongst G7 nations for the past three years. Like the US, the progress is not uniform, with the manufacturing side of the economy in decline, but there is sufficient momentum elsewhere in the services sector to be encouraged, as well as support from business and consumer confidence which is also improving.

Households' real disposable income is rising at its fastest pace in five years, boosted by lower energy and food prices, yet much of this has still to permeate the economy. Add to this the highly stimulative backdrop of low interest rates, which we do not expect to alter until well into 2016, and it appears that, leaving all the external economic distractions to one side, we have a rather benign backdrop against which to make investment decisions.

# Market indices – not always what they seem

We have previously noted the composition of stockmarket indices and their influence on 'market' sentiment. Bellwether indices such as the UK's FTSE 100 Index are quoted extensively in the media and have become a useful gauge from which all investors can obtain a quick market temperature check.

They also allow cost-conscious investors, keen to get quick and broad exposure to a particular 'market', to invest in exchange-traded funds which replicate such benchmarks. But such indices also need to be handled with great care and frequently give a misleading picture of what is actually going on in a particular market, particularly at an economic level.

To illustrate, in the year to date to the end of September, the annals will record a loss of almost 8%, excluding dividends, for the FTSE 100 Index - a disappointing outcome and message, particularly for those invested in index-tracking funds.

But delve a little deeper and one finds that headline indices such as these are giving a very misleading picture, and that the fall-out from the China and emerging market sell-off has perhaps not been as damaging as initially meets the eye. It is worth noting, for example, that the share price movements of just four companies, BP, Royal Dutch Shell, Glencore and HSBC account for almost 70% of this year's UK 'market' decline.

Far from being diversified, investors tracking the FTSE 100 Index will have had an unhealthy bias towards those company shares and sectors most exposed to declining commodity prices or slower emerging markets growth, and will have suffered accordingly. In contrast, by not owning just a handful of stocks, or under-weighting the most vulnerable shares and sectors, and instead focusing more on, say, UK domestic growth, will have given investors a very different investment outcome.

So if one has been invested in active funds, as we have, the chances are that one will have significantly outperformed 'the market' through some smart avoidance of companies and sectors which continue to face some significant headwinds. We have flown the flag for active rather than passive management several times in the past, but this most recent period is as strong an indication as there has been in a long time for the former, and a lesson that we should not pay too much attention to how key stockmarket indices are behaving or constructed. Against an uncertain trading and economic backdrop for many companies, we want underlying managers to have as much free rein as possible, not hands tied behind their backs, and believe that this, along with astute asset allocation calls, is the key to delivering attractive risk-adjusted returns for our clients.


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