Your investment update

Q3 2021

Succeeding together

7IM

Contents

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Welcome

MARTYN SURGUY
Chief Investment Officer

Half-way through the year and we're still inching our way towards the end of lockdown. And while UK social distancing rules might be gone by next quarter, adapting to the 'old normal' is likely to be complicated. Will we be comfortable mingling in large groups at sports, cultural and social events? Will mask wearing ever become second nature to us? Will jetting off to the sun on holiday ever be straightforward again?

Adaptation is also required as we try to navigate the investment challenges of today and tomorrow. After decades of quiescence, inflation – the arch enemy of preserving capital – has reared its head again. But is it transitory as the world reopens or something more entrenched? The signals are confusing. Headline rates are rising fast, but bond yields becalmed. Unemployment high but labour shortages seeing sharp wage rises in some areas. Manufacturers struggling with soaring input costs and supply bottlenecks.

As we digest this information and plot a path for the future, we're encouraged that the framework for our portfolios already has a decent amount of inflation protection built in. Tactically, too, there are a number of steps we've already taken to prepare for the next stage of the cycle – cutting bonds, raising weights to alternatives and introducing more economic sensitivity to equity holdings. One of our strategist, Ahmer Tirmizi, expands on this further in his article.

"As we digest this information and plot a path for the future, we're encouraged that the framework for our portfolios already has a decent amount of inflation protection built in."

To continue the theme of adaptation, it has long been our view that environmental, social and governance (ESG) investing is not just a sleepy backwater for ethically minded investors; it has deservedly moved to the mainstream of the investment world.

We believe that proper consideration of ESG matters can have a positive impact on returns for all investors. It was fascinating to see recently that a tiny investor could force change on mighty Exxon to move climate issues up their agenda. Looking ahead, no company will be able, or should want, to ignore ESG issues. One of our ESG experts, Jack Turner, looks at how this might affect supply chain dynamics across the world in our feature article.

Elsewhere in this publication, Tony Lawrence takes us through some of the opportunities available in the more specialist areas of fixed income, as part of the answer to the low yields on offer in the mainstream. As always, we're trying to think a little differently about today's challenges and adapt to the changing environment in every sense!

I do hope you enjoy reading, and get to enjoy a more traditional summer than last year.

Strategy

And now we wait...

Alfred Hitchcock is supposed to have said "movies are like life with the boring bits cut out." And so, films make everything seem dramatic. Hospitals are always exciting – the blood, the beeping, the junior doctor panicking before the grizzled veteran surgeon with a heart of gold steps in to save a life. Or flying – if you see a plane, it's either going to avoid crashing at the last second, or fireball spectacularly. Or sports films, where every moment is do-or-die, last minute buzzer beaters against an old foe.

Obviously, this is not an accurate reflection of the lives of doctors, pilots, or sportspeople. Most of the time, these jobs are straightforward and repetitive; most days – most years – there are no big events.

Finance movies have similar tropes. The setting is always the high intensity trading floor, and the characters are unscrupulous Gordon Gekkos or Jordan Belforts. But again, that's not a fair reflection of investing. As portfolio managers, we spend much of our time monitoring the world, reviewing the positions we already have and tweaking our process.

Of course, there will be moments of drama. Patients can suddenly fall ill, planes can have faults, and occasionally there's a match which goes down to the wire. Similarly, market stress will happen. And these film-like periods which require decisive action, quick thinking, and bold approaches.

The shock of 2020

The 2020 recession was one of those periods. China thought the virus so severe that they built a hospital in 6 days. The global economy entered a globally synchronised lockdown. Oil prices momentarily went negative. Equity and credit markets sold off by the most in over a decade. Safe-haven bonds, usually the ballast of multi-asset portfolios, barely moved.

As portfolio managers, we spend much of our time monitoring the world, reviewing the positions we already have and tweaking our process."

That was a time for action – a rapidly changing world requires quickly changing views. We made a lot of changes to portfolios in 2020, successfully taking advantage of the opportunities offered. But it's important to remember that these changes were only effective because we had the right process in place.

Dealing with the unexpected

In 1935, the US army set out to test the new B-17 bombers. On its first test flight, the plane crashed due to a 'pilot error'. This new plane was too complicated to be left to the memory of any pilot. But the orders were in, so they had to figure out what to do and came up with an ingeniously simple approach.

They created a pilot's checklist: checks for take-off, flight, landing, and taxiing. With the checklist in hand, B-17s flew a total of 1.8 million miles without one accident.

The checklists provided two main benefits. First, they helped with memory recall, especially with mundane matters that are easily overlooked in more drastic events. A second effect was to make explicit the minimum, expected steps in complex processes. >>

AHMER TIRMIZI

Senior Investment Strategist

Strategy
Continued

Multi-asset portfolios can be equally complex in times of stress. There are too many steps to remember from memory alone. Our checklists helped us to keep things simple in 2020, to make the right changes at the right time to benefit our clients:

- **Rebalanced portfolios:** As equity markets fell in March, the portfolios moved substantially away from target allocations – equity holdings were about a third lower than they should have been. Our checklist made sure we rebalanced portfolios when weights moved past trigger levels. So, we sold bonds and cash to buy beaten up equities. That's the right thing to do but is hard when the world feels like it's falling apart. It's made easier when you've set up a process ahead of time.
- **Formed economic scenarios:** Rebalancing portfolios is the first step. But to change positions, we needed to take a view on where the world is going. Our checklist guides us towards scenario analysis in times of uncertainty. Rather than focus on one big call, we mapped out a range of different economic scenarios (V+, V, L and U) to give us an idea of the investment possibilities.
- **Took profits:** By April, some parts of our portfolios had performed extremely well during the sell-off – particularly our alternatives basket (up nearly 20%) and position in US healthcare (outperforming the wider market by 15%). It can feel tempting to stick with what's worked, but our scenarios and pre-defined price triggers told us to take profits on these defensive positions and reallocate into risky assets.
- **Added risk:** We have a dashboard of economic and market indicators we look at regularly – which strips out the human emotions. This proved invaluable during the spring of 2020. Despite the dizzying flow of negative information, our dashboards were telling us that an economic recovery was imminent. As such, we added to credit and equities.
- **Narrow in on the next cycle winners:** With the broad portfolio risks being managed first, we then had time to focus on more specific long-term opportunities, tilting towards the winners of the next cycle.

> This is what investing is: find the opportunities, allocate, and then hold. The bit of the job you don't see on film."

Waiting for the next cycle

The large fiscal stimulus combined with unprecedented pent-up savings sets up an outlook for strong and long-lasting economic growth. As economies open, companies who struggled last year will benefit the most. These are 'value' companies tilted towards the most economically sensitive parts of the economy. They are smaller companies, nimble enough to navigate and adapt to a changing world. And finally, emerging market companies too: strong developed market consumers spend their money on goods made on the other side of the world.

In the fixed income part of portfolios, we believe that the US housing market and Asian businesses are likely to be winners, so we have shifted the credit part of our portfolios to these markets to generate extra returns beyond what's available in traditional bond markets.

As the economic and profit growth is realised over the coming years the market eventually will move to recognising this outcome – that a new, and strong, growth cycle is underway. This is what investing is: find the opportunities, allocate, and then hold. The bit of the job you don't see on film.

Of course, as the world exits crisis mode, we will keep monitoring our dashboards, rebalancing the portfolios and keep checking those triggers. But now those same checklists, in contrast to last year, are now telling us to not move portfolios.

Like a pilot keeping a watchful eye while the plane is on autopilot, the doctor doing their daily rounds, or an athlete following a training programme, we think the rest of this year will be for us to stand back and allow the positions to play out. We spent the last year tilting our portfolios towards the new economic cycle. Now we wait...

We made a lot of changes to portfolios in 2020, successfully taking advantage of the opportunities offered. But it's important to remember that these changes were only effective because we had the right process in place."

Ahmer Tirmizi, Senior Investment Strategist

Portfolio implementation

A break with tradition

Tradition dictates that fixed income portfolios (a.k.a the 'forty' in the infamous 60/40 double act) are typically split between government and investment grade corporate bonds. Most of the time, the bond portion is implemented by buying huge passive products, predominantly focused on developed market issuers. These products are optimised for simplicity – they lend to a wide range of borrowers without reference to their credit worthiness or the level of interest they are paying.

Right now, a staggering 25% of developed government bond issuance offers negative yields, requiring you to pay for the privilege of lending to them! At the same time, large, stable companies have never offered you less compensation for the extra risk in lending to them instead. And in the traditional portfolios above, that's what you end up buying.

So why not break with tradition and think differently? Because although the large, simple fixed income products look extremely unattractive, if you broaden your horizons and do your homework, there are pockets of opportunity to be found.

> So why not break with tradition and think differently?"

Take our position in the US residential mortgage space. US consumers have never had so much cash in their pocket or a house that's worth so much. Combine this with mortgage rates at all-time lows, and you create the perfect backdrop for re-mortgage activity; people either want to stay where they are and pay less, or move onwards and upwards! So, we invest in the Angel Oaks Multi-Strategy Income Fund which directly benefits every time someone repays their mortgage, providing an extra 2% yield over what you receive when lending to a corporate.

Being prepared to look outside of the main passive indices is crucial – we're also lending to European banks. Regulators insist that banks issue special 'additional tier one' bonds, in order to protect the financial system. Because these bonds are a bit different, they aren't eligible for the traditional indices, and because they are a little harder to analyse, a lot investors shy away. But we're not afraid of the extra effort, and we like what we see; well-capitalised, low-risk national champion banks, paying 2% more on this debt than what their traditional bonds are paying.

We haven't stopped there – our final break with tradition has been to look outside of developed markets and venture east, finding a particularly attractive opportunity investing with UBS into Asian high yield corporate bonds. Once you're over the geographic hurdle, you find that Asian companies, in the same industries and of equivalent credit quality to their US counterparts, offer 4% more per year on their debt – and in a faster growing economy.

It turns out some traditions are there to be broken.

TONY LAWRENCE

Senior Investment Manager

Featured topic

Welcome to the Net Zero Club

For many people, the hardest part of COVID-19 has been that they could not meet up with friends and colleagues, family and grandchildren. That's not surprising. Humans are inherently social animals and many of our fondest memories are of happy times spent with other people. It's in our nature to associate together in groups, cliques or clubs.

This is also true of business and finance. Whether it is the World Trade Organisation, the UN Principles for Responsible Investment or the Investment Association, companies seek friendship and safety in numbers.

This well-trodden dynamic is now playing out in how businesses are dealing with climate change. They are finding that it makes sense to form groups of likeminded companies if they want to limit their impact on the environment. And the main way they aim to do this is by committing to net zero targets.

Net zero targets?

The Earth is warming all too fast, due to the carbon dioxide and other greenhouse gases that modern economies emit into the atmosphere. The more we burn fossil fuels in power stations, cars and factories, the more carbon spews into the air and the hotter our world becomes.

Article 4 from the Paris Climate Agreement of 2015 defines net zero as 'reducing human-caused emissions to the level that natural climate solutions and methods of CO^2 storage and removal can effectively absorb'. This a long-winded way of saying that we must learn to live within the means of our planet, something we haven't done since long before the industrial revolution.

If we are to achieve net zero on a global level, it is vital that people and businesses manage how they interact with the environment. Many companies have begun doing this, with nearly 2000 making net zero commitments thus far.[1]

But for them to be effective, companies must account for *all* of the emissions they are responsible for (see adjacent).

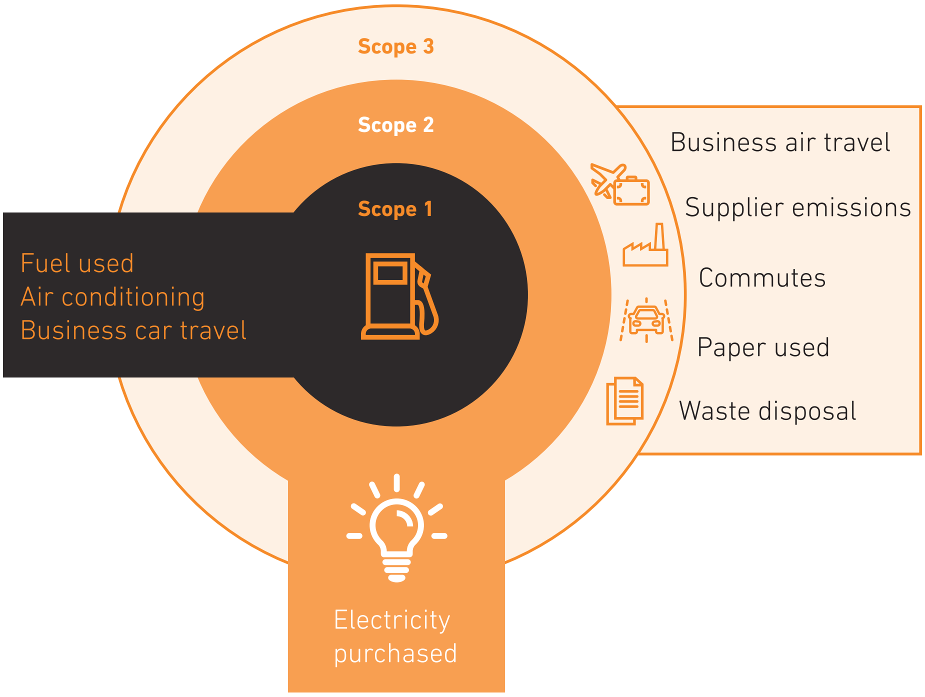
[1] www.wemeanbusinesscoalition.org

Emissions – not quite as easy as A, B, C.

Scope 1 emissions are those caused by a company through its direct operations – e.g. production lines, company vehicles or heating offices. Tracking these emissions is straightforward.

Scope 2 emissions are indirect emissions from the electricity purchased and used by a business. Again, this is pretty simple to calculate, as long as proper records are kept.

Scope 3 emissions are where it gets complicated. It includes all emissions from a company's upstream and downstream activities, such as how its products are used or how it sources its raw materials. It also includes how company employees commute, how waste is disposed of, and any investments made by the company. Scope 3 emissions are complex and hard to monitor but are at the heart of the supply chain problem. >>



Source: https://www.wri.org/initiatives/greenhouse-gas-protocol

JACK TURNER

Investment Manager

Featured topic
Continued

Volkswagen takes the lead

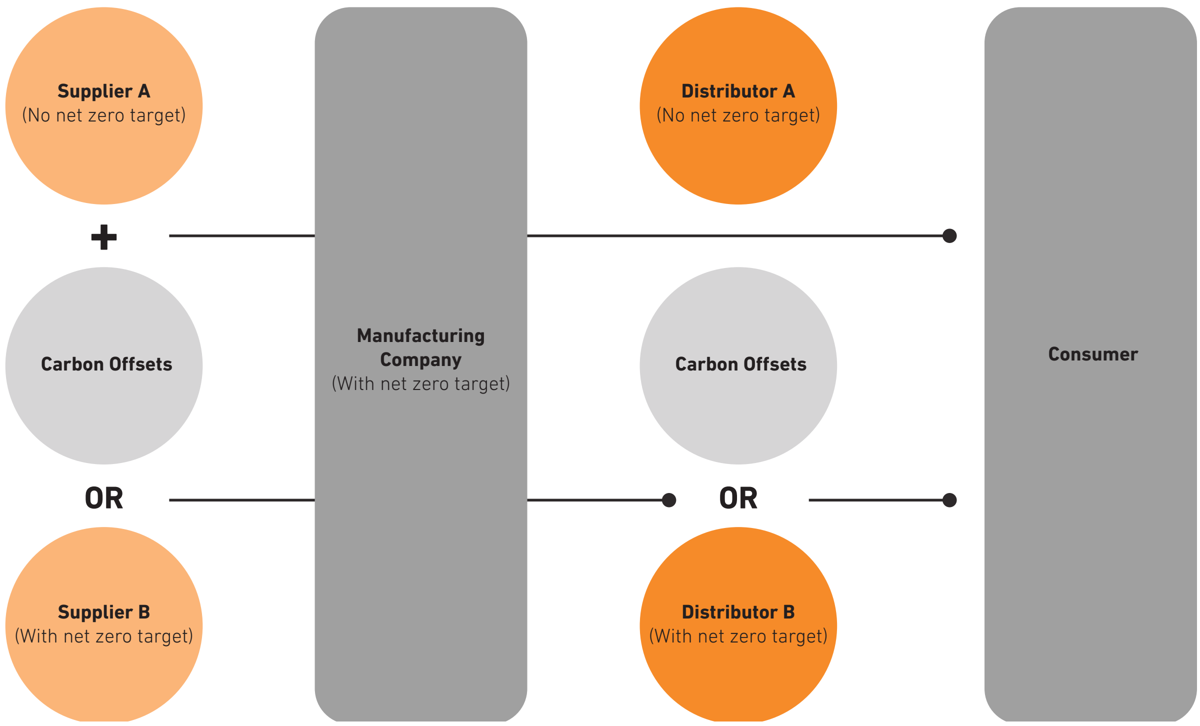
A commitment to consider Scope 3 emissions can lead to drastic changes in corporate behaviour. For example, Volkswagen's recent push into electric vehicles was partly driven by its desire to lower the Scope 3 emissions from people driving its cars. That sets the stage for a massive achievement, given that Volkswagen vehicles contribute no less than 1% of global greenhouse gases.

Likewise, Unilever's push for us to wash our clothes at 30 degrees originated from analysis performed by the company, suggesting that a large proportion of the company's emissions came from people using its detergent to wash their clothes.[2]

What that means is that if you want to commit to a net zero target, it helps if your business partners have also made net zero commitments. This is because some estimates suggest that over two thirds of a multinational's emissions can be traced back to its supply chains.

And this is where the idea of clubs comes into focus.

Companies that want to manage their carbon risk will want to associate with like-minded companies that are doing the same. The diagram below helps illustrate the decision a net zero manufacturing company must make. Will it use a supplier who has committed to net zero, or pick one that is not committing to net zero and then have to offset those emissions itself? Many companies will choose the former, which will act as a powerful dynamic as emissions costs are factored into contract negotiations.



Source: Citi Global Insights

> If we are to achieve net zero on a global level, it is vital that people and businesses manage how they interact with the environment."

Impact on global supply chains

The formation of net zero clubs will have far reaching impacts on global supply chains and may lead to many companies moving suppliers closer to home. This dynamic has started playing out already, according to a recent report from Standard Chartered. It found that 78% of companies will start culling suppliers that are slow to adopt serious carbon targets by 2025, and 15% of them have already done so.[3]

This could have a big impact on supply chains that include emerging markets, which have historically been slower at adopting climate change targets. Over half of the multinationals asked said they were willing to dump emerging market suppliers if they didn't up their game. This could lead to firms moving production back home, at the expense of emerging economies, but to the benefit of domestic workers.

Net zero clubs will also change the logistics of supply chains as they move from being linear to circular in the future. For over 400 years we have dug materials out of the ground, used them and then discarded them, with little thought about the environmental impact. But this model implies that we have access to infinite resources and an infinitely flexible environment – which are clearly not the case.

Increasingly, companies will have to account for what happens to their products at the end of their working life. Many are beginning to realise this. For example, Hewlett Packard Enterprise (HPE) encourages its customers to ship their old or unused hardware or technology back to its recycling centre. In 2018, 89% of products returned to HPE were resold, with 11% being recycled. Only 0.4% ended up in landfill.[4]

Waking up to the challenge

Across the world, the private sector is waking up to the challenge of fighting climate change. And this will have a profound impact on how companies interact with each other in the future. Large companies will increasingly reassess their supply chains in light of the carbon reduction targets that they have made.

Within a few years, most big companies will follow Volkswagen's lead and take upstream and downstream emissions into account in their activities. Many more will follow HPE in managing their products after they've been sold. Soon, everyone will want to be part of a net-zero club.

[2] www.unilever.com/planet-and-society/climate-action/brands-taking-climate-action

[3] www.sc.com/en/media/press-release/carbon-dated-multinational-companies-planning-to-cut-suppliers-by-2025-for-failing-to-curb-carbon-emissions/

[4] www.insights.raconteur.net/the-low-carbon-supply-chain

Meet the teams

Investment Management Team

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

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Fraser Harker
Investment Analyst

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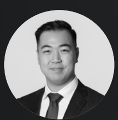

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MSc in Financial Technology, 1 year of industry experience.

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Senior Investment Strategist

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Tony Lawrence
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CFA and CAIA, 20 years of industry experience.

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Senior Investment Manager

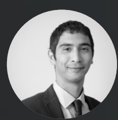
36 years of industry experience.

Camilla Ritchie
Senior Investment Manager

IMC, 31 years of industry experience.

Peter Sleep
Senior Investment Manager

30 years of industry experience.



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