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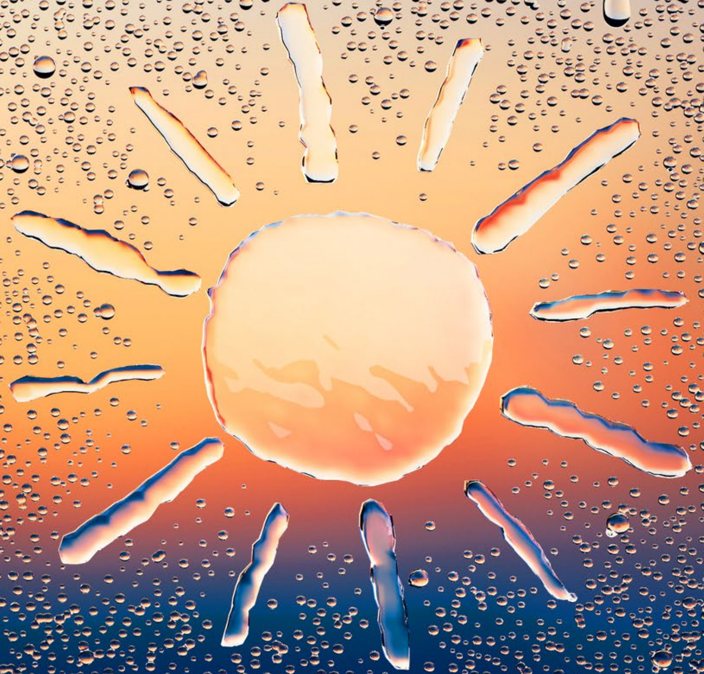

Investment Newsletter

January 2020

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Equilibrium Investment Management

Whatever the weather

We often say that investment markets are a bit like the weather… Sometimes it is bright and sunny, markets are flying and returns are easy to come by. Sometimes it rains, markets fall and losses are hard to avoid.

At Equilibrium, it's our job to provide the umbrella when it rains and the sun cream when it's hot. If we get a bit of drizzle, you'll hopefully stay dry and portfolios will hold up well. If it absolutely pours down, you'll probably get a little bit wet, but a lot less so than if you had no protection at all.

Just like the weather, we can't control whether the outlook for investments is going to be sunny or glum. And, whilst the investment industry has plenty of forecasters, they are generally about as useful as Michael Fish when there's a hurricane approaching!

Over five to 10-year periods, there are some indicators which provide some possible guidance on returns. For example, stock markets tend to see higher returns when price/earnings ratios are low at the start of the period and lower returns when valuations are high.

However, over the shorter term (one or two years) it's simply not possible to accurately predict which way markets will go.

We work equally hard whether markets are going up or down. When they are falling, our job is to keep those losses as small as possible. When they rise, it is to try to maximise gains. The difficulty with this is that one of these objectives requires us to take a lower risk approach and the other requires more risk, so managing this contradiction and being flexible in our approach is vital.

Table one shows the returns of our IFSL Equilibrium Cautious Portfolio Fund in 2018 and 2019. It shows the performance relative to the average mixed fund that has between 20% and 60% in equities (Unit Trust Mixed Investment 20%-60% shares sector).

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As an investor, you will no doubt have enjoyed the rise in portfolios in 2019 a lot more than their fall in 2018! As much as we'd like to take all the credit for 2019's returns, we know that a large part of it was down to the investment climate. 2019 was an excellent year for investors with most asset classes making money.

Just as we can't take all the credit for 2019's returns, we also can't be held responsible for the losses in 2018 when just about every asset class lost money (except cash!). Again, it was just the climate we were in. However, what we did manage to do successfully was keep the losses to minimum.

In fact, looking at the Cautious Fund, there's an argument that we did a better job in 2018 when we outperformed the average fund by 1.41%, rather than in 2019 where it only outperformed by 0.49%!

Some of the metrics we use to assess both external funds and our own performance are what we call 'upside capture' and 'downside capture'. In an ideal world, upside capture would be more than 100% (meaning the fund or portfolio goes up more than the market) whilst downside capture would be less than 100% (the fund or portfolio falls less when markets fall).

Our Cautious Fund captured only 71% of the falls compared to the average mixed investment fund in 2018. However, it captured 104% of the gains in 2019. We're pleased with that ratio.

Compared to the FTSE Allshare which fell 9.47% and rose 19.17% in 2019, the ratios are 38% of the index loss and 64% of the gain.

Tables two and three shows similar stats for our ideal Balanced and Adventurous Funds. The IFSL Equilibrium Balanced Portfolio Fund fell only 82% of the mixed sector in 2018, but its returns in 2019 were 116% of the sector.

The IFSL Equilibrium Adventurous Portfolio Fund fell more than the sector in 2018 (111% of the fall) but outperformed significantly in 2019 (gaining 139% of the average fund's return). All these returns are in line with the expected levels of risk and return of the portfolios.

Table one: IFSL Equilibrium Cautious Portfolio Fund comparison

	2018 total return	2019 total return
IFSL Equilibrium Cautious Portfolio Fund	-3.60%	12.37%
UT Mixed Investment 20%-60% shares	-5.01%	11.88%
Difference	+1.41%	+0.49%
Capture	71.9%	104.1%

Source: FE Analytics. After investment management fees only.
2018 total return from 01/01/2018 - 31/12/2018. 2019 total return from 01/01/2019 - 31/12/2019.

Table two: IFSL Equilibrium Balanced Portfolio Fund comparison

	2018 total return	2019 total return
IFSL Equilibrium Balanced Portfolio Fund*	-4.12%	13.79%
UT Mixed Investment 20%-60% shares	-5.01%	11.88%
Difference	+0.89%	+1.91%
Capture	82.2%	116.1%

Source: FE Analytics. After investment management fees only.
2018 total return from 01/01/2018 - 31/12/2018. 2019 total return from 01/01/2019 - 31/12/2019.

Table three: IFSL Equilibrium Adventurous Portfolio comparison

	2018 total return	2019 total return
IFSL Equilibrium Balanced Portfolio Fund*	-5.60%	16.61%
UT Mixed Investment 20%-60% shares	-5.01%	11.88%
Difference	-0.59%	+4.73%
Capture	111.8%	139.8%

Source: FE Analytics. After investment management fees only.
2018 total return from 01/01/2018 - 31/12/2018. 2019 total return from 01/01/2019 - 31/12/2019.

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2020 vision

If we can't forecast returns, is there anything we can say about what might happen this year?

One thing we can say is that 2020 is unlikely to see returns as positive as those in 2019. However, we hopefully won't see a repeat of 2018 and we're quite optimistic about returns.

Some of the issues which have been worrying markets have receded for now at least, such as Brexit and global trade. As a result, we remain positive that certain UK and emerging market stocks, which have underperformed because of these two issues, may be in for a decent run. We therefore have slightly more in these types of investment than usual.

However, we now have increased tensions in the Middle East to offset some of this increase in clarity, and we therefore still need to be somewhat wary.

We continue to believe a mix of various asset classes is the correct approach and why relative returns were positive in both of the past two years.

At present, we have slightly less in traditional equity than usual but instead we hold a position in defined returns. These are structured products linked to the stock market, where we give up some of the potential gains in exchange for a greater certainty of return.

For example, we set up a product with Citigroup on 3 January last year when the FTSE 100 was 6,693 and the S&P 500 was at 2,448. The terms were that this would provide a 16.05% return provided those indices were both above these levels on 3 January this year.

In the event, the FTSE 100 was up 13.90% in price terms and 19.19% total return (including dividends). Meanwhile, the S&P 500 produced a total return of 29.19% over the same period. Whilst we had less upside than had we bought a tracker fund, had they just gone sideways we'd still have got the 16.05% return.

As well as defined returns, we also have more than usual in alternative equity, which includes 'real assets' like infrastructure funds which invest in things like toll roads, railways and power generation. These underlying assets generally provide a solid return above inflation. Alternative equity also includes funds which can make money from falling stocks as well as rising share prices.

In addition, we hold both corporate and government bonds, some of longer and some of shorter dated maturities and a mix of inflation linked, floating rate and fixed levels of interest.

Overall, we'd describe our levels of risk relative to our long-term position as roughly "neutral", but by being well diversified then we can normally reduce the volatility of the returns.

If stock markets were to fall back, hopefully the alternative equity and government bonds would hold up well. If they power ahead, our equity holding will drive gains. If they are going nowhere, then defined returns come into their own.

As a final note, we would like to wish all our clients and friends a very happy and successful 2020!

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General economic overview

The UK election result and the US/China trade deal have reduced some of the political uncertainty which has hurt global economic growth.

The US Federal Reserve is likely to keep rates on hold throughout 2020 and has been adding additional liquidity to the system. With quantitative easing (QE) in Europe and Japan, and rate cuts by the Bank of China, liquidity is plentiful, and this is usually positive for stock markets.

UK inflation has dropped to 1.3% and we think there is a good chance that the Bank of England could cut interest rates. There are signs that businesses are now looking to invest in the UK again which could boost the economy.

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, particularly in the US where the market has been driven by only a few large companies.

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. Past performance is not a guide to future returns. 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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