Vista

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The outlook

It's often instructive to look back at what one wrote about the market environment in the last edition.

Just after the calendar year end, I was commenting on the reasons for the pronounced equity market correction we had all endured in the last quarter of 2018. The major reason for this, I argued, was the growing perception that the state of the world economy, and particularly the US, was dictating a reversal of the period of monetary ease (low interest rates) to which we had all grown accustomed. Moreover, the unprecedentedly large purchases of securities by world Central Banks might soon need to be reversed (quantitative tightening). Another factor was the ongoing trade dispute between the USA and China and the damaging impact that was undoubtedly having upon China's economy.

Finally, of course, I had to say a few words about Brexit.

I also remarked that, given the falls in markets we had seen, I felt more optimistic about equity market prospects than I had for some time. My view could best be summarised as more positive, but still not wildly optimistic. Valuations looked more attractive and there appeared to be some indications that, with momentum in the world economy slowing, the need for interest rate increases had receded somewhat.

Well, the story of the first quarter of 2019 could be written almost entirely citing the same factors. And my relative optimism was rewarded almost immediately!

One that hasn't changed much is the Chinese situation, at least not on the surface. Trade negotiations between the US and Chinese delegations continue. There is talk of a settlement, but commentators are agreed it would be a temporary arrangement in what is likely to be a long struggle for supremacy. In the meantime, the Chinese authorities seem to have reversed their policy of monetary tightening and have begun allowing the banks to create credit again – in marked contrast to last year.

This is diluting some of the worst effects of the increased tariffs but not by much. Exports were down 20% year on year in February and the trade statistics of many economies in the region, notably Japan, are suffering from the lack of opportunities.

Remarkable rallies in global equity markets

The major thing that has changed, however, is the stance of US monetary policy. At the end of the year guidance was being given that the Federal Reserve was still on course to raise interest rates at least three times in 2019. Amazingly,at its last meeting in March it kept rates unchanged and signalled that no further rate increases were expected for the rest of the year, conditional upon the outlook. This 11th hour conversion to a dovish stance is a remarkable turnaround and one which equity and bond markets have taken to heart. January saw a remarkable rally in global equity markets and this continued, albeit at a slower pace, into March. For the quarter as a whole, the US and Chinese markets have led the way, though markets have generally not reached the levels they were at the end of September last year.

In the meantime, bond markets too have been rallying, with the bellwether ten-year US Treasury yield reaching its lowest point since 2016, on fears of a global recession.

These market movements are a classic reaction to a change in monetary policy regime. Interestingly, though, market reaction is now becoming a little more nuanced. Undoubtedly, the economy is slowing. However, in the case of the US, that is from a very robust pace, where employment and consumer sentiment are strong and investment has been picking up, if anything. The European and Japanese economies have been weak with Germany teetering on the verge of recession.

Markets have recently started reacting cautiously to these data releases. After a point, even if it signals a change in the monetary stance, weaker growth starts to worry people.

> **It has become clear that the different options for Brexit and their impacts are extraordinarily difficult to understand.**

For our part, we are not too concerned. There is enough momentum in the world economy to sustain it for a while as long as the trade dispute does not worsen. But the weakening course of the data is such as to confirm our relatively cautious stance for the moment.

But the interesting thing about the change in the US central bank's stance is that its abrupt nature is evidence of wider concerns at the most important economic policy making body in the world. It's having a bit of a crisis of confidence in its traditional tools – to the extent that it has announced a major policy review, occurring this spring and summer, investigating whether the tools it has at its disposal are appropriate for delivering its mandate, which is to maintain full employment consistent with price stability. The experience of the last few years has been such as to call the framework into question – unemployment is very low but inflation has been below its mandated 2% target since 2012. (Economists call this a flat Philips Curve). The review will even encompass some public consultations (Fed Listens events) and will culminate in a 2-day conference in June.

Brexit: what are the options now?

So what of the Brexit situation? When last we wrote, Parliament was in recess and the newswires were getting a welcome break from Brexit issues. We all wish that were the case now.

Last time I wrote that an extension to the Article 50 process and a referendum were looking the most likely outcomes. With all the machinations going on in Parliament now, though, I would be tempted to revise that opinion slightly, though of course we have already had small extensions to Article 50.

It has become clear that the different options for Brexit and their impacts are extraordinarily difficult to understand. When it appears that many of our elected representatives do not understand it, one worries about the wisdom of allocating the decision to plebiscite.

There are some clear conclusions which MPs need to understand in short order, though.

First is that the only solution to the Irish border question is membership of the Customs Union and the Single Market. The emergence of the Single Market in the 1990s enabled the Good Friday Agreement because it enabled the eradication of the land border on the island.

Second, we do not hold all the cards. We never have, and we had even more of a disadvantage once we had triggered Article 50. We are entirely in the EU's hands in this negotiation. To imagine that a different politician, Boris Johnson or Jeremy Corbyn, could go to Brussels and win the EU over to our point of view is pure illusion.

Finally, I wrote last time that we should not imagine that March 29th, the then date of leaving the EU, would be the end of the affair. I reiterate that conclusion. The issue is unlikely to be resolved quickly. Even if the Withdrawal Agreement is passed, the negotiation of the future relationship will take a long time and the political tensions around it will not dissipate.

As I write, a General Election is being mooted. With both major parties split down the middle about what to do about Brexit, this is unlikely to resolve the issue (although it may lead to party political turmoil and break up).

Along with other financial market participants, we cannot be blindsided by the day to day workings in Parliament and elsewhere. We have to focus on outcomes. Our view, which I suspect is not very different from how the market feels at the moment, is that a No-Deal Brexit is unlikely, a no Brexit (Remain) is a little more likely but the probable outcome (eventually) is a soft Brexit, or what commentators refer to as BRINO, Brexit in name only.

The longer it takes to get to one of these outcomes, however, the more damage the UK economy incurs.

Guy Stephens

TECHNICAL INVESTMENT DIRECTOR

How a polarised market can provide profits for the brave investor

Many investors will be aware and perhaps bemused or sceptical that the UK equity market, as measured by the FTSE-100, has not been particularly impacted by the Brexit shenanigans over the last two years. One explanation is commonly quoted as being the fact that over 75% of the earnings from FTSE-100 constituents such as BP, Shell, Rio Tinto and HSBC are from overseas, principally US dollars. This means that when the value of Sterling dropped after the referendum on 23 June 2016, the value of these overseas earnings rose when translated back into a now weakened sterling.

This means that as the chaos has intensified within parliament, weakening sterling. The FTSE-100 has often appreciated in response, presenting a natural hedge to the worrying economic implications that would normally emanate from such an uncertain environment.

Weakening domestic sectors

However, outside of this, representing the true Brexit effect, there has been significant weakness in domestic sectors which are dependent on consumer confidence and have little or no overseas earnings. Such examples are anything linked to property whether that be residential or commercial. Others are retail which has had the double whammy of hesitant consumer confidence coupled with the impact of internet shopping on the high street. So, any business offering commercial property outlets to general retailers is probably operating in just about the worst affected environment possible.

It's not all doom and gloom

Yet, despite all the doom and gloom and predictions of disaster of two years ago, (the so-called Project Fear as often quoted by hardline Brexiteers) overall, the UK economy is holding up well, relative to other countries such as Italy, Germany and Japan which are all either in recession or very nearly.

Nevertheless, there are areas where the share prices are pricing in future earnings uncertainty as they would potentially be severely affected in the event of a no-deal Brexit. Market capitalisation has come into play where unusually, large capitalisation stocks have been outperforming mid-caps and small-caps. Firstly, large caps are where the largest overseas earners are found, secondly, this is because a lot more of the mid-caps and small-caps are domestically exposed and thirdly, as investors have become cautious they tend to focus on the largest businesses as these should be more able to weather any storms that lie ahead whatever the outcome of Brexit.

This may present opportunity for the savvy investor who is willing to bet that the worstcase scenario is being priced into these currently unloved sectors and stocks. In many cases, the share prices are so depressed that there are eye-watering dividend yields on offer. However, this is classic value investing and fundamental analysis and deep understanding of the underlying business is vital, otherwise the unwary investor may simply buy the chart which shows a depressed share price, get drawn into an 8% dividend yield, only for the business to founder, pass the dividend and collapse into a distressed situation with all shareholder value wiped out. Debenhams would be a case in point.

The alternative is to buy the growth sectors which appear immune from Brexit, perhaps those with significant overseas earnings which are currently doing very well. However, the valuations in terms of price/earnings ratios, will be considerably higher than the value sectors as

> **When investing in a very uncertain environment, one certainty which you can focus on is the provision of income.**

referred to above. The risk here is that either sterling strengthens on a Brexit deal, reversing the currency benefit previously enjoyed, or some other negative appears – either company-specific or sector-specific – which bursts the valuation premium bubble and investors run for the hills as the share price craters.

Keep a foot in both camps

So, we have a rather polarised UK equity market. One half, expensive with beneficial currency support, influenced by politics, the other potentially oversold and cheap, but vulnerable to a no-deal Brexit. When faced with such a dilemma, it is sensible to have a foot in both camps so that, as an investor, you are hedged to either scenario, and as many of the other scenarios currently being debated in parliament. However, when investing in a very uncertain environment; one certainty which you can focus on is the provision of income or more specifically, the payment of dividends, their growth in real terms and the sustainability and security of that dividend.

One quick and easy measure which all professional investors will look at when faced with a share yielding 8% or more is dividend cover. This is the ratio of earnings per share to dividend per share or in plain English, the ability of a company to cover its committed dividend payment by the profits from the company. Clearly, if the latter is deficient in this respect, then the company must pay the dividend from reserves which can only go on for so long before it must cut the dividend.

One definition of a share price, and a valuation measure, is intrinsic value. This is defined as the discounted present value of future cashflows i.e. dividends. Therefore, a company will only cut its dividend as a last resort because the effect on the intrinsic value is significant and especially if the company is viewed as an income share where the earnings are not growing much above inflation. This means that when a company has a high dividend yield and most likely, a depressed share price, if the dividend cover is low and not covered by earnings, the market is expecting that dividend to be cut. This means that the advertised 8% historic dividend yield is an illusion and more likely translates into a 4% yield going forward, coupled with a significant fall in the share price, if and when that occurs. If the price/earnings ratio also looks low, then this is probably a value trap for the unwary investor as the earnings (and the dividend) have not yet officially adjusted down to reflect the anticipated negative outlook.

A window of opportunity

At this point, it is probably useful to look at some of the sub-sectors of the UK equity market and how they have performed since the Brexit vote. Mining & Basic Materials is the top sector, more than doubling over the period, followed by Beverages and Electronic & Electrical Equipment. Conversely, Telecommunications, Industrial Transportation and Tobacco populate the weakest areas.

This is the first step to focusing on where there may be some rich pickings but also some dangerous value traps. Clearly, this is where the skills of equity analysis come in and that is not the purpose of this commentary but perhaps it gives a flavour of why, at times like this, with a polarised market, for the brave investor, there could be some highly profitable opportunities.

Donald Maxwell-Scott

TECHNICAL INVESTMENT MANAGER

The power of income

The power of income is underappreciated, and often when looking at individual shares, consideration is only given to share price performance. What percentage has the share price increased over a month, quarter, year, or even longer? Of course, this information is useful when assessing small fledgling companies - growth stocks. This is because any profit they might make is reinvested back into the company, thus increasing its share price. However, larger more established companies tend to distribute profits as dividends. The misconception is growth is exciting and income is boring!

Would you like a game of chess?

This is not true, and those who ignore the power of compound returns should take heed from a story about a king, a masterful chess player who liked to challenge travellers passing through his kingdom. One day a traveller accepted the kings offer and asked what they would get in the event if they beat him. So confident of victory, the king retorted that the traveller could name his prize. The traveller demanded that should he win all he would want is some rice, albeit grains of rice doubled throughout the chess board.

So, one grain of rice on the first square, two grains on the second, four grains on the third, eight grains on the fourth square and so on, until all 64 squares were covered. The king duly accepted the travellers demand. Unfortunately for the king he lost, but being a man of his word, he asked one of his servants to fetch a sack of rice to fulfil his obligation. He quickly realised that he had been duped, because to fulfil the traveller's prize he would need 18,446,744,073,709,551,615 grains of rice. This figure is over eighteen quintillion.

The king did not appreciate the power of exponential growth. Of course, reinvesting dividends is not exponential, because any positive rate of exponential growth inevitably causes all available resources to be consumed. However, we believe it does illustrate the potential power of growth, and more importantly, the power this can have on investment returns over time.

Focus on the "real return"

As already mentioned, larger, more established companies pay out profits as dividends, so where better to look at the power of dividends than the FTSE 100:

Source:
FE Analytics 2019

> **What does it matter if the value of your money goes up, but it has less purchasing power?**

As you will note in the graph, the blue line represents capital growth only within the index, whereas the yellow line represents capital growth plus income reinvestment (the total return). The period we are looking at is from the 1 January 1986 to present day (5 April 2019).

With capital appreciation the return is 427.53%, whereas with income factored in and reinvested, the return (total return) is 1773.89%!

Whilst a return of 427.23% might not sound too bad for some, this figure does not consider the impact of inflation. According to the Bank of England £1 in 1986 would have been worth £2.88 in 2018 – or 288% more. So, the return would only be 139.17%. The 'real return' is always what matters in the long term, after all, what does it matter if the value of your money goes up, but it has less purchasing power? This isn't the case in the above example, however, there would have been other assets considerably less risky than the stock market to achieve the same level of return. This is known as the risk-free rate of return.

Such examples of risk-free rates of return might include holding cash in the bank or holding government securities such as gilts. As you will note in the graph below I have added the Bank of England (BOE) base rate + 1% - an expected return should you hold cash or invest in certain instruments linked to the BOE base rate.

It is surprising to see that over the same period a safe investment such as cash would have outperformed the FTSE 100 on a capital return basis. Hopefully this illustrates the power that income can have on one's portfolio, and with that income being reinvested, it does offer protection against inflation, but also ensures the rewards of investing in the stock market outweigh the risks.

Opportunity lies in both the rise and fall

Even short-term dips in the stock market can work to an investors' advantage, as they will be able to buy more shares with any reinvested dividends during these dips. When combined with market growth over the longterm the benefits become even clearer.

As hopefully illustrated, the power of growth is not to be underestimated. But for those yet to be convinced, I thought it would be fitting to end on another example of the power of exponential growth. Forbes recently announced that Jeff Bezos is the richest man in the word with a fortune of $137 billion. However, if you gift a new born baby $1 on their first birthday and $2 on their second, and continue doubling their birthday gift every year, by the time they are 37 they will have a fortune larger than Mr Bezos'. By the time the lucky birthday recipient has reached 40, their fortune will have exceeded the current market capitalisation (value) of Amazon.

Past performance is not indicative of future performance.

It is not possible to invest directly into the FTSE 100. An investment in shares will not provide the security of capital associated with a deposit account with a bank or building society.

The value of shares and dividends may fall as well as rise. You may not get back to the amount invested.

Tim Cockerill
INVESTMENT DIRECTOR

Why we blend funds...

> **A fund which is performing well today may not perform as well in six months' time, should the focus of investors have altered.**

The fund Research Team spend their time seeking out the funds which they think will perform well within portfolios. This isn't a case of simply looking for the best performing ones, indeed I'd argue that's a flawed approach – why? Because the performance of a fund will change alongside market conditions, some will be suited to one type of market rather than another. A fund which is performing well today may not perform as well in six months' time, should the focus of investors have altered. So, there are two things we as a team try and do; firstly, to understand when a given fund is likely to do well and secondly, to decide whether we want to hold it in portfolios even if we don't expect it to perform well in the near term.

We refer to this as blending funds – or not putting all your eggs in one basket! In broad terms, equity funds fall into two groups based on their style of investing. By style, we mean how they approach their stock selection, what they look for in a company and what aspects of their analysis are prominent. These two groups are value and growth. There are no hard and fast rules around these descriptions, consequently a multitude of variations exist, however most funds can be put into one of these groups.

Growth or value style?

When we look at funds which we describe as having a growth style and compare them with those having a value style, we are, in simple terms, looking at opposites. The manager of a growth fund is investing in companies which are growing quickly and ploughing back profits to generate more growth. The value manager, on the other hand, is looking for companies where the estimated value of a company is more than the current share price.

All things being equal the manager is expecting the difference between how the market values the company and its actual value to change – hopefully the market will bid the company share price up. Often this type of company is paying out its profits as dividends and not, like the growth company reinvesting.

The above description is by necessity quite basic and many other factors come into play, one being quality. Quality is subjective, but invariably refers to the management team running the company, the nature and type of business, how well established it is, and whether there are barriers to entry and therefore pricing power.

We can't always predict the future

When constructing portfolios, we'll blend value and growth funds with the expectation that over time the performance of the two funds will vary, and the one performing best at any given time will not be the same. Why do it this way? It's because the market is hard to second guess, and although we spend a lot of time trying to do just that, we are realistic and know that predicting the future is difficult. So, by having a foot in each 'camp' when the market changes its focus and stocks that were in favour last quarter are out of favour this quarter, we have a fund that takes up the running.

The value of an investment with Rowan Dartington may fall as well as rise. You may get back less than the amount invested.

Source: FE Analytics 2019