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Investment Update

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Overview

The history books will indicate that 2015 was a tough year in which to make a positive return from investing in world stockmarkets, even after allowing for dividends. But the headlines will undoubtedly fail to acknowledge that many, particularly those who have adopted an active approach, will have experienced a more encouraging outcome.

Mark Robinson
Director
Chief Investment Officer

As the ink dries on year-end values, some investors will certainly be licking their wounds, particularly if they have sat on their hands and been wedded to commodity-related market sectors or had too much exposure to the likes of emerging markets. But whilst the headlines of poor index returns in 2015 may make for uncomfortable reading, prudent allocations away from the troubled areas, and an emphasis on areas and asset classes not caught up in, for example, the worry over slowing Chinese growth, lower commodity prices and uncertainty over monetary policy change, have still enabled some reasonable gains to be made. Such gains, albeit modest, also need to be viewed against a backdrop of extremely low inflation and near-zero cash returns.

Looking ahead, 2016 looks likely to be another year in which active management will produce better results than a passive approach. Like 2015, we do not expect it to be an easy ride, but we do believe that the backdrop is still reasonably favourable for some sensible risk taking, and that it will still be possible to eke out attractive real (inflation-adjusted) returns. Being more selective about sources of income and being fussier about the price paid for stocks will keep our underlying managers very much on their toes. Similarly, we are hopeful that our continued avoidance of areas still troubled by the fall-out in commodities and slower growth in China, a continued focus on areas of economic strength rather than weakness, and a watchful eye over the changing landscape for monetary policy and inflation (and their impact on different asset classes) will deliver the outcomes that investors are seeking in the year ahead, whatever their risk appetite and objectives.

Mark Robinson
1 January 2016

Interest rates – now what?

After all the to-ing and fro-ing last year, we do at last have a little more certainty going into 2016 - December's announcement by the US Federal Reserve of the first increase in US interest rates in almost a decade has given some clear guidance on what we can expect over the coming year.

This guidance is littered with all sorts of caveats, but if all goes according to plan we can probably expect a further 1% increase in US interest rates this year. Use of words like 'gradual' in the Fed's messaging should not necessarily mean it will raise interest rates in a mechanical fashion: it says it will continue to act with 'prudence' and will be willing to adjust policy if its assumptions prove to be incorrect. Inflation, or rather the lack of it, has been the biggest headache for US policymakers at a time when the stars have aligned on other key metrics such as employment and economic growth, and it explains why they have found it so difficult to judge the timing of the first increase in interest rates, and why they could still act with restraint if inflation does not track back to their 2% target in the medium term. Policymakers in the UK face similar difficulties over the timing of a shift in policy, and whilst a first small hike in rates later this year seems on the cards, we are conscious that there could still be many a slip 'twixt cup and lip, just as there has been in the USA.

Dividend reliability in doubt

The ongoing reliability of dividend income will require closer scrutiny this year: dividends tend to provide a more reliable source of return and an element of cushioning for investors during times of stockmarket stress. Furthermore, studies show that dividends have a significant part to play in delivering long-term investment returns.

It has been good to see the culture of progressive dividend policies come to the forefront of company management across the globe in recent years, with healthy dividends now being paid by companies in countries that have historically been rather stingy. This is all fine at a time when companies are making decent profits, but with the pace of global economic growth (and hence profitability) coming under more of a microscope, the quality and sustainability of dividends in some sectors is likely to have a greater influence on market behaviour and stock-selection than it has done historically. Some companies have been more responsible than others by not over-distributing profits, or have been in a position to cut back on things like capital expenditure to counteract any shortfall in earnings, thereby mitigating any potential pressure on dividends. Others are not in such a fortunate position: we now find that the dividend cover, based on anticipated earnings, for UK companies, for example, is at its lowest level in around 20 years.

Some household names and big stockmarket index constituents like Vodafone, BP, GlaxoSmithKline and BHP Billiton have been paying uncovered dividends and appear to have uninspiring earnings growth potential. A dividend cut in any one of these would have an impact on investors' total dividend income receipts and would undoubtedly dent market confidence. Many longer-term investors like big pension funds may therefore need to make adjustments to their portfolios, diverting capital from some of the (current) big income-producing companies into less vulnerable businesses further down the market capitalisation scale. This is a further argument for investing via active, flexible funds, rather than passive, benchmark-hugging approaches in the year ahead.

And a look at key themes in 2016

Most of the themes that were represented in our investment strategy during 2015 are still valid for the early part of 2016: this means retaining stockmarket allocations at the upper end of the ranges for differing risk appetites, with an emphasis on the growth in developed economies and continuing to give emerging markets and commodity-related sectors a wide berth.

With the UK recently having been confirmed as the fastest growing G7 economy since 2010, maintaining a decent commitment to UK-invested funds remains important to us, even if market indices at a headline level continue to be jostled by international and sector influences that have little connection with the domestic economy. As the year progresses, the debate on Britain's status within the EU is likely to become an added complication, but at this stage we see it having greater disruption in currencies rather than stockmarkets. For sterling investors, maintaining some good exposure to equity markets outside the UK therefore seems sensible.

Now that interest rate policy in the US has turned, and is likely to be followed by the UK in the not too distant future, we are likely to see investors seek out new areas where share prices and dividend yields remain attractive, particularly relative to bonds. One area of opportunity appears to be continental Europe, where momentum is building in the economic recovery, which is supported by European Central Bank reassurance that they are standing by to provide further stimulus if required. Stockmarket valuations in continental Europe are generally lower than in the US and UK, and the outlook for corporate profits growth, and hence dividends, also looks encouraging.

Outside of stockmarkets, the income and capital growth attributes of commercial property continue to favour good allocations, although we are mindful that with interest rates on the turn the likelihood of seeing another year of double-digit total returns from this asset class in 2016 has diminished. Exposure to commercial property via 'bricks and mortar' funds has also acted as a good stabiliser during the several bouts of stockmarket weakness that we have seen during 2015. Similar defensive qualities have come to the fore from allocations to 'absolute return' funds – we have seen 'ideal' conditions in which to witness their defensive qualities in action, and it is pleasing to note that they have generally delivered the low, stable, positive returns that we have expected of them.

Great care is still needed within bond markets, but having reduced exposure over the past year or so, and having concentrated our positioning on flexible strategic funds that are positioned with low sensitivity to interest rate changes, as well as inflation-linked exposure, we feel reasonably well prepared for whatever is thrown at bond markets by this new era of rising interest rates.

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