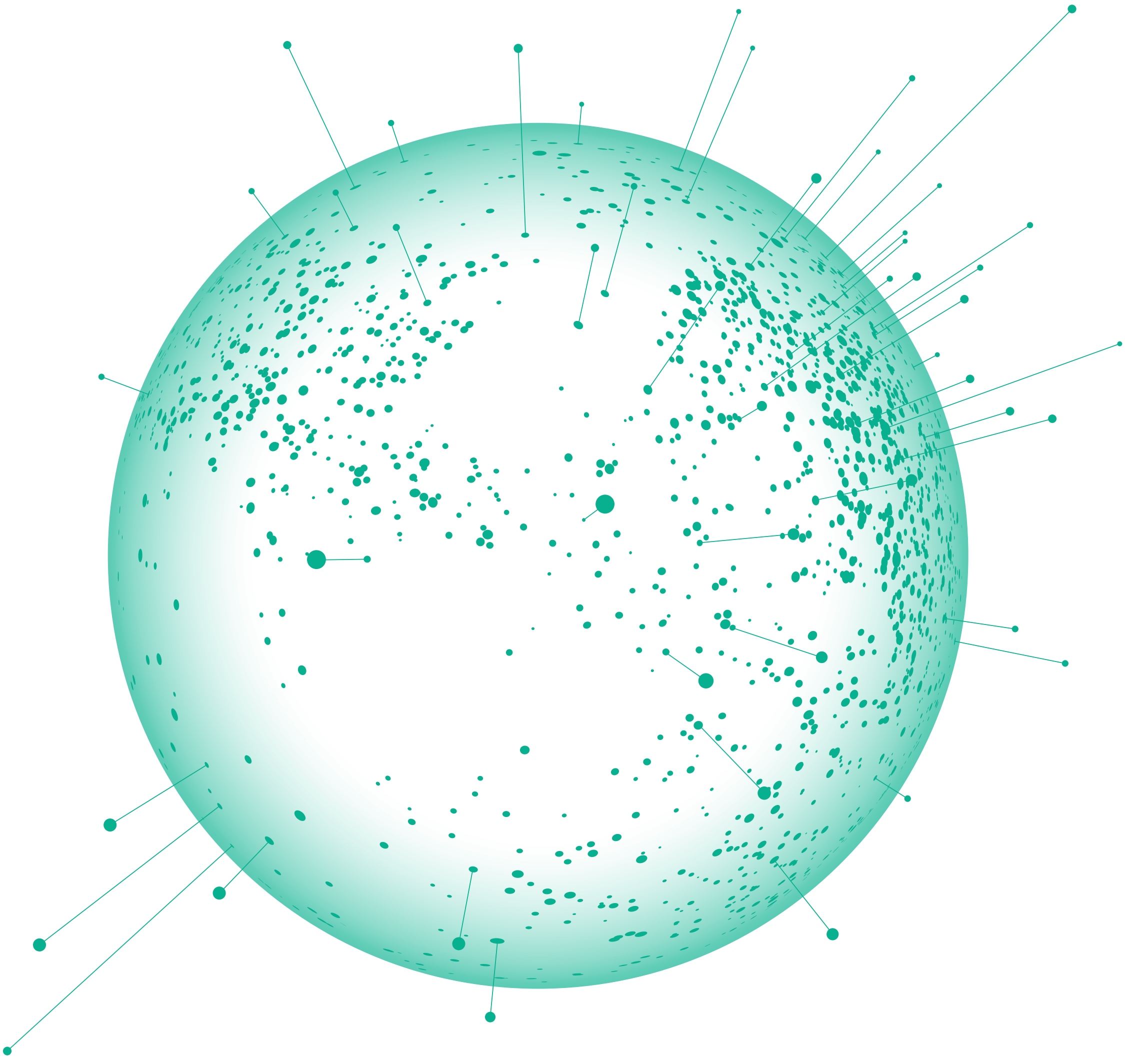
Mid-Year Outlook June 2020



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Introduction

It goes without saying that the first half of 2020 was a truly extraordinary one, both for financial markets and the wider world. In this edition of our *Mid-Year Outlook*, we discuss an exceptional six-month window, and its implications both near and far.

As we adapt to the transforming landscape in which we find ourselves, both as investors and as global citizens, we must consider how the world will look in the wake of the initial COVID-19 outbreak. In the first article – *The changing shape of a post-pandemic world* – the investment team takes a walk through this shifting terrain, from the immediate impact of the crisis on the global economy and financial assets, to the longer-term implications for supply chains and our 'normal' way of life. Importantly, we note that while the COVID-19 pandemic has been a truly unique event, many of the accompanying challenges facing the global economy are old friends and foes.

Policymakers around the globe have responded with speed and scale to the still unfolding COVID-19 event. Central banks have shown us their mettle before – with large-scale quantitative easing and ultra-low interest rates in the wake of the 2008 financial crisis – but this time around, they fight alongside government policymakers, who were all but conspicuous in their absence for most of the last decade. In the article *Can policymakers spend the global economy out of trouble?*, we chart the size and early efficacy of central bank and government efforts in the current crisis, and consider when the bill will come due.

Meanwhile in the White House, President Trump readies himself for the fight of his life against the challenger to his throne – Democrat presidential nominee Joe Biden. As we ask *Does Donald Trump have any chance of re-election?*, we look at the importance of economic growth in the presidential races of the past, the growing support for Biden, and the likely impact of the shifting contest on Trump's behaviour and policies.

Against this remarkable backdrop, it stands to reason that our clients will wonder if their portfolios are well prepared for the fast-changing new world in which we find ourselves. The final piece in our Investment Outlook asks outright *Were our investment portfolios fit for the COVID-19 crisis?* In this piece, we discuss the composition of our portfolios, their diversity of assets (including key examples), and how we see the assets we manage on behalf of our clients evolving as we head into the future.

Graham Bishop
Chief Investment Officer

The changing shape of a post-pandemic world

Only partway through and 2020 is already unique. The tragic human cost of the COVID-19 virus, the unparalleled pace and magnitude of its impact on the global economy (due to lockdown conditions), and the truly extraordinary response by policymakers around the globe have all made for an astonishing and utterly unpredictable opening six months to the year. What can we expect to see next?

The policy response from governments and central banks worldwide is set to remain active for some time, indeed the economic support already set in motion is likely to far outlive the health crisis itself. The economic downturn (which has already begun) is likely to be a deep one, but as recessions go it has the potential to be a relatively swift one too, provided demand can recover as economies reopen. Having taken a violent hit, demand for goods and services is expected to pick up fairly quickly as conditions move towards a new normality. If this takes place, we should expect a positive boost to economic growth from late 2020 onwards.

Taken altogether, despite the near-term pain, this could create a positive outlook for long-term investors. Indeed, as we write, a remarkable recovery is underway in financial markets, which have already recovered much of their composure since the height of turbulence in the spring.

What is the state of play today?

As we limp towards a way out of the COVID-19 crisis, the inevitable debate over balancing health and economic costs is in full sway. At the time of writing, the infamous virus ‘curves’ continue to ‘flatten’, meaning that the rate of confirmed new infections and deaths as a result of COVID-19 is slowing, even as the total numbers continue to grow. There are some initial signs from very high frequency, non-traditional economic data sources (like traffic congestion, energy consumption and hiring activity) that parts of the globe may have already passed their economic low point, suggesting that perhaps we can expect a lift in economic signals from here.

Second waves of infection remain a critical risk, but exit strategies are slowly being implemented in nations whose leaders feel able to ease restrictions. The early signs are relatively promising in both health and economic terms.

However, there are natural concerns about any potentially permanent economic damage created by lockdown conditions, as well as how the pandemic may have impacted how we behave as consumers, workers and global citizens. The entire planet charts an unknown course in the wake of the COVID-19 outbreak. Changeable lockdown states and erratic economic recoveries are very likely, as the world attempts to recover and repair with new uncertainties and evolutions in the offing for governments and central banks, industries and businesses, and consumers and workers alike.

> “Second waves of infection remain a critical risk, but exit strategies are slowly being implemented in nations whose leaders feel able to ease restrictions. The early signs are relatively promising in both health and economic terms.”
>
> **Graham Bishop, CIO**

Does this sound familiar?

Many of these wheels were already in motion ahead of the pandemic. Moral hazard debates that began amid the bailouts of the 2008 financial crisis have never gone away; cloud computing and hot-desking have been increasing features of more flexible workforces, and re-shoring of supply chains has been a growing issue given trade tensions around the world. Investors will be all too aware that low interest rates have long been accepted features of the financial landscape. In this sense, the trends of the post-COVID-19 world are much like the pre-COVID-19 world, but more intensified.

As long-term investors, adapting to and anticipating these developing trends is part of our approach, as demonstrated by thematic positions within our portfolios, including technology (software) and healthcare holdings, as well as a focus on sustainable assets.

What can we expect in this evolving world?

Governments attempting to spend their economies into safety are likely to be indebted for longer, and financial markets can expect to see more government bonds being issued as leaders attempt to shore up their finances.

Having begun to move on from the quantitative easing (known colloquially as ‘money printing’) policies of the post-2008 financial crisis world, central banks can now expect to be locked in to spending programmes and extremely low interest rates for the foreseeable future.

In recent decades, globalisation has spread its wings, but supply chains could be increasingly ‘on-shored’ (brought back inside domestic economies), and the ‘just-in-time’ inventory policies of recent history could be replaced by more cautious inventory stockpiling among businesses. This has wide-ranging consequences, with knock-on effects for everything from taxation and employment to storage costs and shipping.

With most businesses caught short in cash terms during the pandemic, changing corporate behaviours could also include precautionary saving, with fewer capital investments among the obvious consequences. Businesses may also seek to preserve cash rather than paying out to shareholders via dividends.

Economic growth may be lower and more vulnerable to shocks, keeping bond yields lower for longer too. Where growth can be found across markets or sectors, investors are likely to hold that in high regard and trade it at a premium to other investments.

Heightened social awareness could also propel the already-growing move towards a focus on responsible and sustainable business practices, as consumers increasingly scrutinise environmental, social and governance factors.

Digitisation is likely to rise. The move away from the high street and towards online shopping is not new, but could be exacerbated by the pandemic, as shoppers seek to avoid crowded places.

Workforces are likely to move to more flexible structures. Businesses have seen that their workers can be productive at home, creating the potential to save expense on full-time office space for all employees. Commuters may also prove reluctant to return to long journeys on crowded public transport.

Debates around moral hazards linked to the misallocation or abuse of public funding are likely to pick up sharply, particularly as the immediate dangers pass and the reality of government spending levels hits home. The need has been great, but so has the scale, leading to potential imprecision and mistakes. No systems created at such speed are likely to be perfect.

Can policymakers spend the global economy out of trouble?

The economic recession borne out of the COVID-19 crisis has been highly unusual in its course of events. Beginning as a global health crisis, the pandemic has morphed into an economic recession and a financial market shock, particularly impacting shares and other relatively riskier assets. What does this mean for the policymakers trying to respond to it?

Most recessions are triggered by the cost of capital becoming too high for businesses and consumers to access, or to service existing capital obligations. In most textbook recessions, the manufacturing sector is typically hardest hit, as demand for products pulls back, while the services sector (though not immune) is less affected – at least a portion of the population is still able to shop, go out for dinner, or visit their local pub. This time around, lockdown conditions mean that the service sector has been equally impacted (more so in some cases). This matters hugely for developed economies, where services can account for three quarters of the total economy.

Given that the impact on all areas of the economy is so material, central banks and governments have had little choice but to respond forcefully. But the extent of their response has been nothing short of spectacular, dwarfing the remedial actions following the 2008 financial crisis. And it's not just the scale of the response, but the coordination of both central bank and government support that stands out.

Policy responses are not a vaccine for the virus, and nor are they intended as such. Rather, they are part of the medication for one very important patient in this saga: the global economy. Policymakers are aiming to keep businesses and consumers afloat, quite literally buying them time, until both the demand for goods and services and the ability of the economy to provide them can recover.

Central banks have thrown everything at this crisis

There has been much talk in recent years of central banks being out of ammunition for the next crisis. The traditional tool of slashing interest rates to fight a recession seemed to have been exhausted; rates were cut aggressively in response to the global financial crisis, and have stayed low ever since. Against this backdrop, many assumed there was little left in the arsenal of major central banks.

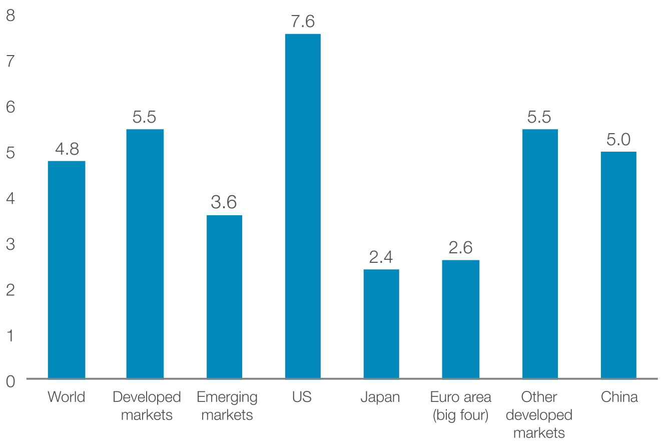
How wrong this thinking would turn out to be. Amid the COVID-19 pandemic, central banks have thrown everything at the crisis. Some of these policies have been seen before – reducing interest rates, reactivating quantitative easing programmes, and restoring some kind of order to the financial plumbing of capital markets. However, some are new – targeted lending to businesses of all sizes, and involvement throughout corporate debt markets. Central banks have gone further than most would have ever imagined, and are likely to do still more.

As a result, the balance sheets of the world's most prominent central banks have exploded. In March alone, the balance sheets of G7 central banks (UK, US, France, Germany, Italy, Canada and Japan) expanded by $2.7trn, comfortably eclipsing the full 12-month increase seen in response to the 2008 crisis.

Naturally, as the COVID-19 saga moves on, talk will return to how central banks can unwind these bloated balance sheets in an orderly fashion, without causing panic in financial markets (no mean feat), but they must take one challenge at a time. For now, in the coming months, central bankers will focus on keeping borrowing costs low enough to facilitate a recovery, while (indirectly) keeping it cheap enough for governments to fund their budget deficits, which have also exploded during the crisis. The latter point opens up a sensitive debate about the political independence, or not, of modern day central banking institutions.

Governments across the globe have stepped up in earnest to support their economies

Government support packages as a percentage of GDP (as at 30.04.2020)



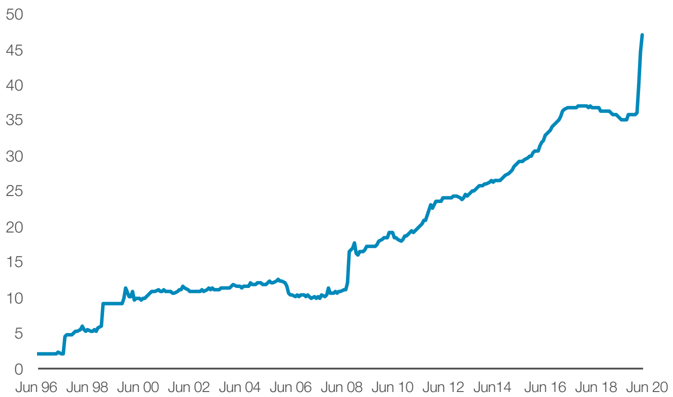
Source: Goldman Sachs

Governments have opened their coffers like never before

While the central banks have been consistently proactive in the 12 years since 2008, the same cannot be said for governments. In the UK, this was characterised as the period of austerity after the liberal spending of the Blair and Brown years. Since the emergence of COVID-19, austerity has gone out of the window, replaced by government spending on a scale not witnessed in generations. The single aim has been to cushion the huge economic destruction that has unfolded amid the global pandemic.

The balance sheets of the world's major central banks have skyrocketed

Central bank balance sheets in the UK, US, Japan and Europe as a percentage of GDP (as at 31.05.20)



Source: Goldman Sachs

In Europe, the governments of Germany, France and Switzerland have guaranteed almost €17bn of bank loans to businesses, under state aid programmes set up during the pandemic. The Germans, ever the masters of disciplined spending, have been forced to change tack, launching a 'limitless' loan programme for small and medium-sized companies. It was always going to take a crisis for Germany to start spending, and that moment has arrived.

> "Since the emergence of COVID-19, austerity has gone out of the window, replaced by government spending on a scale not witnessed in generations. The single aim has been to cushion the huge economic destruction that has unfolded amid the global pandemic."

David Absolon, Investment Director

Meanwhile in the US, we have seen government-sponsored funding for small businesses, aid for state and local governments, and wage protection programmes. Over the course of the next two years, the US government's spending response is expected to amount to around 13% of the size of its economy (in the 2008 crisis, this amounted to just 8%).

The evidence that so far only 0.3% of the Paycheck Protection Programme (at the time of writing) has gone to public companies is very constructive. Analysis suggests that the first tranche of the programme may have saved between 33 and 42 million jobs. Given its magnitude, the programme has struggled to provide expedient enough distributions, but whatever its flaws, without this programme, US employees would be materially worse off. Back across the Atlantic in the UK, the state now pays the wages of over one in ten British workers (3.2 million at the time of writing) via the 'furlough' scheme, which encompasses 435,000 firms.

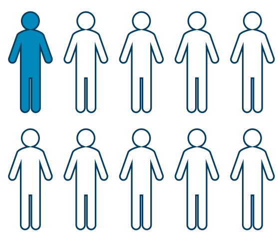
But when will the bill come due?

The coordination of central bank and government policy on this scale does potentially represent an inflation risk further down the line. This did not materialise after the global financial crisis, but that was in no small part due to the fact that large-scale crisis spending by governments was largely absent.

We believe that whether or not you agree with what policymakers have done in response to the COVID-19 crisis, or whether you think they have created a moral hazard for future generations with these unparalleled spending programmes, this is not the time nor the place for that debate. The cost of action is high, but the cost of inaction surely higher. Governments and central banks have bought some time for the global economy to regroup and recover, and thank goodness they have done so. Without their extreme responses, the world would surely be an even scarier place today.

$2.7trn

Expansion of G7 central bank balance sheets in March alone



In the UK, the state now pays the wages of over **one in ten** British workers via the 'furlough" scheme

Does Donald Trump have any chance of re-election?

History tells us that US elections are all about the economy. For a nation priding itself on economic dominance on the international stage, this makes sense. Given a more limited social safety net than many of its developed world peers, and an unwavering belief in the virtues of the 'American Dream', the health of the labour market is also of critical importance to the average American voter. What does all this mean for President Trump's November re-election bid?

If the economy is solid and the employment picture healthy, an incumbent president in the US stands a very good chance of re-election. All the way back to Roosevelt, the incumbent has always been re-elected, provided there has been no economic recession in the two years leading up to his re-election date. Only Calvin Coolidge, the 30th US president, was successful in gaining a second term in spite of a recession within this two-year window – in the 1928 election. Meanwhile, famous casualties of a failure to secure a second term, with recession in the two years leading up to their hopeful re-election, include Herbert Hoover, Gerald Ford, Jimmy Carter and George H. W. Bush.

The derailing effects of COVID-19

At the beginning of 2020, history was on Trump's side. The improving shape of the economy (following an almost two-year long trade dispute with China), and the lowest US unemployment rate in around 50 years stood in his favour. Fast forward a matter of weeks, and COVID-19 struck, potentially changing everything.

The COVID-19 crisis has already had a multi-faceted impact on the US as whole. It has set the US economy on a path to recession, led (albeit potentially temporarily) to unemployment rates last seen during the Great Depression, and severely tested Donald Trump's leadership qualities in a crisis. In an election year to boot, the US electorate is assessing his every move.

Trump's initial response to the crisis – including touting the power of US testing – was taken relatively well. However, as the crisis deepened in both health and economic terms, his handling of the situation appeared increasingly chaotic, and in some instances (such as the suggestion of injecting 'detergent' into the human body to defend against the virus) outright laughable.

By mid-May, when COVID-19 restrictions in much of the developed world were beginning to be lifted, Trump's approval rating was falling. At the time of writing, the average estimate places him at just 43.2% approval. According to the US analytics company Gallup, the average polling rating for elected presidents three and a half years into their first term is considerably higher, at 51%.

Does Trump need approval?

Modern history offers just three presidents who were overwhelmingly re-elected: Richard Nixon, Bill Clinton and Ronald Reagan. Each had solid, positive net approval ratings (their approval rating minus their disapproval rating) a few months before re-election: Nixon at 17.7%, Clinton at 16.1% and Reagan at 15.3%. The last two presidents who were re-elected more narrowly – Barack Obama and George W Bush – had net approval ratings of 1.7% and -0.3% at the same stage. At the time of writing, Trump's net approval rating is a decidedly lacklustre -8.1%.

Perhaps more importantly, Trump is losing support from one of his most crucial constituencies: senior voters. For years, the Republican Party has relied on older Americans (the country's largest voting bloc) to offset the sizeable advantage enjoyed by Democrats with younger voters. In critical states with older populations, like Michigan, Wisconsin, Pennsylvania and Florida, Trump's advantage with this key group has been essential to his political success. But seniors are also among the most vulnerable to COVID-19, and some polls suggest they are losing faith in Trump as he pushes to reopen the economy, at the expense of stopping the virus.

If the approval ratings of the past are a guide, then Trump is a one-term president. But is history really likely to repeat itself so neatly?

> "Making the virus work for them, the pandemic crisis has so far allowed Trump's campaign to both decry globalisation and villainise China. Following relatively recent signs of resolution to the long-running trade dispute with China, the highly politicised topic of bringing manufacturing back to US shores is back on the table."

David Absolon, Investment Director

Making Trump great again

In the face of falling approval ratings and a floundering employment picture, the Trump campaign is reverting to type. Trump's camp touts him as better able to rebuild the virus-hit economy than the presumptive Democratic nominee – Obama's erstwhile vice president, Joe Biden.

Making the virus work for them, the pandemic crisis has so far allowed Trump's campaign to both decry globalisation and villainise China. Following relatively recent signs of resolution to the long-running trade dispute with China, the highly politicised topic of bringing manufacturing back to US shores is back on the table. Some estimates suggest 'reshoring' manufacturing and production from China to the US could create three million more US jobs. The reality is far more complicated, particularly for US corporate profit margins, but the rhetoric will certainly appeal to much of Trump's audience.

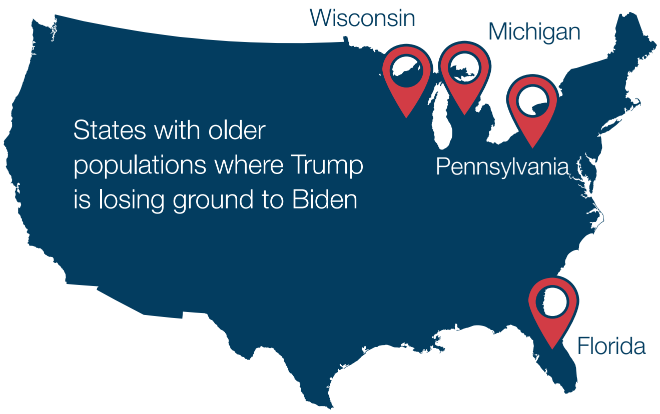
The challenger enters the arena

Of course, November's election also offers another candidate – an alternative to Trump and his Republican Party. To make any significant impact, Biden and the Democrats would need not only to secure the presidency, but also the Senate (upper house of parliament). 35 seats will be up for grabs, and the Democrats require an additional four to gain control; taking over in Republican-controlled states hard hit by COVID-19 could tip the balance in their favour.

Biden himself is a centrist within the Democratic Party, and any Biden presidency would look very different to Trump's. China could probably breathe a sigh of relief, given Biden's longstanding views on free trade, though he could face some opposition to tariff relief (even within his own party). Biden would also look to roll back a number of Trump's 2017 tax cuts, both corporate and personal. This could be meaningful for stock markets, particularly as these cuts have supported US consumer activity, corporate earnings, share buybacks, and the repatriation of hundreds of billions of formerly overseas US dollars.

Biden has strong views on energy policy too: the renewable energy sector would likely be a major beneficiary of a Biden presidency. The technology sector – a powerhouse of the US economy and a dominating feature of its stock market – will also be watching Biden with interest and potential trepidation, given his views on competition laws.

As always, the US presidential election will have huge ramifications, not just domestically, but globally too. It will impact financial markets substantially, and all investors will be closely watching each turn of events in the run-up to November.



- Herbert Hoover, 1932
- Gerald Ford, 1976
- Jimmy Carter, 1980
- George H. W. Bush, 1992

Famous former presidents defeated in their second-term bid, with a recession in the two years before their election

Were our investment portfolios fit for the COVID-19 crisis?

The importance of a well-diversified portfolio has rarely been more in evidence than in the first half of 2020. At the time of writing, financial markets have staged a remarkable recovery since their lowest points during the pandemic crisis. Even so, the opening months of the year can hardly be said to have been a comfortable time for investors. While we could never have predicted the precise events of the past few months, were our investment portfolios ready to face this crisis?

As the COVID-19 outbreak unfolded, our core strategies – which span a spectrum of client preferences for potential risk and financial return – were invested across a diverse range of asset types. This included higher risk assets designed to generate financial returns (such as shares and higher yielding debt market positions), as well as portfolio diversifiers, which are intended to provide balance for risks elsewhere in portfolios, while in some cases (e.g. government bonds) also serving to preserve capital.

From January to the end of March, the UK stock market fell by

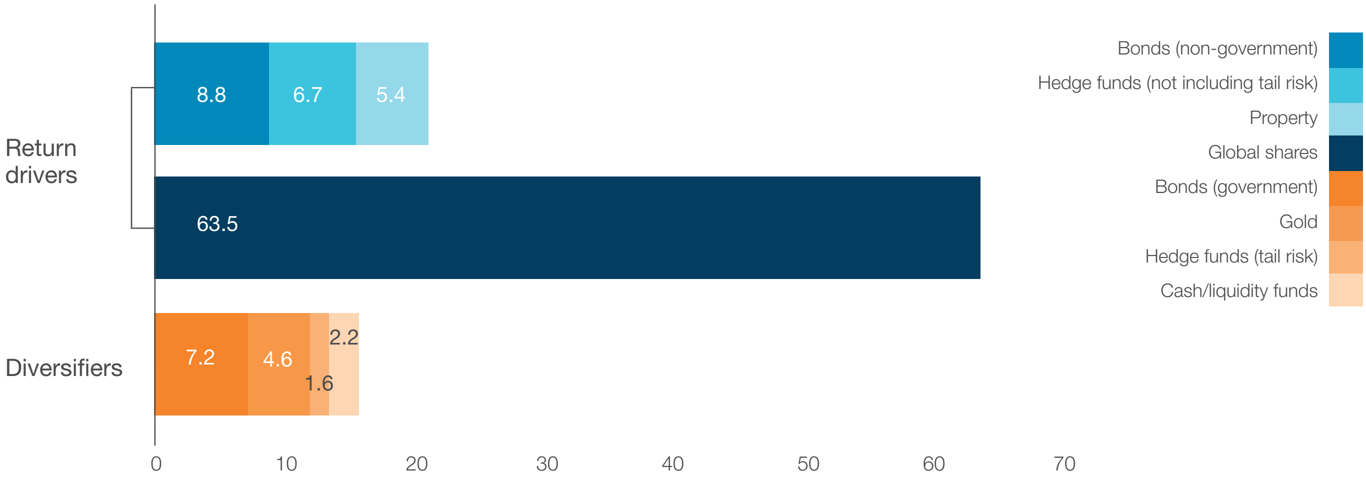
24%

Our Balanced portfolio fell by

13%

Our portfolios include assets designed to create financial returns as well as assets intended to diversify risk

Positioning in our Balanced strategy, % weightings, June 2020



Source: Heartwood Investment Management

How did our portfolios respond to market falls?

This spread of asset types is core to our 'multi asset' approach, and we believe it served portfolios well as the COVID-19 crisis evolved. While, naturally, our portfolios experienced losses as financial markets fell, we think that their varied makeup alleviated the worst of the falls. Between the start of the year and the end of March, the UK stock market (represented by the MSCI United Kingdom Index) fell by 24%, while our Balanced portfolio (which we tend to use as a point of reference among our core portfolios) fell by 13%.*

During the market turbulence, we were pleased to see those portfolio positions designed to partially mitigate exposure to risk, step up. In particular, the protection afforded by our 'tail risk hedging' positions (see overleaf) enabled the portfolios to tolerate concurrent holdings in risky assets in a manner that would otherwise have been extremely difficult. This was particularly helpful when, in the wake of sharp stock market falls in March, we increased portfolio holdings in global stock markets, drawn to attractive, newly-low prices. We were further encouraged by the concerted government and central bank support being offered in response to the ongoing situation, which we continue to believe will outlast the health crisis itself.

> "We continue to see compelling dynamics within key emerging market economies, and maintain selective portfolio holdings within Asia."
>
> **Jaisal Pastakia, Investment Manager**

*Past performance is not a reliable indicator of future results. Data in GBP. Balanced Portfolio performance refers to performance of the LF Heartwood Balanced Multi Asset Fund after ongoing charges have been taken, which is inclusive of a 1% annual management charge ('C' share class) and third party manager fees. Ongoing charges do not include transaction costs, which may also impact investment returns.

The rapid recoveries in stock market prices which ensued (the falls may have been dramatic, but so too was the rebound), and a changeable outlook for financial markets at that time, subsequently gave us pause for thought in raising our exposure to riskier assets any higher. For the time being, given the balance of factors in play, we aim to hold overall portfolio risk levels steady. As always, we remain alert to both opportunity and risk.

Therefore, what should investors expect to see next?

A shifting leader board for stock markets could lie ahead...

Within the wide-ranging pool of global stock markets, we could expect to see developed markets outperform their emerging market counterparts, as tensions rise between the US and China and a range of nations (including the UK) continue to follow an ongoing trend of protectionism. The alarm caused by COVID-19 is unlikely to slow this movement; if anything, it will accelerate the populist push to 'on-shore', as globalisation – once seen as a force for progress – is recast as a threat.

Even so, it will be difficult to completely erode the global supply chains that have been built up over the past 20 years. We do expect to see some changes, but we believe we are unlikely to see mass on-shoring, given the effect this would have on the revenues and market dominance of many companies. We continue to see compelling dynamics within key emerging market economies, and maintain selective portfolio holdings in markets like China and India.

We could also see an impact on share price valuations through changes to corporate behaviour (such as holding back cash at the expense of capital investment or dividend payments). Financial markets will likely deliver new winners (and, by extension, new losers) as the world re-evaluates its priorities. Increases to our high conviction positions in themes like healthcare, technology (particularly software) and insurance, as well as assets with good sustainability credentials, indicate our own predictions and preferences.

... but investors will prize growth and certainty wherever they can find it

For much of the past decade, shares which fall under the 'value' category (typically belonging to businesses with limited potential for future growth, and which normally therefore trade at lower prices) have lagged those classified as 'quality' or 'growth' shares. The latter includes giants of technology and ecommerce, such as Netflix, Amazon and Facebook, whose share prices have been driven upwards by an insatiable hunt for growth amid collapsing interest rates around the globe.

'Value' shares have shown some signs of rebound during the latest period of recovery, following the springtime market lows. However, while we should expect some short periods of outperformance for 'value' shares, the strong balance sheets and resiliency of 'growth' businesses mean that their share prices are probably likely to continue to lead the way over the medium term.

The shares of 'value' companies have underperformed those of 'growth' businesses over the past decade

MSCI World Value Index versus MSCI World Growth Index

Source: Factset and MSCI

> Our preferences remain for high-yielding corporate debt, emerging market debt, and alternative income areas like specialist trade financing. Holdings like these feature in our core portfolios, alongside traditional fixed income assets like UK government bonds.

Scott Ingham, Investment Director

Meanwhile, yields on bonds (which move inversely to their prices) are likely to stay low. With investors prizing certainty where they can find it, there will be limited incentive for bond issuers to offer high yields to their lenders. Our preferences remain for high-yielding corporate debt, emerging market debt, and alternative income areas like specialist trade financing. Holdings like these feature in our core portfolios, alongside traditional fixed income assets like UK government bonds.

Should investors worry about inflation?

Unlike in the aftermath of the 2008 financial crisis (when central banks were acting largely without government programmes to back them up), both government and central bank support packages are in action today. Given the size and scale of these programmes, there is a greater chance that they will make an impact on the 'real' economy. This includes inflation, although as ever, many factors will be acting in the opposite direction too.

Taken alongside some slight moves towards 'on-shoring' of production (which will likely bring with it some increased pricing pressures at certain points over the coming decade), we would not be surprised to see a slightly higher – or at least a little more volatile – inflationary outlook ahead than we have become used to over the last ten years. Even so, while there is potential for a slightly higher inflation regime ahead, the probability of a sudden surge in inflation remains very low, given the fragile current state of demand.

> Beyond the unexpected hit to global growth caused by the COVID-19 crisis (and in particular lockdown conditions across the globe), we are cognisant of other risks to the outlook for financial markets, including re-emerging trade tensions and politics – the ongoing Brexit process and the US presidential election spring to mind.

Michael Stanes, Investment Director

Taking a cautiously optimistic stance on the outlook for financial markets

This move towards increased volatility is likely to be present in financial markets too. We believe markets are likely to retain some increased turbulence over the coming months, more so than we have become used to in the recent past.

Beyond the unexpected hit to global growth caused by the COVID-19 crisis (and in particular lockdown conditions across the globe), we are cognisant of other risks to the outlook for financial markets, including re-emerging trade tensions and politics – the ongoing Brexit process and the US presidential election spring to mind. Nevertheless, the unparalleled support of governments and central banks for the global economy gives us courage, and our portfolio positioning reflects our cautious optimism about the outlook for financial markets over the longer term.

Understanding the diversity within our portfolios: a closer look at 'tail risk hedging'

> At the time of the worst COVID-19-related market falls, we held positions in two tail risk hedging strategies, both of which become more potent amid falling markets.
>
> **Charu Lahiri, Investment Manager**

Different types of investments do not generally move in tandem – some will go up while others fall, and the situation can reverse quickly.

Our multi asset investment strategies have a variety of investments, with a mix of different asset types designed to do two things:

1. **Find a greater number of opportunities for compelling returns**
2. **Manage the fluctuations that occur in financial markets**

This means that the funds are diversified across different types of investments to help smooth the investment journey for our clients. In the run up to (and during) the worst market falls of the COVID-19 crisis, the diversifiers within our core portfolios included specialist strategies called 'tail risk hedging'.

Thriving on turbulence: the aims of tail risk hedging strategies

Tail risk hedging strategies are designed to protect against dramatic market falls. During the recent period of extreme stock market stress due to the pandemic sell-off, these complex, actively-managed strategies made a significant contribution to the performance of the funds. As is their nature, they benefited both from the fall in risk assets like shares as well as the generally increased market turbulence.

During benign market conditions, when risk assets are generally moving up and market volatility is relatively low, these strategies generate small negative returns, much like the cost of holding an unused insurance policy. During times of market stress, however, these strategies are able to generate strong positive returns.

Packing a big punch: performance within our portfolios

At the time of the worst COVID-19-related market falls, we held positions in two tail risk funds, both of which become more potent amid falling markets. We opted for positions in these funds of a size which would offset approximately a third of any share price losses we might incur, should stock markets fall by 20%. This meant taking on a holding of between 0.33% and 0.66% across our core portfolios.

Despite these relatively small positions, over the first quarter of 2020, our tail risk positions contributed between +1.2% and +2.6% to overall performance within these core portfolios. This level of positive performance contribution is meaningful, and we think it reiterates the value of holding highly specialist strategies like these, which react positively to extreme market falls.

Sizing our positions: did we have the right amount invested?

In hindsight, of course, we would have liked to have had even larger positions in the tail risk hedges! However, outside of times of extreme market distress, specialist positions like these do underperform, at a cost to portfolios.

As a result, sizing such positions is always a balance between the potential pay-off during periods of market stress, the uncertainty around the exact magnitude of that potential pay-off, and the cost of holding these positions during more benign market environments.

After the storm

We have monetised a portion of the gains made in our tail risk hedges to date, selling out of these positions to generate cash which can potentially be used to buy cheap assets elsewhere in portfolios. That said, we do continue to retain some of our tail risk position. Having proved its worth in early 2020, we believe that it could continue to serve as an important source of positive performance during any future periods of market stress.

Key investment terms

Active management	Where the fund manager uses their expertise to pick investments to achieve the fund's objectives rather than copy the investments in a market index.
Assets	Anything having commercial or exchange value that is owned by a business, institution or individual.
Balance sheet	A summary of a company or institution's financial position, made up of assets, liabilities and (where applicable) shares.
Bond (government or corporate)	An investment in the debt of a government or corporation, where investors receive a fixed rate of interest over a specified time period, at the end of which the initial amount is repaid.
Capital investment	Funds used by a company to further its business objectives, which could include the acquisition of assets such as property, manufacturing plants, or machinery.
Capital markets	The area of the financial system concerned with raising capital via shares, bonds, and other long-term assets.
Developed economy/market	Well-established economies with a high degree of industrialisation, standard of living and security.
Dividend	A share of profits which a company pays out regularly (typically annually) to its shareholders.
Diversification	Holding different types of assets in a portfolio to spread the risk.
Emerging economy or market	Countries that are progressing toward becoming advanced, usually shown by some development in financial markets, the existence of some form of stock exchange and a regulatory body.
Exposure	The proportion of a fund invested in a particular asset type, bond, sector/region, usually expressed as a percentage of the overall portfolio.
Fixed income	A sector of investments which offer fixed rates of interest over a specified time period, at the end of which the initial amount is repaid. This may include government bonds and corporate debt.
Hedging	A method of reducing unnecessary or unintended risk on a portfolio.
Index	A representative portfolio of assets which helps to track market trends and performance.
Inflation	The rate at which the price of goods and services rises.
Multi asset	Investment across different types of assets such as company shares, bonds, property or cash.
Quantitative easing	The introduction of new money into the money supply by a central bank.
Recession	A period of economic decline, technically defined as two consecutive quarters of negative growth.
Risk	The level of risk in a portfolio is essentially the probability for loss.
Risk management	The activities a manager undertakes in an effort to limit the risk of losses in a fund.
Sector	An investment category used to define the primary business of a company, such as technology, energy, or healthcare.
Share/stock	A stake representing part ownership of a company.
Volatility	The degree to which the price of a given asset, or price levels of a given market, rapidly changes. The higher the volatility, the riskier the asset/market tends to be.
Yield	The income from an investment, usually stated as a percentage of the value of that investment.

Investment team

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Chief Investment Officer

Michael Stanes
Investment Director

Scott Ingham
Investment Director

David Absolon
Investment Director

Jaisal Pastakia
Investment Manager

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Investment Manager

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Investment Performance and
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Wealth Briefing European Awards 2019

Winner: Best Fund Manager

Winner: Change Management Process/Best Implementation of a Technology Solution

Shortlisted: Most Promising New Entrant (Sustainable)

Financial Services Forum Innovation Awards 2019

Winner: Customer Loyalty

Highly Commended: Customer Interaction and User Experience

Investment Week Sustainable and ESG Investment Awards 2018

Shortlisted: Best New Entrant - Services

Citywire Investment Performance Awards 2018

Shortlisted: Best Medium Firm

Investment Week Fund Services Awards 2018

Shortlisted: Best Technology Solution (small to medium firm)

FE Trustnet Alpha Manager Ratings 2018

Winners: David Absolon, Scott Ingham, Michael Stanes

Portfolios may include individual investments in structured products, foreign currencies and funds (including funds not regulated by the FCA) which may individually have a relatively high risk profile. The portfolios may specifically include hedge funds, property funds, private equity funds and other funds which may have limited liquidity. Changes in exchange rates between currencies can cause investments of income to go down or up. The value of any investment and the income from it is not guaranteed and can fall as well as rise, so that you may not get back the amount originally invested.
Past performance is not a reliable indicator of future results.

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