Your investment update

Q4 2019

SEVEN VII IM
Investment Management

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MARTYN SURGUY

Chief Investment Officer

Time flies! With the blink of an eye summer is over, it's back to school and we're heading into the final quarter of the year. We trust that the miserable stock market performance of last December will not be repeated, but there are plenty of challenges all the same.

Parliament prorogued, government by tweet and the polarisation of political debate. Has the political environment ever been more toxic or harder to understand? On the economic front growth is slowing, the current expansion is one of the longest on record and the world's two largest economies are locked in a trade war with no obvious endpoint.

Perhaps surprisingly, we are not unduly concerned by the vagaries of the current political climate or the short-term oscillations of financial markets. We are long-term investors. The real danger of short-term uncertainties and fear is their ability to blow investors off course from the strategic positioning required to deliver their goals. When markets look wild, many investors are tempted to move to the sidelines and sit it out in cash.

"Discipline and patience are the key to long-term returns."

This may feel comfortable for a while, but basing a long-term strategy on the almost impossible task of predicting short-term markets is not a recipe for success. Often it is difficult to reinvest that cash – if markets rise many prefer to wait as their negative views become entrenched, while if they fall many also prefer to wait fearing further falls. Both routes leave investors underinvested and sooner or later markets run away from them.

Discipline and patience are the key to long-term returns. In our view the best way to navigate shorter term uncertainty is through holding a sensible spread of assets that can withstand most market conditions. Ben Kumar discusses the importance of achieving genuine equity diversification in his article ahead.

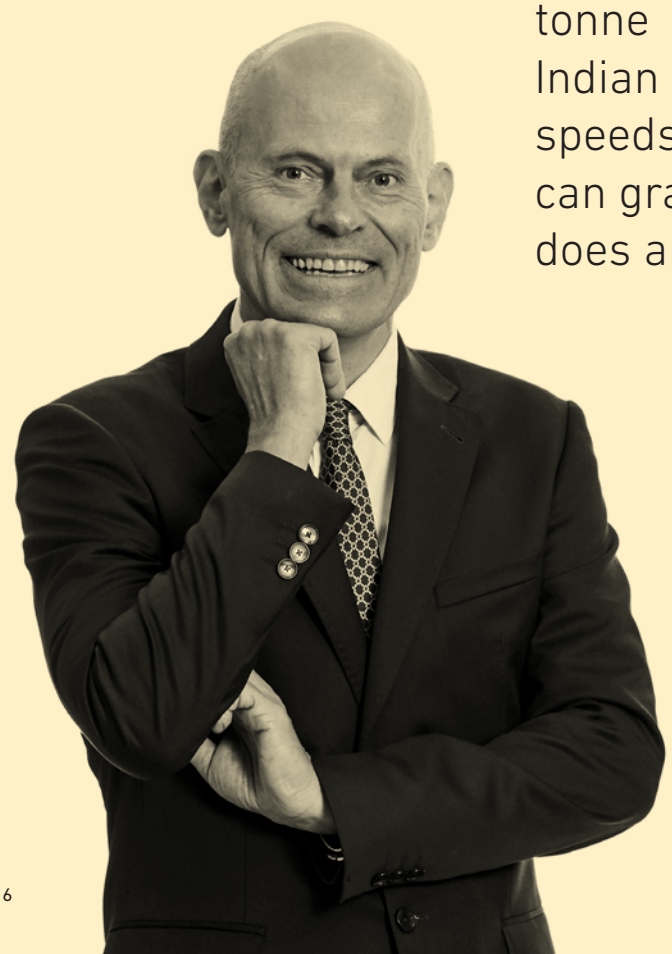
Elsewhere, we have given our Chief Strategist, Terence Moll, the near impossible task of making sense of the current investment environment and the ongoing Brexit shenanigans. Good luck Terence! What does this all mean for our portfolios? Haig Bathgate turns his attention to answering that. Enjoy reading!

TERENCE MOLL

Chief Strategist

It's hard to stop a supertanker

The world economy is like a 400,000 tonne supertanker chugging across the Indian Ocean. It is big, and it is robust. It speeds up and slows down at times and can gradually change direction, but rarely does anything very quickly.



> "Our portfolios have a great deal of global exposure and are not especially vulnerable to the UK, so we're not overly concerned from a narrow investment viewpoint."

This analogy is useful because the economic world is pretty stable most of the time. Companies make and sell stuff, people work hard, earn incomes and buy stuff, governments collect taxes and spend, goods are moved around internationally if it's cheaper. The supertanker moseys along.

The exception is when supertankers bump icebergs, like in the global financial crises of 1929 and 2008. We see no such crisis on the horizon right now.

But market perceptions of economic conditions do change... sometimes dramatically. Late last year investors turned pessimistic about global growth and trade, and the S&P 500 index of large US companies fell by one fifth in the three months leading up to Christmas Eve. Then investors recovered their mojo, helped by falling interest rates, and the S&P 500 made up its losses by April 2019.

More recently, bond yields have plunged across the developed markets. US 10 year rates went from 2.5% in May to a low of 1.43% early in September, before bouncing a little. German 10 year rates fell from zero to -0.7%. Investors now have to pay the lucky German government for the privilege of lending it money (see box overleaf).

Why did yields fall so much? Partly because the US Fed changed its noises on interest rates early this year, and cut its key Fedfunds rate in July and September. Lower short-term rates drag long-term rates down.

Equally as important, investors have become fearful about slowing global growth, recession and deflation in the last few months. They've been buying bonds by the truckload.

Far from disastrous

Their fears are exaggerated. Okay, the world economy has indeed been slowing: JPMorgan, the investment bank, expects 2.6% real growth in 2019, compared to 3.2% last year, with most of the major economies weakening. But 2.6% growth would be far from disastrous, and it looks as though global manufacturing – the most erratic part of the economy – will bounce late this year or early next year. We may be at the nadir of the economic cycle right now.

Growth has slowed in the biggest economy of them all, the US, but is still rumbling along at about 2% per year, according to the latest estimate from the New York Federal Reserve Bank. That's close to the ten year trend.

And our proprietary Recession Risk Indicator says a US recession is unlikely in the next 6-12 months. Of its six traffic lights described in a previous Investment Update, only one (the yield curve) is on red. We'll get nervous when three or more lights turn red.

Meanwhile, US core consumer inflation (excluding food and energy) was 2.4% in August, and looks set to drift up rather than down. The labour market is tight and wages are rising steadily, while trade tensions with China are likely to raise prices a little. This does not look like deflation to us.

From a long-term viewpoint, today's ultra-low rates look like madness. We think the world's investors are suffering another bout of deflationary psychosis, as they did in mid-2017. The madness should pass quickly... the global economic supertanker has slowed but is certainly not grinding to a halt. 'Investing' in negative-yielding Swiss, German, Dutch and French bonds right now looks downright reckless.

We prefer to focus instead on assets with good macro support that look fairly priced by historical standards. Two examples in our portfolios are US Healthcare stocks (good value by long-term standards, political risks look exaggerated) and emerging market hard currency debt (reasonable spreads to US treasuries, underlying economies are in good shape).

Saving for retirement

The bigger problem is that the world is full of people who want to save. Baby boomers in the developed economies are approaching retirement age and are saving furiously while they're still earning incomes. Germany is saving on a gigantic scale and its government should be spending more but doesn't want to. Many emerging economies like Korea, Russia and Thailand are also saving heavily, partly to keep their currencies competitive, partly to build up war chests of foreign exchange reserves in case another financial crisis comes along.

Meanwhile, companies worldwide are reluctant to borrow and invest – because demand is weak, with many economies turning down, because of trade-related uncertainties, and because many business models have shifted towards capital-lite services.

To make matters worse, low interest rates can become self-reinforcing. Take a German doctor in her fifties who is planning for retirement. She is cautious of equities, because of how they can crash in bad times, and holds mostly government bonds in her portfolio. The more rates fall, the lower the income she can expect in retirement – and the more she has to save now!

We think low rates worldwide are ultimately driven by a global surplus of savings, for demographic reasons. So low rates and low inflation will be with us for many years yet.

Brexit, again

And then there's Brexit. We've long had the view that sensible heads would prevail, and that the likely outcome would be softer rather than harder – which would be good for sterling and UK equities.

Now we're not so sure. The government is behaving as though No Deal would be just fine, and we can plot a route by which the Tory leadership would like to use a delivered No Deal as part of an election platform in a few weeks' time.

That route could be tumultuous and entail enormous policy and economic uncertainty. Our portfolios have a great deal of global exposure and are not especially vulnerable to the UK, though, so we're not overly concerned from a narrow investment viewpoint. A fall in sterling would raise the non-sterling value of portfolios, and might boost the prices of UK companies with high non-UK sales. Meanwhile, we will watch for Brexit-related sell-offs that could make quality assets available at attractive prices.

The remarkable fall in German bond yields

This remarkable chart shows how German 10-year yields have fallen – from 9% in 1990 to -0.7% currently. German inflation has been around 1.5% for about 25 years. So 'real' yields – what investors would earn if interest rates and inflation remain the same – are about -2%. Bonds are supposed to be a safe investment for insurers and pensioners, but it's hard to imagine how German bonds could make money, after inflation, over ten years.

Source: Bloomberg Finance L.P.

HAIG BATHGATE

Head of Portfolio Management

What we are doing in portfolios

Summer is often a quiet time in the financial markets, as investors take time off to enjoy the British weather. But at 7IM we've been busy, as we updated our Strategic Asset Allocation (SAA) and looked to implement changes across portfolios.

The SAA is the default asset allocation for our funds. It's the output of a lengthy process, which generates the baseline portfolios of equities, bonds, cash and other assets that are appropriate for various levels of risk and return. The aim is for a robust combination of asset classes over a 20-year time horizon. This means being broadly diversified: allocating to a range of equity regions as well as different types of debt and alternative strategies.

This year, we simplified our SAA, removing some of the more niche asset classes we have previously allocated to. Going forward, there will be no default allocation to commodities, private equity or frontier market equity. We can still allocate to these on a tactical basis, though, where we think the asset classes will do well.

We still have holdings in frontier market equity and private equity, because we believe in these asset classes, and don't want to change portfolios too much at once. Markets are 'thinner' in summer – some people do indeed go away – meaning that there is less trading volume, and it doesn't make sense to try to sell down large positions quickly. We will phase out changes at a deliberate pace where we have reduced conviction: we are long-term investors, so there's no rush.

The US healthcare opportunity

One interesting change is the addition of US healthcare to the portfolios, as part of our allocation to US equity.

We believe that there is a long-term structural case for holding US healthcare. Firstly, demographics: in the developed world, life expectancy is increasing and older people want more healthcare. But can they afford it? Well, increasingly, they can. The world economy is continuing to grow, meaning people are getting richer, and spend more on healthcare as they age. Healthcare is also a historically defensive position, outperforming the market significantly in recessions and growth slowdowns, as well as over the long-term more generally.

On a shorter-term view, the signals are positive. The sector is innovating and the U.S. Food and Drug Administration (FDA) have become more accommodative towards research and new drugs than at any other time over the last 20 years. What's more, healthcare prices have fallen versus the US market this year, providing us with a good entry point.

This fall is largely because of US politics. The election cycle is getting underway and healthcare is often used as a whipping boy for US politicians. Democratic presidential hopefuls have already been arguing over different healthcare pledges, ranging from 'Medicare for All' to proposals more similar to Obamacare, while Mr Trump has threatened to scrap the latter. Political uncertainty around healthcare is likely to continue for a bit, but as long-term investors we are happy to wait it out.

Underweight | Neutral | Overweight

Equities

We are modestly underweight equities. We do not favour any particular regions at the moment.

- UK
- US
- Europe
- Japan
- Emerging Markets

Bonds

We remain underweight government and corporate bonds. Emerging market (EM) bonds offer more attractive returns.

- Government
- Corporate
- High Yield
- Emerging Markets

Alternatives

We are overweight market neutral alternative strategies. They offer diversified returns are views as a substitute for bonds.

- Real Estate
- Alternatives

Cash and Currencies

While we think there will eventually be a deal, the potential for higher volatility in the coming months means we move sterling to neutral.

- Cash
- Sterling
- Other Currencies

7IM's key investment views

Equities look moderately expensive in the face of trade wars. Global interest rates are heading back to all-time lows, making bonds unattractive.

BEN KUMAR

Investment Strategist

Deliberately different diversification

Investors know the mantra. Diversification makes sense. Don't put all your eggs in one basket! It remains excellent advice – and even though no one buys baskets of eggs anymore, the example still works.

But it's also worth checking your baskets before you go home from the market. Are they strong? Will they survive the journey? Are you sure your baskets aren't too full? Can you carry them comfortably? Do you even want all of the eggs?

The financial world isn't always as sensible as the egg-carrying world... it's always worth checking your investment baskets. For example, let's look at global equity investing.

Read the label. There are lots of ways to invest globally. The MSCI World index includes over 1600 companies. An iShares ETF tracking this index has over $5 billion under management. This sounds sensible: you're investing in shares all over the world – how much more diversified can you get? Well, once you check the basket...

> "Donald Trump might like the sound of this portfolio, but we don't think it makes sense."

Names can be misleading. The MSCI World index only covers developed markets. Only 23 countries are represented, out of 195 in total. The index contains no Chinese companies. No India. No Brazil or South Africa. No emerging market companies at all.

The global index that does include emerging markets is the less snappily titled MSCI ACWI (All-Countries World Index). Lots of investors know this – the iShares ETF tracking the ACWI has $10 billion in it. So, is this the basket you want?

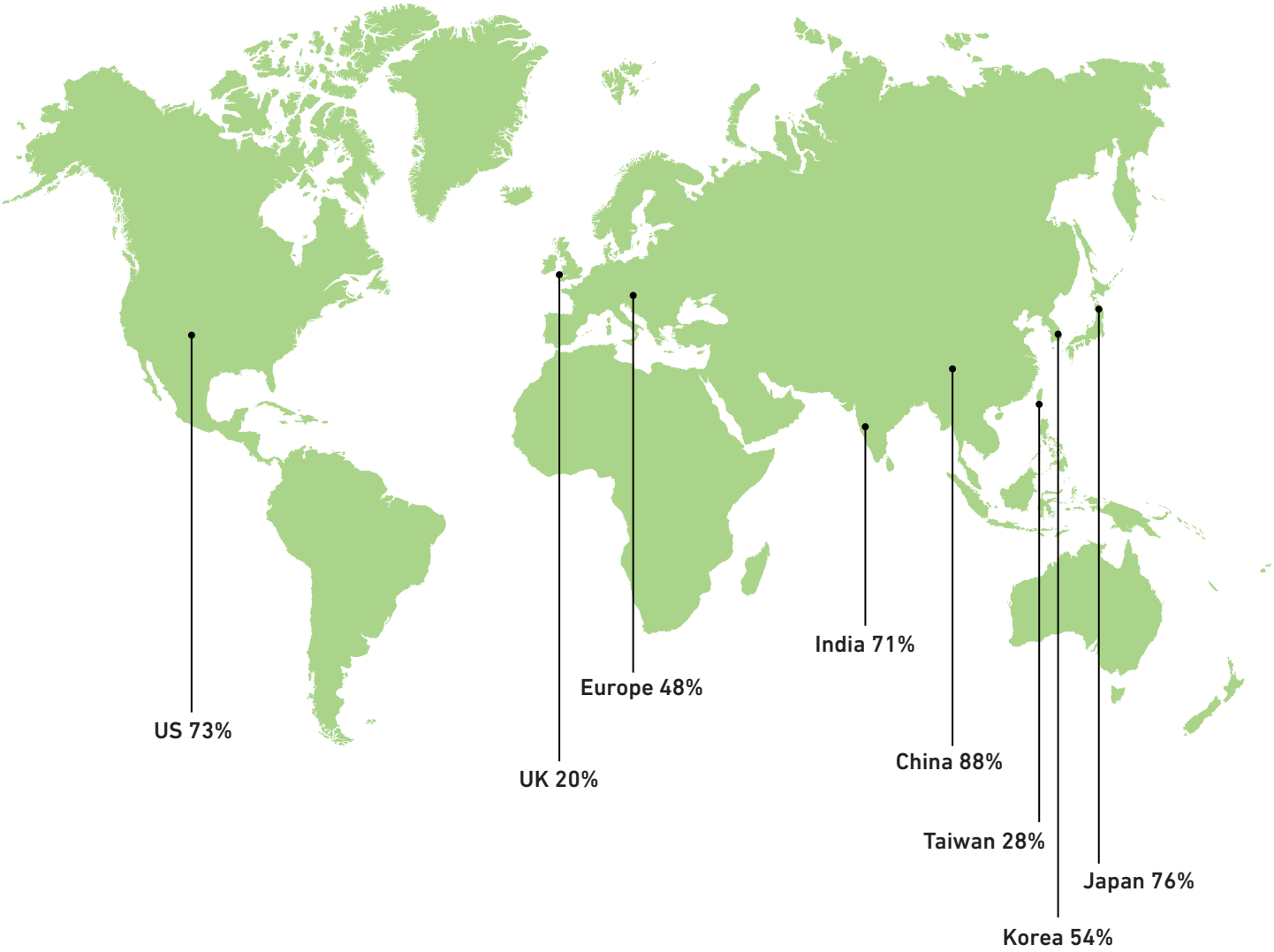
The devil is in the detail. The MSCI ACWI covers a great deal of the world economy. It doesn't include every single country (despite the name) – many of the 195 nations don't have investable markets – but has 50 of the biggest. China, India and Brazil are there, as are Egypt, Pakistan, and Qatar. So, the emerging markets are represented – but not in the size you might expect.

If you want to invest globally, common sense might suggest that you allocate your investments roughly according to size. The US is the largest economy in the world, making up one quarter of global GDP, so would need a decent chunk of your investment. China and Europe (excluding the UK) are each around one sixth of the total. Their allocations should be a bit smaller than the US, but still substantial.

The MSCI ACWI coverage is quite different. Over 55% of the index is invested in US companies – more than twice its global economic weight. European companies are around 12% of the index, compared to Europe's nearly 20% of global GDP. The biggest difference is China. The second largest economy in the world makes up just 4% of company weight in the 'All-Countries World' equity index.

Donald Trump might like the sound of this portfolio, but we don't think it makes sense.

Domestic sales exposure of equity indices (%)



Home isn't always where the heart is. Of course, companies can be listed in a country and have very little to do with it. Just because BP has its headquarters in London, it doesn't mean it only sells oil in Britain. Apple is American, but iPhones are a global phenomenon. What matters is not where a company is based, but where it does business.

One way to look at this is to breakdown the sales exposure of the companies in the MSCI ACWI index. Where do they actually make their money?

The chart shows the amount of sales that the companies listed in a country make from their home market. Some equity markets are global, others are far more domestic.

The UK has lots of global companies listed there for the London postcode. Some have little or nothing to do with the UK economy. Only 20% of the sales of UK-listed businesses actually come from here.

With China, the opposite is true. Over 88% of Chinese company sales are in mainland China. With 1.2 billion potential buyers, perhaps that's no surprise.

European companies are evenly split, with half of sales internal, the rest external, while the US story is very similar to China, with 75% of company sales inside its borders.

Breaking the ACWI down in this way – by sales rather than country of listing – does balance things out a little. Europe accounts for almost the same share of global sales as it does of the global economy, while China rises to 9% of the total exposure.

Ultimately though, the US still dominates. If you have a lot of US companies, you'll have a lot of US sales exposure; even on a sales basis, the US is still 50% of the portfolio – double its share of the global economy.

Deliberately different. At 7IM, our portfolios look a bit different to many of the others out there. We invest in proportions closer to the economic world, rather than the way the financial markets portray it. We also look at the underlying revenue exposure of businesses, which is more revealing than the country of listing.

To be exposed to the growth in China, the only real option is to invest in China – so we do. This is also true of many other economies that are undersold by the MSCI index, particularly the emerging markets.

In fact, when we look at the revenue exposure of our equity portfolios, over one quarter comes from the emerging markets. That's great, because that's where world growth will be generated in the long term.

Our portfolios are also less dominated by the United States, largely because we have a portfolio allocation that is closer to the US GDP weight.

Our portfolios don't match the economic world exactly – ultimately there is no 'perfect' diversified portfolio. What we're looking to do is capture the big picture in a sensible way.

We check our baskets, and then we worry about the eggs.

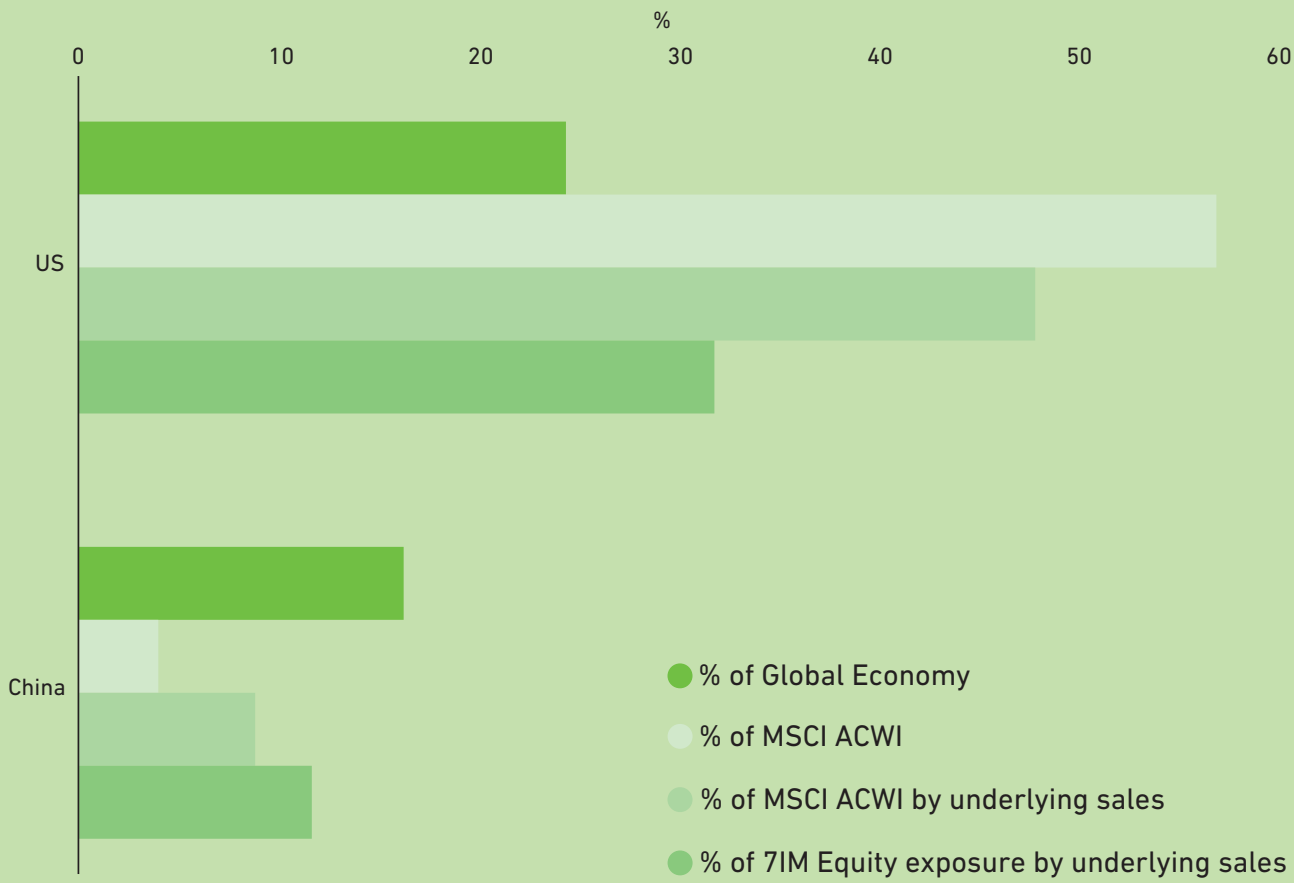
Four different ways to weight the US and China

The economic and financial worlds don't always align. The US is around 25% of global GDP, but is nearly 60% of the MSCI All-Countries World Index. The opposite is true for China – 16% of global GDP, but under 4% of the 'World' index.

Broken down by where companies make their sales, the picture gets a little better – the US is 50%, and China rises to 9%.

But to start diversifying properly, you need to do something different. For us, that means having allocations that can seem out of sync with the rest of the industry, but get our investors much closer to actually reflecting the real world.

Source: Datastream



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