Your investment update

Q4 2021

Succeeding together

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Welcome

MARTYN SURGUY

Chief Investment Officer

No sooner had we begun to live with coronavirus and return to some form of normality, than another crisis comes along in the form of fuel shortages. Although not nearly as serious, it's another issue that impacts our daily lives in a negative way – unless you drive an electric car. These kinds of issues can have a disproportionate bearing on our mood and can colour our judgement.

As investors, it's vital that we don't allow this to happen, since history shows that responding to emotions can *really* damage your wealth. Similarly, an overly local focus (in our case, on the UK) is also not helpful for us as a global investor.

And so any investment process must keep the twin evils of greed and fear at bay. At 7IM, we have devised a number of tools and techniques to help us do that. We like to look dispassionately at the facts and the fundamental drivers of market performance, rather than noise and sentiment.

It was this focus that enabled us to ignore the cataclysmic gloom pervading through investment markets in March last year when the world locked down. We were able to put the crisis to one side and recognise that portfolios had left their long-term moorings as stock markets collapsed. We added to equity positions by rebalancing portfolios which helped us in the subsequent recovery. This proactive type of approach will become ever more important as markets move into a choppier phase as they digest the twin issues of higher inflation and a gradual tightening of policy globally.

> Every portfolio we manage is well diversified in terms of asset class, equity style, region, industry and, crucially, currency."

In the UK, the news about queues at the petrol stations and empty shelves at the shops is certainly troubling. It's worth remembering, though, that the UK as an investment region has a relatively minor role in our investment fortunes.

We calculate that for a medium risk investor, no more than 10% of underlying portfolio revenues are driven by domestic developments. It's far more important to focus on the Federal Reserve, the Chinese government and the global manufacturing cycle. Every portfolio we manage is well diversified in terms of asset class, equity style, region, industry and, crucially, currency. So we are comfortable that there are checks, balances and the cushion of foreign currency to mitigate any local risks.

We've developed some of these themes in this quarter's publication. Senior Investment Strategist, Ahmer Tirmizi goes through our latest investment views, focusing on growth and the all-important inflation outlook – and you'll see he takes a global perspective. Investment Analyst, Fraser Harker covers healthcare in an ageing society, and climate change and its implications for investors, two of our long-term themes. And our resident behavioural expert Ben Kumar, expands on the dangers of emotional investing.

The financial markets are entering an interesting phase and there is much to consider. I hope you enjoy the read.

Strategy

Investing for the present

Are you ever *sure* of something, and then it happens? Those moments when something plays out exactly as you expected?

Parents are good at this. Watching their kids playing from afar, they scan the area for dangers just like Jason Bourne. The spidey-senses often kick in just before the child falls off the climbing frame, leans too far over the water or slips on tiles. Mum or dad swoop in just in time.

In the wider world, this sense of inevitability is everywhere. As much as we love the unscripted drama of sport or elections (ok, only some love those), the results of most matches are fairly predictable – which is why bookmakers are profitable businesses!

Forecasting the now

While sometimes you might be able to convince yourself that you're the next Derren Brown, usually the truth is a bit simpler. You observed the present. And through experience, you instinctively just *know* what comes next. I mean there really is only one outcome when my young son is running on tiles with his socks on… he can barely walk in a straight line on a good day!

Even in investing it's normally the present that dictates the future. But the problem is complex.

There are too many parts of the present, all combining in unseen ways to form the future. It's like having to try and keep a thousand sons from slipping over at the same time.

What will economic growth be next year? How high will inflation go? Have markets priced this in? Does X matter? Will Y happen? Should Z be taken seriously? Even if we had the answers, there are too many questions!

So, how should you invest? If you accept that we don't know exactly what the future holds, you'll have a healthy respect for risk. The best investors deal with this by thinking of the future as a 'probability distribution'. Billionaire investor Howard Marks explains: *"while superior investors — like everyone else — don't know exactly what the future holds, they do have an above-average understanding of future tendencies."*

So, as we look into 2022, we should ask ourselves what *tends* to happen? We're not looking for a precise outcome, just trying to establish our baseline on some factors which *tend* to be important. Let's look at some possibilities right now:

01

More savings *tend* to mean more spending

If you want to have an idea of where economic growth is going, look at the consumer. Consumer spending makes up around two-thirds of an economy. But how would you know what 7 billion consumers are going to do? You could look at yourself. When you have extra money you probably spend it because, why not? And when you don't have extra money you don't spend it because you can't.

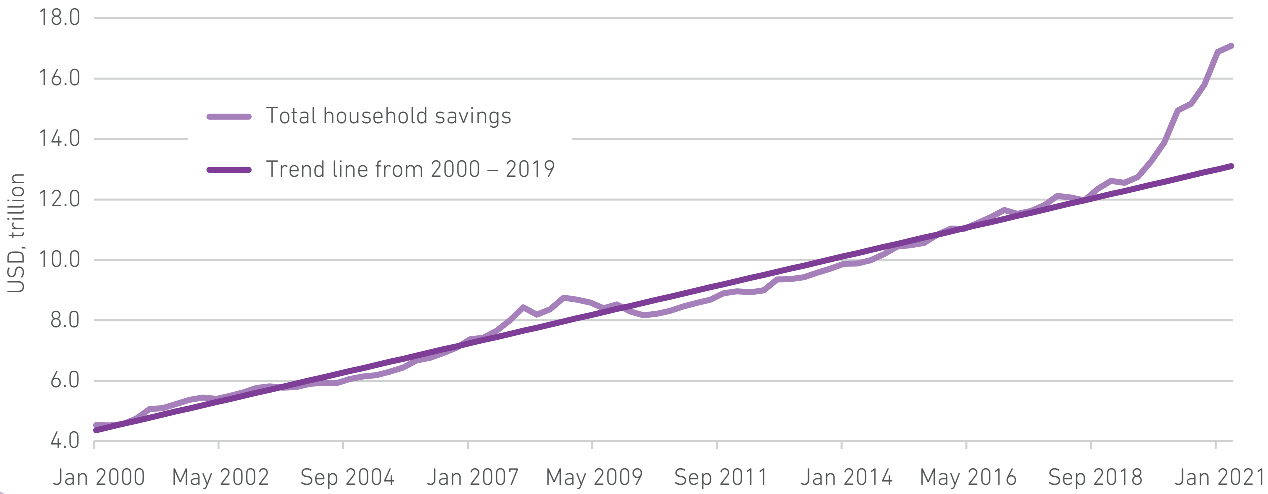
This is why we keep stressing the spare cash situation in the US – it's at record highs. A confluence of factors has led to this: pent-up savings from lockdowns, high-income workers keeping their jobs during lockdowns and unprecedented fiscal stimulus. People have money. And it's not just in the US but around most of the world. And like you, the 6,999,999,999 other people in the world will do the same when they have money. Spend! >>

Time to spend

People react to recessions in a predictable way. Cut back on non-essentials, save money where possible and wait until it's safe to spend again. This happened during the 2008 financial crisis, which made that downturn worse but also then helped support the economy as the recovery took place.

People reacted to the COVID recession in the same way. But a combination of furlough schemes, stimulus cheques and loan moratoriums have seen an explosion of cash that households are sitting on. And it won't be long until they feel safe to spend it.

The COVID recession has left US households with plenty of cash



Source: Macrobond

AHMER TIRMIZI

Senior Investment Strategist

Strategy
Continued

02

Rising home prices *tend* to support more building

There are many economic losers from COVID. Face-to-face service workers for one. The high street, another. But there have been winners too. One was the technology sector. Another was the housing market. Strong demand has led to record high house prices in the US – close to pre-financial crisis levels.

The difference this time is that rather than being led by exorbitant borrowing, it's been driven by the low housing stock. The demand/supply imbalance is eye-watering. Homebuilders know how to react to rising prices and falling supply… build!

03

Low inventories *tend* to be followed by high inventories

In a recession, the first thing that tends to go is spending on big-ticket items. If you're worried about your job, you don't buy a new car. But during the COVID recession, the opposite happened. Not only did discretionary spending hold up, it actually surged.

People replaced visits to restaurants, hairdressers and hotels with spending on cars, furniture and (in the US) firearms.

The companies that make these goods were taken by surprise. They were readying themselves for leaner times, but instead had to draw down on inventories to meet demand. The result has been record low inventories, and concerns that there won't be enough goods to go around soon. But manufacturers know how to meet high demand and low supply – produce more.

04

Low debt *tends* to be followed by high debt

The financial crisis of 2008 set in motion a fairly predictable set of events. Those that had borrowed too much over the preceding cycle were forced to pay it back, resulting in less spending. Less spending meant lower growth, lower inflation and lower interest rates.

But the flipside also holds. Household debt levels are back to much more reasonable levels while rates have fallen so far that interest payments as a portion of income are at record lows.

When people feel sure that an economic recovery is taking place and find that their debt costs are low, they tend to conclude they can borrow more.

> And the rising inflation we've seen recently shouldn't be a great concern, even though we think the era of deflation is over."

05

High inflation *tends* to lead to lower inflation

When people hear the word inflation they tend to think of the spiralling kind. The 1970s, Zimbabwe, the Weimar Republic. But those are the exceptions and not the norm. Instead, inflation is what economists call 'mean-reverting'. It's self-correcting.

When you see the price of something shoot up, what is your immediate response? To buy more? No. You wait it out or you find an alternative. That self-correction is built into all of us.

We're already seeing this in the markets. The sectors where prices surged earliest in the cycle – lumber, used cars, furniture – are seeing less demand. While the sectors where prices were hit most – hotels, restaurants, leisure – are seeing a resurgence.
This is how the free-market system works. When prices rise, habits adapt and alternatives appear, and those prices correct. The higher inflation we've seen recently will eventually ease.

Investing for tendencies

One of the easiest mistakes to make as an investor is to base decisions on just one factor. Instead, the right approach is to look at an array of them. So we aggregate these tendencies and many others that are not listed: the end of austerity, the productivity boost from technology adoption, receding globalisation and so on, to produce our view.

Together, these factors suggest growth in the next few years is going to be stronger than in the last decade or so. And the rising inflation we've seen recently shouldn't be a great concern, even though we think the era of deflation is over.

More growth and less deflation should benefit our **Growth+** basket – a combination of cyclical holdings like Warren Buffet's Berkshire Hathaway, nimble global mid-caps, beaten up world value stocks and emerging markets. But we balance this exposure with more stable positions like US healthcare and defensive alternatives – because we acknowledge that our view is only one possible world; in investing, *tendencies are not certainties.*

Our Strategic Asset Allocation (SAA) is the bedrock of our investment process, ensuring that portfolios are diversified across asset classes, geographies and factors we believe will drive returns.”

Fraser Harker, Investment Analyst

Portfolio implementation

Two opportunities

Our Strategic Asset Allocation (SAA) is the bedrock of our investment process, ensuring that portfolios are diversified across asset classes, geographies and factors we believe will drive returns. We aim to enhance returns by adding tactical positions on top of our SAA, and thematic positions are an important element of our tactical thinking.

Our thematic positions are targeted to provide investors with exposure to opportunities that arise in an ever-changing world. As proactive investors, we look out for thematic ideas that can benefit from long-term economic and demographic trends.

Let's look at two of them.

Source: www.solarilluminations.co.uk

01

Greener

Companies at the forefront of the green revolution are our most recent tactical addition to portfolios. The messaging around the need for action on climate change could hardly be starker, with the International Panel on Climate Change recently issuing a 'code red for humanity' and many viewing the upcoming UN Climate Change Conference in Glasgow, COP26, as the most crucial to date.

We believe that achieving a cleaner world without sacrificing our standard of living is possible, but it requires more than ditching coal and embracing green energy. Via the Ninety One Global Environment Fund, we have gained access to clean, low-impact leaders across the business spectrum – companies that are going to profit from helping the world cope with climate change.

What really attracted us is the range of businesses and geographies in which the fund invests. Not just wind turbines and solar panels, but a wide range of companies that are committed to cleaning up their activities and providing others with the opportunity to do so in areas like electric cars and trucks and efficient heating, cooling and recycling.

02

Healthier

The world is getting older. By 2030, nearly a quarter of Europe's population will be over the age of 65. It costs nearly three times as much to treat someone over 65 than it does for someone aged 18-44.

Healthcare companies are well aware of this trend, and the potential market opportunities. Over half of all new drugs in development target diseases that occur in those over 65. And as economies become richer, people spend more on their health, with China and India as great examples.

There is also a healthcare revolution on the go, given the developments in human genome sequencing (DNA mapping), processing of big data and personalised therapies. Healthcare innovation could be an area for investment at some future stage.

Our thematic positions are targeted to provide investors with exposure to opportunities that arise in an ever-changing world."

FRASER HARKER

Investment Analyst

Featured topic

Battling our brains

The human brain is incredible. Yours contains roughly 86 billion neurons, firing information around your body at over 400 km/h. Every minute, a bottle of wine's worth of blood passes through your brain and it consumes one fifth of your oxygen.

Your brain requires less power than a lightbulb to function, but a supercomputer in Japan took 40 minutes to replicate a single *second* of normal brain activity. And with a memory capacity enough to store over 100 billion books, you'll never have a "full brain" notification.

But, although it's wonderful from an objective, scientific standpoint, living with our brains isn't always easy. There's a lot going on in there that we don't grasp, dictating what we do and how we feel, without us consciously being aware of it. It's not that your brain is going wrong; it's just in the wrong period of history!

The acceleration of history

The difference between human society 75,000 years ago and 70,000 years ago was almost zero. And the difference between human society 20,000 years ago and 15,000 years ago was almost zero. You could have swapped a human from any of those eras with another, and they'd have had almost no adjusting to do.

Then about 5000 years ago, history really got going. The Bronze Age on Crete, the first dynasty of pharaohs in Egypt and the building of Stonehenge all took place within about 100 years of each other. And it began speeding up from there.

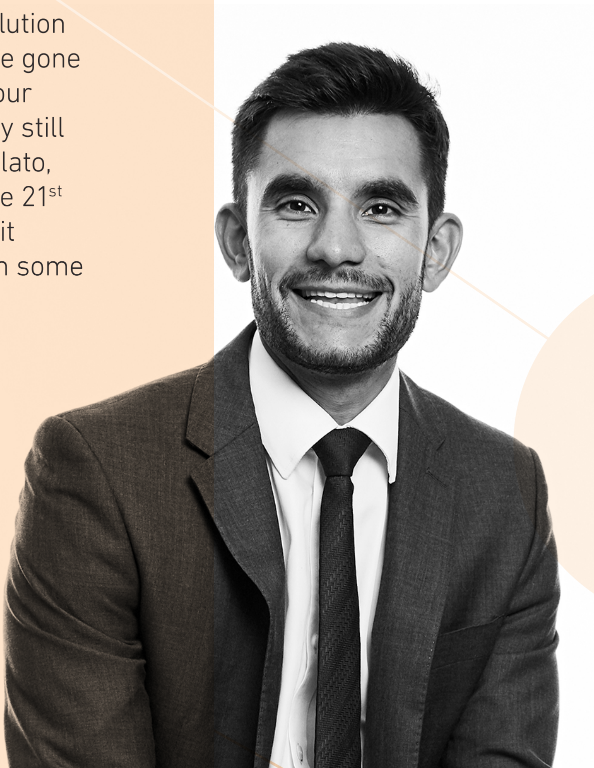
A classical Greek like Plato or Aristotle (~400BCE) would have found Julius Caesar's Rome (~40 BCE) pretty familiar. And they might even have been able to come to terms with 1500's Elizabethan England (other than the weather). But show Plato the Industrial Revolution, or the First World War, or the moon landings, or anything from the modern day, and he'd have been utterly discombobulated. He wouldn't be able to cope with how the world works – progress has been too swift.

A time-travelling brain

As the distinctly modern species *homo sapiens*, we've been around for 200,000 years. We departed from other apes at least 4 million years before that – largely driven by our superior intellect (have you tried talking to a chimpanzee about the weather?) rather than our physical strength (don't try fighting a chimpanzee). Our brains took us to where we are today – from savannah to caves to city.

For most of the time, evolution and human progress have gone hand in hand. But now, your brain, which is biologically still very similar to that of a Plato, finds itself shoved into the 21st century. Is it any wonder it doesn't cope too well with some parts of modern society?

> But now, your brain, which is biologically still very similar to that of a Plato, finds itself shoved into the 21st century."



BEN KUMAR

Senior Investment Strategist

Featured topic
Continued

Biased towards survival

Our brains are wired to remember bad news. There's a part of the human brain called the amygdala that commits our experiences to memory. We actually have two amygdalae – one on each side of the brain. The amygdala in the left hemisphere of the brain deals with positive or negative stimuli. But the one on the right only processes negative events – and ignores all happy experiences.

This negativity bias formed over hundreds of thousands of years when fear about threats was the best way to survive. The consequences of running away too often were minor – a touch of embarrassment around the fire that evening, perhaps. But if you didn't run away often enough you could be eaten, if it turned out that the shadow in the grass really was a lion.

Some fear is still useful in life today. As a long-term strategy for road-crossing, waiting for the green man is slower but more successful than jaywalking. But more often than not, our brain overreacts – society is much safer now than a hundred thousand (or even one thousand) years ago. Nowhere is that truer than in the financial markets.

Fighting the fear in finance

Our brains are permanently scanning the world for bad things, reminding us of the negative consequences and prompting reactions to limit the chance of any pain. That's not a helpful characteristic for long-term investors. The amygdalae see a market decline and start sending fear signals to the rest of the brain and body. Those signals prompt the kinds of actions we see so often in crises – selling at the bottom, throwing good investments out with bad, and abandoning long-term plans.

How our brains work

What's there

What the amygdala sees

> When times are calm, we spend a lot of our time building models that help when the world gets scary. We benefit from the range of thinkers in our team, not all of whom have the same fear-triggers."

Sensible investors can make that someone else's problem – by working with an investment manager whose job it is to look after the portfolio day-to-day. After all, if you don't see the market, your brain has nothing to be scared of!

On the Investment Team at 7IM, we can't ignore the markets (or your portfolios!). Instead, we rely on our investment processes to keep the fear from our minds. We take time to build scenarios – thinking of more than one future, rather than just the darkest. When times are calm, we spend a lot of our time building models that help when the world gets scary. We benefit from the range of thinkers in our team, not all of whom have the same fear-triggers.

There's no one thing that works to overcome a million years of being scared, and we're always looking for new techniques. Above all, though, we acknowledge that the fear *will* happen. We can't remove our amygdalae from our brains, but we *can* try to use the rest of our grey matter to think past what they're screaming about.

Meet the teams

Investment Management Team

Martyn Surguy
Chief Investment Officer

ACA Chartered Accountant, MCSI, CISI Level 4, 35 years of industry experience.

Uwe Ketelsen
Head of Portfolio Management

MEcon, CFA, 25 years of industry experience.

Terence Moll
Head of Investment Strategy and ESG

MPhil, PhD. in Economics, 30 years of industry experience.

Matthew Yeates
Head of Alternatives and Quantative Strategy

BA Economics, CFA, 10 years of industry experience.

Duncan Blyth
Senior Investment Manager

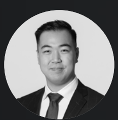
BSc Actuarial Mathematics & Statistics, CFA, 24 years of industry experience.

Christopher Cowell
Quantitative Investment Strategist

MSc, PhD, CFA, 6 years of industry experience.

Fraser Harker
Investment Analyst

MA in Economics & Accounting, CFA, 6 years of industry experience.



Tiziano Hu
Junior Quantative Strategist

MSc in Financial Technology, 1 year of industry experience.

Salim Jaffar
Investment Analyst

BA in Economics, IMC, 1 year of industry experience.

Ben Kumar
Senior Investment Strategist

CFA, MsC Behavioural Economics, 10 years of industry experience.

Tony Lawrence
Senior Investment Manager

CFA and CAIA, 20 years of industry experience.

Stephen Penfold
Senior Investment Manager

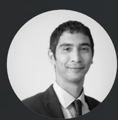
BSc in Economics & Computing, 36 years of industry experience.

Camilla Ritchie
Senior Investment Manager

IMC, 31 years of industry experience.

Peter Sleep
Senior Investment Manager

30 years of industry experience.



Ahmer Tirmizi
Senior Investment Strategist

MSc in Economics and Finance, 12 years of industry experience.

Jack Turner
Investment Manager

CFA, 12 years of industry experience.

Risk Team

Joe Cooper
Head of Risk and Portfolio Analytics

CFA / MSc in Applied Economics, 10 years of industry experience.

Alex Mitsialis
Senior Performance and Risk Analyst

MSc / CFA, 5 years of industry experience.

Hugo Brown
Risk Analyst

BEng, 2 years of industry experience.

Haris Slamnik
Investment Risk Analyst

MSc, 2 years of industry experience.

Matthew Donlan
Junior Investment Risk Analyst

MSc, 1 year of industry experience.

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