UPDATE FROM INDEPENDENT ADVISER – Colin Robertson
Quarter to 30 September 2019

Market performance

The 3 month period to 30 September 2019 was made up of two distinct halves. In the first, equity markets fell as investors worried about the US / China trade war and global economic growth. In the second half, equity markets recovered their falls and have continued to rise since the end of the quarter as central banks cut interest rates and otherwise eased monetary policy, reassuring investors once more.

A feature of the second half of the period was the outperformance of “growth” stocks by “value” stocks after many years of “growth” stocks outperforming “value” stocks. While the relative valuations of the two groupings had become very stretched, it is not clear what triggered the reversal in performance. Possibly, the poor performance of recent tech IPOs (Initial Public Offerings) and the withdrawal of others before they took place led to investors reassessing their attitude to the likes of Amazon and Facebook. In any event, there are considerable implications for fund manager performance if this trend continues.

Bond market performance was also made up of two halves. In the first, bond yields fell sharply reflecting the same factors which were driving equities and also pre-empting central bank action. However, bond yields stabilised over the second half and, at the time of writing, yields are back up close to their level on 30 June as investors have taken on board that central bankers have become more circumspect about further monetary stimulus and that interest rate cuts are close to an end.

Economics and markets

The US economy continues to grow at a moderate rate while growth elsewhere in developed countries is generally lower but still positive. Periodically, there has been fear of impending recession, notably in Germany, but more stimulative monetary policy and talk of looser fiscal policy appear to have turned the situation around. While this economic cycle is very long in the tooth, as the saying goes “economic cycles don’t die of old age”.

Meanwhile inflation remains not far below the 2% target in the US and UK. Although inflation of 0.5% - 1.0% in the Eurozone and Japan is more worrisome, nevertheless it remains positive and the dangers of deflation have so far been avoided. Indeed there is now some concern that central bankers are creating too much inflation in *asset prices* (soaring equity markets and negative bond yields) as they try to boost growth and *consumer price* inflation.

The problem is instability caused by issues that refuse to go away and which could tip markets and economies over. Progress in resolving the US / China trade war has been modest while the impact is increasing. President Trump continues to attack the Federal Reserve Board in the US and its chairman Jerome Powell, undermining policymaking. In Europe, minority governments struggle to take decisions and Brexit, whether deal or no deal, will cause short term disruption. With so much stimulus being already applied, it will not be easy to stabilise the situation and instigate a recovery should one of the many dangers become a reality

Equity valuations have become quite stretched by historical yardsticks as company earnings forecasts have been cut back, be it only modestly, and equity markets continue their relentless if somewhat erratic rise. However with bond yields at such extraordinary low levels and other competing asset classes bid up to such an extent, equities are not unappealingly valued on a *relative* basis. Nevertheless, as equities are a particularly volatile asset class, they can be expected to initially fall just as much or more than other classes when markets fall.

There is very little new to say about bonds. Cuts in short term interest rates have acted to push yields down while central bank purchases of bonds by way of "quantitative easing", whether actual or expected, have suppressed yields. However sharp increases in bond yields from time to time have made it clear that short term interest rates need to keep falling and central banks need to keep buying bonds to avoid bond yields riseing

Rising equity and bond markets have dragged "alternative" asset classes up with them so that it is now difficult to find any attractively priced asset classes. The so called illiquidity premium which rewards investors for purchasing illiquid assets now appears to have been eliminated in some cases by investors desperate for any investment with a relatively high yield.

Asset allocation
At the time of writing, the US equity market as measured by both the S&P 500 and Nasdaq indices has reached a new all-time high, up 23% and 27% respectively on these measures in 2019. With plenty of scope for bad news as highlighted above, equity markets are clearly vulnerable. The problem is that it can be argued that other asset classes, most notably bond markets, are even less attractive.

This points to making sure that the fund's equity weighting is no greater than the strategic equity benchmark. As suggested in my previous reports, funds with a "cash plus" return target such as Diversified Growth Funds can provide a suitable home until other asset classes become more attractive.

Infrastructure is one asset class where it appears justified to make a commitment to invest without delay. In any case, the drawdown of funds to invest in infrastructure will be spread over a number of years. Diversification within infrastructure investment is as important as for any other asset class and in my view a start should be made when a viable fund is on offer, rather than waiting until the "perfect" fund becomes available, especially if this would mean running an overweight equity position in the interim.

Investment Managers Performance Review

London CIV
As the London CIV (LCIV) has selected the investment managers for the majority of the funds held by the London Borough of Tower Hamlets pension fund, I have commented on the LCIV in this report.

At least from the perspective of the core activity of manager selection, resourcing at LCIV appears to be in crisis with the organisation unable to either retain or attract suitable staff. This is evidenced by:

- the new Chief Investment Officer resigning within a matter of weeks of joining LCIV
- one of the two senior manager researchers leaving at the end of 2019 for an unknown period
- no new experienced manager research people being appointed when I believe LCIV was already short staffed in this area prior to the departures referred to above.

In my view, the LCIV's manager monitoring reports are unsatisfactory, showing limited ability to look beyond what the LCIV are told by the managers. Given the LCIV's resourcing issues, I find it remarkable that the LCIV are opposed to letting the underlying managers send reports directly to their London Borough clients.

At this stage it is difficult to assess the performance of the LCIV in selecting managers. This is because most of the managers were chosen on the basis that their funds were already held by quite a number of London Boroughs and also because insufficient time has passed since appointment to make a fair assessment. However, a few of the managers selected have already been placed on the 'Watchlist" which, while not wrong, is surprising,

Active Equity Fund

After many years of strong outperformance, the Baillie Gifford fund's performance has become more mixed and the fund performed particularly poorly this quarter. This left it underperforming its benchmark by 1.5% over the last year and it has continued to underperform since quarter end.

To a large extent this performance can be attributed to Baillie Gifford's philosophy for managing the fund which is to focus on longer term themes, in particular on those related to disruptive technology. This leads to holdings of so called "growth" stocks whose performance tends to be an exaggerated version of overall market performance and also to exposure to the performance of "growth" versus "value" stocks. Recently, investors have been moving towards investing in "value" stocks, following a very long period of outperformance of "growth" stocks. This has doubtless hit the fund's performance.

Baillie Gifford cannot be expected to suddenly change their investment style so it is a case of potentially waiting out a period of underperformance in the belief that longer term returns will be good (as indeed they have been in the past). It should be noted that the London CIV do not offer a "value" fund and that the LCIV Sustainable Equity Fund has some similarities with the Baillie Gifford equity fund.

Diversified Growth Funds

Both of the Diversified Growth Funds performed strongly over the quarter and Baillie Gifford's return of 4.5% over the last year is good. Ruffer have done less well over the last year with a return of 2.0%. Both managers have retained relatively high exposures to equities and to economically cyclical investments although these exposures have been edged down over the quarter. Nevertheless, a recession induced fall in equity markets would be likely to be quite painful for both managers.

A major contributor to Baillie Gifford's performance was a holding in nickel which is rather unusual and illustrates the benefits of holding a diverse range of asset classes. Ruffer benefitted from their unusually large (relative to their peers) holdings in index-linked gilts and gold which were in fact held for defensive purposes.

Absolute Return Bond Funds

I have not commented on the GSAM fund which is in the process of being sold.

Insight had yet another poor quarter with the fund underperforming the return on cash by 0.2% over the quarter and by more than 1.4% over the last year. As their stated target is to outperform cash by 3% p.a. they are actually behind target by 4.4% over the last year. Over 3 years they are behind target by 4.2% p.a.

For the second consecutive quarter, Insight's long US Treasuries / short German bunds position came right. However the benefit was more than wiped out by taking two separate mistaken views on Italian bonds. Argentina was the disaster area for bond managers in the quarter to 30 September and Insight had some exposure to that market.

Multi Asset Credit Fund

The returns over the quarter and the year were both positive but below the target return, as the LCIV point out in their quarterly commentary. The LCIV is also concerned that the manager, CQS, do not hold any investment grade bonds and that the manager is taking on unnecessary risk. However, CQS must invest in credit markets and if both credit spreads (excess yield of corporate bonds and loans over government bond yields) and the underlying government bond yields are very low then the target return may not be achievable without taking very high risks. In short, the target return may be too high for current market conditions. Reassuringly, CQS produced positive returns from all 5 sub asset classes.

Property Fund

There is little new to report with regard to the Schroder Real Estate Capital Partners fund except that Schroders' head of real estate has resigned and will be leaving early next year. Schroders appear to have the situation under control. Performance continues to be broadly in line with the benchmark over all time periods up to 5 years. The successful strategy of overweighting the industrial sector, regional offices and niche areas such as retirement villages and student accommodation while underweighting retail and London offices is unchanged.

Passive Funds

The LGIM passive funds performed in line with their benchmarks as one would expect except for the Low Carbon fund which outperformed its benchmark by 0.5% over one year.