Your investment update

Q4 2020

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Welcome

MARTYN SURGUY

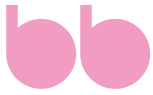
Chief Investment Officer

Has there ever been a more confusing time to be going about our daily lives? Can we go out? Who can we meet? Mask on or off? Can I sit or must I stand? Who's included in the 'rule of 6'? Can I visit my family?

Fortunately, it's rather easier to understand the broad guidelines around long-term investing as they have been established over many years in different market environments and regimes. First, have a plan that you can stick to. Apply it consistently with total disregard for your emotions. Diversify across regions, asset classes, styles and individual investments. Fine-tune your strategy as market conditions evolve and opportunities appear. Review periodically. And above all – stay calm.

These guidelines can be hard to apply as we are buffeted by newsflow on COVID-19, economic concerns and political shenanigans. It's important to separate shorter-term influences from more important longer-term ones. Quite often, many of the things that seem so critical in the here and now amount to little more than noise when viewed in retrospect.

As I write, the newswires and political debate in the UK are preoccupied with the prospect of a second wave of COVID-19. Investment markets seem much more sanguine.



The old adage that you spend most of your life worrying about things that never happen has never been better applied than to politics."

Our own view on the situation is clear. We believe that current concerns are overdone. The virus seems to be on the wane, particularly when measured in the stark terms of deaths, treatments have greatly improved and vaccine(s) might be closer than generally expected.

But we are not epidemiologists, we are investment managers. We have adjusted our portfolios a little to reflect our more positive stance on post-virus economic recovery, but all of our core investment beliefs on diversification and sticking to the long-term plan continue to apply.

It's also worth remembering that if you're based in the UK, events here tend to colour your mood and attitudes. We reckon about 10% of a 7IM Balanced portfolio is affected directly by domestic developments. While recent news on the virus in the UK may have been troubling there is ample evidence that much of the world economy, notably Asia, is returning to normal.

We are global investors so developments across the rest of the world are far more important to our portfolios. The policy of the US Federal Reserve or decisions of the People's Bank of China have a greater bearing on portfolio returns. This is a key source of comfort for us as investors.

In a similar vein, politics attracts headlines and triggers fears and concerns for our wealth. Usually these are exaggerated. The old adage that you spend most of your life worrying about things that never happen has never been better applied than to politics.

Welcome
Continued

Once again, the dreaded Brexit debate has reappeared of late as speculation has mounted that a trade deal might not be possible. Much of the chatter is little more than tactical posturing and scaremongering. We think a deal will materialise – but probably at the last minute, as has been the case before. Our portfolios are not particularly exposed, given the limited sensitivity to the UK. Sterling is a concern, though, and we have reduced our allocation here in recognition of the inevitable game of brinksmanship that is looming.

Staying with politics, the US election is the major political event of the coming quarter. The debate is highly polarised, given President Trump's personality and approach. We are watching closely but the lesson of history is that US electoral outcomes don't affect financial markets much.

A Trump victory should see lower taxes continuing, with a slightly harder line on China and global trade. A Biden victory would probably result in somewhat higher taxes and more regulation but a softer stance on China and a more positive approach to international trade. The two could easily offset each other.

Ultimately, it will not be the virus or politics which determines our investment fortunes in the medium term. Markets are underpinned by significant fiscal and monetary stimulus, with the likelihood of extraordinarily low global interest rates for a protracted period. Global growth is recovering, while opportunities can still be found in areas and sectors of the equity market that have not enjoyed a strong recovery during the summer. These areas are currently our focus.

Ultimately, it will not be the virus or politics which determines our investment fortunes in the medium term."

There is lots to think about as this tumultuous year draws to a close. Thus far we have navigated the challenges carefully and with some success by adhering to our firmly-held beliefs. On that note, in a fascinating piece in this update, our Head of Investment Strategy, Terence Moll, sets out some key lessons he has learned in the last 20 years of investing.

Senior Investment Strategist Ahmer Tirmizi paints the long-term economic picture for us. And our Head of Portfolio Management, Haig Bathgate, looks at an example of how we are reflecting the more positive tilt to our views in portfolios.

Enjoy the read, and be assured that we will remain focused on developments in economies, politics and, of course, the virus in the coming quarter.

Strategy

COVID-19 is accelerating trends – and not just technology

How many work meetings are interrupted by Amazon parcel deliveries? My personal count is one per week. How about the number of times someone begins making an impassioned point on a team work call, only to find they forgot to unmute? The count here is closer to one per day.

And what about the phrase 'can everyone on the call please go on mute'? I hear it at least once per meeting!

We may as well get used to all this. Work from home is here to stay – at least for some of the time. Before 2020, the trend towards working from home and online shopping were already in place. But old habits die hard. It took a global pandemic to get us over the line. And there's no going back.

There are a number of other trends which have been accelerated past the point of no return. Here are just three, looking at the US:

1

US Housing:
What financial crisis?

Pre-COVID trend: The effects of the housing crash were felt long after 2008, with stagnant home prices, rising savings and below-par housing construction. But coming into 2020 things were changing. Household wealth had reached all-time highs – without a housing boom! Mortgage rates were coming down and wages, for even the lowest earners, were going up.

And there was a demographic anomaly: a bulge of twenty-somethings becoming thirty-somethings – getting married, having kids and ditching the city for a house in the 'burbs... and then COVID-19 struck.

Post-COVID trend: Usually the first thing to collapse in a US recession is the property market. This time, the opposite has happened – housing sales are booming. Mortgage rates have hit all-time lows and the Federal Reserve has promised to keep them there for a long time. Those thirty-somethings who were sitting on their hands are now looking for a house with a study and a garden. And the sad reality is that most of the people who have lost their jobs were in low-paid work – the least important to the housing market.

Put this all together and you have a recipe for a house price, consumer spending and construction boom in the US.

AHMER TIRMIZI

Senior Investment Strategist

Strategy
Continued

2

US Onshoring: Forgotten America is the new emerging market

Pre-COVID trend: The complex 'just-in-time' global supply chains that service the demands of the western consumer are mindboggling; a microchip travels round the world five times before it is ready to power your iPhone. Technology and lower trade barriers allowed this interconnected world, but most importantly, businesses had a reason to move abroad – manufacturing costs in 2004 were over one fifth lower in China than in the US.

The result was a large emerging economic and market boom as China's tide lifted all the boats around it. But that story has largely played out and was going into reverse as we entered 2020.

Post-COVID trend: In 2011, Japanese car companies were amongst the hardest hit stocks in the world due to the floods... in Thailand. They learnt the hard way that 'just-in-time' supply chains could end up 'not-in-time'.

In addition, the political winds have shifted significantly. The hole left in US manufacturing has become too big to ignore, sparking the recent trade war. Most important though, US costs are now much closer to China's. The supply disruptions from China's late-winter shutdown seems to have been the last straw. Just like those thirty-somethings, the COVID-19 recession has been the catalyst for companies to relocate back to the US.

A manufacturing renaissance appears to be taking place in the middle of forgotten America. The good ol' industrial heartlands could just be the new emerging market.

3

US Fiscal Spending: The Republicans – austerity to profligacy

Pre-COVID trend: The rise in anti-establishment parties has been a decade in the making. The rise in inequality in many countries has had an interesting effect, muddying the left/right distinction. Some right-wing governments now have economic policies that almost look leftist: anti-trade, protectionism and more generous fiscal outlays. The Republican's 2018 tax cuts were the biggest-ever US fiscal stimulus outside of a recession.

Meanwhile, Boris Johnson's government promised to 'level-up' the left-behind parts of the UK. That's not what you expect from a Tory PM.

Post-COVID trend: The unprecedented nature of the COVID-19 recession forced incumbent conservative governments to act fast, via furlough schemes, eviction freezes and state guarantees for loans. The stimulus packages were huge, fast and extraordinarily effective.

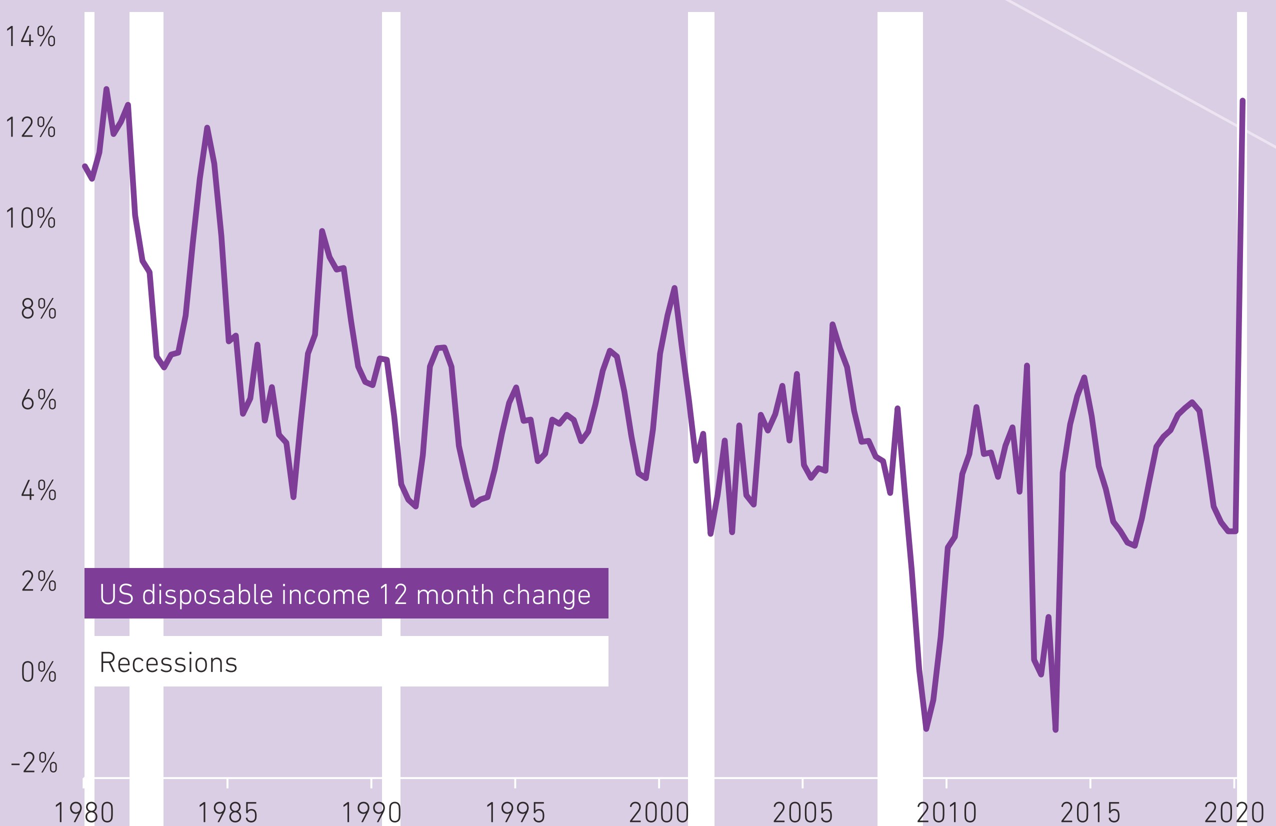
In the US, households have $2trn more in their bank accounts than they did before the recession. That's around 10% of GDP in spending power. Disposable personal income usually falls in recessions – not this time! (see graph).

In this recession, US incomes are up!

Recessions are often driven by a hit to incomes. People lose their jobs, they stop spending, companies stop hiring, and on it goes.

The COVID-19 recession this year is not because people can't afford to spend but rather because they can't, due to lockdowns. When you add in the size and speed of the US government's actions, the amount of money in people's pockets has risen by the most ever in a recession.

Source: Macrobond



Strategy
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Our view –
Not all recessions are created equal

Recessions are scary. Jobs are lost, houses repossessed, livelihoods destroyed. The COVID-19 recessions this year were no different. But economies always recover, as is happening already. The path out of a recession is often slow, uneven and unpredictable. But this recession will be different.

The depth of a recession and the recovery from it are generally driven by how the economy got into the mess in the first place. Usually, the strongest parts of the economy in the ups get overexcited and overextended, and end up driving the downs.

Banks in the early 2000s, were the pride of the UK and US economies. But too much borrowing and overconfidence in financial engineering brought the whole edifice crashing down in 2007-08. The strong became the weak. What happens to all those jobs that relied on the strong? They are lost. Often there is no sector able to take up the baton quickly enough. Hence most economic recoveries are 'jobless' recoveries.

But the COVID-19 recession is different. The strongest trends in the economy have remained strong – tech, housing and manufacturing. And the weakest parts of the economy – retail, entertainment and hotels – have unprecedented fiscal support behind them.

But the positive outlook doesn't need to rest on government support or even an end to lockdown measures because the strongest parts of the economy are also the job creators. For instance, for every job created in US real estate, nine other jobs are created. Think about when you buy a house: the estate agent, the solicitor, the removal company, the redecorations, the trips to Wickes, the new furniture. This isn't the same for the jobs lost in say, retail.

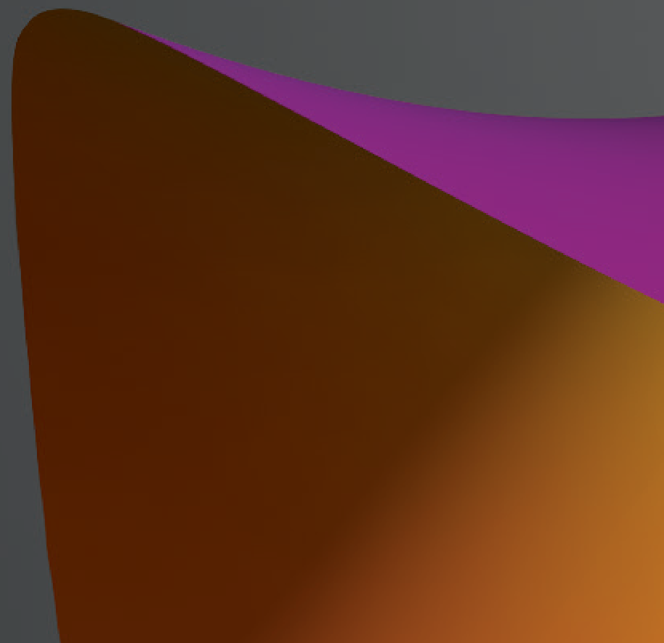
Given the strength in certain economic sectors, the recovery doesn't require an end to the government's social distancing measures to keep going. But we do believe that the virus will come under control much quicker than generally expected, as described in our 'Surge and Burnout' White Paper. And those theatre usher, waiter and bartender jobs will return soon, boosting an already strong recovery.

This outlook leaves us positive on equities, implemented through an economic recovery basket to take advantage of the strong economic trends. This is discussed further in the next section.

The path out of a recession is often slow, uneven and unpredictable. But this recession will be different."

We've had three huge market crashes in the last two decades: in 2001-02, in 2008-09, and earlier this year. All were glorious buying opportunities."

Terence Moll, Head of Investment Strategy



Portfolio implementation

Thinking tactically: Berkshire Hathaway

We are optimistic about the ability of most economies to recover from the economic pain that COVID-19 has caused. So we've introduced a 'global recovery' basket of positions into our portfolios that should do well if growth recovers strongly.

Berkshire Hathaway, the American conglomerate run by one of the world's most famous investors, is part of this basket and its inclusion in portfolios demonstrates how we look to add value for investors.

Diversification is one of the key tenets of our investment process, ensuring that our clients get exposure to a wide range of return drivers. In practice this is implemented via our Strategic Asset Allocation (SAA), which is long term in nature – think five to 20 years.

When shorter-term opportunities arise, we utilise our Tactical Asset Allocation (TAA) to tilt portfolios in whatever direction we think will be rewarded over the near term.

Our recovery basket is a TAA tilt with several components, since recoveries can occur in different places at different times.

All the holdings share a common theme – they are assets that should do well if global economic growth is strong, as discussed in the previous section.

Berkshire Hathaway is a company that we've researched extensively, and was the ideal candidate. Warren Buffet, its CEO, is one of the world's most famous investors and wealthiest people who, at the age of 90, shows no signs of slowing down. His premier skill over many years has been to identify and nurture high-quality businesses.

Berkshire and its underlying businesses have pristine balance sheets and look inexpensive, but have lagged the wider market due to their cyclical and consumer-facing exposure. In a strong economic recovery we would expect the rise in cyclical manufacturing and consumer spending to boost the Berkshire portfolio.

Berkshire Hathaway trades on the New York Stock Exchange, meaning that we get exposure to a host of fantastic businesses without the burden of annual management charges. The downside is that it's not suitable for our model portfolios.

Investors in our model portfolios will enjoy access to a range of other assets that we expect to perform strongly in a global economic recovery, such as increased allocations to Japanese and European equities. These markets are highly exposed to the global demand cycle due to their high allocations to consumer discretionary stocks, industrials and banks.

They are underpinned by the same thesis as Berkshire Hathaway – providing clients with access to businesses that we believe will perform strongly when the world begins to recover from the economic distress caused by the virus.

Berkshire Hathaway trades on the New York Stock Exchange, meaning that we get exposure to a host of fantastic businesses without the burden of annual management charges."

HAIG BATHGATE

Head of Portfolio Management

Featured topic

From Y2K to COVID-19: Lessons from investing over two decades

Twenty years ago the UK economy was larger than China's. General Electric was the biggest company in the world. Facebook had not yet been founded. And Tiger Woods was winning the Grand Slam in golf – the youngest player ever to do so.

The world has changed enormously in the last two decades. It's been a complicated period for investors, with several huge crashes, big investment themes coming and going, the rise of populist politics, and the COVID-19 shock this year. What can we learn from it?

Let's begin by looking at three investment principles that have survived the last 20 years rather well. Then we look at various ways in which investing has changed.

Three tried and tested investment principles

1

Buy, hold, grit your teeth

Most investors have long time horizons, whether they realise it or not. If you're 45 years old, say, and in good health, you can expect to live until your eighties. You should be taking a decent amount of investment risk to maximise your returns over your lifetime.

TERENCE MOLL
Head of Investment Strategy

That means equities. Since 1900, world equities have returned about 5% per year after inflation. For bonds, the number is 1.9% per year, while cash is on 0.8%. Equities have won by far.

Yields on government bonds are now low or negative in much of the world. You buy a bond expecting to lose money after inflation. So it's even more important to hold a sensible range of equities.

But investing in stocks can be scary. Much of the time, they're below their highs and you feel anxious. And you might be tempted to cut your losses when the news is terrible and markets are plunging and most of your holdings are flashing red.

That is usually a mistake. We've had three huge market crashes in the last two decades: in 2001-02, in 2008-09, and earlier this year. All were glorious buying opportunities.

Long-term investors have time on their side. They should try not to panic in tough times... and aim to buy, rather than sell.

2

Spread your risk

Forecasting is hard. It's hard to predict who will win the US election this year, let alone which companies or markets are likely to succeed in the long run.

So long-term investors should diversify. Buy some of everything and you won't go far wrong. If you spread your risk across lots of markets you will usually perform just fine.

Not diversifying is dangerous. The more concentrated your portfolio, the higher the risk that it can go horribly wrong.

We've seen many examples of this in the last 20 years. World equities and world bonds have both done well. But some large stocks like General Electric and Exxon have crashed, as have some emerging markets and popular investing themes like banks, solar energy and uranium.

Featured topic
Continued

3

Don't listen to doomsayers

Most news out there is gloomy. Negative headlines hit you in the face. Negative headlines sell papers and generate clicks.

We're more likely to read an article about the impending collapse of the global financial system than one saying that investors are likely to do all right in the next decade. But the latter outcome is far more probable.

In the last 20 years I've heard many forecasters predicting global financial disaster. Thus far, they've all been wrong. I have a sneaking suspicion that none of them are rich. But they continue to get lots of attention in the media, despite their appalling track records.

Investors are too scared most of the time. The disasters they fear rarely happen. Y2K (remember it?) was a non-issue, the global financial system survived 2008, the euro has not split up yet, we will get over COVID-19.

Humanity tends to muddle through eventually. Don't get bogged down by the nabobs of negativism.

Three ways in which investing has changed

1

Madness has become normal

Negative interest rates. Rule by tweet. Lockdowns. Apple more valuable than the FTSE 100.

Lots has happened in the last two decades that would have seemed inconceivable in the 1980s, and seemingly goes against Economics 101. Sometimes it feels as though the world has gone mad.

The world is wilder than we can imagine, and financial deregulation and technological advances make extreme outcomes all the more likely. We should expect many more mad surprises in the near future – both good and bad.

2

The internet is an unprecedented disruptor

New technologies always disrupt old ways of doing things. Usually this happens fairly slowly, and often within an industry, as when cars displaced wagons in the early 1900s.

But technological disruption has reached new highs in the last 20 years. Internet-based firms are changing the nature of modern business. Companies like Apple, Amazon and Google are reaching across the world and eating everybody's lunch. And they're still hungry.

Tech disruption will keep on motoring: think electric vehicles, renewable energy, meat grown in labs, artificial intelligence. Investors need to adapt, or get left behind.

In the last 20 years I've heard many forecasters predicting global financial disaster. Thus far, they've all been wrong."

3

ESG has become mainstream

Twenty years ago, people who talked about Environmental, Social and Governance (ESG) issues in investments were regarded as slightly whacky. You thought of hippies with long hair and sandals wanting to put the world to rights.

These days, ESG is becoming the norm. Why? Because taking it into account can help investors make better decisions. Well-governed firms and countries, for example, tend to beat their dodgy counterparts. Likewise, an environmental focus can highlight portfolio risks like extreme weather or stranded fossil fuel assets.

The world will go on heating up. And managers that don't understand ESG will look increasingly fusty.

And finally...

Beware complexity

The investing world has become amazingly complex in the last 20 years. There are a myriad stocks, funds, derivatives and structured products. You can buy a Pet Care ETF that lets you 'capitalise on people's passion for their pets.' Or a 3x Long Tesla product that gives you three times the daily return on a Tesla share.

Joy when Tesla rises, but you lose money three times as fast when it's falling.

Does this immense range of products benefit investors? I am not convinced. Much of the financial industry creates unnecessarily complex products, charges too much for them, and obscures the fact that they don't deliver.

Hedge funds charging two percent per year and one fifth of the profits?! Just say no. Most investors are better off sticking to simple.

Meet the teams

Investment Management Team

Martyn Surguy
Chief Investment Officer

ACA Chartered Accountant, MCSI, CISI Level 4, 30 years of industry experience.

Terence Moll
Head of Investment Strategy

M.Phil. Ph.D. in Economics, 28 years of industry experience.

Haig Bathgate
Head of Portfolio Management

CFA, 22 years of industry experience.

Camilla Ritchie
Senior Investment Manager

IMC, 30 years of industry experience.

Peter Sleep
Senior Investment Manager

29 years of industry experience.

Stephen Penfold
Senior Investment Manager

35 years of industry experience.

Duncan Blyth
Senior Investment Manager

CFA, 22 years of industry experience.

Tony Lawrence
Senior Investment Manager

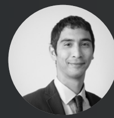
CFA and CAIA, 19 years of industry experience.

Christopher Cowell
Investment Manager

PhD, MSc, CFA, 5 years of industry experience.

Jack Turner
Investment Manager

CFA, 10 years of industry experience.



Ahmer Tirmizi
Senior Investment Strategist

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

Ben Kumar
Senior Investment Strategist

CFA, 9 years of industry experience.

Matthew Yeates
Head of Alternatives and Quantative Strategy

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9 years of industry experience.

Harriet Massie
Business Manager

Level 3 Candidate in the CFA program, 4 years of industry experience.

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Head of Risk and Portfolio Analytics

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MSc / CFA, 5 years of industry experience.

Aaron Chhokar
Investment Risk Analyst

MSc / MEng 2 years of industry experience.

Hugo Brown
Risk Analyst

BEng, 2 years of industry experience.

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Risk Developer

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