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Global Matters | Weekly

Annual Compendium 2022

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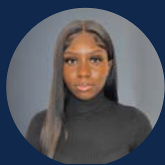
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Foreword

"Prediction is very difficult, especially about the future". Attributed to the Danish Nobel laureate physicist Niels Bohr, that quote so often rings true and events in 2022 have once again highlighted just how difficult it is to forecast the path that lies ahead.

US interest rates offer one of the best examples this year. A year ago, the median expectation of Federal Reserve officials for rates at the end of this year was just 0.9%[1], but it has turned out to be 4.5%[1]! That difference has of course had a massive bearing on the returns for virtually all asset classes. It's easy to justify ex-post why markets collectively got that so wrong, but we should remember that surprises happen all the time – investors often have too much confidence in what the future will look like.

2022 has been a quite remarkable year though. Much has been, and in time will be, written about the events of this year, which will likely reverberate long into the future. Geopolitical and macroeconomic events since the onset of the pandemic have pushed the world into uncharted territory, which we believe ushers in a new era in financial markets, one that will result in a very different pattern of asset class and strategy returns from the decade or so post the global financial crisis.

But amidst all the gloom, with most now convinced that 2023 will be a bad year for the global economy, with recessions in the West generally viewed as a near certainty, there's a significant chance that things work out better than expected, if not for the economy, then perhaps at least for markets. Uncertainty cuts both ways. Our outlook on page 78 expands on our thinking of what might be ahead.

The Global Matters readership has grown hugely since we started producing it seven years ago and once again, we mark the end of the year by sharing this compendium of 2022's articles. The weekly blogs set out to share our perspective on many of the key issues as they develop, with a healthy dose of real life or topical events thrown in; from the intricacies of Liability Driven Investing (LDI) to the politics of the Eurovision song contest, or from the metaverse to 'the upside down' we've covered a lot this past year... As well as being short but (hopefully) interesting and educational reads, the articles offer insight into our approach and showcase the diversity of thought that the individual personalities in our investment team bring to the table, which we value greatly.

We would like to use this opportunity to thank all our clients for their support. We never lose sight of the imperative role that you play in our business. The reason why your clients trust us is because you trust us.

From the whole team at Momentum Global Investment Management, we wish our readers an enjoyable and relaxing holiday season and all the very best for 2023.

Momentum Investment Team

[1] www.federalreserve.gov.

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January

10 January 2022

Turning the corner?

Stephen Nguyen, CFA

Happy New Year to all our readers. As we enter the third year of the COVID-19 pandemic, uncertainty remains elevated in financial markets, largely centred on further Covid variants and the prospect of tighter monetary policy. Markets have largely brushed off these concerns of late and have come a long way since the lows of 2020. A quick reflection on the performance of different asset classes in 2021 highlights another strong year for risk assets, in contrast to bonds which were generally more challenged in the face of surging inflation. US equities again posted strong gains of close to 30% in local terms for the year whilst other equity regions lagged, particularly Japan. As equity markets continue to rise and reach new highs, valuations across many developed equity markets are looking stretched and it is becoming increasingly difficult for investors to find value. While many markets appear expensive, we believe there are opportunities to which investors should pay attention: one of those being Japan.

Historically, Japanese equities have been shunned by investors and they are generally only small holdings within global investors' portfolios with the region accounting for around 6.5% of the developed equity market. The 'lost decade', a period of economic stagnation with low economic growth and low inflation, has blighted the Japanese economy since the 1990s. Combining this with an ageing population, low profitability, and weak corporate governance has further deterred investors from allocating more to Japan.

We believe the corporate landscape in Japan has taken a turn for the better. The composition of the market is geared towards more cyclical sectors such as car manufacturers and exporters which are more likely to benefit from the post-pandemic global recovery. The country's progress on vaccinations (close to 80%, one of the highest in developed markets) is another key factor which could drive its recovery. The introduction of the Stewardship Code in 2014 and the Corporate Governance Code the following year has improved governance standards which will improve corporate performance. Accommodative monetary and expansionary fiscal policy are likely to remain in place for longer than elsewhere and could provide another tailwind. While inflation poses a challenge to other developed markets, it would be a welcome surprise for Japan.

The aforementioned points support the case for Japan, however the most important considerations for us, the one which we believe act as the best predictors of long-term returns, are fundamentals and valuations. As the saying goes; "price is what you pay, and value is what you get". All too often investors ignore the starting valuation, despite the critical importance of the price one pays for an investment.

Our analysis on this suggests that over the last 10 years (ending December 2021), we have witnessed significant fundamental improvements from Japanese companies, which are not yet being rewarded. For context, if we compare the performance of Japanese companies versus the US (far and away the best performing developed market), we find that the fundamentals (i.e., net margin, return on equity and real sales growth per share) of Japanese companies have either kept pace with or outperformed their US counterparts. Decomposing the returns of these two markets indicates that around 40% of the S&P 500 return has been driven by re-rating (multiple expansion, with PE ratios almost doubling) while approx. 60% came from growth in company fundamentals. We see a stark difference in Japan, which delivered stronger growth in fundamentals, but where valuations have instead detracted from returns (i.e. multiples have contracted). This clearly highlights investors' lack of appetite for Japanese equities over the last 10 years, with the region having delivered one of the strongest fundamental performances in the developed yet still trading at lower valuation multiples.

As a result, our equity modelling suggests that Japanese companies today appear more attractive than other developed regions (on valuation grounds). On this basis we are excited by the return prospects for Japan in the medium to longer term. A much lower starting valuation should provide a tailwind to returns whilst offering a healthy margin of safety versus other risk assets hovering near all-time highs.

17 January 2022

Making money in bonds

Richard Stutley, CFA

Last year, US Treasuries suffered one of their worst years this century[1]. Treasury Inflation-Protected Securities (TIPS), on the other hand, returned +6%, making 2021 a pretty good year for these bonds versus their long-term average[2]. So how did investors like us make money in TIPS; was it purely down to QE-fuelled irrational behaviour; and what do we expect from here?

TIPS respond to real interest rates (the rate you receive after inflation) in the same way as regular bonds respond to nominal interest rates. Real yields went down last year meaning bond prices went up. Driving this was an increase in inflation expectations with no corresponding rise in interest rate expectations (something we don't see very often): while investors came to realise that inflation in the US was running faster and for longer than they had predicted, they nonetheless staunchly held onto the view that it would come down without the Fed having to do much at all.

10-year TIPS started 2021 yielding -1.0% and by August were yielding -1.2%. Is there any justification for paying away 1.2% a year in real terms? If you're not compensated for lending your money you should…

1. Spend it. Ah but wait; you've got a retirement to fund so you have to save some of your money.

2. Hold it in cash. In that case you'd stand to make -2.4% per annum in real terms, assuming inflation expectations were roughly accurate in August last year.

The theoretical lower bound to nominal interest rates (not real) is probably somewhere around -1 to -2%: beyond this level, I'd imagine it becomes cheaper for people to hold their monwey in a vault. From that, deduct inflation. So real interest rates on 10-year TIPS approaching -4.5% last year would have been within the bounds of what's theoretically possible – you don't need 'QE-fuelled irrational behaviour' to achieve that, despite what you may think.

Why don't we always and everywhere have negative real interest rates of -4.5%? It would seem a much cheaper way for governments to fund themselves. The answer is the same when we ask the question why we don't we have interest rates of +20%: because it would collapse the economy. In the case of negative interest rates, if the difference between the riskless rate and the growth rate is large enough, everyone will rush to invest their savings (plus any borrowings) into new ventures, and we'll quickly run out of spare capacity and the economy will stall. While people ascribe a lot of power to central banks, growth rates and risk appetite ultimately determine interest rates: central banks' only job is to try and gauge what these variables are and to set policy accordingly.

At the start of 2021, the market and the Fed's narrative was that inflation would come down of its own accord. Come the start of 2022, the view has shifted and the consensus now is that it will take a few hikes to get us there. We think the hiking cycle discounted by markets may still be too benign to bring inflation down. Hence we're expecting further tightening and remain underweight duration.

As we head into the second half of the year, the picture is likely to become more balanced if we're right and there has been a further leg-up in the path of interest rates. In the long run, interest rates are determined by growth and risk appetite, as stated above. Unless you think Covid has increased one or both of these variables, then it is not clear why the economy will ultimately settle at materially higher interest rates than prevailed pre crisis. In the short run, interest rates may need to overshoot this long run neutral level to arrest the current surge in inflation. As we head into H2, we may find we're looking for interest rates to roll over again if consumers are under too much pressure from the combination of higher interest rates and higher prices, which would therefore require a pivot in our duration positioning.

[1]J.P. Morgan GBI US Unhedged USD; source Bloomberg Finance L.P.
[2]Bloomberg US Govt Inflation-Linked All Maturities. Data on Bloomberg Finance L.P. 1997-2022.

24 January 2022

DiversiChination

Lorenzo La Posta, CFA

Our regular readers would have read the word "diversification" countless times across our pieces, especially about it being "the only free lunch in finance". Now, everyone loves a free meal but certainly you're not going to eat it only because it's free, am I right? It needs also to look, smell and taste good, and the various courses need to be well balanced. We have recently added a new course to our menu, with a certain eastern flavour, that should make that free meal a lot more palatable for our clients: Chinese government bonds.

Before we continue, it's worth highlighting that a good diversifier is not necessarily also a defensive asset, despite defensive assets being often good diversifiers. Defensives are in fact those carrying little risk, typically offering lower return potential but outperforming riskier assets when things go badly, showing little to negative correlation with main risk assets like equities. Diversifiers are instead simply those having different, alternative return drivers than the rest of the portfolio.

Government bonds are very often part of a defensive allocation and are typically good diversifiers, but they don't all share the same characteristics. Developed market bonds today offer low nominal yields, even lower real yields, and, given the inflationary outlook and the prospects for rate hikes, they don't have a particularly rosy return outlook. Emerging market bonds offer higher yields, but that comes with significantly higher price volatility, currency and credit risk and a higher correlation with risk assets. Somewhere in between the two we find China, an emerging country on paper, but one of the two largest and most powerful economies in the world, offering a good compromise between the two.

We believe Chinese bonds offer an attractive combination of high income, good diversification benefits (low correlation with global equity and bond markets) and solid defensive characteristics, having held up really well during the pandemic and during most of the crises in the past 15 years.

At the time of writing, the yield on a 10-year Chinese government bond hovers around +2.7%[1], solidly above the latest year-on-year inflation print of +1.5%[1] and down from as much as +3.3%[1] in November 2020. For comparison, a 10-year US Treasury bond is yielding +1.8%[1] today, up from +0.9%[1] fourteen months ago, with the latest headline inflation number at +7.0%[1]. Chinese bonds have outperformed the US thanks to a higher starting yield and divergent monetary policy: while markets have been pricing in increases in interest rates across the Atlantic to fight soaring inflation, reduce the central bank's balance sheet and withdraw some of the liquidity injected during the pandemic, they have instead been expecting quite the opposite for China.

The short term should be particularly beneficial. The People's Bank of China is shifting its policy focus from deleveraging to growth, with increased expectation of some monetary easing ahead and thus rising bond prices. The country's exports and trade balance continue to rise, making the external balance sheet stronger than ever. Chinese government bonds today are well positioned to outperform.

This investment doesn't come risk free per se and there are a few things to be mindful of: the central bank is not independent from the government, the country's facing slowing growth (though, still growing its GDP at an impressive +4%[1] p.a.) and a high level of corporate debt and its economic policy remains highly interventionist. However, we think we are being more than compensated for these risks, especially when placing these bonds in a multi-asset portfolio context.

[1]Source Bloomberg Finance L.P.

31 January 2022

New Year's Revolutions

Andrew Hardy, CFA

2022 has started with a bang! Barring a recovery today January will close out as being the weakest start to a year for global equities – down 7.0% in US dollar terms – since 2009, when markets were still spiralling through the financial crisis. While that's enough to warrant attention, some of the underlying trends in markets have been considerably more abrupt. Nonetheless, rather than being cause for panic, we believe this is a healthy correction, led by parts of markets where the most excess had built up, and that the conditions for further medium-term progress in equity markets remain in place.

The vast majority of equity market falls have been driven by highly valued growth stocks, with the MSCI World Growth index down 12% in US dollar terms on a year-to-date basis. The ARK Innovation ETF, a widely held aggressive growth portfolio and poster-child for the dominance of growth stocks in the last few years, has fallen 27% over that period and has nearly halved from its high in June last year. From Zoom to Coinbase, Peloton to RobinHood Markets, highly valued growth stocks, many of which were direct beneficiaries of lockdowns, have rapidly moved out of favour and seen their valuations plunge, often with share price falls of over 60%. Larger index constituents are increasingly feeling the pain too; despite delivering quarterly earnings well ahead of expectations, Netflix and Tesla saw their share prices immediately slump over 20% and 10% respectively on the back of their latest results being reported.

It's no coincidence that real yields in bond markets (the difference between the nominal government bond yield and the market's expected rate of inflation) have been climbing rapidly since the falls in growth stocks began to broaden out. In the US, 5-year real yields touched multi-decade lows of nearly -2% p.a. in mid-November and have since climbed to nearly -1%. Real yields are still deeply negative and far below the normal historical range, so discount rates may yet need to move considerably higher before financial conditions materially tighten. Valuations for growth stocks are generally more sensitive to interest rates because they earn proportionately more of their earnings in the distant future, and the present value of those earnings is reduced more if discount rates rise, than for 'value' stocks.

Portfolios of value stocks have generally proved highly resilient over this period. The MSCI World Value index has only dipped 2% this year, supported by higher weightings in the outperforming financials sector, where many companies are benefiting from the rise in real yields and the energy sector, supported by a resurgent oil price. 'Value' stocks also tend to be more economically sensitive and should benefit most from the continued rebound in economic growth that is expected this year. Barring an extreme reversal later today, this month will see global value outperform the growth index by the most since MSCI records began in 1974. The fact that headline index returns are set to be so poor highlights how dominant expensive growth stocks have become in market indices, a risk we have long been alive to and mitigated in our portfolios.

The monetary tightening underway is set to be far more rapid than in previous cycles, clearly underlined by Fed chairman Powell's comments following the latest FOMC meeting last week. Markets are now pricing in around five 25 basis point rate hikes from the Fed this year, along with a start to quantitative tightening (the opposite of QE). The liquidity withdrawal that this is driving is rapidly unwinding other excesses that had built up: that includes sky high valuations on speculative growth stocks, but arguably extends much further; a basket of crypto currencies*, heralded by many to be an effective hedge against inflation, is down 48% from it's high (so far...).

We're witnessing a material shift in monetary policy, which is likely to be mirrored across many other major economies and will continue to have significant implications for investors. Markets were remarkably benign last year, but a continuation of the elevated volatility we have seen so far this year should be expected as we adjust to this next and more difficult phase of the cycle, especially while supply chain issues persist, and inflation remains so high. Geopolitical risks, most notably around the ambitions of Russia and China, contribute further to uncertainty, for investors but also central bankers; the risk of a policy error at this point is high.

However, as things stand, we do not believe the conditions are in place for a sustained fall in broader markets. Although growth will clearly be slower than last year, recently downgraded global GDP estimates for this year from the IMF still stand at 4.4%, well above historical trend, and corporate earnings will, broadly speaking, continue to follow suit. But with such a significant shift in the monetary policy landscape coming into view, we expect the best returns are likely to come from a very different cohort of stocks than that which led returns over the past decade. As well as maintaining broad diversification, we believe it is more important than ever to include a significant allocation to value stocks in portfolios, across a broad range of industries and geographies. New Year's resolutions rarely last beyond the end of January, but the revolution unravelling in markets may well prove more enduring.

Source for all data Bloomberg Finance L.P./Index and stock returns to 28th January 2021 in US dollar terms.
**Bloomberg Galaxy Crypto Index.*

February

7 February 2022

Stay Ahead of the Game

Richard Parfect

My mother used to say to me "a stitch in time saves nine", as a child who grew up in the war and rationing, she was the product of her formative years. In the 1970s and 80s I would see her darning my father's socks in the evening, something I doubt many households do today as the price of clothing and the expectation of durability has waned in the decades since. My father ran an industrial clothing firm, John Peck Ltd, on Edge Lane in Liverpool; it had hundreds of employees and was renowned as a high-quality supplier to a wide range of customers throughout the public and private sectors, they even held a Royal Warrant as a supplier to the Royal Households.

The firm closed down in 1981 and the site where the factory existed became a retail park. As always, there was no single cause for the failure; however high up on the list were inflation, high energy costs and the emergence of cheap (but low quality) imports; predominantly from Hong Kong and Taiwan. I suppose it the was the beginnings of the "throw away" generations as my father called it. This was of course before "sustainability" was a thing.

We are all influenced heavily by what we experienced in childhood- the knocks leave their marks. For me it was growing up under the self-imposed austerity of our household when my father lost his job. A cold house meant you put a jumper on, meals where nothing went to waste, clothes that had been worn by my cousins and even my brother (17 years older than me). "Cry me a river" you may say, as millions had it worse than us.

That fear of inflation stuck with me, it always bemused me when people thought it had gone for good. When I applied for my first job as a graduate trainee in 1996, I had to write an essay answering the question,"Is Inflation Dead?"

The answer was "no" of course, it was just dormant, but little did I appreciate it had actually gone into long term hibernation. The forces that kept it down for so long were powerful and long running.

Unfortunately, just like a bear awaking from its winter hibernation, inflation has now emerged, and it has a ravenous appetite. Central bankers have been afraid to pick up their darning thread in time and are now confronted with an enormous job. Just like a pilot, who should always be mentally five minutes ahead of the aircraft, central authorities should have stayed ahead of the game.

They are now scrambling around the cockpit trying to get their charts out and plot a new course, in the meantime telling their passengers to behave themselves and not ask for pay-rises to even match inflation.

We are in for a bumpy ride as policies and markets readjust to what is likely to be a longer period of higher energy costs than people initially thought. It can be argued that energy has been mis-priced for years anyway, as the long-term financial costs of carbon intensive energy was ignored. It is for that reason we have been seeking to participate in the energy transition story with investments in renewable power generation, storage and distribution. For in a world where there are many casualties of a 1970s style energy crisis, they are some of the few beneficiaries.

14 February 2022

The Boutique Premium

Gary Moglione

There have been a number of academic papers that have examined the performance of funds managed by smaller "boutique" investment houses versus the much larger "asset gatherers". The outcome of these various studies is overwhelming; that boutiques tend to be the better performers with a consistent performance premium across various asset classes, ranging from 0.23%[1] to 0.62%[2] per annum net of fees. As a fund selector who has worked for one of the world's largest asset managers and one of the smallest, and having met with and analysed the portfolios of managers ranging from new fund launches to $50billion funds, I can provide some personal insight and views on the "boutique premium".

Larger funds may underperform for a variety of reasons. Firstly, a manager of a large fund has a shrinking investment universe as his or her fund grows. The result is they are precluded from investing in stocks further down the market cap scale. If a fund has £5 billion in assets, a 1% position will equate to investing £50 million. If you then want your investment to be less than 5% ownership of that company, you can only invest in companies with a market cap over £1 billion; removing huge swathes of potential investments from your universe. Smaller cap stocks have outperformed larger caps over the long term[3], so by excluding these stocks you are missing out on a strong potential alpha source. In addition to this, larger funds tend to have more holdings to increase liquidity further. Is a portfolio manager's 70th best idea really as good as their 20th? Then comes the manager's mindset. A large fund will be a cash cow generating tens of millions in fees and the asset gathering firm will have a huge marketing budget and well-resourced sales team selling it globally.

As long as it does not underperform too much, the brand and sales machine will keep it growing. The manager may be getting a huge annual salary and bonus to stay at the helm and the last thing they would want is to upset this perfect scenario, so the path of least resistance is to hold some of the larger index stocks to dampen down active risk. The result is likely to be a low conviction, low tracking error fund. Everybody wins, except for investors who are suffering poor performance.

A manager in a boutique fund will often have equity in the business and therefore it will not be the salary and annual bonus that motivates, but the chance to build up the company. If the business is a long-term success, they will have a much larger share of the upside. The manager within a boutique may have built the product from inception using their own process and philosophy formulated exactly how they think money should be managed. A manager within an asset gatherer may have inherited the fund and process and have to utilise a house "macro view". A smaller fund will be free of liquidity constraints so, when appropriate, can have a size skew towards smaller cap stocks. Free of liquidity constraints, the portfolio will typically be higher conviction as only the best ideas will be added to the portfolio.

I have no doubt there are lots of things in which bigger is better in asset management. Sales coverage, reporting, IT, marketing spend, brand etc all benefit from economies of scale.

The one area in which bigger may not be better is performance.

Sources: [1]0.23% Taken from Cass Business School study (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3542243). [2]0.62% Taken from AMG study (https://www.amg.com/content/dam/amg/boutique-advantage/The_Boutique_Premium.pdf).[3]Fama & French as of 11.14.18.

21 February 2022

Taking the (not so) long view

Robert White, CFA

The latest elevated CPI print of +7.5% has spooked investors this year, triggering volatility in both bond and equity markets. In trying times, it sometimes helps to take the long view. In a recent paper the Bank of England has taken this advice to the extreme, looking back 800 years to the 14th century to calculate the average global GDP-weighted inflation rate of just +1.51%[1]. Unfortunately, 800 years is not a particularly sensible investment horizon for most people, but there are plenty of other more relevant periods for us to examine when considering the importance of current economic events.

We "only" need to go as far back as 1982 to find a period where inflation in the US has been at the levels we see today, and of course back then the US economy was in a very different place. First off, unemployment was +10.7% by the end of that year with manufacturing, construction and auto industries hit particularly hard. Today unemployment appears under control at +4.0%, and much of the job uncertainty has been in leisure and hospitality sectors due to Covid-19.

Inflation was also coming down from a much higher point in 1980 when it peaked at +14.8%. Price stability was in fact not explicitly part of the Fed's mandate until the Reform Act of 1977, and Volker's appointment as Fed Chairman in August 1979 signalled a change of course for monetary policy. Under Volker, the Federal Reserve raised interest rates as high as +20% in 1981, and by 1982 they were on their way down as the worst of the inflation prints were already in the past. Today we are in a much easier environment with interest rates at +0.25%, and we are just at the start of a hiking cycle. While no one expects rates to reach the highs of the early 1980s, there is uncertainty ahead as to just how far the Fed will go.

What about markets? The early 1980s were famous for "Volker's Bear" as the steep increase in rates resulted in a long-term bear market decline from November 1980 to February 1982. Today equities have bounced strongly from their most recent bear market in 2020, but we have seen some volatility this year as the S&P 500 was down +5.2% in January. Such periods can feel painful for investors, for a number of reasons.

The first reason comes down to human psychology. Prospect theory is a field of behavioural economics which scientifically describes how individuals assess their losses and gains asymmetrically; the pain we experience from a loss is greater than the pleasure we derive from an equivalent gain. This doesn't seem to make sense if we behave completely rationally, however it can be understood anecdotally as many of us can relate to the pain of having something we value taken away from us. The truth of this fact is not merely anecdotal; Kahneman and Tversky formalised this principle scientifically, and the former won a Nobel prize for his work[2].

Secondly, the decline in January has come in a period of relative calm for markets, and so has felt particularly sharp. Over the last decade, the S&P 500 has averaged +15.4% return per annum with a standard deviation of +13.2%. Again, we can look further back at history to compare these numbers. Since 1927, the average return has been lower than the last decade at +9.7%, while the standard deviation (a common measure of risk) has been higher at +18.7%.

While investors cannot control their natural behavioural instincts, nor the overall direction of markets, we should focus on what we can control. The best way to deal with market volatility is to hold investments over the long term and to diversify risk optimally across a range of asset classes, regions, styles and companies. This is what we do on a daily basis for our clients, making the journey as smooth as possible through these tough periods.

Sources: [1]https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2020/eight-centuries-of-global-real-interest-rates-r-g-and-the-suprasecular-decline-1311-2018. [2]Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. Econometrica, 47, 263-291. All other sources taken from Bloomberg Finance, L.P.

28 February 2022

Style Box

Tom Delic

Men's heavyweight boxing is perhaps set for its biggest year this century. Two upcoming bouts could lead to the winners meeting later in the year in a bid to become the undisputed champion of the heavyweight division. When assessing the potential entertainment value for spectators, an often-used phrase is "styles make fights", meaning the blend of the two fighters' boxing styles will ultimately determine how exciting a fight is. This is not too dissimilar to investment styles, where some work better together than others.

The first match-up is between Dillian Whyte, and undefeated fellow Brit, Tyson Fury. Whyte, who has been waiting for a title shot for several years, reminds me of the high dividend yield style, an under-appreciated boxer/style that's been in the wilderness for some time. Unfairly characterised as a slugger that possesses little more than a hard punch, like high dividend yield equities, there's more to Whyte than just the obvious qualities (big dividends). Most recently we have seen defensive qualities and resilience to the style, and it may be Whyte and high dividend equities that cause the most surprises in 2022.

Tyson Fury can be likened to the momentum style of equity investing. At 6 foot 9 inches tall, Fury defies gravity with his slick switch hitting and quick footwork. Just like momentum equities in recent years, he's currently ranked number one and despite at times thinking their time was up (see Fury's 12th round survival vs American Deontay Wilder and MSCI Momentum performance, both in late 2018), they remain the ones to beat.

The second fight sees a re-match between Anthony Joshua and unified heavyweight champion, Oleksandr Usyk. Like the value style, Anthony Joshua is arguably the most well-known of the four heavyweights, becoming a global superstar after his 2017 win against Usyk's fellow Ukrainian, Wladimir Klitschko. Since then, and similarly to value, his stardom has waned, with two defeats, including his most recent one against Usyk. Despite underperformance in recent years, his stature and longer-term consistency (the highest knockout ratio of the four at 85%[1]), means you can never rule out Joshua or value equities, to return to the top of the pile.

If there was one boxer that could be likened to the quality investment style, it may well be Oleksandr Usyk. Like quality equities, Usyk possesses an almost unblemished track record, winning 335 of his 350[2] amateur fights before turning professional. After becoming undisputed cruiserweight champion, he moved up to the heavyweight division and following just two fights at the weight class, went on to defeat Anthony Joshua (our value man) to become a unified heavyweight champion. Quality equities, like Usyk's pure fundamental style, is the most pleasing on the eye and is only second to momentum (Tyson Fury) in the rankings.

As fans, we have the advantage of watching all four fighters over the coming year and the styles should certainly blend well to make for two very entertaining fights. As investors we also have the benefit of blending styles. Using MSCI indices, an equally weighted combination of the high dividend yield, momentum, value and quality styles would have returned 8.8% annualised since 1998, compared to 7.5% for MSCI World[3] . Where the investment styles may differ to our heavyweight fighters is while we expect plenty of volatility in the ring in 2022, the equally weighted style portfolio was less volatile than MSCI World over the period.

2022 has so far been the year of the value and high dividend yield styles but whether they can become champions remains to be seen. We know however that when going the distance, the four styles provide a knockout combination for portfolios. Seconds out![4].

Sources: [1] BoxRec. [2] The Ring. [3] Bloomberg Finance, L.P. 4 https://www.dazn.com/en-GB/news/boxing/what-does-seconds-out-mean-in-boxing-explaining-one-of-the-sports-most-confusing-phrases/crrz72o8pwezzk1p4nusovmi. All other sources taken from Bloomberg Finance, L.P.

March

7 March 2022

Goodbye to Greenwashers

Michael Clough, CFA

The last two years have seen a huge increase in demand for sustainable funds, or those explicitly integrating environmental, social and governance (ESG) factors into their processes and portfolios. Naturally, fund companies cottoned on and there has been a proliferation of strategies available for investors to buy. Greenwashing, when marketing material and disclosures overstate the true level of ESG integration within a strategy, was an inevitable consequence of this trend.

Anyone who has interviewed a fund manager of late will doubtless have seen an ESG slide or two in their presentation. Most will say they have always considered these factors and so for fund selectors the key questions are: who is genuine and how do they stack up versus a burgeoning list of peers?

These questions cannot be answered by looking at a fund name, studying a presentation or solely using third party scores. Rather, the only way to answer them comprehensively is by meeting the manager, investigating their approach and challenging them appropriately. So how do we go about this? Below I list some key considerations and then name one manager we think stacks up well (spoiler: it doesn't have responsible or sustainable in the name).

It is very important for a fund manager to be able to articulate how sustainability factors are considered. Bland, vague responses don't impress; rather we seek evidence of exactly how they are considered in their process. Managers nearly always have a few stock examples listed in their presentation, ready to give you a polished spiel on why that company bleeds green. Naturally, they will be well-rehearsed narratives and so we would rather challenge names hidden away elsewhere in the portfolio. This is where quantitative third-party tools can come in. Whilst these shouldn't be treated as gospel, by looking at a full portfolio breakdown we can see which constituents score less well, be it from an environmental, social or governance perspective. It is these names which we like to question managers on. Can they clearly explain why that third party tool is potentially misguided and why the company is worthy of a spot in the portfolio? Furthermore, can they evidence a deeper knowledge of the business operations and strategy that extends beyond a high-level description.

A key component of investing responsibly is engagement and pushing for change when necessary. This takes time and resources to be done effectively and so it is crucial to assess whether the investment team is sufficiently resourced to carry this out. Furthermore, it is important to see a track record of engagement and the impact of these activities.

Some investment teams take care of engagement themselves; others have separate teams dedicated to this activity. If it's the latter approach, then it is key to understand the communication processes between the two. Exploring the approach in more detail can often reveal an indication of the fund management firm's stance as a whole and whether it has invested in its team sufficiently. Linked to this is assessing whether the fund management firm is also practicing what they preach. Does it benefit from strong corporate governance, or are they making commitments as a firm to improve employee diversity, for example?

Now, back to my spoiler comment. Surely the end game from this heightened awareness of all that encompasses sustainability is that ESG considerations are embedded in all funds without the need for sustainable or 'green' labels. Whilst we aren't there yet, even now a fund can score well against the above criteria and not necessarily be labelled responsible or sustainable. One such fund we rate highly is Evenlode Income.

Evenlode focus their time seeking high quality companies with asset light business models. This typically steers them away from more controversial sectors such as energy, mining and utilities. However, what impresses is the depth of consideration evidenced in their process. One way the team appraises sustainability is by considering various risk factors that feed directly into a company's maximum position size in the portfolio. Of nine risk factors scored, four are ESG-linked. Evenlode's analyst team has grown in recent years to enable the evolution of their process and research capabilities. The investment team is 15 strong with three focused on sustainability and stewardship. There is a transparent approach to voting and engagement and the team have also spent time building out carbon emissions analysis, considering scope 1, 2 and 3 emissions for their portfolio, which separates them from many peers. Many other managers make some or all of these claims, but far fewer live up to proper scrutiny so well.

At Momentum, we manage three distinct product sets with sustainable mandates. We have a range of model portfolios for UK clients and a global multi-asset fund in our Luxembourg UCITS range. In these solutions we have selected third-party managers who we consider to be leaders at incorporating sustainable considerations into their strategies. Lastly, we manage a Global Sustainable Equity fund where we have partnered with systematic manager Robeco to deliver a portfolio that provides exposure to rewarded investment style premia whilst also targeting a significant reduction in carbon emissions, waste generation and water usage. We would be delighted to discuss these portfolios and our approach in more detail with you.

14 March 2022

Mind the Gap

Mark Wright, CFA

It took less than a week for investors in Russian equities to see their holdings effectively become worthless. The Russian stock exchange has been closed for trading since Monday 28th February, which meant depositary receipts listed on stock exchanges in London and elsewhere felt the full brunt of anyone wishing to head for the exit.

Having fallen to near zero, these securities were then suspended and index providers, such as MSCI, started removing or assigning nil value to Russian equities that were constituents of various emerging market indices.

Putin's invasion of Ukraine and the collaborative application of sanctions by the West has served to remind investors of the gap risk associated with investments, and in particular, emerging market investments.

Gap risk is difficult to account for in any sensible investment framework. In derivative markets, binary options pay a fixed sum or nothing at all depending on whether the price of an underlying index or asset crosses a pre-set threshold. They are considered a trader's worst nightmare, because of the gap risk they entail.

Derivative traders effectively embed additional premium into the pricing of such options when selling them to customers. The hope is that in the long run the cumulative additional premium charged will outweigh the inherent heavy costs that can occur from hedging such options as they approach maturity. They also typically form only a small part of a much larger derivatives trading book i.e., the risk can to a large extent be diversified away.

But traditional long-only investors don't have the same luxury. In theory, investors could apply an additional risk premium when appraising the value of assets in countries perceived to pose a significant risk of "gapping" to the downside. It is difficult, however, to calculate what exactly that should be, and most long-only investors will not have the same level of diversification that a high volume, derivatives trader will likely have.

Maybe the best option is to simply exclude countries, such as Russia, from one's investable universe, accepting that it is simply not possible to value the assets of companies in those countries. At Momentum Global Investment Management (MGIM), we do not claim to be specialists in emerging markets, instead entrusting our clients hard earned savings with specialist global emerging market managers.

One such manager is Aikya. The company was established in 2019, headed up by Ashish Swarup, who established a strong performance track record at Stewart Investors(formerly First State).Good stewardship is at the heart of the investment philosophy at Aikya and as a result the Aikya Global Emerging Markets Fund in which our clients are invested had zero Russian equity exposure prior to Putin's invasion of Ukraine.

In fact, the investment strategy employed at Aikya has had no Russian equity exposure for over five years and there wasn't even a single Russian equity on their watchlist. The reason being "weak rule of law, weak institutions and also the fact that there are no companies without some form of links back to Putin / oligarchs".

Diversification for the sake of diversification, whether by geography or asset class, combined with an underappreciation of gap risk can lead to bad outcomes, as those emerging market managers that were heavily invested in Russian assets are now realising. We have the utmost confidence that Mr Swarup and his colleagues will continue to generate an investment track record that many emerging market managers will be enviable of, despite excluding big emerging economies, such as Russia.

Remember the concept of investing in BRICs (Brazil, Russia, India and China)? What an overly simplistic and evidently flawed concept that has proved to be. It's better to put in the hard work to find a diligent active fund manager with a clear philosophy and investment process that lends itself to outperformance in the long run. That is what we do at MGIM.

21 March 2022

Metaverse: real estate

Jackson Franks

The largest ever land acquisition took place towards the end of last year; it's value: US$2,400,000. You may be thinking I'm missing a few zeros here, but what I haven't yet mentioned is that this transaction does not relate to the real world but instead refers to Tokens.com's purchase within the metaverse.

In November last year, Tokens.com's subsidiary, Metaverse Group, paid more than US$2.4m for a plot of virtual land in the fashion district of Decentraland, one of several growing platforms within the metaverse. Although this amount may seem obscene to many readers (including myself), the more eye-catching fact here is that it accounted for less than 50bps of real estate sales within the metaverse for 2021.

According to MetaMetric Solutions, real estate sales on the four major metaverse platforms reached $501m for 2021, a trend which is set to continue in 2022 with sales forecasted to be $1bn. In January alone, sales topped US$85m with one person spending US$450,000 to be Snoop Dogg's neighbour in the Snoopverse district of The Sandbox, another platform within the metaverse. With a substantial amount being invested in 2021 and real estate sales anticipated to double this year, more attention to the space is warranted, but firstly, and many readers may be asking, "What exactly is the metaverse?"

The metaverse is an immersive internet experience that lets you replace or complement reality with computerised simulations that strive to be as realistic as possible. Essentially, it's a world of endless, interconnected virtual communities where people can meet, work, and play, using virtual reality headsets, virtual reality glasses, smartphone apps, or other devices. It's the continuation of living but instead of doing so through the real world, it's lived online via your created avatar, i.e. your digital self.

However, the metaverse isn't just one virtual world but instead is made up of different platforms.

An infinite number of platforms within the metaverse can be created and large tech names such as Meta (Facebook), Microsoft, Epic Games, Apple (and over 160 more companies) are investing billions of dollars to build their own platform that they believe will have the same stature as planet Earth.

So why are investors buying real estate in the metaverse? The investment narrative is similar to that of investing in real estate within the real world. Investors source a location with positive supply and demand dynamics and then purchase land at a price that would enable them to develop an asset at a yield in line with their return profile. However, the risk profiles between real estate in the metaverse vs the real world are chalk and cheese.

There are numerous factors as to why, but the main drivers are (1) infancy of the market, (2) an infinite number of platforms can be created (unlimited supply) and (3) currency risk. As the metaverse is blockchain based, all transactions are implemented in the specified platform's cryptocurrency.

To contextualise the currency risk associated with buying real estate in the metaverse today, the above-mentioned land transaction was implemented in MANA, the cryptocurrency of Decentraland. At the date of payment, the coin rate was US$3.88 per MANA but has since devalued to US$2.42 per MANA, a 39% devaluation in the cryptocurrency and therefore a 39% devaluation in your asset. To me, anyone buying land or real estate in the metaverse today are crypto traders not real estate investors.

Although fascinating, I don't see the metaverse replacing the real world anytime soon. The real estate sector continues to advance, and technology continues to adapt the way we think about assets. We are constantly looking for new opportunities to add value for our investors, but as of today, the metaverse is not one.

Sources: https://www.tokens.com/metaverse-media. https://coinmarketcap.com/currencies/decentraland/Momentum Global Investment Management

28 March 2022

It's lights out and away we go

Matt Connor

The first race of the 2022 Formula One season didn't disappoint, as Sir Lewis Hamilton sought a strong start to his record-breaking 8th World Championship in Bahrain. Many were quick to write off the Mercedes man, due to a lack of pace in free practice and qualifying compared to rivals Ferrari and Red Bull. Despite the negative outlook, Hamilton still managed to achieve a podium. As value investors we often view negative sentiment around a company as a potential opportunity to capitalise on irrational valuations.

A prime example of such irrationality is Purplebricks, an online estate agent in the UK. After underperforming peers in a buoyant housing market, coupled with an issue in its lettings business, it's shares plummeted, reaching a low of 12.5p*. This gave a business with close to £60m of cash on the balance sheet, and no debt, a market capitalisation of just over £38m i.e. a negative enterprise value for what is the UK's largest estate agent brand.

The dislocation between Purplebricks' valuation and logicality did not go unnoticed by us or company directors who have been actively buying the stock over the last few weeks. With a new management team at the helm, market sentiment has now turned more positive, with the share price more than rallying from its lows, however the UK's largest estate agency still only has an enterprise value of less than £30m; a lot less than what it was twelve months ago, despite the company gaining market share in recent months.

Another recent opportunity presented to us was dotdigital Group, a SaaS omnichannel marketing company. Its shares tumbled after revenue growth slowed. We have followed dotdigital closely for some time and despite the recent headwinds to the business, we believe it to be of high quality and able to continue delivering healthy returns on invested capital. This was not reflected in the 2x enterprise value-to-sales multiple, a 66% discount to dotdigital's 5-year average. The shares have subsequently rallied 50% but still only trade on a 3.4x multiple.

Irrational moves in valuations aren't always preceded by bad news or a downgrade, as demonstrated by our most recent investment, Games Workshop, the world's largest hobby miniatures company behind Warhammer. Games Workshop has seen its market capitalisation almost halve in the six months from September 2021 to March 2022, caught up in the market sell-off that started with the onset of Omicron.

Games Workshop is an extremely high-quality business with a shrewd management team and solid business model. The company has demonstrated that it can grow invested capital rapidly, whilst increasing economic profits meaningfully. The unwarranted sell-off in the company's shares has provided an attractive entry point.

Unlike Formula One where it is difficult to draw long term conclusions this early on in the season, our long-term, value focussed approach allows us to invest in companies that can provide shareholder value over the long haul, and in the short-term we can take advantage of opportunities that may arise, just like Hamilton in Bahrain.

April

4 April 2022

Jordy Shore

Alex Harvey, CFA

Covid travel restrictions have now finally been lifted for passengers arriving in the UK. I've been fortunate to travel abroad in recent months including a trip to Jordan, with its rich cultural heritage spanning ancient civilisations and sites sacred to Christianity, Judaism and Islam. One regional constant over the millennia has been the Dead Sea; the world's deepest hypersaline lake. Its shores emerge from a depth of over 300m to mark the lowest land elevation on our planet at 430 metres below sea level[1], although my Altimeter app registered it at 450 metres. This may not be an error as it was striking how far the shore had receded in recent years, down and away from the hotel's original beach. Guests in white dressing gowns needed trainers, not slippers, as they ventured down several terraces to the water's edge for their customary Dead Sea float.

The Dead Sea's surface area has almost halved over the last 90 years. Today it covers a little over 600km², down from 1050km² in 1930, and is 20 miles shorter than it was in 19502. It gets barely 10% of the 160 billion gallons of water needed to maintain its current size. Not so much dead as dying, as are the vibrant ecosystems that it supports. Unsurprisingly it is not nature that is the undoing of this natural yet unusual geological feature. Like many environmental challenges the world faces today, this is of man's own making. Extensive irrigation projects by Israel, Jordan and Syria have seen the River Jordan's once annual flow of 343 billion gallons of fresh water reduce by almost 90%[3]. It is no coincidence that as Covid becomes a subordinated risk factor, environmental considerations like this - as well as those pertaining to society and governance – are rising rapidly back up the investment agenda.

Beyond the issue of water scarcity, the recent surge in energy, metal and grain prices are once again shining a light on commodity supply chains, energy security and renewables. Following Russia's invasion of Ukraine, the price of Brent crude rocketed through $100 a barrel and peaked out above $130 before falling back. Last Thursday's announcement that the US would release an 'unprecedented' amount of oil from America's Strategic Petroleum Reserve – up to 180m barrels over six months – should help keep a lid on prices, notwithstanding any further escalation of geopolitical tensions. With the shares of the global energy and mining companies returning close to 30%[4] so far this year, the ESG 'factor' has undeniably underperformed as heavier industry has profited from the confluence of the release of pent-up post covid demand, supply chain disruption and a war on Europe's eastern flank. Could now be a good time to re-engage with sustainable investing?

After sitting out the initial wave of 'ESG' fund launches, and taking time to consult with clients, Momentum has recently launched its own range of sustainable investment solutions. Working with management teams which we feel exemplify the high standards required of sustainable investors, we invest our clients' capital into strategies where we feel there is an active desire to 'do the right thing' and facilitate change through engagement, in many cases preferring that to outright exclusion. We now count the Momentum GF Global Sustainable Equity Fund, Harmony Sustainable Growth Fund and Momentum Sustainable MPS amongst our available client solutions. Momentum has been a signatory to the United Nation's Principles for Responsible Investment (UN PRI) since their inception in 2006, long before most investment managers signed up, and details of that and our other responsible investing policies can be found on our website.

The Nabataeans were an ancient nomadic Bedouin people who amongst other things built the incredible city of Petra which is found in Southern Jordan today. They were a resourceful people known for their skills in harvesting rainwater through rock hewn aqueducts, and they created a bustling metropolis around this man-made oasis. Irrigation in these parts started thousands of years ago. It is only recently that mankind has overexploited this resource. If we want the Dead Sea not to die, then a concerted effort needs to be made to ensure that the water flowing into it is managed sustainably for future generations. Without water, cities like Petra would never have survived, let alone thrived.

[1]https://en.wikipedia.org/wiki/Dead_Sea. [2&3]Smithsonian.mag.com. [4]Bloomberg Finance L.P.

11 April 2022

Whatever it takes, China

Lorenzo La Posta, CFA

This is not the first time I have written about Chinese equities and loyal readers will remember last August[1], when the media were calling it an "uninvestable" market, we were finding pockets of value and interesting opportunities. This year, a new wind is blowing under the Red Dragon's wings.

But let's rewind the tape and press play on February 2021. Valentine's Day had just gone, the stock market was at a peak, but no one knew what was coming. Chinese regulators tightened regulation around privacy and data protection, specifically targeting the hugely successful internet sector. Widely held stocks, such as Alibaba, Tencent and Meituan, started falling as markets marked down their growth expectations. The private education sector was made not-for-profit almost overnight and the main players such as TAL Education and New Oriental Education were wiped out. The real estate sector's excessive leverage was brought down through the "three red lines" regulatory guidelines, introduced in August 2020, aimed at making the sector less appealing for speculators and more stable for the population. As a result, one of the largest developers, Evergrande, moved toward default. All these actions were taken in the name of "common prosperity"; a political objective aimed at making sure China grows in a sustainable and socially responsible way, but global markets saw that as an attack to the private sector and a negative for the country's growth potential.

Now fast forward to the middle of March 2022 - the market was down more than 50%[2] from its peak and the People's Bank of China (PBOC) stepped in to avert this trend. It's not quite a "whatever it takes" moment[3], but certainly the central bank has loaded the big guns.

In a press conference in January, the PBOC had already stated that "after a few months, the downward pressure on the economy will become yesterday's story"[4]. The decline in the macro-leverage in the past five quarters has created room for a more proactive and front-loaded monetary policy and signals are that corporate lending rates are likely to be cut, following the December cut in the medium-term lending facility, and that a reduction in banks' reserve ratio requirements (RRR) could also be in play. The central bank is guiding markets towards a cautious stance on the Chinese Yuan and is willing to keep fighting excessive appreciation.

At the Financial Stability Committee special meeting in mid-March, a few more practical points were laid out[5]. Credit growth was again a priority; the transition to the new model for the housing sector outlined by the "three red lines" is to be smoothed; big technology names will face a more transparent and predictable regulatory environment; Beijing is to work with Hong Kong to stabilise the local market; economic and monetary policies will coordinate to prioritise financial stability; American Depositary Receipts (ADRs) are going to be audited jointly by China and the US; a balance is being struck between Covid-19 containment and economic growth.

Markets have got what they were hoping for. At the time of writing, Chinese equities are up more than 20%[6] from their lows and this could prove to be the inflection point. But there are some lingering questions. Is China going to try to take over Taiwan? Are the trade wars with the US going to escalate further? Is the PBOC going to change its mind and not go through with this accommodative policy? We warrant caution, as always, but we have been constructive on China for a while now, partly because of the cheaper valuation of local assets and partly because of the undeniable attractiveness of a deep equity market with the added tailwind of a more accommodative monetary policy.

[1]Momentum Global Matters, "Experts' view on China", 23 August 2021. [2&6]Bloomberg Finance L.P., MSCI China Index. [3] Former European Central Bank President Mario Draghi, 26 July 2012. 41167 Capital, Morgan Stanley Research, "NPC: Unequivocal Reassurance on Growth", 06 March 2022. 51167 Capital

Investing goals

Stephen Nguyen, CFA

As an avid sports fan, I have always enjoyed being involved in all things sports related. Having participated in various team-based and individual sports throughout my life, I of course enjoy watching a variety of different sports, be it golf, tennis, or football. Sporting events often bring people together and teach us the importance of values and hard work. If we look at successful sports teams or individuals, there are lots of similarities that can be drawn between them and professional investors.

Over the Easter weekend, I took my son to watch the Liverpool vs. Manchester City game at Wembley Stadium, firstly as it would be fun, but also as an opportunity for him to learn from two top teams competing at the highest level. Sports and investing have lots in common: taking advantage of opportunities, learning to avoid or minimise mistakes and having the right mental tenacity, and these are what differentiates the average investment/sport managers from the great ones.

As the footballing season approaches its final stretch, it is interesting to see both teams fighting for the top prizes (both with very good chances). The recent successes of these two teams did not happen overnight, as they required patience and arguably two of the best managers in the world overseeing the project. Football managers offer an interesting analogy for the skills, temperament and challenges presented to investment managers.

A key attribute common to both fields is the ability to maintain conviction and discipline, particularly to one's philosophy and process. An investment manager lacking discipline will be less consistent in their decision making and as a result would often have unpredictable returns over the long run. Similarly, take Manchester City manager Pep Guardiola's footballing philosophy: it did not yield a trophy immediately, but he did not abandon it. Rather, he stayed disciplined and patient and of course has now been handsomely rewarded. Good football and investment managers with a strong long-term track record have the ability and confidence to maintain discipline in both good and challenging times. Staying focused is another important attribute as both are often faced with numerous ideas and opinions, but they require the ability to block out unnecessary noises when making key decisions.
Setting clear objectives is also important as this will dictate decisions when constructing portfolios or selecting eleven players, as it is not simply an exercise of picking the best individuals. Football managers select a combination of players that are best suited to achieve the objective – beating the opposition team up next. Similarly, an investment manager's job is not simply picking the 'best' investments but constructing a portfolio combining the optimal selection of holdings to best achieve the desired outcome. Investment managers would need to choose a mix of asset classes and strategies to strike an appropriate balance between delivering on the return objectives whilst minimising risks. The optimal portfolio also requires constant monitoring and changes depending on market conditions, which is not dissimilar to football managers tweaking formation depending on the opposition.

Deciding on the optimal portfolio / starting team is just the beginning. Over the course of the season, players could underperform or suffer injuries which would require difficult decisions to be made. Similarly, over the course of an investment cycle it would be naïve for investment managers to expect today's best ideas to remain so indefinitely. Our job is to adapt to prevailing market conditions and to tweak portfolios regularly to ensure an optimal blend of assets is in place. Lastly, to ensure portfolio holdings are the best in class, we are required to be constantly searching for new ideas, just as a football manager would look at the transfer market to ensure the team has the right players to achieve the desired objectives.

The challenges faced by top managers are non-trivial, so therefore it is vital that investors and fans remain patient and don't get overly influenced by shorter term adversities. Successful, disciplined managers with a sound, seasoned process and strong long-term track record will often deliver on their objectives, so it would be unwise to bet against them.

May

9 May 2022

Central banks get serious

Robert White, CFA

After the first 50bps interest rate rise by the Fed in over 20 years (with more to come) and the announcement of quantitative tightening starting in June, there is no doubt that the Fed is getting serious about containing inflation. Inflation data in April continued the pattern of the past year, generally exceeding expectations, with price rises becoming more broadly based and accelerating to multi-decade highs in the US and Europe. Strong demand, supply chain shortages, and war in Ukraine have combined to push producer price inflation (PPI) in the US up by 11.2% in the year to March. The figures are even more dramatic in Europe, with German PPI up by 30.9%, the highest since immediately after WWII, and this pricing pressure is feeding through to consumers.

Both these central banks are now on a much more aggressive tightening path than anticipated only a few months ago. The European Central Bank (ECB) signalled an end to its huge asset purchase programme in July, followed shortly thereafter by its first-rate rise. The market is now expecting the ECB's policy rate, currently -0.5%, to move into positive territory by Q4 2022, although the extent to which the ECB can tighten is limited by Europe's much greater exposure to the knock-on effects of the war in Ukraine.

It is the US, however, which is key in this monetary cycle. The Fed is now expected to push the Fed Funds rate close to or above the rate which it estimates to be the neutral rate by year end, being neither expansionary nor contractionary. This would imply a rate of close to 3%.

The result has been one of the worst periods of performance for US Treasuries in history, -3.2% in April and -8.2% year-to-date (YTD). Bond markets around the world have followed the US with big falls, the only notable exception being Japan, where inflation has remained remarkably subdued, and the Bank of Japan has reaffirmed its policy of yield curve control and committed to buy unlimited amounts of 10-year government bonds to cap the yield at 0.25%. Inevitably the currency has taken the strain, with the yen down 6.2% in April and 11.3% YTD against a resurgent US dollar. All major currencies have fallen significantly this year, and the USD trade-weighted index has risen by 7.6%, including a rise of 4.7% in April, taking it to a 20-year high. With the Fed's much more aggressive monetary tightening than other central banks and rapidly rising interest rate differentials in favour of the dollar, further rises cannot be ruled out, in effect imparting a significant tightening of financial conditions globally through the dollar's status as the world's reserve currency and the widespread use of dollar borrowings, especially across developing countries.

We undoubtedly face a much more challenging environment than for some time, but, importantly, there are no significant systemic risks arising from the deterioration in the outlook, and unlike in the Global Financial Crisis, banks are in strong financial shape and well placed to handle the difficult period we are entering. The economy starts from a strong position, with a very robust jobs market, and household wealth and corporate balance sheets in good shape.

The next few months are likely to be volatile and uncertain in markets, but as we move through the second half of the year inflation is likely to have peaked, the Fed's tightening well underway and the risks from war diminished. Equity markets have already corrected, in some cases materially, from peak levels and are offering some valuation opportunities on a longer-term perspective. With careful diversification, now more important than ever, we believe it is important to ride out the short-term volatility and stay invested for those longer-term opportunities now emerging.

Source: Momentum Global Investment Management, Bloomberg Finance L.P.

16 May 2022

Venturing overseas

Andrew Hardy, CFA

With the skies and borders mostly open for international travel again, I've been visiting our parent company's home market of South Africa this past week, a welcome opportunity to catch up with colleagues and clients in person. The hot topic has been investing overseas, following the local central bank's recent relaxation of offshore investment limits; now investors can take up to 45% overseas. One of the many questions this brings into focus – for investors there but also around the world – is the risks that come with having so much of a portfolio invested overseas, and how best to manage them.

The high-level risks one must consider fall into the same categories as those found in the domestic market (macroeconomic, political, market related, geological etc.) but now with many more underlying shapes and colours. While the number of risks is multiplied across many geographies and regions, they're of course not additive due to diversification benefits.

It's important to remember that risks aren't necessarily all bad; investing is all about deliberately exposing oneself to many such risks on the basis that they are rewarded over the long term. For instance, over a very long period of the last 122 years, investors in US equities have achieved approximately a 7% annual real (above inflation) return[1] – handsome reward for bearing the associated risks!

Currency risk is often the first thing investors worry about when going overseas, however it's by no means unique to international portfolios. Consider the contrasting fortunes (on average) of net importing business in the domestic market, relative to net exporters for a given move in the domestic currency. This is the manifestation of an indirect currency exposure. The greater concern attached to direct exposure to international currencies is reasonable, given it can be one of the more volatile risk factors in the short term, however, it usually has less impact over the long run.

Often risks can lie undetected beneath the surface; a portfolio of hundreds of stocks across multiple geographies might appear well diversified but could still be heavily exposed to a common underlying risk factor, such as if they were all heavy importers of a certain raw material. Another more subtle example would be taking an overweight to 'value' stocks while underweighting interest rate duration – both are likely to detract from performance at the same time e.g., when bond yields are falling.

The key to more effective and successful risk management in any portfolio, domestic or international, is to understand and monitor the various risks, while ensuring the right level of exposure to each. Asset allocation is a key part of this solution, but not everything. A well-constructed portfolio should capture as much of the benefits of the desired rewarded risks as possible (for a given overall risk budget), while diversifying as much of the associated volatility away as is possible by mixing in un/low correlated assets as far as possible.

A good case can be made for strategically allocating to a broad basket of defensive or diversifying assets at any given time, especially given the range of choices an international universe brings. The allocation of a multi-asset portfolio to this area could fluctuate over time depending on the opportunities in other asset classes, but diversifying your diversifiers beyond just government bonds, to include areas such as precious metals, real assets, hedge fund strategies etc. brings huge diversification benefits for portfolios.

The various risk factors an international portfolio is exposed to will manifest themselves to varying degrees through time and will drive divergence in returns relative to other asset classes, countries, or broad benchmarks. Rather than fearing this, the associated volatility can be welcomed by those in a position to take advantage of the valuable tactical asset allocation opportunities it brings.

As a current example, we believe the Japanese equity market represents an exciting long term investment opportunity. In aggregate the market appears undervalued relative to its earnings power and asset values, but a position becomes more compelling when you factor in that the economy and stock market is relatively lowly correlated to Western markets. On top of that, there's arguably a greater potential reward for active management there, due to the depth, breadth, complexity, and low sell side coverage of the market.

The bottom line is that international investment risks can and should be managed, not eliminated. As with investments in the domestic market, good risk management requires a long term, consistent process with carefully considered and deep diversification across asset classes, strategies and currencies. Furthermore, we believe in always having a very deep understanding of the strategies or securities we hold before investing in them, as being selective about what you hold in the first place is one of the best and most underappreciated forms of risk management. Most of us have encountered our share of surprises or troubles on foreign expeditions, and have learnt it pays to set off well prepared...

Source: Momentum Global Investment Management, Bloomberg Finance L.P. [1] Yale University, http://www.econ.yale.edu/~shiller/data.htm

25 May 2022

Definitely Maybe

Richard Parfect

In our industry there is often a level of expectation placed upon fund managers to fully understand everything that is going on and, worse still, to have Sage like skills in predicting the future. This pressure is heightened should the unfortunate individual concerned be in the public eye or rolled out in front of the media to give comment on events. Of course, the investment industry is not alone in this.

When someone is interviewed on the premise of being an "expert", I am reminded of Michael Gove who commented in the lead up to the Brexit vote in 2016 who said, "I think the people in this country have had enough of experts…"

Recent tragic events in Ukraine have illustrated in depressingly graphic detail how badly "experts" can get it wrong. From the governments and their agencies who were convinced with all certainty that Putin could be contained through economic cooperation; to the armchair commentators who (so far falsely) predicted Ukraine would be defeated within a few weeks; we have seen how the "known unknowns" are often beyond the analytical skills of even the most informed.

Over confidence in the prediction of something positive or negative is an easy trap to fall into - as they say, "a little knowledge is a dangerous thing". Such excessive conviction is what leads towards the mispricing of assets that we seek to exploit. One such example is an investment that we have to admit to having got partly wrong prior to COVID, but in more recent times has defied market expectations and added value to our portfolios:

We have been investors in two aircraft leasing vehicles, which without going into too much detail have two key components to them: a lessee in the form of Emirates and physical assets in the shape of a portfolio of A380 "super jumbos". Entering a global pandemic with such an asset was admittedly painful (but not excessively so as we are careful with sizing our investments). Despite aviation shutting down, the high-quality counterparty of Emirates came through, as they continued to pay their lease obligations, consequently we received our contractual income on time and in full. Meanwhile, turning to the physical asset value, industry "experts" had professed with complete certainty that the pandemic was the final nail in the coffin for the A380 and that all operators would retire them as soon as possible.

Fast forward to this year, and despite a war waging in Europe (which one would ordinarily expect to bring aviation to a halt), airlines are struggling to keep up with the level of demand for air travel. They are rushing to reactivate their fleets to enable travellers to reconnect with the world. Of greater concern for Emirates is the protracted delays to the certification process and deliveries of the new Boeing 777x (the purported successor to the A380) and the technical problems befalling the relatively new Airbus 350. The result of these problems with new aircraft means the embedded fleet of A380 aircraft will be crucial to Emirates for many more years to come. Furthermore, other airlines that declared they were to retire their A380s have reactivated them for similar reasons. The result for us is that we received a high level of income from the vehicles through the pandemic and their capital value over the last six months has been strongly positive whilst other "risk assets" have fallen in value.

The moral to all of this is that valuation continues to dictate returns and that the nearest we can get to certainty in investing is, with apologies to Oasis, "Definitely Maybe".

30 May 2022

Upside Down

Gary Moglione

One of my favourite TV shows is Stranger Things and this week marks the release of the much anticipated fourth season. For those who are unfamiliar with the show, it follows the adventures of a group of young friends as they battle with various creatures that enter our world through a portal into an alternate dimension, which they call the "upside down". Looking at markets right now feels like we may have slipped into some sort of alternative dimension…

If we review the market environment over the past ten years there is a very consistent backdrop in the form of:-

- Falling interest rates
- Deflation concerns
- Bull market in risk assets
- Growth stocks outperforming value stocks
- Technology sector driving markets upwards
- Huge expansion in valuation multiples, particularly amongst the highest growth stocks
- High levels of speculation resulting in prices for assets such as cryptocurrency and non-fungible tokens (NFT) reaching extreme levels

Appearing that we entered the "upside down" sometime around the end of October 2021, the current environment is vastly different:

- Rising interest rates
- Inflation concerns
- Bear markets (NASDAQ is down 24% from peak, S&P 500 teetering on the edge of one)
- Value outperforming growth
- Technology sector pulling markets downwards
- Valuation discipline is increasing as multiples contract, particularly amongst the most expensive stocks
- Lower levels of speculative investments causing a crash in value of assets such as cryptocurrency and NFT's

Effectively, the market environment we are now operating in is some sort of mirror image of the preceding ten years. Investors become conditioned by the environment they operate in, particularly when it has had such success and longevity. Many market participants under the age of 35 have only really witnessed one cycle.

Behaviourally we all take comfort from investing with the herd and find it much more palatable to make investments in assets that historically have performed well. As a result, many portfolios have become more and more skewed to assets supported by a falling interest rate environment. This has resulted in a massive allocation to growth and technology stocks with many portfolios ill-prepared for what has been a pretty sharp inflection point.

If you have not already reviewed your portfolio, then I suggest you do and continue to do so periodically. Ensure your investments have not become overly skewed towards the old environment. Many are not aware of bias in their portfolio when it is performing strongly and then are tempted to "buy the dip" when prices start to fall, compounding their losses. Check that you have plenty of diversification across asset classes, regions, market caps, sectors and styles. You are more likely to be light on value stocks and investments with inflation linkage. Liken it to packing your suitcase for a holiday: you will pack some swimsuits for the beach but you may need a raincoat if the weather turns. The same thought process should apply when constructing your portfolio. Looking through history these style cycles can last anything from 2 to 12 years so there is still time to acclimatise your portfolio.

June

A Jubilant Subject

Robert White, CFA

6 June 2022

While we generally do our best to avoid home bias here at Momentum, I propose to break that rule today in recognition of last week's Platinum Jubilee celebrations. Whatever your views on the monarchy, no one can deny that to serve one's country as Head of State for 70 years is truly an impressive feat. Since her ascension to the throne on February 6th 1952, Queen Elizabeth II has lived through seven recessions, met 13 US Presidents and outlasted 14 UK Prime Ministers.

Travelling back in time to her Coronation, the country was in a very different place. Although recovering from a brutal world war, Britain still had an empire with over 70 overseas territories, and formidable presence on the global stage. India had recently gained independence five years prior, and many more countries soon followed. The Queen's reign has seemingly run parallel to a reduction in the UK's global power, and we have seen the rise of the US, Japan, the EU and China as dominant economic forces in her time.

If you ask the UK public what tangible changes they remember over the last 70 years, the most common responses tend to be more mundane, esoteric events. Issues such as the shift from metric to imperial measurement systems are often cited, as is the transition from the pre-decimalised monetary system of pounds, shillings and pence, to the much simpler framework we know today.

The latter provides a good example of just how gradual change has been over the years; the UK's old money system had been in place since Henry II's reign in the 12th century, and it took parliament over a century to make the change after the Decimal Association began advocating for the move in 1841[1]. Nonetheless, the Queen's portrait adorned both old and new notes alike, a welcome sign of continuity for many in a fast-modernising world.

Since decimalisation in 1971, the British pound's decline in value has mirrored Britain's reduced importance on the global stage. The GBP/USD exchange rate has nearly halved from 2.4 to 1.25, and UK consumers have felt the pinch over the years as Retail Price Index (RPI) inflation hit as high as 26.9% in 1975, still well above the rate today of 11.1%.

Despite this, UK consumers have certainly grown wealthier with Elizabeth II on the throne, as steadily increasing GDP per capita provides a useful proxy for improving living standards over the period. Research from analytics firm YouGov also provides interesting insights into how perceptions of the public have changed over The Queen's reign. Somewhat bizarrely, survey data suggests that Britons believe they are wealthier with more opportunities today, however they also believe that general happiness is worse today than it was in 1952[2].

One final encouraging parallel today is the increasing awareness of our environment. As well as the Queen's Coronation, 1952 was the year of the "Great smog of London", a severe and lethal case of air pollution which caused an estimated 8,000 to 12,000 deaths. The response to this crisis was the passage of the Clean Air Act in 1956 which restricted the burning of coal and signals some optimism for future legislative action to the current climate crisis.

Perhaps Prince Charles, the Queen's successor, can have a small part to play in this regard. Prince Charles has been a passionate champion of environmental causes over the years[3], and if the monarchy is to remain relevant to today's youth, the Royal Family will likely have to be vocal on such issues. Whether or not any future monarchs can match Queen Elizabeth's longevity and popularity remains doubtful however, and she will certainly be missed by many when she is gone.

Sources: [1] The Guardian. [2] YouGov. co.uk. [3] Prince of Wales.gov.uk. All other sources from Bloomberg Finance, Ltd.

Emerging Outperformance

Tom Delic

13 June 2022

An investor in Emerging Market (EM) equities over the last 12 years has had a torrid time. The asset class has not only suffered poor returns in both absolute terms since 2010, but also relative to Developed Market (DM) equities, with the latter being driven by the strength of the US equity market.

At the beginning of 2010, EM equities were valued at a premium to both its own historical average valuation, but also versus DM equity valuations. DM equities on the other hand, looked attractive relative to their own history. Starting valuations matter and EM's 4.6% annualised returns from 2010 to 2021 have significantly lagged the 11.6% annualised return of DM equities over the same period.

Today's investor is faced with a different proposition. Since the end of 2021, EM valuations are standing at their biggest discount to DM equities since the late 1990s. What followed in the 2000s was effectively zero returns for DM equities, while EM equities returned 10% annualised. It is early days yet but excluding the effect of Russia which made up around 4% of EM indices[1] at the beginning of the year, EM equities have outperformed DM equities year-to-date.

While relative valuation can be instructive, a more important consideration however is absolute valuation. Part of today's dispersion in valuation between EM and DM can be explained by the elevated absolute valuation of DM equities. After reaching a price-to-book ratio of 3.3 times at the end of 2021, DM equities almost reached bear market territory in May[2], before rallying over the last few weeks. At today's valuation of 2.8 times, the asset class still trades above its long-term average of 2.4 times.

EM equities however trade at 1.4 times price-to-book, below their long-term average of 1.6 times and around a 50% discount to DM equity valuations. This is a much more reasonable starting valuation, and while there is never any guarantee that markets cannot fall further (as we have seen so far this year), we believe a larger margin of safety exists in EM given both absolute and relative valuations.

It is worth repeating that starting valuations matter, but only with a strong emphasis on future long-term returns.

Anything can happen in the intervening period, not least attractive valuations becoming even more attractive, which is a kind way of saying 'a period of poor performance can last even longer'. If you are willing to stay the course however, investing at low starting valuations puts the odds of a good outcome on your side. When EM equities have traded at a price-to-book ratio of 1.4 times or lower, 12-year annualised returns have at least been 10% and have averaged over 15% per annum. For DM equities, the picture is less rosy, with a premium starting valuation producing maximum 12-year returns of 6.9% per annum historically, but an average of just 3.4%. However, this year's weakness has already improved the return outlook for DM equities.

We are big believers in active investment strategies, more so in regions where considerable inefficiencies remain, like EM equities. Using a bottom-up universe of companies to analyse the attractiveness of equity markets, we calculate around one fifth of EM equity stocks trade below a price-to-earnings ratio of 10 times. This compares to just 6% of our North American universe.

Therefore there is plenty of opportunity for an active EM manager to deliver attractive returns, despite what occurs in the mainstream indices, over the next decade or more.

[1]Russia's weight In MSCI Emerging Markets Index (%), MSCI. [2]Bear market defined as a 20% fall from its prior peak. All return and valuation figures sourced from Bloomberg Finance, L.P

20 June 2022

Striking a Chord

Mark Wright, CFA

Just over a month ago the United Kingdom (UK) reversed years of embarrassment to finish second place in the Eurovision Song Contest. Sam Ryder's 'Space Man' impressed but was pipped to the post by Ukraine's entry, 'Stefania' by Kalush Orchestra.

Popular opinion is that politics has a big influence on how votes are cast, and this year's result did nothing to dispel those suspicions. It is not inconceivable that the votes cast for Ukraine merely reflected an act of solidarity towards a nation that has tragically found itself mired in war. The UK has also been one of Ukraine's strongest allies – it was the first European country to supply lethal aid.

Prior to this year's competition, the UK's poor performance between 2015 and 2019 was often cited as the consequence of damaged relations from Brexit. The UK finished in the bottom five in four of those years1. In the other year, Lucie Jones' 'Never Give Up On You' still only managed fifteenth, leaving the UK firmly in the bottom half of the points table.

Before Brexit entered the British vernacular however, the UK often found itself placed in the bottom quintile; finishing twenty fifth in 2008, 2010 and 2012 – quite a record!2 Ukraine also had great success prior to this year's competition, finishing fifth as recently as last year and winning back in 2016[1]. So what else could explain the UK's turnaround?

According to Mark Savage, BBC Music Correspondent, representing the UK in Eurovision became a poisoned chalice. Given the UK's abysmal track record, record labels were unwilling to put capital at risk in upcoming popstars for them to only then finish humiliatingly near the bottom of the points table[2].

However, following the commercial success of last year's winners, Italian rock band, Maneskin (who have since toured with The Rolling Stones), there has been a change in attitude within the UK's music industry. A willingness to take risk and invest in both talent and production has now potentially freed the UK from the shackles of Eurovision misery. Sometimes it pays to be bold.

To deliver successful returns for shareholders, it is essential that companies are equally willing to put shareholder capital at risk, invest in the future and take bold decisions. Two companies we have recently invested in have demonstrated a willingness to do just that.

Games Workshop is the world's largest hobby miniatures company. Hobbyists collect, assemble, paint and build armies of these miniatures that they then take to battle in large fantasy tabletop wars. The company is best known for its Warhammer: Age of Sigmar and Warhammer 40,000 universes.

Games Workshop has nearly quadrupled its asset base over the last ten years without making a single acquisition[3]. The returns from this investment has enabled the company to grow its dividend per share more than six-fold over the same time period. Along with investing in the quality of its product offering, management also took a bold decision to reinvent longstanding Warhammer Fantasy Battle as Warhammer: Age of Sigmar, which has paid off handsomely.

Cranswick, the UK's largest pork processor (it processes over 60,000 pigs a week), recently increased its dividend for the thirty second consecutive year[4]. Over the last decade, the company has put shareholder capital at risk by spending over half a billion pounds on building state of the art manufacturing facilities to maintain a competitive edge through industry leading margins.

Cranswick also took the bold decision to enter the poultry market the same year that Games Workshop reinvented Warhammer Fantasy Battle. Shareholders have been rewarded - its market share now stands at high single digits, and it contributes twenty percent of group revenues. Management see no reason why the division cannot ultimately be the same size as the existing pork business which has over a 30% market share.

Risking capital alongside bold decisions often reaps reward. Hopefully, the UK's pop industry won't revert back to past timidness and Eurovision misery will prove a thing of the past.

Sources: [1] Eurovisionworld.com, [2] bbc.co.uk. [3] Games Workshop Group Plc, [4] Cranswick Plc

27 June 2022

Inflationary Pressures

Jackson Franks

Having a Swedish partner meant that this weekend was spent eating a whole load of pickled herring and drinking unsweetened flavoured schnapps. For those who are unaware, this means it was Midsommar, an annual celebration in Sweden which celebrates the middle of summer. The festivity consists of a never-ending lunch party which involves flowers in your hair, dancing around a maypole, singing songs and enjoying the acquired tastes of the above-mentioned food and drink. This year we spent it in Hyde Park and were lucky enough to be close to The Rolling Stones Hyde Park concert. So, whilst Gimme Shelter was playing live in the background, we were dancing around the maypole singing Små Grodorna, which translates to The Little Frogs. You can make your own mind up, but I know where I would have rather been...

Surprisingly this year's maypole, which is traditionally made from birch, pine or ash and bound with leaves, flowers and ribbons, had its main structure built from steel. The organisers must have been thinking about longevity over price, as over the last 12-months structural steel prices have increased by 38.5%1. Steel is not the only commodity that has seen its price soar. Over the 12-months to June 2022, aluminium, timber and concrete were all up 41%, 30% and 28%, respectively[1]. With these being key materials used in developing an asset (which typically accounts for 25% to 30% of the total build cost) margins within the sector are being squeezed, and we are starting to see the impact.

Here in the UK, the construction industry is booming. What should translate to healthy profitability for building companies has in fact seen more than 3,400 smaller UK construction businesses enter administration in the year up to April 2022, the highest number since the global financial crisis. Soaring material and labour costs have caused construction prices in the UK to increase by 25% over the last 12-months[2]. The inflationary pressures are hitting the smaller construction companies harder than the larger companies. Where larger construction companies have access to cash to buy supplies in advance, visibility on demand, room to store materials, and the ability to pass the costs on to customers, smaller builders do not.

However, larger developers may begin to feel a tighter squeeze in the months to come. Adding to the already soaring material prices, energy costs continue to rise, meaning plant equipment on building sites are becoming increasingly more expensive to use, and therefore margins will continue to tighten.

Nevertheless, with the construction industry under significant pressure, current asset owners may be the beneficiaries. Due to the ever-rising costs in developing a new asset, the new supply coming to the market is minimal. Berkley Group, one of the UK's largest home builders, recently announced that the number of new homes being built in London could halve in the coming years because of these rising costs. With a lack of new supply entering the market, competition for existing space may intensify, enabling landlords to take advantage as supply and demand dynamics shift across sub-sectors.

At Momentum, we gain our property exposure by investing directly and indirectly in REITs and property companies. Our managers are highly skilled in the form of their asset management capabilities and capturing opportunities within their specified sub-sectors. Both these factors are key in providing a positive impact on shareholder returns over the long term.

Sources: [1] Energy & Petroleum Regulatory Authority (EPRA), Main Suppliers of Construction Material in Kenya, KNBS & MACE YMR.
[2] Department for Business, Energy and Industrial Strategy

July

4 July 2022

Buy Now, Paid Lots

Matt Connor

Over recent years, the acronym 'BNPL' has dominated headlines due to the stratospheric rise of companies such as Klarna and Clearpay offering consumers a modern spin on a type of credit that was made popular in the twentieth century, instalment plans. Headlines associated with Buy Now, Pay Later have overwhelmingly been negative as regulators look to crack down on loose lending amid the cost-of-living crisis.

In this week's Global Matters Weekly we focus on 'BNPL' stocks; high dividend-yielding companies within our UK Equity portfolio that you can Buy Now, (and be) Paid Lots.

Our first example is Vistry Group, the UK's 'Large Housebuilder of the Year' with an estimated dividend yield of 8.8% that has grown by over 7% per annum over the last five years[1]. This impressive yield is coupled with an attractive valuation, trading at only 0.8x of its book value for a business that delivers double-digit return on equity.

In its latest results, Vistry delivered exceptional financial performance, growing revenue by 23% and doubling adjusted operating profit. It has since commenced a share buyback programme. The current housing market backdrop of high demand and lack of supply is overwhelmingly encouraging for Vistry, who have seen the positive momentum continue into this year and have already guided that pre-tax profit will be at the top-end of market forecasts, as a result of price increases outstripping build cost inflation.

An inflation beating dividend yield, high cash generation, and strong Environmental, Social and Governance (ESG) credentials sounds too good to be true, especially in the current high inflationary environment. However, Diversified Energy Co ticks all those boxes with an estimated dividend yield of just shy of 12%, having grown 13% per annum over the last three years with cash conversion of 93% and a $15m investment in reducing emissions[2].

Diversified Energy owns, operates, and retires natural gas wells in the United States (US) and produces enough natural gas to meet 5.5% of daily residential US demand[3]. Whilst on the surface a producer of natural gas may not seem like the best ESG candidate, it is the cleanest fossil fuel and Diversified Energy has a sustainability focus at the core of its business. The company performs asset management on existing oil and gas wells, preventing additional environmental impact of drilling new wells as well as removing a large financial liability of retiring wells from the States where it operates. Diversified Energy also recently invested to focus on leak detection and well retirement, exceeding its State-obligated targets by 70% for the latter.

As rampant inflation is at the forefront of investor's minds and with yields on cash and gilts dwarfed by inflation, high-yielding and undervalued companies may provide investors with attractive returns from both an income and capital appreciation perspective.

Sources:[1] Vistrygroup.co.uk. [2]Diversified Energy: 2021 Annual Report – cash conversion. [3]Diversified Energy: 2021 Sustainability Report

11 July 2022

Inflation Licked Bonds

Alex Harvey, CFA

Before the 4th of April this year, it cost 85 pence to send a letter first class in the UK. After that date you have needed to stick another 10 pence stamp onto your letter to maintain its first-class status. But if you had a '1st' class stamp knocking about in a drawer, it effectively increased in value by an inflation busting 11.7% this year (and 11.8% the year before that). That's because, as I recently learned, in the UK a postage stamp with '1st' or '2nd' class on it holds its 'class' value through time, even after the annual increase in the price of sending post. Luck runs out for wannabe stamp arbitrageurs at the end of January 2023 however, as Royal Mail looks to introduce barcoding on these stamps, but there will be a two month 'stampnesty' when old stamps can be swapped for new.

50 years ago, it cost 3 pence and 2.5 pence respectively to send a letter by first- or second-class post in the UK[1]. At 95 pence and 68 pence today, that equates to an annualised increase of 7.2% and 6.8% respectively for first and second-class stamps. Over the last 25 years, a period of lower inflation (until this year), their prices have increased by an annualised 5.3% and 5% - more than twice the UK's Consumer Price Index (CPI) rate of 2.1% annualised over the same period. In fact, they almost match the 1-10 year UK Inflation Linked bond index's annualised return of 4.9%. That's pretty good inflation protection, if an unexciting one (apologies to the philatelists out there). And since 2001, Christmas hasn't tasted the same after the arrival of the first self-adhesive stamps.

When it comes to inflation though, postage costs are probably not front and centre of people's minds. Utility bills, food and petrol prices have all been rising sharply in recent months, with the last data release showing that consumer prices in the UK rose by 9.1% year-on-year through May, up slightly on the prior month's 9%. In the US, the equivalent number is 8.6% with the numbers for June out on Wednesday 13 July, expected to show another increase to 8.8%. Core inflation there is expected to fall again, as it did last month, in both the US and the UK but it remains at around 40-year highs. One way to protect against inflation is by owning inflation linked bonds whose coupon and principal (the amount to be repaid) is linked to an underlying inflation index , CPI in the US and Retail Price Index (RPI) in the UK. They also embed the market's expectation for future inflation and can be a useful bellwether for inflation pricing. Back in March 2020 – what was arguably 'peak Covid' for financial assets – expectations for future inflation, as measured by the inflation 'breakeven', fell off a cliff such that US 5-year inflation expectations dropped as low as an annualised 0.11%. The US 10 year breakeven rate fell to 0.47%. This provided a significant relative value opportunity for our funds which held Treasury bonds, and which could switch into Treasury Inflation Protected Securities (TIPS). The 175bps increase in 10 year breakevens from mid-March 2020 to the end of June 2022 resulted in a whopping 20% outperformance of TIPS over nominal Treasuries.

As with most insurance though, you need to buy it before the event, and this trade was largely exhausted by the start of the year. Much of this inflation risk has since been recycled into strategies that benefit more directly from inflation once it is going up, rather than from future inflation expectations. Over the course of the last year, we have increased our exposure to real assets – those which have an intrinsic value, such as real estate and infrastructure – much of which generates an income that is directly or closely linked to inflation. As outcome based multi asset investors these strategies, along with equities, are some of the most effective at capturing this inflation 'pass through', and arguably their best returns remain ahead of them. A must have for any investment collector's album.

Sources: [1]https://channelx.world/2019/03/historic-royal-mail-stamp-prices-1971-2019.
Unless stated all other sources Bloomberg Finance L.P.

18 July 2022

Outrunning dinosaurs with artificial intelligence

Lorenzo La Posta, CFA

I am a Millennial, born in the early 90s, which makes me probably one of the last generations to have experienced life before digitalisation took over. Maybe I was too young to be afraid of the millennium bug, but as a kid, using the internet meant monopolising my home's landline. Digital technologies, once a premium item for few, are today embedded in all aspects of our lives and have brought significant changes and improvements to the way we live and operate. Across the many fields of digital innovation, artificial intelligence (AI) has been the most mysterious and perhaps misunderstood: not just an inspiration for fantasy novels, but a game-changer in information processing, used today mostly in search engines, autonomous vehicles, facial recognition, virtual assistants, and automatic language translation.

Ever since the two letters were first put alongside in the 1950s, AI has seen lovers and haters; those who think robots are going to revolt and destroy mankind and those who think AI is just a cool nickname for using a calculator. The reality is (as always) more boring and way simpler: artificial intelligence is simply a discipline across mathematics, statistics, and information technology that seeks to mimic human cognitive skills within a computer. These skills include learning, processing, perceiving, rationality, and logic.

The investment industry has been trying to take advantage of AI to provide better services, from a customer relation perspective to user experience, or from investment strategies to risk management. In particular, we have been exploring what benefits an AI interface can bring to an investment strategy, especially when integrating digital and analogic, quantitative and qualitative, machine and human brain. A well-trained machine can analyse large datasets and discover new information, change, and adapt to fast-changing dynamics, compensate for human cognitive biases (hindsight, hedging, anchoring, confirmation bias etc.) and for human weaknesses (the struggles with complexity), with immediate application in security selection, asset allocation and research, more generally. We still have question marks, but the more we learn about it, the more we see the strengths and weaknesses of incorporating artificial intelligence within an investment process. Naturally, there are also some myths and untruths to put right. AI is not always right, especially when the input data is "trash", or problems are ill-defined; AI is not a black box, or at least no more than a person's mind; AI is not just a fancy name for a quantitative strategy, as the latter is a human-driven, human-defined set of rules while the former is only a human-supervised autonomous process; and AI will definitely not solve all your problems, as that would be called "magic".

As an investment manager, we need to keep exploring the extent to which artificial intelligence can enhance our existing investment research capabilities. We need to operate closer to the frontiers of where technology is going. Unless we can tap into that and adopt a more flexible approach to technology, we will lose out as an industry. We risk becoming dinosaurs.

25 July 2022

Finding your anchor

Stephen Nguyen, CFA

What a difference a few months make. After a relatively calm year in 2021, we have witnessed several asset classes posting significant losses in the first half of 2022, including equities, credit, and sovereign bonds. We have seen an increase in volatility, and traditional diversifiers like government bonds have failed to provide protection as their correlation with risky assets has risen. The increase in correlation between bonds and equities has caused major headaches for the traditional multi-asset investors. It is worth remembering that asset prices habitually swing from week to week and at times, even intraday. Stock markets are volatile creatures and while historically they have reliably delivered strong returns when held for the long run, it is anybody's guess what will happen in the short term. You cannot control the market, but you can control how you react to it, by finding your anchor.

Markets have been very choppy amid mounting concerns about the economic and corporate earnings outlook. Investor sentiment has deteriorated over the course of the year due to many factors, not least the ongoing conflict in Eastern Europe, supply chain disruptions and soaring food and energy prices (pushing inflation to levels not seen for decades). Consequently, corporate margins are under pressures from surging producer input prices and rising labour costs. Central banks' 'transitory' view on inflation has, in hindsight, proven to be incorrect and they are now being forced to act much more aggressively than initially anticipated by both themselves and investors. The probability of a 'soft landing' is diminishing as the cumulative effects of these front-loaded rate hikes could potentially push the economy into a recession.

We believe market volatility is likely to persist in the coming months, but we are hoping to see some of the biggest drags on markets ease in the second half of the year: more visibility on the corporate earnings outlook; inflation peaking; and the Fed's tightening coming closer to its end.

Losses in sovereign bonds are somewhat to be expected as the rate re-pricing began from an unsustainably low level. However, the pace of the rise in bonds yields has caught investors by surprise. The market is struggling with the (low) growth vs (high) inflation dilemma, and this has led to continued elevated volatility in bonds. Corporate spreads have also widened meaningfully, albeit from extremely low levels at the end of last year. At the same time, the decline in equities so far this year, particularly in the US, has been predominantly driven by a contraction in multiples.

We are conscious of the risks but can also identify longer-term opportunities. Equity valuations are now more attractive having seen multiple de-ratings across all regions. Meanwhile government bonds in the US are now offering higher yields across the curve, making them more appealing. Spread products (i.e. high yield) are already pricing in economic weakness and a pick-up in defaults which present opportunities for active investors. We continue to see promising opportunities presenting themselves in Japanese and non-US equities, and we are paying closer attention to US equities as valuations there become more attractive.
During times of turmoil, it pays to find your anchor and stay true to what works best and reliably over the long run. We let our bottom-up valuation discipline steer us towards the most attractive opportunities, whilst being mindful of the risks. Portfolio construction resiliency is important at the best of times, but it becomes vital when the seas are turbulent.

Investors should stay broadly diversified and remain patient when allocating to risky assets. One of our tenets is "diversify your diversifiers", and this has become increasingly important in recent months. While traditional diversifiers in the form of US Treasuries and gold have come under pressure this year, our allocation to Chinese government bonds and liquid alternatives have held up much better. Stocks are not outright cheap by historical standards; however, they are no longer expensive.

The biggest risk for investors is not price volatility, but rather the probability of not achieving their longer-term investment objectives. However, we are cognisant that short-term price swings could lead investors to act irrationally. Stay invested, be prepared for a bumpy ride, but avoid the temptation to try and time the next recession.

August

1 August 2022

Build up not out

Richard Stutley, CFA

I met with one of our underlying global listed property managers last week and I thought some of the discussion points were worth repeating here. Until such time that we all live in the metaverse, what is happening with physical space remains important, with implications for investors beyond dedicated property buyers.

From a sector perspective, we discussed the supply outlook for industrial/logistics space, following Amazon's announcement earlier this year that they plan to mothball several new warehouse projects and sublet excess space. Amazon front-loaded securing new space in the immediate aftermath of the pandemic, to ensure they did not run into capacity issues further down the line, and now they are refining their plans. Despite Amazon's size, the impact of this change is expected to have only a modest impact on the supply of logistics space[1]. Is there scope to double or triple existing space by building premises up and not out? As unlikely as it sounds, Prologis have tried exactly this in Japan, but the fact that the initiative appears to have run out of steam suggests the build costs are uneconomical at present.

In terms of global listed property fundamentals, data tends to be less timeous compared to other asset classes, but we can nonetheless make certain observations based on what we have seen so far this year: rental growth is accelerating for most property types, led by industrial and apartments, which are enjoying close to record rental growth[2]. Driving that strong rental growth is ultra-low vacancies: vacancy rates are now at historic lows in several sectors, with the exception of offices[3]. Taken together, demand-and-supply dynamics are leading to lower vacancies, higher rents, and higher prospective earnings.

Debt is a great way to ruin a good investment (the business may endure, but your ownership will not). Property companies are lowly levered by historical standards[4] and that debt is extremely easy to service[5] at present. Interest coverage ratios have improved across the vast majority of companies[6], rather than just at the headline level, hence there is less risk of contagion from a reasonable-sized cohort of distressed companies. What about rising interest rates? Companies have extended the maturity of debt[7], buying them time should we be about to enter a prolonged period of higher interest rates. They also have access to more diversified sources of financing (primarily public debt markets and other non-bank lenders, like private equity debt funds) and are therefore less reliant on the traditional banking sector.

With regards to inflation, looking at the average company's cost base[8], they are relatively insulated from rising costs of goods and services. Instead, taxes are the biggest part of costs, which are linked to property prices, which in turn are linked to demand and supply. If demand strength is leading to increases in your costs, then it stands to reason that you can pass those costs on in the form of higher rents.

Overall, fundamentals look good in our assessment. However, armed with this information alone, one still does not know whether global listed property is a good investment. Critically, a reasonable amount of the deteriorating macroeconomic outlook appears to be in the price (2.4 standard deviations cheap on the basis of price to book[9]), although prices are still some way above crisis troughs like in Q1 2020. Further rises in real interest rates would pose a challenge to the sector, as would a derating on par with those kinds of crises, but the asset class looks reasonable value from a top-down perspective today, with more opportunities for active managers under the surface.

Sources: [1]"the amount of space that Amazon is expected to sublease equates to 0.2% of total industrial inventory and would increase available supply growth from 2.6% to 2.8% in 2022". Catalyst Fund Managers Quarterly Fund Commentary 2022 Q2. [2]CoStar, NAREIT. Data as of 2022:Q1. [3]CoStar, NAREIT. Data as of 2022:Q1. 4S&P Capital IQ Pro, NAREIT T-Tracker®. 5S&P Capital IQ Pro, NAREIT T-Tracker®. 6S&P Capital IQ Pro, NAREIT T-Tracker®. [7]FactSet, NAREIT, Federal Reserve Economic Data (FRED), Raymond James research. [8]Catalyst Fund Managers. [9]S&P Global Property USD Total Return Index, as seen on Bloomberg. Daily data from 15/04/2013 to 28/07/2022. Trimmed mean excluding top and bottom 10% of observations.

8 August 2022

Shinzo Abe; a tragic death but a promising legacy

Robert White, CFA

Japan has been in the headlines for the sad and shocking death of Shinzo Abe, one of the few truly visionary democratic leaders in modern times. The former Prime Minister was instrumental in transforming Japan's economic and military ambitions, and while both remain a work in progress, he became a revered figure on the international stage. As investors, we are optimistic about the opportunity in Japanese equities; not only are they cheap, but nascent structural reforms and robust corporate profitability should provide a healthy tailwind over the coming years. As a result, our Japanese equity allocation is one of our largest overweights today.

The valuation case for Japan is nothing new; Japan has been consistently cheap over the past two decades, both in relative and absolute terms. Despite being a value trap for much of this time, the extent of the valuation gap relative to the S&P 500 is now historically large, despite a small retracement this year.

Aside from the equity market, the yen also looks cheap on purchasing power parity terms, undervalued by over 30% relative to the dollar according to Organisation for Economic Co-operation and Development calculations. This comes as we enter what has historically been a strong month for the currency, and growing recession fears combined with lower US yields over the last month should provide some support for the yen, which has struggled so far this year.

Part of the currency's weakness has been due to continuing easy monetary policy, now sharply diverging from Western central banks which have been aggressively tightening. The Bank of Japan (BoJ) maintained its negative 0.1% short term interest rate target in July, as well as its yield curve control policy and quantitative easing program. These extraordinary measures are consequences of Abe's bold economic reforms dubbed "Abenomics", which focussed on three arrows of change through higher government spending, loose monetary policy, and structural reforms.

While current Prime Minister Kishida has somewhat distanced himself from Abe's economic program, putting more emphasis on narrowing the wealth divide, Japan's monetary policy has remained accommodative as a reaction to a chronic lack of inflation. Kuroda's goal as Bank of Japan (BoJ) governor has been to reverse two decades of deflation that has curtailed long term growth. As global inflationary pressures have risen, consumer price inflation in Japan has risen to 2.4%, above the targeted 2%, however it remains well below the US at 9.1%.

Intriguingly, there have been numerous reports of Japanese firms increasing prices for the first time in decades[1] something that was recognised in the latest BoJ meeting summary, published last week[2]. It seems that the BoJ is keen to increase the likelihood of sustained and stable wage price increases to break the deflationary rut that has embedded itself in the Japanese economy. This stands at odds with concerns about wage price inflation and the impact on corporate profitability in the US, and this is because Japan (and Asia in general) is on a very different cyclical path to western economies, given proximity to the economic slowdown in China.

It is important to also recognise that Japan does have long term structural issues that have held back growth in recent decades. Notoriously, the country has the world's oldest population with a median age of 48.4 years[3]. It is also shrinking due to the low birth rate, and because immigration is low due to cultural, as well as language barriers. Without population growth, economic growth has been difficult to achieve. Despite this, corporate profits have been encouraging, and we think a big reason for this has been the structural reforms which have been undertaken in recent years.

The main thrust of these reforms has improved corporate governance of Japanese companies, with the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015. These changes have helped to increase institutional and foreign ownership, while also reducing crossholdings, increasing director independence, and increasing mergers and acquisitions activity. Shareholders return on equity has been increasing as a result, and we think that the recent upward trend here can continue.

Here at Momentum, we are accessing this opportunity through active, mid cap Japanese equity specialists with a focus on domestic companies. Specialist managers are important in Japan, where it pays to understand the language and culture when meeting companies, and there are plenty of undiscovered gems in the 1,800 stocks listed on the local exchanges. In a global market which has become overly concentrated in a few giant US technology stocks, Japanese equities should form an important part of any truly global portfolio today.

Sources: [1]https://www.theguardian.com/world/2022/jan/27/japans-favourite-snack-falls-victim-to-global-inflation-with-first-ever-price-hike, [2]https://www.boj.or.jp/en/mopo/mpmsche_minu/index.htm/, [3]https://www.imf.org/en/News/Articles/2020/02/10/na021020-japan-demographic-shift-opens-door-to-reforms. All other sources from Bloomberg Finance, L.P.

15 August 2022

Change - it's a constant

Richard Parfect

Back in February I gave a sob story of my childhood of how the 1970s and early 80s saw "austerity" hit my household, including my father's industrial clothing factory closing down. Recent developments on the Continent, brings another childhood memory to mind; cold housing. Admittedly, the central heating system, decades past its use by date and an insufficiently insulated house, was not conducive to staying warm. However, an article caught my eye in the Financial Times[1] this week that showed the average temperature in British homes has risen considerably since the 1970s; even those that actually had central heating in 1971 saw average temperatures rise from circa 14C to 18C today.

What does this tell us? Well probably a variety of things: insulation has improved (but remains broadly sub-standard), meanwhile households have (broadly) become wealthier and can afford to stay warmer (until the current energy crisis at least anyway). However, the most impactful change, has been a change of behaviour. A while ago, I was amazed to hear from someone that they kept their heating over 25C; quite how that is even comfortable frankly escapes me. I suspect their thermostat will be turned down this Wintertime.

Being a grumpy middle-aged father, I am frequently having to turn off lights in abandoned rooms, telling my daughters we aren't a lighthouse, whilst also reminding them that they have perfectly serviceable jumpers to wear. There will certainly be a lot more similar conversations being had in other households. Even more illustrative, German leisure centres have turned off the hot water; whilst in Spain commercial premises are banned from adjusting the thermostat below 27C in the Summer or above 19C in Winter.

Such policies would have been unthinkable a few years ago, despite such significant behavioural change that would have been helpful for the climate emergency that we are now sadly witnessing. Whilst outright rationing may or may not hit the UK's shores (the politicians publicly say not, but I am not so sure), the prices households are going to face this Winter are going to force a change of behaviour, that is tantamount to self-inflicted rationing.

The risk that Russia completely turns off the gas taps is real, and that event alone presents Europe with a huge binary risk for its economy, as German industry in particular will have to play second fiddle to the priorities of keeping the population warm(ish). Even if the war in Ukraine ended and regime change in Russia were to occur in the very near term, there has been a wakeup call to all nations, that unfettered globalisation and a dependence on the kindness of strangers is not a very resilient model (COVID had already shown us that).

Governments, households, and investors alike always need to have an eye on the "what if?" scenario and have something to call upon to at least alleviate the worst effects of things beyond their control. In our portfolios, apart from the obvious activity of diversification, we seek to ensure there are investments that benefit from negative scenarios, whether it be renewable energy trusts, inflation linked infrastructure, or the age old "port in a storm" against the most aggressive of exogenous shocks, gold. For the only thing we can be certain of (other than death and taxes) is change.

Sources: [1]Financial Times: "Energy crisis: shiver not at colder houses and warmer clothes" August 6 2022.

22 August 2022

Navigating fund fees and finding value

Gary Moglione

As investors in the investment trust market, we have seen the UK market grow significantly over the years. In addition to diversification and access to many asset classes not usually available to retail investors, closed-ended trusts have significantly outperformed open-ended funds over the long term. In the UK, over the ten years to September 2021, the average investment company returned 265% versus the average open-ended fund returning 70%. The AIC provides a good article explaining the benefits of the closed-ended structure.

https://www.theaic.co.uk/financial-advisers/guides/investment-company-performance-vs-oeics

However, new regulations in the UK are making it increasingly difficult for multi-asset funds to hold investment trusts. This is because we are having to report much higher fees for these vehicles in the form of "other ongoing costs" than we otherwise would with directly held equities or funds, thereby making our own UK funds seem more expensive.

Let's consider an example of two investment vehicles with no assets other than £100m to invest. One is a listed UK Equity, the second is a closed-ended vehicle. If each vehicle uses their £100m to buy the same asset what would a multi-asset fund reportable cost be for holding each vehicle? The UK Equity could report zero cost, as we would not have to report "look through costs". Meanwhile, in addition to the management fee, the closed-ended vehicle would have to report indirect ongoing costs such as board costs, auditor fees, marketing costs, transaction fees, finance costs etc and borrowing costs. The result often leads to reported costs of 2 to 3%. Most of these "look through costs" would also be incurred by the UK Equity but are not reportable under the current regulations.

Therefore from a cost reporting perspective, it is more beneficial to hold direct equities than closed-ended vehicles, despite the strong performance and structural advantages. It creates a perverse incentive to keep costs down by holding investments that may not have the best total return prospects.

Most of our property exposure is in closed-ended vehicles (real estate investment trusts or 'REITs'). The reported costs are higher than direct equities, such as British Land or Property Funds, but the structure is much more efficient for investing in property. As a result, our closed-ended holdings within the VT Momentum Diversified Income Fund that were launched over five years ago have an annualised return of +8.23% versus the average open-ended property fund +3.96% and British Land -1.62%. If cost had been the deciding factor, British Land would have been chosen, resulting in 10% per annum lower returns.

Cost is an important component of returns, so should factor into investment decisions. However, one must consider these various reporting methods to make an accurate comparison. You should also consider what parts of the reportable cost are simply investment managers taking fees and what part are drivers of additional returns. An example is our holding in AEW REIT. It is closed-ended and has a reportable cost of 3.41%. Just 0.9% of this is the management fee, the rest is made up of running costs of the properties, finance costs etc. This year they have realised significant value by developing and selling numerous properties. Despite the high reportable cost, the trust has returned 16.6% after costs over the past year.

In summary, UK fee disclosure regulations create uneven comparisons and risk encouraging investors toward lower reported cost vehicles, rather than investments that have the best risk/reward. An additional complexity is that to date only a proportion of open-ended funds have adopted the new fee disclosure proposals to include closed-ended vehicles, making it difficult for investors to make like-for-like comparisons across funds.

Sources: Unless stated, all other figures sourced from Bloomberg Finance, L.P. Before investing in the VT Momentum Diversified Income Fund you must read the key investor information document (KIID) as it contains important information regarding the funds, including charges, tax and fund specific risk warnings and will form the basis of any investment. The prospectus, KIID and application forms are available in English from Valu-trac administration services (01343 880344) the authorised corporate director of the fund. MGIM is the investment manager of the fund.

September

5 September 2022

The Law of Lindy

Tom Delic

In 1964, American author and academic Albert Goldman wrote an article in US magazine The New Republic, titled 'Lindy's Law'[1]. While dining at Lindy's, a New York delicatessen, Goldman became interested in the discussions that took place between entertainment industry veterans who frequented the restaurant and would analyse the latest televised comedy shows. The unwritten rule amongst the gossipers was that "the life expectancy of a television comedian is (inversely) proportional to the total amount of his exposure on the medium", in other words, the more frequent the comedian was on the television, the shorter the comedian's time in the spotlight…due to running out of material!

Almost twenty years later Lindy's Law reappeared in mathematician Benoit Mandelbrot's book The Fractal Geometry of Nature. Mandelbrot however came to the opposite conclusion and expressed mathematically that the expected survival of an artist's work was, on average, lengthened as the work continued to survive. He called this the 'Lindy effect'.

Mandelbrot's expression of the Lindy effect was popularised and expanded by Nassim Taleb, particularly in his book Antifragile, where he stated that non-perishable items such as technologies, ideas and non-biological objects follow a relationship close to that of a power law, whereby the average remaining life expectancy increases with age. Taleb links the Lindy effect to his theory of fragility, in that time is the ultimate judge, given it exposes everything to shock and disorder. The non-perishable that can survive the passage of time is therefore robust or even anti-fragile, the latter meaning it gains from disorder.

An example of the Lindy effect can be seen in literature. William Shakespeare's Macbeth has been read or performed for over 400 years. We can therefore expect it will be read for another 400 years. If Macbeth features in the curriculum for schoolchildren a century from now, we will then expect the play to survive a further 500 years. Asymmetrically, mortality decreases as age increases. The world is full of non-perishables that have stood the test of time: democracy, fermentation, teapots, double-entry bookkeeping, and so on.

While the Lindy effect is a useful heuristic to apply across many aspects of our lives, we can also use it as a filter in the portfolios we manage for clients. First, we can focus on time-tested investment styles that have been stressed across multiple investment cycles, such as value and momentum. Secondly, we can invest in assets that have centuries of evidence of retaining or increasing an investor's real net worth. Examples may include gold as a reliable alternative to fiat money or an equity investment in a business that has survived war, technological disruption, and everything in between.

This is not to say we cannot invest in new business models but often the most successful new businesses are centred around ideas that satisfy age-old basic human wants and needs. Take Jeff Bezos' answer when he is questioned on what is going to change over the next decade: "I almost never get the question: 'What's not going to change in the next 10 years?' And I submit to you that that second question is actually the more important of the two - because you can build a business strategy around the things that are stable in time… In our retail business, we know that customers want low prices, and I know that's going to be true 10 years from now."[2]

Thirdly, we should diversify, a concept that has endured for many years. Taking a quote from Lindy-filtered book Don Quixote, "It is the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket"[3]. Lastly, we should focus on the long-term, embracing compound interest which is itself a power law that benefits from the passage of time.

Sources: [1]https://www.gwern.net/docs/statistics/probability/1964-goldman.pdf, [2]What's Going to CHANGE in the Next 10 Years? | Jeff Bezos - YouTube, [3]Don Quixote (Part I, Book III, Chapter 9) by Miguel de Cervantes Saavedra [1547-1616]. Translated by Peter Anthony Motteux [1660-1718]. Unless stated, all other figures sourced from Bloomberg Finance, L.P.

20 September 2022

Lessons to learn from Queen Elizabeth II

Ferdi van Heerden

It is not often that an event causes so many people globally to take note and to pause. And all this in the midst of a frenetic and very uncertain world in terms of geopolitics, conflicts and macro-economics.

The death of Her Majesty Queen Elizabeth II has prompted a time of quiet reflection. And I think this also best describes the mood of our nation (and beyond) over the past 10 days since her passing.

But the global recognition of The Queen and the impact of her life on so many should not be surprising: she had a multitude of impactful interactions throughout her reign over seven decades with so many ordinary people as well as world leaders. She was a constant in a world of change. Her legacy will remain and will continue to be a reference for future leaders and all of us.

For me, and all of us at Momentum Global Investment Management, the most valuable reflection has been on the lessons that we can take from how she lived her life. The Queen will be remembered for the values that she lived by. These are also values that we hold dear and that we aspire to live by.

Anchored in principles. The Queen was someone who brought a sense of steadfastness, calmness, durability, continuity… an anchor in a world of change that transcended political, technological and economic changes over many decades. Through all this, she stayed true to her core principles.

A focus on service. She had an innate understanding of what it means to serve, and to be a role model. On her 21st birthday she said: "I declare before you all that my whole life whether it be long or short shall be devoted to your service". Looking back, we can all agree that she truly kept her word.

Delivering on commitments. At her coronation in 1953, The Queen said: "Throughout all my life and with all my heart I shall strive to be worthy of your trust." Again, as far as it was possible for her, she devoted her life to her work and the people that she represented, not only here in the United Kingdom but also across the Commonwealth. She never wavered in this commitment; and will be remembered as a great example of "do as you say".

Connectedness and engagement. One of The Queen's many hallmarks was her networking ability and the way in which she engaged and connected with people. She upheld a strong sense of diplomacy and was known for her inquiring mind and wealth of knowledge. She was a person who could connect, irrespective of her and others' differences. The Commonwealth of Nations of today that she was instrumental in building is a great example of inclusiveness at a global scale. Her influence across the globe over so many years and presence in the world will be missed but will also be remembered for a long time to come.

Continuously reinventing. It is remarkable how The Queen throughout her long reign remained relevant and focused in her contributions and engagements; continuously adapting and reinventing herself. She never lost the moral compass that seemed to guide her, and she remained authentic in herself and her engagements. This, for me, stands out as a key lesson to all of us personally as well as in business. Continuous reinvention is key to success and to staying relevant in an ever-changing world.

Sense of duty above all else. The last image of The Queen receiving the outgoing and incoming prime ministers a day before her death, even though she was clearly frail, is the greatest example of her sense of duty from which she never shied away. What a remarkable commitment. If we could do the same in our commitments, the world would be a very different place. We too often give up or change our ways / direction in the face of adversity. The Queen showed us all what commitment and perseverance truly mean.

Key lessons to take with us.

In our business, when we invest money, we very much value consistent, principled, and predictable behaviour, delivered in as unbiased and unemotional a way as possible…no surprises. We are very analytical in our industry, but often, if not mostly, those who use our products are driven by sentiment and emotion.

The Queen demonstrated consistency and an unbiased approach to her engagements throughout her lifetime. At the same time, her ability to adapt and to understand people's emotions enabled her to evolve throughout the years.

There are clear lessons for us as individuals, businesses, and as an investment industry to reflect on and to take from The Queen's life. Once this moment has passed, will we simply carry on as before? Or will we commit to better serving our peers, our clients, and our communities?

As she so eloquently commented "The true measure of all our actions is how long the good in them lasts."

God Save the King.

Calm before the storm

Mark Wright, CFA

Not long back from my first holiday abroad since the pandemic, I was looking out my window longing to be back swimming in the warm Mediterranean ocean off the East coast of Mallorca. I will spare you the details of the travel chaos we experienced both ways, it was a lesson learned!

I was expecting 10 days of sun and nothing much else weather-wise, but it didn't quite turn out like that. We were fortunate enough to witness not just one but two thunderstorms. I say fortunate because they served as a healthy reminder that it is always calm before the storm.

When it rains in Mallorca it doesn't just rain, it pours and not only does it pour, it hails! One minute I was soaking up the sun, swimming in the sea with little care in the world, the next I was running back to the hotel to take cover from giant hail stones. The speed with which the weather turned was breath-taking, but maybe not quite as remarkable as the speed with which inflation has gone from close to zero in the UK and other parts of the world, to double digits now.

For the last three decades, inflation had been relatively calm - mostly range bound between 1% and 3% in both the UK and United States. There had also been little in the way of interest rate volatility for over a decade. In the UK, the Bank of England had kept the base rate below 1% since 2009.

However, the latest UK inflation print is close to double digits (and comfortably double digits for those who prefer to reference RPI)[1]. It was looking unlikely to stop rising any time soon, but UK Prime Minster Liz Truss's latest policy to alleviate pressure on household finances by capping energy bills should hopefully bring peak inflation much nearer. It does, however, also risk inflation remaining elevated for longer.

Central bankers now appear to be in competition to see who can raise interest rates the quickest, driving the cost of credit up for borrowers. They, and other policymakers, appear to be getting off lightly for causing one of the worst cost of living crises in living memory. We now find ourselves in the eye of an inflationary storm and are all paying the price for significant policy errors that are eroding people's standard of living at an alarming rate. Russian President Vladimir Putin's invasion of Ukraine has certainly not helped, but inflation in both the UK and US had already started to take off before any Russian tanks had crossed the Ukrainian border.

The first policy error was the complacency with which central bankers naively believed that high inflation had been defeated and was a thing of the past. Their complacency was best demonstrated when Chairman of the Federal Reserve Jerome Powell stated just two years ago in August 2020, that the Fed would relax its inflation target, willingly allowing inflation to temporarily run hot in an attempt to instead target average inflation over a cycle. It didn't get much coverage at the time but in one fell swoop, the seeds were sewn for previously well-anchored inflation expectations to start rising.

The second was a complete lack of foresight and disregard for basic economic principles. It is frustrating to read almost daily quotes from central bankers that suggest they are simply reacting to the latest inflation print or data on economic activity. Any economics student will tell you that monetary policy acts with a significant lag and central bank policy should always be addressing inflation 18 months to two years out from the present day.

There is also a well-known relationship between unemployment and inflation that on a graph, plots what is called the 'Phillips Curve'. This shows us that low levels of unemployment leads to higher levels of inflation. Central bankers seem to have ignored this relationship in recent years. Governments around the world devised policies to deliberately keep unemployment low during the pandemic[2]. It barely rose above 5% in the UK and very quickly started to fall at pace in 2021; a time when the Bank of England was still printing money along with many other central banks around the world. The European Central Bank was even still printing money when inflation was north of 8%! Why? Because of an apparent obsession for policy to be consistent with prior forward guidance.

Forward guidance has become a commonly used monetary policy tool within the last decade. Central banks essentially guide the market as to where interest rates are heading. In theory, it should reduce economic volatility as individuals and businesses can make spending and investment decisions with an idea as to where the cost of finance is trending. However, the problem is that stability breeds instability, and forward guidance in itself can be counterproductive by dampening the impact of each interest rate decision on asset markets and the economy.

The last two policy errors didn't sit with central banks but instead with politicians. Poor energy policy has made the UK and the rest of Europe highly vulnerable to energy shocks. In the case of the UK, an inability to press on with more nuclear power generation and an unwillingness to invest in gas storage facilities has been a grave policy error. In Europe, the decision by industrial powerhouse, Germany, to rely so much on Russia to satisfy its energy needs was an even bigger policy error. The antiquated link between gas prices and electricity prices is yet another, given that over 40% of the UK's power generation now derives from renewable energy sources at a substantially lower cost of production[3]. Both the UK and the rest of Europe now appear to be waking up to this issue.

Lastly, Government policies during the pandemic were driven far too much by health considerations and specifically one isolated healthcare issue. The stress placed on supply chains across the world from overzealous Covid-19-related work restrictions has contributed significantly to today's runaway inflation. This will sadly now likely lead to considerable ill-health, as a consequence of greater poverty. Added to the increased incidences of cancer from missed screening appointments during the pandemic and greater cases of mental health suffering, it begs the question whether society really benefitted from those heavy-handed policies that restricted economic activity.

Sources: [1]Inflation and price indices - Office for National Statistics (ons.gov.uk). [2]Job retention schemes during the COVID-19 lockdown and beyond (oecd.org). [3]How much of the UK's energy is renewable? | National Grid Group. Unless stated all figures sourced from Bloomberg Finance, L.P

October

3 October 2022

Data, data everywhere and not a number to guide

(with apologies to Samuel Taylor Coleridge)

Richard Parfect

All through life our brains like to use "general rules of thumb" when dealing with problems. These rules may come through personal experience or maybe they are more prescriptive and laid down by doctrine.

When dealing with problems I have sometimes found it useful to use a "factor of three". For example, if I plan to do a DIY job in the house, bitter experience tells me it will take three times as long as I might expect. Similarly, in my distant past, my military training followed the doctrine that when attacking a defended position, your force would need to be at least three times the size of similarly equipped defenders; events on the ground have shown that Russia overestimated its forces and underestimate those of Ukraine (and its Western support) thereby putting itself on the wrong side of this golden rule. Such a guide can help avoid the shock of a gross under-estimation of outcome.

The Bank of England (BoE) publishes its expectations for inflation 12 months hence. Looking back at the Bank of England's Monetary Policy Report of August 2021, the Monetary Policy Committee's own 12 month forecast for the Consumer Price Index (CPI) inflation we are experiencing today was only around 2.2% (with little difference between including or excluding energy and VAT); indeed, external (to the Bank of England) forecasters were also only expecting 2.2% in Q3 of 2022. Fast forwarding 6 months to February 2022, (the report was written prior to Russia's invasion of Ukraine, but with other post COVID-19 inflation forces already on the loose) the Bank of England had increased its Q1 2023 inflation expectation to circa 5.3%, whereas the average of external forecasters was somewhat behind at 3.1%.

Even in May this year, with much more relevant information available to all parties, the Bank of England in that report was projecting CPI to be (only) 6.5% in Q2 2023, more surprisingly there were no external forecasters predicting it to be over 6% and their average forecast was for just 3.7%.

Last month, Citi, the investment bank, issued a headline-capturing warning of UK CPI likely to exceed 15% in the first quarter of 2023 (around three times what the BoE was predicting for Q1 2023 back in February 2022); even the Bank of England's report of that month was predicting Q3 2023 inflation to be almost 10%. Clearly, the forecasts as recently as February were in "gross error" territory.

What does this tell us apart from the folly of attempting to predict macro-economic data? Answers on a postcard; however, I would contend that it is a perfect example of the danger of anchoring. After many years of official and (optically at least) succeeding in achieving inflation of around 2%, there was a classic case of group think and anchoring at play in the minds of economic forecasters. Personally, it reinforces the fact that in circumstances that are not particularly unusual (war, pestilence, and famine) there is a high risk of underestimating things by a factor of three, even when the forces at play are known.

With such uncertainty and variability of outcome being an almost inevitable result of numerous known and unknown factors, it often baffles me how the forecasting industry garners so much attention and apparent credibility from observers. Perhaps it is the inevitable result of a lucrative machine who's vested interest is to convince people that they need their services.

The folly of blind faith in forecasts was illustrated even more starkly last week as a result of the fiscal event or "mini budget" (indeed the government did not even publish any forecasts to accompany the policy announcements). Gilts have been regarded as the benchmark "risk free" security, providing little volatility and a measured reflection of future interest rate "normalisation". Therefore, how shocking it was to see the quiet backwater of the 30 year UK Treasury Index Linked Gilt fall from around 118p in early September to around 53p on Wednesday 28th September (it has since recovered to 101p).

Humans like to have a number to hold onto as it feels tangible and brings confidence. Gross Domestic Product (GDP), inflation, and employment figures are only as good as the data fed into them; they are the measurements of the immeasurable. The reality of course is that the economy is far more ethereal than that. Furthermore, who is to say that doubling GDP is a good thing, if it comes at the woefully underestimated cost of climate change and catastrophe?

That desire to measure and have a number to point to is understandable, however it can be misleading, especially when used to compare things that are not actually directly comparable. My colleague Gary Moglione wrote about the subject of fees back in August (read Gary's thoughts here) and how the new rules on the disclosure of total look through costs, while laudable in principle, can run the risk of false comparisons in practice. As these rules are now having to be applied across the funds industry, it is essential that investors take time to appreciate what is actually being disclosed, what services are being provided by whom, and how they're being charged. We would welcome any questions from investors on this matter to explain the recent changes.

Sources: Unless stated all figures are from Periodic Monetary Policy Reports of the Bank of England.

10 October 2022

Welcome to the New Age

Matt Connor

Like it or not, there is no doubt that social media is now an integral part of our lives, with our online presence an extension of who we are, and for many, who they aspire to be. There were almost three billion monthly active users on Facebook in the second quarter of this year[1], some 37% of the global population. For a business, social media offers a treasure trove of potential customers, but still so many seem to get it wrong when advertising through these channels.

The genesis of the large US internet companies, such as Facebook, Google, and Snapchat are well known and in the case of Facebook, immortalised on the silver screen with the 2010 film The Social Network. The early days of LBG Media, a UK-listed digital publisher, were similar, with co-founders Solly Solomou and Arian Kalantari forming the business whilst studying at university in 2012. LBG Media operates multiple brands across social media to a global audience of over 315 million[2], predominantly made up of millennials and Gen Z – one of the most valuable segments to advertisers.

LBG Media's business segment, LBG Direct, works closely with brands in launching successful advertising campaigns across the likes of Instagram and TikTok, harnessing its insights and expertise to successfully target the right audiences. LBG can also help clients by tapping into LADNation – its own youth panel with over 50,000 members to offer valuable feedback from a notoriously difficult group to reach.

The recent explosion of TikTok has made brands rethink their advertising strategies and move away from traditional forms of advertising such as TV. Young people now spend more time watching TikTok videos than they do watching broadcast TV[3], spending almost an hour a day scrolling through the TikTok app. TikTok are notably reaping their newfound riches, with European revenues increasing six-fold last year[4].

LBG Media offers investors the opportunity to capitalise on this change in how media is consumed and thus monetised. As more businesses look to develop effective marketing strategies, they will seek to partner up with companies, such as LBG, in order to target the right audience and not waste precious marketing dollars on a dud campaign; and who better to approach than the biggest publisher on TikTok, LBG[5]. That is certainly what Vodafone have done, partnering with LBG to create content for its VOXI mobile network.

With LBG's share price falling significantly since Initial Public Offering last year, much like US social media giants Meta and Snapchat, the company now trades on a price-to-earnings ratio of just over 10 times[6]. With bright prospects such as expanding into the US where they reach around one third of the population, LBG could be an attractive investment for investors wanting exposure to the new age of advertising.

Sources: [1]Statista 2022, [2]LBG Media plc, Half Year Results 2022, [3]Ofcom, 2022, FT article referencing it, [4]FT article 2022, [5]LBG Media plc, 2022, [6] Unless stated all figures sourced from Bloomberg Finance, L.P.

17 October 2022

Gilty Pleasures

Alex Harvey, CFA

Three weeks ago, I had just landed in Morocco and with impeccable timing, as I worked out how to use Agadir airport's ATM, Sterling tanked on the back of the UK government's now well pored over 'mini-budget'. I found it mildly amusing that the ticker for the Sterling-Dirham currency pairing is GBPMAD. It certainly felt like it! Of course, this wasn't a bout of Dirham strength but a Sterling maelstrom resulting from the aforementioned budget, and the Pound was in freefall against every major currency. After reaching an intraday low of 1.035 dollars to the Pound on Monday 26th September (the lowest level ever plumbed and breaching the 1.054 set in February 1985[1]), the currency has bounced back, albeit limply, to over 1.12 dollars to the Pound today.

Readers will know that the last few weeks have also seen whipsawing prices for UK government bonds. As they are known, these' gilts' derive their name from the perceived security that accompanies their ownership. Indeed, the original certificates, issued by the newly founded Bank of England in 1694, had gilded edges to attest to their quality. In recent months however, security is not what gilts have been known for. Although we might be an island nation, the pricing of UK financial instruments is not immune – far from it - from global influence. Readers will know we have the highest inflation for 40 years and the heady rise in yields is both a market and policy response to that. Short end yields are largely a function of Bank of England policy rates, and expectations for said policy rates looking forward a couple of years; long bond yields should pay a 'term premium' over shorter bonds, which embodies several risk premia including both liquidity and longer-term inflation risk (and the volatility thereof). Supply and demand does the rest which can further distort yield curve shape.

The rise of Liability Driven Investing (LDI) in recent decades has seen UK pension funds increasingly use long dated 'swaps' – a financial derivative instrument which replicates the return profile of long dated gilts, but which is achieved without paying for them fully upfront. Where this is unfunded it creates leverage, and leverage creates risk, which has manifested in recent weeks in a gilt sell-off of epic proportions. Other commentators have exhausted the LDI analysis so I will not go there, but suffice to say that a massive repricing has taken place in gilts and also sterling corporate bonds, whilst there's more than a whiff of discount hanging across all UK assets right now (as there has been since the Brexit referendum vote in 2016).

The UK government's on/off messaging with respect to tax cuts and budgets, and the rapidly evolving political backdrop (Kwarteng out, Hunt in on Friday), has done little to calm the markets. The Bank of England has also now ended its emergency gilt purchase programme, but the Temporary Expanded Collateral Repo Facility (TECRF) remains in place until at least 10th November[2] which should support residual gilt trading for any pension plans that have not already sufficiently delevered.

Gilt yields continue to oscillate with an amplitude more fitting of an emerging market nation or the high yield corporate bond market, but then you only have to roll back twelve months and that's where both those markets were both trading[3]. The outcome of all this is that a modicum of value has come back into the UK bond market. It is far too early and difficult to see a point where gilt yields settle, but you have to go back to the Global Financial Crisis (GFC) to see yields on 'linkers' – UK inflation linked bonds – at the levels they are today, which are now positive across most tenors having been deeply negative for the best part of a decade (the 5yr linker yield first went negative in October 2009; it bottomed at -4.18% on 13th December last year; a week ago it was +1.3%). UK investment grade corporate bonds now yield over 7% which, bar a period of GFC capitulation, have not been higher for 25 years. For investment grade paper with limited default risk that looks attractive. Gilt yields can of course go higher from here, and corporate bonds would follow their lead, but for long term investors targeting real (post inflation) returns, there could be worse times to put your toe back into the Sterling bond market.

Sources: [1]keycurrency.co.uk, [2]Bank of England, [3]On 18th October 2021, the yield on the Bloomberg Global Yield index was 4.78%; on the JP Morgan EMBI Global index it was 4.9%. The 30yr gilt yield traded as high as 5.135% on 28th September 2022. Unless stated all figures from Bloomberg Finance L.P.

12 October 2022

(IL)Liquid of property

Jackson Franks, CFA

As mentioned in my previous blogs, I am an avid Watford football club supporter. Although there are some ups and (a lot more) downs, being a Watford supporter has had one positive outcome. It's enabled me to cope with the ever-changing UK political situation. Since David Cameron resigned as Prime Minister in 2016, following the UK's vote to leave the EU, there have been three UK Prime Ministers over the preceding six years, with the fourth set be announced. However, comparing this to the Watford managerial hot seat, we have seen twelve people come in as manager over the same period. Although the owners have had to absorb a lot of negativities for their cutthroat approach, their methodology has worked. Since 2016, Watford have been in the Premiere League for five out of seven seasons, the best in its history. So, although there is a limited appetite for uncertainty, I am of the firm belief that if something isn't working, then change it.

Following Liz Truss's government's mini-budget, turmoil ensued in UK financial markets. The sell-off in UK government bonds (gilts) amid concerns about monetary policy, debt, and pension funds' financial status, shook sectors including property. As with the 2016 Brexit referendum, and a period during 2019, daily dealing property funds saw high levels of redemptions. In turn, Columbia Threadneedle suspended dealing in their daily dealing property fund, bringing back the debate on whether the UK regulator should restrict retail investors from open-ended property funds.

At Momentum Global Investment Management (MGIM) we do not invest in open-ended real estate funds because of the clear liquidity mismatch of offering daily dealing on an illiquid asset such as a property. Due to the length of time it takes to sell a property, a minimum of 3 months, but in times of market stress often longer, when the sector sees an increased level of redemptions the open-ended property strategies are unable to cope with the cash demand, and therefore suspend dealing. Gating the fund enables the manager to postpone redemptions for a period of time so they can raise the cash needed to pay out to investors by selling an asset or raising further capital. This could be an uneasy time for retail investors who are wanting to reduce their exposure to the sector but are unable to do so.

Open-ended property funds are not the only way to gain direct exposure to the property market. At MGIM we gain exposure to the sector through Real Estate Investment Trusts ("REITs") and a private equity vehicle known as the Momentum Africa Real Estate Fund ("MAREF"), which are suitable for retail and qualified institutional investors respectively. A private equity style vehicle, such as MAREF, has its advantages and disadvantages for investors. Investors would be locked into the strategy for the duration of the fund's life, this gives the manager time to generate returns undistracted by the impulses of investor flows. Having said that, this style is illiquid and if the investor requires liquidity during the life of the fund (the majority are eight+ years), they cannot redeem.

REITs, similar to private equity vehicles, have a fixed pool of capital for the investment manager to invest across the sector whilst offering a similar liquidity experience to investing in publicly traded stocks. REITs are easier to understand from an investor's perspective: by leasing space and collecting rent on its acquired real estate, the company generates income which is then paid out to shareholders in the form of dividends. REITs are required to distribute 90% of their taxable income to shareholders which on average is significantly higher than other equities. However, because REITs are listed on the stock market, their share price is driven by two factors: firstly, the valuation of their underlying assets, and secondly, the broader market sentiment and buying/selling pressures. The manager never has to handle redemptions, as investors simply sell their shares in the market if they so wish.

It is critical that any investor in the real estate sector understands and appreciates the illiquid nature of the underlying asset class. At MGIM, we manage this illiquidity risk by sizing our real estate exposure appropriately and investing in liquid REITs instead of open-ended daily investment vehicles, thus avoiding the risks arising from an asset-liability mismatch. Although the listed status of a REIT introduces an element of equity market risk and pricing volatility, which is particularly evident in these uncertain times, investors can still liquidate their holdings if so required, or indeed add to their holdings at what might prove to be heavily discounted valuations. Neither of these options are available to holders of most UK open-ended property funds at this point.

Sources: Unless stated all figures from Bloomberg Finance L.P.

31 October 2022

Will the strong dollar continue to spook markets?

Robert White, CFA

We are living in a dollar-dominated world, a fact most famously captured by John Connally, President Nixon's Treasury Secretary, who once told a group of global finance ministers "the dollar is our currency, but it's your problem". Students of economic history will be aware of the disruption that a strong US dollar can cause, however, at times such as this it is important to remember that the global economy is cyclical, and such periods eventually do pass.

To appreciate this fact, cast your mind back to the early 1980s. The Federal Reserve was sharply increasing interest rates to combat high inflation, which triggered a prolonged dollar rally. The dollar's rise came despite the US government running a large deficit, and the strength relative to its major trading partners caused prolonged pain for exporters. Furthermore, all this was going on at a time of geopolitical uncertainty as tensions between the US and Russia were escalating, culminating in Reagan's infamous "evil empire" speech. During this time, the US dollar index ultimately reached a peak of 164 in 1985, much higher than the current level of 110.

The parallels between the early 1980s and today should hopefully be obvious to readers, as Putin's war continues in Ukraine, and we are living through the most hawkish Fed Reserve policy since the Volker era. Given this similarity, many speculators believe that the dollar can still go much higher from here, and many hedge funds are heavily leveraged in long dollar contracts.

As the dollar is the global reserve currency, such periods of strength create a liquidity squeeze across the entire economy, which can then generate inflation in countries that import goods priced in dollars. An example of the supremacy of the US dollar can be seen from the fact that 60% of global reserves are held in dollars[1], with countries such as Japan and China being big buyers of US financial assets in recent years.

The other negative impact of a stronger dollar is on US exporters who find it more difficult to sell their products to international buyers. This has a restrictive impact on growth, but also creates political tensions as domestic industries come under pressure, and corporates are incentivised to offshore production to cheaper overseas markets. If we go back in time to the 1980s, these issues were of paramount importance. After political pressure and lobbying from large industrial companies in Congress, finance ministers met in the Plaza Hotel in New York to agree on the famous "Plaza Accord" whereby global central banks agreed to act in concert to weaken the dollar.

The effect on the US dollar index was dramatic; from a peak of 164, the index fell to 85 by the end of 1987. This sharp move was driven by a mix of fundamental weakness, an abrupt change in central bank policy, interest rates falling sharply from their highs, and the technical buying power of speculators who were betting on a weaker dollar.

Are there grounds for a "Plaza Accord" moment today? At first glance, the current political environment seems the biggest obstacle to this. The 1985 agreement was a triumph in international relations between some of the most powerful finance ministers in the world from the US, Japan, Germany, France, and the UK. That level of coordination seems more difficult to achieve today as world powers have become more inward-looking. There is also the complication of China's importance on the world stage today, and the backdrop of geopolitical tensions over Taiwan.

On the other hand, we have already seen Japan and China take action in recent weeks to strengthen their currencies; the Bank of Japan has been directly buying yen in the foreign exchange markets, while the People's Bank of China has been issuing statements warning of pain to come for speculators shorting renminbi. In a more recent example, in 2016 the US and China came to an informal agreement to keep the yuan from depreciating after the shock of the devaluation in 2015.

It is always difficult to predict currency movements over the short term, but many factors are aligning which suggests that the recent bout of dollar strength may eventually run out of steam. Much still depends on the level of inflation and the pace of interest rate rises in the US, however, we believe that we are near the peak, and we expect that the biggest portion of interest rate rises are behind us in the current cycle. If the dollar rally unwinds to the same extent as it did after 1985, it could well spark a sharp relief rally across global markets.

Source: [1]International Monetary Fund

November

7 November 2022

Yet another update on China

Lorenzo La Posta, CFA

For some reason, any time it's my turn to write our weekly Global Matters blog, there is something happening in China worth writing about. Or perhaps, it is just my colleagues deliberately leaving me with the honour of updating our readers on the latest developments within the Chinese walls (pun intended). Luckily, these days we are not short of significant news and while the west is struggling with rising rates and elevated inflation, China is facing a different set of issues that still have global consequences.

On 22 October, the country witnessed the closing of the 20th Chinese Communist Party Congress, where president Xi Jinping consolidated his power for another five years, becoming effectively the second most powerful person in modern Chinese history, after Mao Zedong. Financial markets were disappointed, with Chinese stocks experiencing the deepest daily fall since 2008.

While the re-election itself was widely expected, what markets didn't like was that Xi's politburo is now composed of his supporters only, with his predecessor Hu Jintao having even been escorted out of the congress. What they liked even less, is that during the congress the word "security" was mentioned more frequently than the last congress five years ago, while the word "reform" significantly less, raising fears that this new regime in China might actually follow the recent past: zero-Covid policy, common prosperity and the (mostly grim) economic consequences of the two.

We expect the public sector to continue strengthening over the private sector and that the Party's social reforms should support growing the middle class. Whilst the former may not necessarily be a positive from the perspective of an international investor, the latter should benefit the country and ultimately the growth of a broader investible universe. Moreover, technological growth is still heavily incentivised, and we expect economic growth to come back to being a priority in the coming months, as that is a key element to common prosperity and social stability.

Markets have been revising down their expectation around the country's economic growth over the past 18 months and today Chinese equities are down about 50-60%[1] from their peak in February last year. However, it is seemingly obvious that investors are eager to put money to work and hungry for a pivot in narrative around the zero-COVID-19 policy. The stock market valuation has rarely been as attractive in recent years and the catalyst it needs is simply a small step in favour of global and local investors, a hint of easier conditions. Last week, for instance, markets cheered the continued rumours of zero-COVID-19 rules being relaxed in order to prioritise the economy and rallied on the back of a picture that circulated on social media, unveiling the existence of a "reopening committee".

We don't spend much time on Chinese social media, nor do we invest based on rumours and hopes. However, despite the depressed market sentiment, high volatility, and weaker economic data, we believe the investment opportunity within Chinese equities remains strong. Active management is key, and to take full advantage of the available universe we advocate the use of experienced stock selectors as the best solution, from a risk and return perspective, to navigate current risks and select outstanding businesses that will prosper and grow.

Source: [1]Bloomberg Finance L.P. data as of 4 November 2022

14 November 2022

Temperature Check

Richard Stutley, CFA

I wanted to provide a quick update on the Euro-zone economy. It's good practice to step behind the headlines, which as we know are written with the aim of being interesting, rather than painting a complete picture of any topic. While we firmly believe that a good macroeconomic outcome is neither sufficient nor necessary for good investment returns (although it does help, particularly in the short term!), we nevertheless need to be aware of the macro when managing portfolios.

Consumption, which translated means day-to-day spending by individuals, rightly makes up the majority of total spending in the region – around 52% according to Eurostat[1]. Hence we're primarily interested in household finances (current and prospective) when taking the temperature of the Euro-zone economy.

Gross Domestic Product grew by 0.2% quarter-on-quarter in Q3, a bit below its 10-year average of 0.37% but well within the norm, with adjustment for the effects of the pandemic[2] . Hence real incomes continue to expand and coming into the start of this year households had approximately 12% excess savings tucked away[3]. From a debt perspective, household debt to disposable income is comfortably within its recent range and approximately 50% lower than around the time of the Great Financial Crisis[4].

That's the good news. Debt mostly in the form of mortgages is sensitive to rising interest rates and hence, as we look forward, today's good starting point begins to look less rosy. While the widening gap between US and Euro-zone short-term interest rates[5] may seem strange, one needs to understand that the transmission mechanism of central bank policy to the real economy is much weaker in the States, due to the predominance of 30-year fixed-rate mortgages far longer than anything generally seen in Europe. This means that rising interest rates will start eating into the disposable income of Euro-zone households much more quickly than their American cousins.

Unemployment in the Eurozone is low[6], and unlike in the US isn't flattered by a falling participation rate post-pandemic. According to data from the World Bank[7], one of the clearest signals from this inflationary period is that more Americans need to find their way back to the labour market – there are too few workers to deliver the goods and services the US needs. As with household debt, the employment picture looks set to deteriorate, with hiring intentions slowing and likely to turn negative resulting in a fall in new orders reported by companies[8].

The main issue the region faces isn't poor balance sheets, but huge distortions in the price of goods and services. Stripping out the effects of energy price rises only makes sense when prices fall back quickly. Power prices in the Euro-zone's industrial heartland Germany remain in a range some five times higher than their pre-pandemic level[9]. This has led to a huge redirecting of spending towards energy, and away from all other goods and services. On this basis, the outlook for many businesses is tough, and the redistribution of profits from energy producers via windfall taxes seems appropriate.

Overall, the Euro-zone looks like it is in for a tough time, made only slightly easier by the healthy state of household balance sheets. However, the significance of that conclusion shouldn't be overstated, to repeat what I said at the outset, we are macro-aware rather than macro-driven. Economies are self-righting over time and even bad policymaking can't upset them for long, the UK's recent experience being a case in point. Despite the weak macroeconomic outlook, we are neutral European equities, given signs of some good valuation opportunities emerging.

Sources: [1]Euro Area Household & NPISH Final Consumption Expenditure as a percentage of Euro Area Gross Domestic, as seen on Bloomberg Finance L.P., [2]Euro Area Gross Domestic Product Chained 2010 Prices QoQ, Eurostat, [3]Euro Area (17 Countries) Gross Household Saving Rate, Eurostat, [4]Eurozone Household Debt to Disposable Income Ratio, Bloomberg Finance L.P., [5]US Federal Funds Effective Rate less the ECB Main Refinancing Operations Announcement Rate., [6]Eurozone Annual Unemployment Rate (%), Bloomberg Finance L.P., [7]Euro area Labor force participation rate ages 15-64, World Bank Group, [8]S&P Global Flash Eurozone PMI, 24/10/2022, [9]EXAA Germany Day Ahead Baseload Electricity Spot Price.

21 November 2022

The World Cup Effect

Gary Moglione

As a keen student of behavioural investing, I love reading articles on how human behaviour is influenced by emotion and how this translates to stock market movements. If only there was an event that stirred up extreme emotions that the majority of the world will participate in. It just so happens that the FIFA World Cup is here, and according to audience data around 3.6 billion people watch the tournament on television[1]. This equates to about half of the world's population1. Over the years there have been many academic studies on the behaviour of stock markets during the World Cup. Here is a summary of some of my favourites.

Edmans, Garcia and Norli (2007)[2] found a strong association between the results of important soccer games and local market stock returns. Looking at 39 stock markets they found an asymmetric effect where losses have a significant negative effect in the losing countries, but victories do not have the same significant effect in the winning countries. They found that the effects only last a day, and it was difficult to take advantage of as transaction costs swallowed up most of the effect.

Levy and Kaplinski (2008)[3] demonstrated that the negative sentiment effect creates a longer-lasting negative effect during the FIFA World Cup, as a result of billions of fans around the world mourning their teams' exit from the tournament. They sought to exploit it in the US Equity market as it's the most global in nature and around one-third of transactions involve non-US investors.

Their analysis looked at 15 World Cups from 1950 to 2006 and found that the average return during the World Cup period was -2.58% compared with +1.21% for all-days average returns over a similar number of days. This is a meaningful difference. If you invested $1000 in the S&P 500 from January 1950 it would have been worth $4.4 million by the end of 2007. If you had adjusted your investment process to account for the World Cup effect and switched your portfolio to Treasuries for each world cup, before switching back at the end of the tournament, your portfolio would be worth $6.5 million[3].

Before you get excited and start shorting equities, once a behavioural effect becomes widely known it ceases to be effective and is arbitraged away. Research presented before the 2010 World Cup was widely accepted, and even resulted in an Investors Chronicle article detailing what trades retail investors should place to take advantage.

Prior to the 2014 World Cup, Goldman Sachs published their research on the "Winner effect"[4]. They looked at 10 World Cups between 1974 and 2014 and found that on average the victors stock market outperformed the global market by 3.5% in the first month following the final. Only one victor did not outperform and that was Brazil in 2002, but they were in the midst of a deep recession and a currency crisis, so the winner effect was probably drowned out by the severe economic backdrop.

I won't be adjusting my portfolios based on this research, but if the S&P 500 declines over the next month you can be confident that the subconscious actions of billions of heartbroken football fans will be partly to blame.

Source: [1]fifa.com. [2]Edmans, Garcia and Norli (2007), The Journal of Finance, 'Sports Sentiment and Stock Returns', Vol. 62 (4), p.1. [3]Levy, H. and Kaplinski, G. (2008), Journal of Behavioural and Experimental Economics, 'Sentiment, Irrationality and Market Efficiency: The Case of the 2010 Fifa World Cup'. [4]Goldmansachs.com

28 November 2022

Has gold lost its shine?

Stephen Nguyen, CFA

As we approach the end of 2022, it is worth reflecting on asset class returns this year. Global equities and bonds have both suffered significant declines and as a result the traditional balanced portfolio, anchored by these two asset classes, has struggled. Risk assets have had a torrid time due to a combination of factors including bleak economic and earnings outlooks, inflation concerns and heightened geopolitical tensions, which have all weighed on investor sentiment. Surprisingly, gold which has traditionally been deemed as a 'safe haven' asset has also disappointed this year. Gold is often thought of as a hedge during market downturns and in an inflationary environment, so why has it struggled this year? And does it still warrant a place in investors' portfolios.

Gold attracts its fair share of criticism as an 'unproductive' asset, but the same can be said of cash. Unlike cash, gold doesn't pay any income, which makes it difficult to value.

It is worth exploring gold's relationship with other 'income' producing safe haven assets and inflation. This year we have witnessed a significant repricing in nominal interest rates across most advanced economies, the most notable being in the US where rates have risen from close to 0% to 4% today. All else being equal, as nominal rates rise, the opportunity cost of holding non-income bearing assets increases and therefore dents the appeal of the yellow metal for savers looking to earn a positive yield. However, we have also experienced rapidly rising inflation which erodes the purchasing power of paper money and theoretically should increase the attractiveness of gold. So why haven't we seen this in terms of gold prices?

The final piece of the puzzle which provides a better explanation to gold pricing is its relationship with real (inflation-adjusted) interest rates. The two are negatively correlated: as real rates increase; the price of gold is driven down. Despite high levels of inflation, investors have been placing more emphasis on the pace of the rise in nominal rates which has proved to be a major headwind for gold. Although the relationship is weaker, we believe that US dollar strength has also provided another headwind for gold in in the past year, as this makes it more expensive for investors holding currencies other than dollars, since gold is priced in dollars.

Despite the headwinds mentioned above, it is worth reminding ourselves of gold's role in multi-asset portfolios. Historically, gold has proven its ability to preserve its purchasing power when compared to fiat money as it cannot be devalued by central banks, and it serves as an insurance policy at times of geopolitical tensions or any systemic / credit events. Typical insurance policies pay out should a specified event occur, but in a truly dire scenario this is no more than a pledge and you must question the ability of the counterparty to deliver. This is a fundamental risk in all insurance as historically there have been scenarios in which the private sector was unable to cope, requiring intervention from the state. Gold does not bear this type of default or counterparty risk. Lastly, gold has shown to have little to no correlation with other risk assets over the long-term and certainly at the peak of severe market shock.

Whilst it is difficult to predict, we believe that the Fed is getting close to peak rates with the significant portion of rate rises behind us, and in our view the US dollar is also nearing its peak; both of which could be supportive for gold. Severe market stress occurs infrequently however it happens often enough to justify an allocation to this precious metal. The recent turmoil in cryptocurrency is a useful reminder for investors as to what is the ultimate alternative to fiat currency. Gold's long and illustrious status can continue to shine.

December

5 December 2022

A turning point for UK mid-caps

Mark Wright, CFA

So far, the year 2022 has been one that investors in UK mid-capitalisations (mid-caps) would probably prefer to forget. The first six months of this year witnessed the worst relative performance of UK mid-caps vs UK large capitalisations (caps) on a rolling six-month basis since 1986 (as far back as I could find data). By 30th June, they had underperformed UK large caps by a staggering 18%. The performance gap has since widened a little to over 19% on a year-to-date basis.[1] The absolute performance of UK mid-caps is not as stomach churning, but at -15% it is still poor.

The miserable returns are not because earnings have fallen. They have grown significantly. Profits in the first six months of this year (H1 22) were 80% higher than the first six months of 2021 (H1 21), because companies benefitted from increased demand for their products and services, as COVID-19 restrictions were loosened.

Earnings were clearly depressed in H1 21, making for an easy comparative. However, earnings in H1 22 were still ahead of the last six months of 2021 (H2 21) by 6%. If forecasts are to be believed (questionable), earnings in the second half of this year (H2 22) are expected to increase by a healthy 36% on H1 22.

So, it's clearly not earnings that are the problem. Or maybe I should be more precise with my words... it is not THIS year's earnings that are the problem. Of course, stock markets are a discounting mechanism, and all eyes are on the outlook for profits in 2023.

One needn't be a member of Mensa to see that there might be a squeeze on corporate earnings next year (higher interest rates, higher taxes, higher costs etc.) and that will no doubt be one reason why UK mid-caps, which generate a much larger percentage of revenues from the UK economy than UK large-caps, have suffered so much this year.

But have they suffered too much? We all know markets overshoot in both directions, because ultimately share price moves are the result of human behaviour which itself is victim to the uncontrollable influence of animal instincts (fear and greed).

Fearful investors heading for the exit have crushed valuations this year by driving down share prices. At the start of 2022, UK mid-caps traded at 1.8x book value (net assets). On 12th October they traded at just 1.1x book value. That is the lowest valuation they have traded in the last two decades, matched only during the first quarter of 2009, in the nadir of the Global Financial Crisis (GFC), and in the depths of the pandemic during the first quarter of 2020.

Pricing the equity of companies at close to book value implies that investors don't believe those companies will be able to earn a return over and above their cost of equity ever again. I find that hard to believe.

There are simply too many vested interests in improving returns for shareholders. Companies do not stand still, boards and management work hard to improve returns on equity, regardless of the environment they are operating in. Over the last decade, prior to the pandemic, UK mid-caps earned a return on equity exceeding 10%, which is above any reasonable estimate of the cost of equity for a developed market such as the UK .

It is also notable that companies have much stronger balance sheets now than when they were heading into both the GFC and the pandemic. So, as is customary as we enter December, I am going to put my head above the parapet and make a prediction for 2023 (hopefully no one will remember if I am wrong). I think there is a very good chance that the market for UK mid-caps bottomed on 12th October and that returns in 2023 will be much better than they have been this year, which is why we have an overweight position in our portfolios.

Aside from attractive valuations and stronger balance sheets, the 4% upward move in UK mid-caps on the day of softer than expected US inflation data (10th November) warrants attention. It was the second biggest daily rise in the market this year. For the chartists out there, there is a growing number of companies with share prices now trading above their 200-day moving average. This is presently the case for almost half of UK mid-caps[2]. Less than two months ago, the figure was just one in ten company share prices.

Going back to valuations, a look at history provides further reason for optimism. If we look back at 18-month returns following similarly low valuations, such as 18 month returns from the end of Q1 2009 and end of Q1 2020, the numbers are +73% and +57%. Maybe this time is different, but that's usually a phrase that leaves people with egg on their face.

Sources: [1]31 December 2021 to 24 November 2022. [2]As of 24 November 2022. Unless stated, all data from Bloomberg Finance L.P.

12 December 2022

What were you thinking?

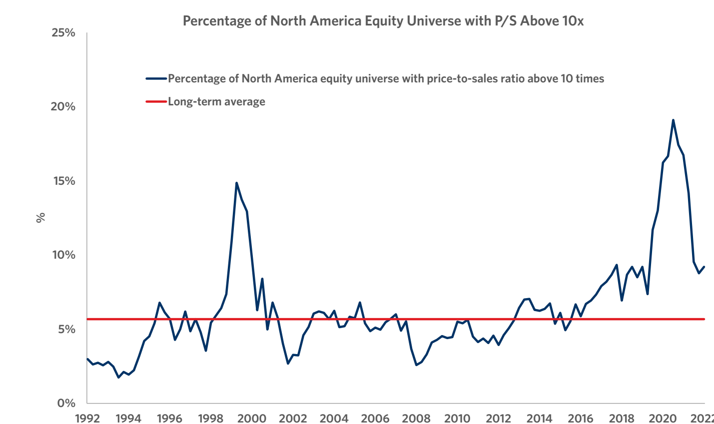
Tom Delic

2022 has been an eventful year across financial markets, and while anything could happen during the last few weeks of December, I thought it would be worth reflecting on the extraordinary market behaviour we have seen over the past few years.

It feels as though there are numerous examples from the final throws of this cycle that could be placed under the microscope of the financial historian, decades from now. Could it be Austria's 100-year bond that yielded 0.375% in December 2020, down over 60% since? Or perhaps US CCC rated corporate debt yielding 7.5% in the summer of 2021, a credit rating that has a long-term average annual default rate of 25%?1

Echoes of Scott McNealy's well-known "What were you thinking?"1 post-DotCom crash interview from 20 years ago rings in the ears, as investors have once again collectively failed to learn the lessons of history. At the time, McNealy was CEO of Sun Microsystems, a poster child of the technology bubble at the turn of the century. Valued at a price-to-sales ratio of 10 times, McNealy walked through the illogic of making an investment in his business at that price.

As the chart below demonstrates, the speculation in the US equity market has not only matched the bubble at the turn of the century, but has exceeded it in an impressive fashion. 15% of the North American equity universe we track at Momentum Global Investment Management was trading at a price-to-sales ratio of ten times or more than in 2000. During the summer of 2021, as speculation raged in the 'junkiest' of junk bonds, the growth stock party was reaching its hedonistic highs as 19% of the universe traded above McNealy's "What Were You Thinking?" high watermark. While correction since then has put an end to the festivities, if you believe the below chart will revisit the long-term average the hangover may have not yet reached its head-splitting worst.



What can we learn from the latest cycle of speculative excess? It's satisfyingly easy to blame investment losses on an external factor and when the finger is pointed at central bank behaviour, there is understandable merit to this approach. The problem, however, is those kinds of external factors are never in your control, but your own actions and behaviour are.* A conservative, valuation, absolute return focus cannot necessarily shield an investor from volatility, but it can protect from the peril of permanent loss of capital.

A valuation discipline is designed to place the odds in your favour. Paying less than you think for something is a concept that appears to come naturally to most of the population - Just watch the crowds of shoppers at the upcoming Boxing Day sales! Bargain hunting often gets lost for investors as the daily price movements in financial markets shifts the focus away from fundamental investing to one of speculation.

Further, the era of TINA (There Is No Alternative) is coming to an end. The philosophy has its roots in a relative return investment approach, but comparing less rotten apples to very rotten apples doesn't mean you need to take a bite out of the former. With global interest rates starting at sub-atomic levels, the normalisation of interest rates has drastic effects in a relative investing world. Like an accidental nudge of the James Webb Telescope, a two to three percent increase in interest rates has put you in a different galaxy. A reset to an absolute return world is long overdue, assessing an asset on its own risk-return profile, instead of relying on the over-valuation of one asset class to justify the other.

**Or at the very least, they are more likely to be in your control, depending on your view of free will, but that is beyond the scope of this blog and my own intelligence!*

Sources: [1]Bloomberg Businessweek – A Talk with Scott McNealy, April 1 2002. Unless stated all figures and Chart information sourced from Bloomberg Finance, L.P. Chart data as at 6 December 2022.

Outlook - 2023 - *Glyn Owen*

2022 has been an exceptionally difficult year, with very few assets preserving capital let alone earning a positive real return. Global equities and bonds have suffered steep falls, in the case of bonds one of the worst periods in decades. Despite the over-arching pessimism we see the foundations for a recovery in markets in 2023 and believe the prospects ahead are more promising than for some time. The reasons are several:

1

Inflation, the scourge of 2022, is at or close to a peak, and we expect it to fall materially next year. Central bank policy tightening, particularly in the US, has been steep, interest rates are in restrictive territory, money supply in the US is shrinking month-on-month, an extremely unusual occurrence, and dollar liquidity is very tight. The Fed will tolerate an economic slowdown and increase in unemployment to bring inflation down to its 2% target. Monetary policy takes effect with lags, but its impact on activity and inflation is beyond doubt.

2

Economic activity is already under pressure due to the impact of high inflation on disposable incomes, and rising interest rates on mortgage costs, while businesses are suffering from steep rises in input prices and labour costs. A recession is inevitable in the UK and Europe, which are more exposed to surging energy prices than the US, but even in the US a recession is increasingly likely. Reduced activity will bring supply and demand back into balance and weaken inflation.

3

The end of the post-pandemic boom and the impact of weakening activity levels is already evident in falling commodity markets, notably in European natural gas prices, from the surge following Russia's invasion of Ukraine, and easing global supply chain pressures, including steep falls in shipping costs. These will flow through to inflation in due course.

4

The Fed is very likely to downshift the pace of tightening before pausing and peaking some time in the first half of 2023. While there is considerable uncertainty around the duration of restrictive policy, there is less uncertainty around the peak, and we are very confident that most of the Fed's tightening, and its steepest part, is behind us. This could well result in the dollar's strength also peaking, resulting in a significant easing of financial conditions globally. That is critical for markets.

5

The world's second largest economy, and the driver of global growth for much of the past 20 years, China, has had a torrid year. The crackdown on China's digital economy, the deleveraging of its huge property development industry, the zero-Covid policy and weakening global growth, have resulted in the slowest growth rate in China since the 1970s and dramatic falls in the stock market, culminating in a huge sell-off in October following the 20th National Congress and President Xi's consolidation of power. Since then there have been some positive developments, with increasing assistance for the property sector and an easing of Covid restrictions, and more is likely to follow. China is set for a significant recovery next year, albeit well below earlier levels of growth. From peak to trough the Chinese stock market fell by over 60% and now offers substantial upside.

6

Falls in markets elsewhere have been less precipitous but nevertheless substantial and have improved valuations materially. From historic lows in 2021 of near zero or below in some cases, government bond yields have moved up sharply and now offer good diversification benefits, while equities have gone a long way to discounting much of the uncertainties and consequences of the looming slowdown. While corporate profits face headwinds and there are likely to be some disappointments ahead, the longer-term recovery and upside potential is significant.

7

Risks and uncertainty have been in abundance, and there remains much to worry about, but most of those risks are now in better balance. The war in Ukraine has been a disaster in every respect but the worst fears during the initial stages are now much diminished. 2023 is set to be a difficult year for the global economy but most of the developed world enters that tough period with households, corporates and banks in good shape, with generally strong balance sheets. There will no doubt be some casualties ahead, especially if, as is quite possible, central banks risk overkill with policy, but the risks are not systemic. In many cases those casualties, while painful for some, are a healthy longer-term development, removing the excesses of the boom such as crypto markets, Chinese property, zombie companies and vastly over-valued assets such as UK gilts and other safe-haven bonds.

8

Investor sentiment in recent weeks became extremely negative, as evidenced by the sharp rallies on the first sign of some positive developments. This is invariably a signal of unusually good buying opportunities.

9

We might not yet be at the point of maximum risk aversion, and the uncertainties are considerable around further policy tightening required to bring inflation sustainably to target levels of 2%, the damage inflicted on economic activity to reach that goal and the unintended consequences of aggressive central bank tightening, but we are a long way through the monetary cycle in the US and the substantial falls in nearly all asset classes in 2022 provide some excellent opportunities for investors in 2023, when we expect monetary policy to turn and recovery to begin.

"Despite the over-arching pessimism we see the foundations for a recovery in markets in 2023 and believe the prospects ahead are more promising "

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