

UPDATE FROM INDEPENDENT ADVISER – Colin Robertson

Quarter to 30 June 2020

Market performance

Equity markets rose strongly over the quarter with global equity indices recovering all of their first quarter losses when expressed in sterling. Initially this was driven by aggressive action from policymakers, both central bankers and politicians, and then as the pandemic appeared to be stabilising, by investors believing that perhaps the worst had been seen.

Since the end of the quarter, US equities have continued to rise, regularly making new all time highs. However, the nature of this bull market has changed somewhat, becoming US centric and focussed on a small group of the very largest technology or technology enabled companies. Companies adversely affected by COVID-19 (retailers, hospitality companies and banks) or which are ESG unfriendly (energy stocks) have been left out. The latest upward move appears more speculative and driven by excess money sloshing around the system.

Usually when equity markets perform strongly on expectations of an economic recovery, government bond markets perform badly (yields rise). On this occasion government bond yields have remained broadly flat as central banks have indicated they will not be raising short term interest rates for a long time and as they repress longer dated bond yields through market purchases. Corporate bonds have done particularly well because additionally credit spreads (the excess yield of corporate bonds over government bond yields) have fallen on reduced economic concerns.

The one market which has fallen and appears to have stayed down is the property market. This is because of the non-payment or deferral of rent and the potential direct impact on occupancy of COVID-19.

Economics and markets

Investors seem fairly confident that the worst of the impact of COVID-19 on economic growth has been seen. There is hope that a vaccine will be found this year and an effective vaccination program carried out early in 2021. Investors also seem to believe that second and subsequent waves of the disease will be able to be managed on a local basis in the interim.

On these assumptions the horrendous falls of 10% to 20% in GDP growth in Q2 in Europe and the UK and slightly less than this in the US are history. Economies can start growing robustly, regaining 2019 economic levels in 2022 if not earlier. However, there are many risks to this scenario. Most obviously, an effective vaccine or treatment may not be found for some time and even if one is found, economies will need to withstand the withdrawal of significant fiscal support. For example, in the UK companies are now preparing for furlough schemes ending at which point the unemployment rate will rise sharply.

Bullish investors argue that quoted companies are less affected by COVID-19 than the corporate sector as a whole. While this is likely to be true because of the very largest quoted technology/technology enabled companies, nevertheless these companies can be expected to pay higher corporate taxes in future to finance the COVID-19 driven surge in

government spending and supply chains will become more expensive and less efficient. Environmental costs will also be higher. Forecasts of 2021 US S&P earnings being back up to 2019 levels seem ambitious.

There is very little new to say about bond markets. Government bond yields continue to be blatantly manipulated downwards by governments and central banks so as to support the economy. From such low starting yields, it is difficult to envisage anything other than very low returns, at best. Corporate bonds may look more attractive but of course are subject to similar risks to equities.

An area of potential investment interest could be inflation-linked bonds or the equivalent in the context of protecting against an increase in the fund's inflation linked liabilities. Although inflation is expected to remain subdued in the short term, there is a debate to be had as to whether inflation will rise sharply further out on the back of all the stimulus put in place to mitigate the impact of the pandemic.

Asset allocation

The risks to equity markets appear very high at present and putting an equity protection strategy in place, combined with bringing the fund's equity exposure down to the strategic benchmark, appears desirable. The US equity market has shown distinct outperformance of other equity markets of late (on top of previous relative outperformance) and this should be taken into account in the implementation of an equity protection strategy.

Infrastructure continues to look attractive, not least because it can provide long term inflation linked income. However greater selectivity is probably required. Clearly COVID-19 has made investors rethink certain types of infrastructure (e.g. airports) while other types have received too much investor interest and have become expensive (some forms of renewable energy).

As discussed above, inflation-linked bonds or the equivalent could be attractive.

Investment Managers Performance Review

London CIV

Some new senior managers are now in place, notably Jason Fletcher in the crucial role of CIO with whom I have had a fairly in depth meeting. Among his top priorities are building the investment team's capability and credibility which is encouraging.

However, while I have an open mind, I have some concerns about his planned investment process. Jason's vision is of "working with consultants" in the investment process, as distinct from using consultants' shortlists or commissioning them to produce recommendations. It is not at all clear who will do what and it seems to me that the consultants might become concerned about selling their intellectual capital too cheaply. I still believe there is a need to hire senior in-house analysts but Jason places less importance on this in his new process.

Of concern to me is that Jason seems to want to make the investment decisions on infrastructure investments, rather than leaving this to Stepstone and exercising a right of veto on occasion. Another Independent Adviser and myself have told Jason that we believe LCIV does not have the resources to make individual infrastructure decisions

Active Equity Fund

The performance of equity markets has been increasingly driven by a very small group of technology enabled growth stocks (Amazon, Apple, Alphabet, Facebook, Microsoft, Netflix, Tesla) on which Ballie Gifford has focussed for many years. This led to quite remarkable outperformance of 8.5% over the quarter and 5.7% p.a. over 3 years. Notably, the fund has outperformed in the down markets of Q1 as well as in the up markets of Q2.

This narrow focus in the US equity market has led many investors (including myself) to question how much longer the market can continue to rise and this small group of stocks to outperform. A period of sharp underperformance some time during the rest of this year would therefore seem to be a distinct possibility. However the fund has around 100 holdings and the fund managers are continually adding new names while cutting back holdings which have become too large. Given the strong long term track record, it is not unreasonable to believe that a reversal in performance would be shorter term in nature.

Diversified Growth Funds (DGFs)

A quarter of collapsing markets followed by a quarter of strongly rising markets should be a good test for any investment manager but especially for DGF managers whose function is to use the whole range of asset classes to produce a not too volatile performance. While Baillie Gifford and Ruffer both performed strongly in the latest quarter, the difference in performance has been marked over the year to date with Ruffer up 3% and Baillie Gifford down 6%.

Ruffer do two things differently from Baillie Gifford in my view. Firstly, they are more aggressive in diversifying away from so called 'risk assets', using what should be *negatively* correlated assets and doing so in meaningful size. Specifically, they have a large exposure to inflation-linked bonds and a meaningful exposure to gold. Ruffer also make more use of a range of derivatives (equity, credit, volatility) to protect the fund. This is not to say that Baillie Gifford is a poor DGF manager but rather that it is more vulnerable to tough economic and investment conditions.

Absolute Return Bond Funds

With underlying government bond markets performing well and credit spreads falling sharply from Q1 peaks, unsurprisingly the GSAM and Insight funds performed strongly. GSAM more than made up the Q1 loss while Insight failed to do so. For both managers, the main driver of performance was the exposure to investment grade bonds, together with the exposure to High Yield bonds in the case of GSAM.

While encouragingly almost all the main investment views taken by the two managers over the quarter contributed positively to investment performance, it would be good to see more

of the performance coming from non-directional views (whether bonds as a whole are going to go up or down). After all, these are so called “Absolute Return” bond funds

Multi Asset Credit Fund

The CQS fund performed strongly in Q2, recouping around 60% of the Q1 loss. Nevertheless this still left the fund down over 6% for the year to date and 4.5% over the last 12 months. Encouragingly, all of the main asset classes - loans, High Yield and asset backed securities - made a significant contribution to performance.

The allocation between the asset classes is almost unchanged over the quarter except that investment grade bonds have been increased to 5% of the fund. The portfolio manager has become more defensive in security selection and in the quarterly report says “What began as a technical price-driven crisis is now evolving into a crisis of fundamentals and the true impact of COVID-19 is yet to be properly felt in credit markets”. Hopefully this means that CQS will not run the level of risk that led to the scale of underperformance in Q1.

Having swithered, the LCIV have now decided to add a second manager to the MAC fund. The success of this new approach will depend on LCIV’s skills in manager selection for which see above.

Property Fund

At 30 June, valuers applied material uncertainty clauses to property valuations, with the notable exception of industrial properties, because they could no longer rely on market experience to form an opinion of value due to COVID-19. In these circumstances performance numbers need to be taken with a considerable pinch of salt. Having said this, Schroders’ performance does seem to be satisfactory, being broadly in line with the benchmark over all the usual measurement periods.

Schroders’ dislike of the retail sector and emphasis on industrial properties has paid off. However the focus on niche areas has proven mixed with retirement villages doing well but leisure properties having clearly suffered. Currently the manager is looking for discounted secondary market opportunities in favoured sectors.

Colin Robertson
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