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Investment update

Autumn 2017

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Overview

As autumn approaches and we move into the final quarter of the year, several recurring themes and headwinds continue to influence the direction of both economies and financial markets, and indeed our thinking.

Tighter monetary conditions, squeezed consumers, stretched equity valuations, compressed bond yields, escalating debt levels and geopolitical tensions are just a few important issues to consider at a time when complacency, as reflected in low volatility measures, remains elevated.

Our current focus is the examination of the existing risks embedded within economies and financial markets, with perhaps greater attention being devoted to areas that have the capacity to partially or permanently destroy capital, both in the near and longer term, rather than to the more limited pockets of opportunity that seem to be in front of us. The fact that we are devoting more time to downside risks, and how to protect against some of them, perhaps sums up our general mood of continued caution.

However, we are not blind to the possibility that financial markets could continue to ignore many of the issues and grind even higher over the course of the remainder of the year. The outlook beyond this, however, does look much more uncertain, particularly since the global economy and its financial markets are enveloped by distortions created by the last financial crisis. The challenge for policy makers is to ensure that their forthcoming actions do not trigger the next one. Overall, this does not feel the right time to be increasing risk.

1 October 2017

Equity content pulling its weight

It is important to note that the stockmarket commitment that we have in portfolios is working hard, and focused on active funds which broadly have a free rein and are not constrained by the make-up of any market index.

This flexible approach means that funds should be less exposed to some of the more expensive market sectors, or areas being supported more by currency influences and the search for alternative sources of income, than by fundamentals. Significant flows of capital have been directed into passive investment funds in recent years, propelling share prices, and valuations, in some companies to unacceptably high levels and creating market biases with which we are not comfortable. Active managers can navigate around these skews in markets, and should be better prepared when the general appetite for risk assets reduces and the present recipients of passive investment encounter more challenges. This is likely to happen when capital flows reverse and the misallocation of capital becomes more apparent.

Income in portfolios

The income component of portfolios' total returns is currently tracking at a lower level than normal.

This is due to reductions in stockmarket exposure as well as the elimination of commercial property investments last year. Additionally, lower levels of income from fixed interest investments are not only reflective of the current low interest rate environment, but also our current policy of investment away from more vulnerable areas of bond markets, which we feel could see greater risk to capital as monetary policy changes. The contribution that income makes towards any portfolio's total return is expected to rise when our confidence in both stock and bond markets improves, but in the meantime we feel that placing greater emphasis on safeguarding capital values should take priority over income provision. This is particularly relevant for mandates where portfolios are being managed on a total return basis, where there is no set income requirement, or income is being reinvested.

Chill winds for the UK

In the UK, there is an autumnal chill in the air, where the nights are not just drawing in for residents but the economy too.

Several forecasters are expecting UK economic growth to deteriorate quite significantly over the course of the coming year. The Organisation for Economic Co-operation and Development, for instance, currently predicts that the UK's GDP growth will fall to just 1% in 2018, and could potentially flirt with lower levels, largely due to Brexit's stalling influence on business activity. Recent figures from the Office for National Statistics already show that having been in pole position just prior to the EU referendum, the UK's economic growth rate has now sunk to the lowest level among the league of G7 economies.

Credit rating agencies, which did not cover themselves in glory during the financial crisis by being slow to respond to the unfolding systemic risks, are now on the front foot and paying closer attention to the health of the UK economy. Moody's, for example, has cut its UK rating by another small notch. Understandably, the UK Treasury was not impressed with Moody's decision, claiming that the numbers on which its assessment was based had passed their sell-by date. The government's protests, however, are likely to fall on deaf ears as this issue is added to its growing list of troubles. For 35 years until 2013, the UK held the equivalent of the restaurant sector's three Michelin stars, despite several chef changes along the way. Having now lost that top accolade and recently seeing its ratings slip even further, regaining support from both critics and its top international clientele is going to take some hard graft and long hours in the heat of the government's kitchen.

Overall, the UK economy does not appear to be in great shape, and neither does its currency. There would certainly be a shockwave on inflation if the pound were to plummet, impacting the UK's ability to import essential goods and taking the country closer to recessionary conditions. Whilst resultant higher interest rates might, ultimately, allow sterling's supporters to return, the immediate damage done by the higher cost of government borrowing in international debt markets could box the economy into a corner from which it would find it hard to escape. It is perhaps no surprise, therefore, that we are looking to modify some UK stockmarket exposure to reduce the dependence on the domestic economy and increase overseas earnings streams that might also benefit from a weaker pound. Broadly speaking, this involves a reduction in some smaller and mid-sized UK-centric company exposure and an increase in larger, global businesses that should be less exposed to the UK's growing challenges.

In conclusion

It appears we are nearing the endgame in this drawn out, and experimental, financial chess match.

We have a good defence strategy in place and feel well prepared for when the clock finally stops for policy accommodation. We have perhaps sacrificed some gains in doing so, but we are trying to look several moves ahead, combining shorter-term tactics with longer-term positional play. The benefits of this approach may only become more obvious when markets finally surrender as years of excess liquidity are removed from the table. To quote the investment world's own grandmaster, Warren Buffett: "after all, you only find out who is swimming naked when the tide goes out".

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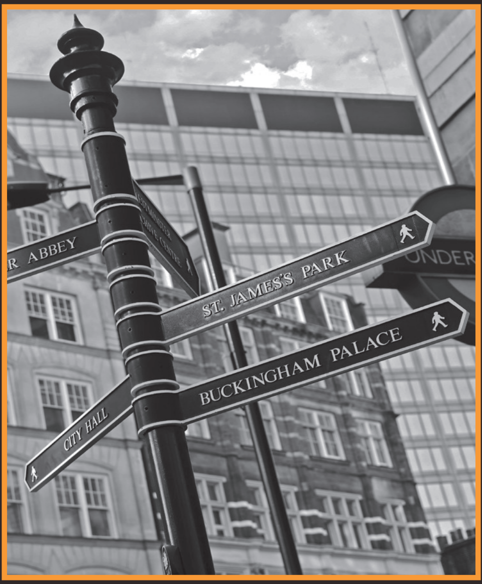

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