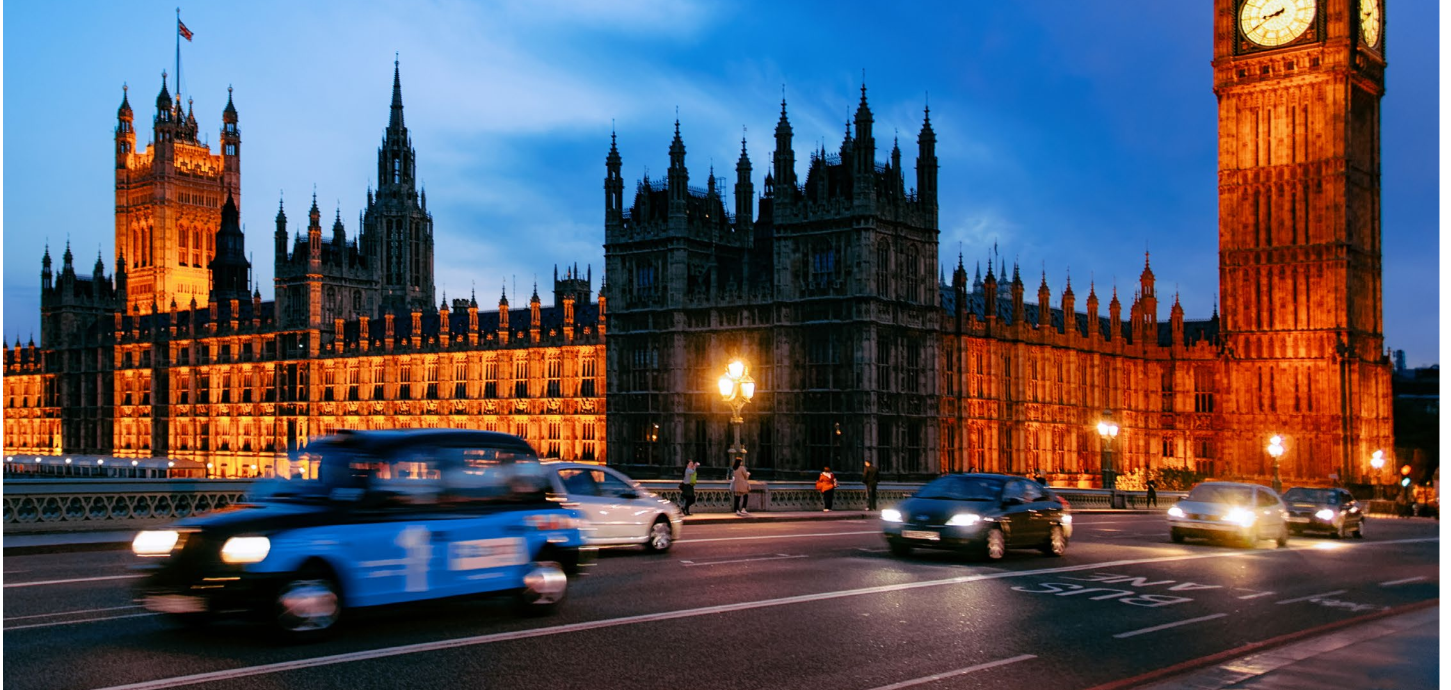

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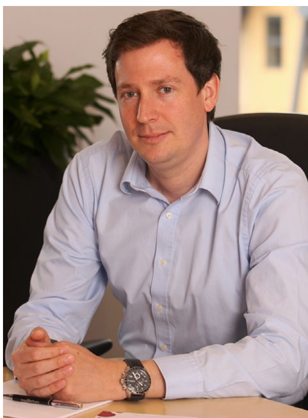

Mike Deverell
Investment Manager
Equilibrium Investment Management

Some certainty at last!

For once, the opinion polls were pretty much right and the Conservative party gained a large majority in the general election.

We have talked a lot recently about the way political uncertainty has been weighing on markets, both in the UK and overseas. We believe that businesses and individuals have been deferring decisions on purchases and on investments. A Tory majority removes much of the UK-related uncertainty (at least in the short term) and markets have reacted positively to the news.

As I write (8.30am on 13 December) the pound is up just over 2.5% against the dollar. The FTSE 100's gain has been somewhat constrained as around 75% of revenues come from overseas, but it is still up by around 1%. The more domestically focused FTSE 250 Index has done much better and has risen by around 4%. The Alternative Investment Market (AIM) has gained around 2%.

We have favoured UK small- and mid-sized stocks for some time, believing that the market is, globally, cheaper than most others. We feel there are some high quality companies which have been largely ignored by international investors. Today's move illustrates the potential here, perhaps being driven by those global investors cutting their UK underweights.

Our overseas equity holdings will not have had such a great morning, with the increase in the pound reducing the value of those shares in sterling terms. However, President Trump (the other great source of uncertainty) has helped us here!

Trump announced yesterday that he had reached a trade deal with China which will see a reduction on tariffs. This has helped Asian markets rally in particular, with the Japanese and Hong Kong markets both up around 2.5% - roughly offsetting the move in the pound.

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A note of caution should be sounded here; until the trade deal is actually signed, it doesn't exist! With a firm majority, Boris Johnson should be able to get his Brexit deal through parliament, and we now look set to leave on 31 January 2020. This should allow businesses to better plan for the future and begin investing again with some additional clarity.

However, it is worth remembering that we now have to agree a deal on future trade. The deadline for doing so is December 2020 which is an extremely short timescale for such complex negotiations. Johnson has ruled out extending this, so it is possible we could still leave with no deal on trade, even if a withdrawal agreement has been reached.

On the other hand, with such a firm majority there is an argument Johnson may tack more toward the centre ground, sidelining the European Research Group, and consider an extension if required.

Liquidity

You may have read in the financial press that dealing in the M&G Property Portfolio fund has been suspended. Rest assured, we do not have a holding in this fund. In fact, as we explained in last month's newsletter, we recently sold our last holding in mainstream commercial property funds, when we came out of the Kames Property Income fund in November.

There were several reasons for selling. In addition to structural changes in the property market, the asset class is struggling as a result of economic and political uncertainty in the UK. However, the final straw was our concerns over liquidity (the ability to buy and sell). We monitor flows carefully and were aware that all mainstream property funds were seeing major outflows. We therefore worried that the funds could 'gate', temporarily halting withdrawals in order to give them time to sell buildings.

Crucially, we believe that M&G is unlikely to be the last fund to gate. The publicity alone will see investors trying to get their money out of other funds – if they haven't already.

The FCA has already reviewed the rules around illiquid assets after property funds gated following the EU referendum in 2016. This has been scrutinized further since the Woodford Equity Income fund was forced to gate earlier this year.

We never want to be stuck in something that we don't want to hold, and we've historically always sold out of property funds when liquidity concerns rise. We sold all our property holdings in the financial crisis, and then again on the day of the EU referendum result. We have never yet had a gated fund in our portfolios.

The only remaining property fund we hold is around 2.75% of our portfolio in the Time Commercial Long Income fund. This has a completely different approach to mainstream commercial property funds. It invests in very defensive assets on long leases, where rents usually go up with inflation. Both the asset class and the fund are seeing strong inflows.

Risk premiums

We often say that risk and return are correlated. If you want to obtain a return that is greater than cash, then you have to take some sort of risk.

When investing in equities, our main risk is volatility – how much markets move up and down. If you bought a single share you would have to accept the risk of catastrophic loss, but we can all but eliminate this by diversifying across enough companies, sectors, countries and markets.

Whilst volatility can be unpleasant, as long as we have a long enough time horizon, it is a risk we can accept. To put it another way, we can stomach short-term losses as long as we have the patience to wait for the recovery.

In financial services, the words 'volatility' and 'risk' are often confused. Volatility is simply one type of risk. Open ended property funds don't have a great deal of volatility but they do generally provide returns well above cash. The excess return in itself tells you that there must be some risk present. In this case, the risk is not volatility but liquidity. To put it another way, property funds have an 'illiquidity premium' – you get paid for taking liquidity risk.

We know this risk is present when we invest in this asset class, and the ability to gate is essential to these funds. We therefore find it surprising how much publicity is generated when gating does occur!

In our view, the problem is not the assets themselves, but the mismatch between the assets and the risk tolerance or time horizon of the end investors. Property funds are often marketed as low risk because they have low levels of volatility, but this is a fundamental misunderstanding.

Mislabelling of funds can be damaging. For example, the Woodford Equity Income fund wasn't an equity income fund (even if it had started out that way). It was a growth fund made up of smaller companies and should have been labelled as such.

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equilibrium

What's the REIT approach?

Many people prefer to invest in property via closed ended funds, known as Real Estate Investment Trusts (REITs) These are companies which buy properties. Investors can buy shares in those companies which are then traded on the stock exchange like any other share, making them more liquid.

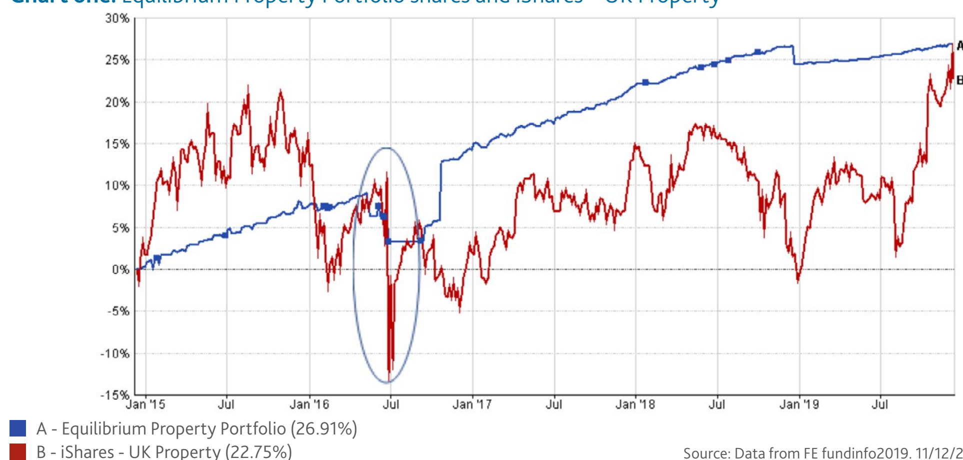
One trade-off for this extra liquidity is that it gives you more volatility. Chart one shows the performance of Equilibrium's property portfolio in blue, compared to a fund which tracks the REIT index in red.

Over five years, the returns are similar but the dramatic difference in volatility is clear to see in chart one.

The chart includes the period around the EU referendum (circled) when many open ended property funds were forced to stop investors from withdrawing.

In theory, the closed ended funds were still liquid and clients could sell, but only for a loss of around 20% compared to the pre-referendum levels.

Chart one: Equilibrium Property Portfolio shares and iShares – UK Property



A - Equilibrium Property Portfolio (26.91%)
B - iShares - UK Property (22.75%)

Source: Data from FE fundinfo2019. 11/12/2014 11/12/2019

The illusion of liquidity

Property funds are often accused of providing the illusion of liquidity. They remain liquid except when clients really want them to be. There is an element of truth to this.

However, in our view this also applies to other asset classes to some extent. For example, it applies to smaller company stocks. Even where stocks are listed on an exchange they are only liquid if someone wants to buy! Many smaller stocks only trade perhaps a few hundred thousand pounds on a normal day, and so buying or selling in any size can be difficult (as Neil Woodford discovered!). This also applies to REITs.

Some corporate bonds are even less liquid, with most only traded 'over the counter' (directly between participants or via a market maker) rather than on an exchange. The point is, if everyone wants to sell, then everything becomes less liquid. Or even if it is liquid, the price you may be able to achieve may be well below fair value.

In the future, we may well invest in more property companies rather than direct property funds. The FCA is rightly tightening the rules around illiquid assets, with enhanced risk warnings to stop them being sold to people who don't understand them.

However, there is a fine balance because we also don't want investors to only be buying the top 100 stocks, for example. We want to be able to capture the liquidity risk premium that smaller companies have, for example, because this can enhance returns.

Whilst we need to accept some risk, we also monitor every fund in which we invest for their liquidity levels. We ask them how much of their portfolio they can liquidate in a single day, week, and month. Based on this analysis, in normal market conditions we believe we could liquidate our entire holding in any of the funds in our portfolio, within a single week.

Risk warning: The content contained in this newsletter represents the opinions of Equilibrium Investment Management. The commentary in this blog in no way constitutes a solicitation of investment advice. It should not be relied upon in making investment decisions and is intended solely for the entertainment of the reader. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

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General economic overview

The general election result removes some of the uncertainty which has hit the UK economy, with a Brexit deal now all but certain to get through parliament. This should help businesses plan for the future, perhaps unlocking some pent up investment. A lack of business investment has certainly hurt the UK, with zero economic growth over the past three months.

Inflation has fallen and the stronger pound will help to keep it lower. A Bank of England rate cut now looks less likely and we expect them to remain on hold. The Federal Reserve has also said they will hold rates as they are throughout 2020.

The global economy continues to see relatively weak growth, and much hinges on whether the trade deal Trump says has been agreed with China is formalised.

Equity markets

We remain optimistic about equities, in particular part of the UK and Asian markets which we believe remain relatively cheap. By contrast, we are somewhat wary of having too much exposure to expensively valued growth stocks at present.

Fixed interest

We remain wary about having too many bonds with yields generally at very low levels. However, they remain a good insurance policy against an economic downturn. We still like short dated bonds and prefer corporate bonds to government bonds.

Commercial property

Given the rising risks and concerns over liquidity, we have reduced property exposure to less than 3% of most portfolios. Property returns are likely to be in the low single-digit percentages for the foreseeable future.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest and traditional equity, and are very light on property. This is balanced by holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent Equilibrium's collective views and in no way constitutes a solicitation of investment advice. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.

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