Your investment update

Q4 2023

Succession Model Portfolios
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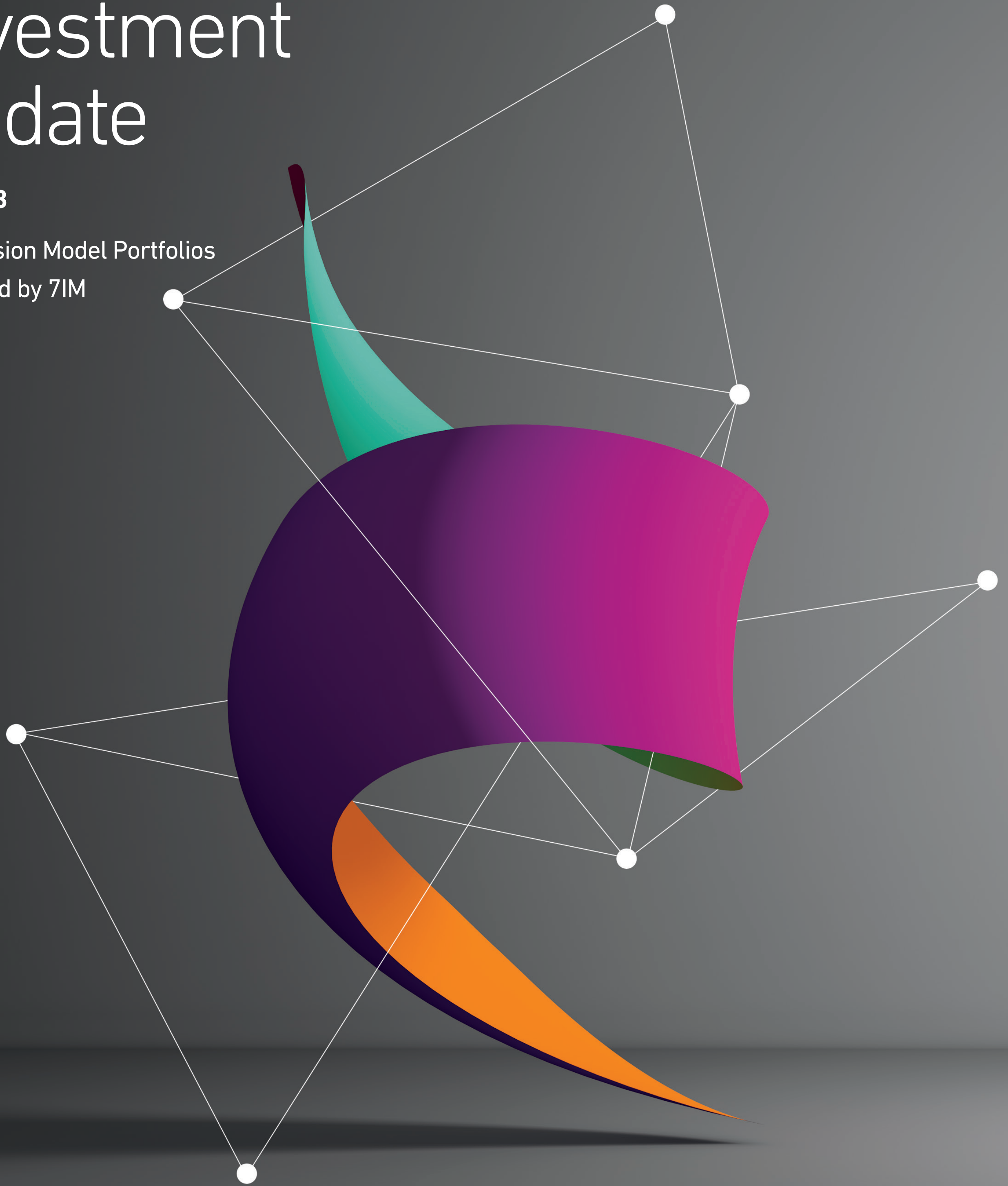

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Contents

04 **Welcome**
Changing times
Martyn Surguy
Chief Investment Officer

06 **Strategy**
If I were an influencer pt. 2: the comments section
Ahmer Tirmizi
Head of Fixed Income Strategy

10 **Special feature**
Nvidia reaching for the Sun
Terence Moll
Head of Investment Strategy

12 **Culture & sustainability**
Carbon offsets – saving grace or green scam?
Wenqian Zeng
Junior ESG Investment Analyst

Visit us at **www.7im.co.uk** to find out more about our latest news and views.

Welcome

Changing times

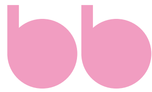
Exciting corporate news to start – 7IM is to have a new owner. We are delighted that the Ontario Teachers' Pension Plan Board (OTPP) has decided to add 7IM to its considerable portfolio of assets.

It's particularly exciting as it's clear that there is a common culture and joint vision for our firm, which puts your interests as clients at its very core. OTPP is absolutely committed to providing the investment to enhance our clients' experience, at every level of the business. There has been some speculation over our future in recent months and it's great to remove that uncertainty, put it behind us and look forward to the future with confidence.

Onto investment matters. We live in changing times for investment markets too. Investors are faced with challenges and decisions that haven't been presented for many years. Inflation has risen to levels not seen for decades, leading to interest rate levels that no longer appear to punish savers (although for borrowers, it's a different matter). What should investors do when confronted with the apparent certainty of more attractive cash rates? After all, mixed-asset returns have been decidedly lacklustre in recent years. Frustration is entirely reasonable. The temptation is to retire to the comfort of cash and a 'reliable' return. But is that sensible?

The answer, as always, is 'it depends'. For investors with a very short time horizon or for those who have a specific cash demand, high cash rates are to be welcomed. But for long-term investors whose investment goals haven't changed, it's much less likely to be a good decision. Higher cash rates provide a much better environment for bond markets, most alternative assets and significant sectors of the stock market – mainstays of a mixed investment strategy.

In investing, what's comfortable is rarely the same as what's profitable.



Staying the course is an important part of successful investing. Abandoning a long-term strategy after a disappointing period is unlikely to result in success."

Staying the course is an important part of successful investing. Abandoning a long-term strategy after a disappointing period is unlikely to result in success – and is somewhat counter-intuitive when you consider that poor returns in the short term are an opportunity to buy something at a discount! Investing is one of the only areas of life where people buy LESS of something when it's on sale! We need to fight against that urge, as our investment influencer Ahmer explores.

In a similar vein, being tempted into prevailing trends in markets also feels comfortable. As humans, we feel safety in numbers. Investors will usually prefer to congregate in investments that have just done well. History suggests this strategy often ends badly. Our own approach is to be anti-fashion. It's a hallmark of our identity. Terence Moll covers this further in his piece.

Looking to the future (both of the investment markets and of the planet), one of our ESG specialists, Wenqian Zeng, digs into the details of carbon offsets – and explains how they feature for 7IM as a company.

Plenty to get your teeth into!

Let me end by saying that our ownership may be changing, but our investment approach will not be. We remain committed to delivering steady growth with an absolute respect for the preservation of capital. Enjoy reading.

MARTYN SURGUY

Chief Investment Officer

Strategy

If I were an influencer pt. 2: the comments section

Cash savings accounts are finally offering a meaningful return. But that doesn't mean that investors should change their portfolios.

Last quarter, I tried to imagine that we were producing social media content. The obvious 'hook' in today's investment climate was, and still is, **'Three BIG problems with cash'**. This turned out to be a wildly popular topic amongst our followers (you, the readers). Like any good content creator, inspiration for future topics often comes from the comments section.

So, this quarter, I thought I'd look at the most popular questions our readers have asked...

1

"Current interest rates are high enough for me. What's the point of investing?"

The rise in interest rates over the last few years has been astonishing. Just 18 months ago, they were close to zero. Now: the highest they've been in a decade. And looking at the actual number, cash rates of 5.25% *are* pretty attractive. Lock it away for a year, take no investment risk and get paid a handsome return over and above what the Bank of England believes will be long-term inflation (2%). What could be wrong with that?

In isolation, we agree that this is a great 'risk-free' return. The question we'd ask back is, *if you think interest rates are worth locking in, why just do it for a year? Why not lock it in for longer?*

This is what the bond market offers you. Today, you can lock in a 'risk-free' return over five to 10 years of almost 4.5% per year just by lending to the UK government. And the UK government has an excellent track record of paying lenders back. Or you can go further and lend to a range of different borrowers too. From big, stable *investment-grade* companies like Visa, Disney and HSBC to smaller, but still pretty serious *high-yield* companies, which include the likes of Nissan, Ford and Vodafone.

How best to lock in those higher interest rates? Well, the 7IM Moderately Cautious portfolio has around two-thirds of its assets in income-generating assets. From short-term government bonds all the way to corporate bonds that mature decades into the future. Put together, investing offers the chance to lock in higher interest rates across the world, to different types of lenders, over multiple years – something an annual cash account can't do.

2

"Even 7IM are saying we'll be sideways with volatility for a while. Why hold any equities?"

We've established that a large part of a 7IM portfolio will lock in higher interest rate exposures for longer than cash can currently. But our analysis (and history) suggests that this won't be enough to deliver inflation-beating returns over the long run. This is why we need equities.

The problem with equities is that they can be scary. It can seem like they are subject to uncontrollable global forces; investment banks, hedge funds and traders all moving the markets in unpredictable ways. Putting your hard-earned cash into that maelstrom doesn't seem appealing.

But that's a bit like never going outside again because there was once a thunderstorm. But the storm subsides. This was a key finding from Nobel prize winner Robert Shiller[1]. He found that most of the short-term movement in equities was not explainable by the underlying health of the company. This sounds scary. But hold equities for long enough, he says, and they find their way back to something more sensible.

Take the FTSE 100, a market of large companies listed in the UK; AstraZeneca, HSBC and BP. Altogether, the index has a dividend yield of over 4%. While the dividend yield is not as certain as, say, the yield on a UK government bond, it's pretty stable over history, whether markets are up, down or sideways. This is because the CEOs of these companies have an incentive to keep their investors happy – and the best way to do so is to pay them back a cut of annual profits.

The impact has been that since 2007 (the peak before the financial crisis), about 80% of the market's returns (nearly 5% per year) have come from the dividends (see graph on page 9). That includes two major recessions. So, while it's always tempting to wait for a 'better entry-point', this example shows that you don't need to if you want a slice of inflation-beating returns. >>

AHMER TIRMIZI

Head of Fixed Income Strategy

[1] https://www.nber.org/system/files/working_papers/w0456/w0456.pdf

Strategy
Continued

3

"The last few years have been underwhelming. When am I going to see a return on my investment?"

7IM portfolios mix equities, which look to offer an inflation-beating return, alongside bonds, which look to provide the certainty of locking in interest rates. But it isn't lost on most people that investment returns haven't quite stacked up over the last couple of years. However, these points are connected.

Bonds have lost money in that period, with the UK gilt market being one of the worst hit. This is because interest rates have risen (causing the price of bonds to fall) – in the UK, yields have gone from close to 0% all the way to 4.5%. So, what has hurt investors recently is what also makes bonds even more attractive now – prices are lower, and yields are higher. The upshot is the bond part of your portfolio is now much more likely to make a high return.

Similarly, equities have been sideways and volatile for a couple of years now. But what we tend to find is that periods of equity market choppiness eventually give way to stronger returns. Remembering that CEOs are keen to return money to shareholders through things like dividends when they can, means that periods of low returns don't usually last too long (otherwise there'd be no investors left!).

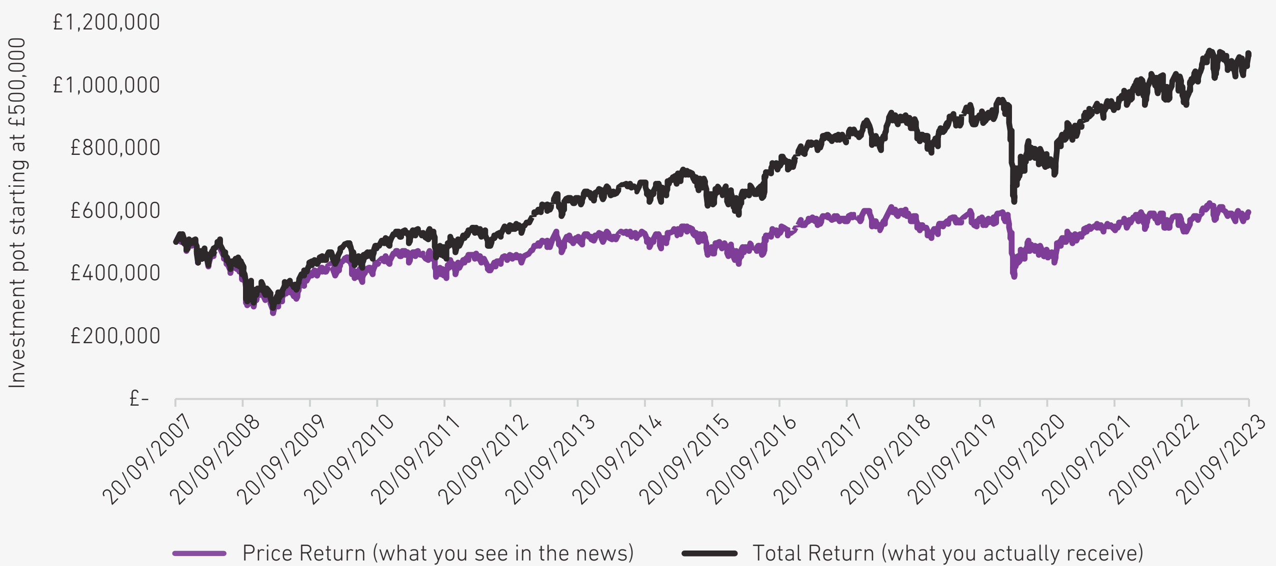
Put together, the last couple of years of downward bond returns and sideways equity returns have pushed *up* the guideline returns of portfolios. Take the 7IM Moderately Cautious portfolio again, where long-term annual returns have gone up from 3.5% to 5.5% in the last two years. This is by no means a *guarantee* that returns will come immediately. But there's never been a better time to gain exposure to these inflation-beating, cash-plus long-term returns. The chance won't be here forever – the last two years have shown how quickly things can change. And the cost of moving to cash now could become costly very quickly.

So, what has hurt investors recently is what also makes bonds even more attractive now – prices are lower, and yields are higher."

Equity returns – don't listen to the headlines!

Investors often hear about the price movements of the stock market... *'The FTSE climbed x-points to y-thousand and something'*. This gives the impression that investors need to wait for big price moves to make their returns. Instead, dividend returns (which is just a slice of company profits) have a big part to play.

Take the FTSE 100 since 2007. While the price movement has delivered a return of less than 1% per year, investors actually received a return of almost 5% per year. That's the difference between a 15% return and doubling your money! Through two major recessions, companies have found a way to pay investors who stick with them through good times and bad.



Source: Bloomberg Finance L.P.

Special feature

Nvidia reaching for the Sun

In early 2000, investor hype pushed the price of Sun Microsystems to an absurd extreme. It was destined to disappoint its shareholders, as its CEO noted. Likewise, can artificial intelligence (AI) help Nvidia grow enough to justify its current valuations?

In the late 1990s, Sun Microsystems was one of the world's winningest 'New Economy' companies. It was a leading producer of high-performance workstations and servers (computers that serve other computers over a network), and developed the Java programming language, business software and storage solutions for companies.

It was a star of the emerging internet, and its shares raced up for years. By March 2000, the firm was worth $150bn. Its revenues at the time were about $15bn per year, so its price-to-sales ratio at its height was about 10.

Two years later, after the Nasdaq crash when Sun had lost 90% of its value, its CEO Scott McNealy addressed investors as follows:

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate.

"Now, having done that, would any of you like to buy my stock at $64? Do you realise how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. ***What were you thinking?****"* *(our emphasis)*[2]

Sales matters

A firm's sales are often an excellent indicator of how the business is doing. Sales numbers tend to be clear and simple, and can't easily be fudged by accounting shenanigans – which often confuse earnings measures.

The price-to-sales ratio is a measure of how much those sales are worth to investors. When it's high, those sales are very expensive. In Sun's case, McNealy said it would have needed to grow phenomenally to justify its early-2000 valuations. It did grow strongly over the following decade, as the internet spread across the world, but not nearly enough. In 2010, it was bought by Oracle Corporation for $7.4bn. Investors who bought Sun shares in the late 90s and held on lost almost all their money.

How did Sun become so absurdly expensive? Because of two features of human behaviour.

[2] https://www.gmo.com/globalassets/articles/quarterly-letter/2021/gmo-quarterly-letter_2q-2021.pdf

First, investors tend to be seduced by growth. They see a company growing fast, they make money from it for a while, and they extrapolate its growth far into the future. A hype cycle builds up. But few companies continue growing fast for a long time, especially large ones. Competition intensifies, roadblocks appear, and the firms' numbers end up slowing.

Second, investors are social animals and like being invested in fashionable stuff on the way up. When a bandwagon comes past full of happy people, they tend to leap aboard without necessarily scrutinising the proposition carefully. So hype cycles drag in more and more investors and can be self-fulfilling for a while.

This is until the business disappoints, and everything falls in a heap. However, the hype cycle can lead to companies and markets being dissociated from fundamentals for a long time.

The Nasdaq bubble of 1998-2000 was the classic example. There have been many since. Think of Zoom Video Communications, whose price soared from $75 in January 2020 to $560 in October 2020, in the first phase of the pandemic. We were all using Zoom, and at its height, the company was worth $160bn. Then investors realised the hype had gone too far and began selling. Zoom is now trading around $68, and the firm is worth only $20bn.

How Magnificent are the Seven?

We have concerns about the Magnificent Seven, the seven huge technology stocks – Nvidia, Meta, Tesla, Amazon, Alphabet, Apple and Microsoft – that have been driving global markets this year. By late August, they were up by an average of 89% (!), compared to the rest of the S&P 500 on 3%. Well done to them.

And their valuations have soared. Tesla has a price-to-sales ratio of about 8.8, Microsoft 11.5, and Nvidia 32.9. Nvidia's number is three times that of Sun Microsystems at its height, and is one of the highest for any large company in world financial history. The firm would need to grow spectacularly to justify this valuation.

Let's assume that Nvidia's investors expect a return of 10% per year. Its sales would have to grow by 30% per year over the next decade to bring its price-to-sales ratio down to a more reasonable 5 by 2033. That would mean sales surging from $33bn this year to $450 bn in 2033, which is higher than Meta, Microsoft and Tesla together. No huge company has *ever* grown sales that fast... not even Apple!

Sure, Nvidia is benefiting from the boom in artificial intelligence, which should boost world economic growth a little. But AI will have a limited impact on most companies and it may take many years for this to be achieved. Don't expect a world productivity miracle anytime soon.

Unfashionable

One of 7IM's core investment axioms is to be cautious of fashionable assets. When we see investors piling into trendy companies, markets or products, we prefer to keep our distance, because they tend to become overvalued and deliver poor returns in the future.

We follow this discipline because we believe it works. We limited our exposure to the Magnificent Seven – missing out on some equity growth – through 2023 because we know that in the long run, avoiding market fashions and hype tends to pay off.

This is one of those occasions. The Magnificent Seven have been over-hyped. There will come a time when we will look back on investors in Tesla, Microsoft and Nvidia in late 2023 and ask, *'What were they thinking?'*

TERENCE MOLL

Head of Investment Strategy

Culture & sustainability

Carbon offsets – saving grace or green scam?

Carbon offsetting isn't the answer – it's just one of many tools to help the world come to terms with climate impact.

'Offset the CO2 emissions of your trip from £4.99.'

Sound familiar?

You've probably come across this at your online checkout recently. Carbon offsets are everywhere, from train journeys and flights to online shopping deliveries. And in the corporate world, they're even more common. On the back of the Paris Agreement, companies are finding themselves scrambling to make progress towards their climate targets, and carbon offsetting is seen as a simple way to address carbon emissions.

But *what* are carbon offsets, and do they *actually* help our carbon footprint?

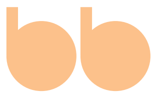
Carbon offsetting is supposed to 'balance out' (or offset) the carbon emissions of a company or person by investing in projects elsewhere to compensate for those emissions. It's like paying compensation to the planet.

These projects tend to be avoidance projects (e.g. renewable energy or community projects) or carbon removal projects (e.g. forestry and conservation). The benefit is broken up into chunks called carbon credits, which are bought and traded within a voluntary carbon market (VCM). Each credit represents a tonne of carbon dioxide avoided or removed. The idea is, with a few clicks of a button, you pay to counteract your emissions and someone on the other end plants trees or invests in cool green technologies.

Sounds simple, right? So what's the catch?

There has been a lot of talk recently (with some good reason) on the $2bn voluntary carbon-offset credit markets' credibility and quality, with some credits not delivering the promised emissions reductions. As a result, some companies are having cold feet. The likes of Nestlé and EasyJet have exited the market and are seeking alternatives.

Our view is that this is still a young and evolving market – both in terms of technology and finance. The standard setters, Integrity Council for the Voluntary Carbon market (ICVCM) and the Voluntary Carbon Markets Integrity Initiative (VCMI), are trying to improve reliability by raising standards.



Carbon offsetting should be seen as a *complement* to emission reductions – especially those hard-to-reduce ones, such as space flight or high-grade steel furnaces – rather than a substitute."

But carbon credits can only ever be part of the emissions solution. Relying solely on carbon offsetting without substantial emissions reductions in high-emitting sectors may not achieve the necessary global mitigation targets. Carbon offsetting should be seen as a *complement* to emission reductions – especially those hard-to-reduce ones, such as space flight or high-grade steel furnaces – rather than a substitute.

This is why, at 7IM, we are tackling the source by taking steps to reduce the environmental impact of our platform. All electricity used in our new London office and used by our data centre partners come from 100% renewable sources. We have also reduced the power consumption of our own IT infrastructure through more efficient equipment and by cutting down the number of IT communication rooms.

We then offset any remaining operational carbon emissions by continuing to support the World Land Trust – specifically the World Land Trust local partner FUNDAECO, which protects critically threatened tropical forest through its REDD+ Project for Caribbean Guatemala: The Conservation Coast. The project supports local landowners and communities in registering and obtaining land titles to protect threatened areas of coastal forest, for the benefit of the region's incredible biodiversity.

Solving climate change needs all the tools available, and carbon offsets is just one of many!

WENQIAN ZENG

Junior ESG Investment Analyst

Meet the teams

Investment Management Team

Martyn Surguy
Chief Investment Officer

ACA Chartered Accountant, MCSI, CISI Level 4, 36 years of industry experience.

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CFA, FRM, BA Economics, 12 years of industry experience.

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Investment Analyst – Alternatives

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Tiziano Hu
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MSc in Financial Technology, 3 years of industry experience.

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Head of Equity Strategy

CFA, MSc Behavioural Economics, 11 years of industry experience.

Tony Lawrence
Head of Model Portfolio Management

CFA and CAIA, 22 years of industry experience.

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Senior Investment Manager

BSc in Economics & Computing, 37 years of industry experience.

Peter Sleep
Senior Investment Manager

31 years of industry experience.

Ahmer Tirmizi
Head of Fixed Income Strategy

MSc in Economics and Finance, 16 years of industry experience.

Jack Turner
Head of ESG Portfolio Management

CFA, 15 years of industry experience.

Fiammetta Valentini
Investment Manager

MSc in Accounting, Financial Management and Control, 5 years of industry experience.

Wenqian Zeng
Junior ESG Investment Analyst

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MSc Finance, 3 years industry experience.

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Loic Yegba
Investment Risk Developer

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