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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Unusually, both fixed interest securities and equities have achieved positive returns in the latest quarter. The returns from equities have been more widely dispersed than usual, with several areas showing negative returns, but with many more showing positive returns. In the foreign exchange markets, sterling was generally stronger as the vaccination programme progressed well and the UK's economic growth forecasts were upgraded. The oil price rose amidst continuing strength in commodity prices generally over the quarter.

The tables below detail relevant movements in markets :

International Equities 30.04.21 - 30.07.21

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.8	+0.2	+0.6	+2.2
Finland	+12.3	+10.2	+10.6	+12.3
France	+6.3	+4.2	+4.7	+6.3
Germany	+3.1	+1.2	+1.6	+3.1
Hong Kong, China	-3.2	-3.6	-3.2	-1.8
Italy	+6.0	+3.9	+4.4	+6.0
Japan	+0.4	-0.4	N/C	+1.5
Netherlands	+9.1	+7.0	+7.4	+9.1
Spain	-0.1	-2.0	-1.6	-0.1
Switzerland	+10.3	+10.5	+11.0	+12.7
UK	+1.7	+1.7	+2.1	+3.7
USA	+5.5	+5.1	+5.5	+7.2
All World Europe ex UK	+7.2	+5.5	+5.9	+7.5
All World Asia Pacific ex Japan	-3.6	-5.4	-5.0	-3.6
All World Asia Pacific	-2.3	-3.8	-3.4	-1.9
All World Latin America	+2.8	+5.9	+6.3	+7.9
All World All Emerging Markets	-4.1	-4.5	-4.1	-2.7
All World	+4.0	+3.2	+3.6	+5.2

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : +4.0%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	30.04.21	30.07.21
Sterling	0.84	0.56
US Dollar	1.63	1.22
Yen	0.09	0.01
Germany (Euro)	-0.20	-0.46

Sterling's performance during the quarter ending 30.07.21 (%)

Currency	Quarter Ending 30.07.21
US Dollar	+0.6
Canadian Dollar	+2.1
Yen	+1.0
Euro	+1.9
Swiss Franc	-0.2
Australian Dollar	+5.7

Other currency movements during the quarter ending 30.07.21 (%)

Currency	Quarter Ending 30.07.21
US Dollar / Canadian Dollar	+1.5
US Dollar / Yen	+0.4
US Dollar / Euro	+1.4
Swiss Franc / Euro	+2.2
Euro / Yen	-1.0

Significant Commodities (US dollar terms) 30.04.21 - 30.07.21 (%)

Currency	Quarter Ending 30.07.21
Oil	+13.0
Gold	+3.8

MARKETS

It has been another steady quarter for investors, with both equities and bonds advancing in price. The total return on the FTSE All World Index in local currency terms was +4.0%, in sterling terms, +3.2%, in US dollar terms, +3.6%, and in euro terms, +5.2%. Looking at local currency returns firstly, the FTSE All World Europe ex UK Index was the best performer of the regions in our table, returning +7.2%, within which there were particularly good returns from Finland, +12.3%, Switzerland, +10.3%, and the Netherlands, +9.1%. In specific countries, there were strong performances from Australia, +5.8%, and the USA, +5.5%. Underperformers were the FTSE All World All Emerging Markets Index, -4.1%, the FTSE All World Asia Pacific ex Japan Index, -3.6%, the FTSE Japan Index, +0.4%, and the UK Index, +1.7%.

Turning now to sterling adjusted performances, the FTSE All World Latin America Index showed the best regional performance, returning +5.9%. Despite currency weakness against sterling, there were still above average performances from the FTSE All World Europe ex UK Index, +5.5%, and the FTSE USA Index, +5.1%. However, weakness in the Australian dollar meant that, in sterling terms, the FTSE Australia Index returned just +0.2%. Elsewhere, sterling adjusted returns weakened against local currency returns, with the FTSE All World Asia Pacific ex Japan Index returning -5.4% and the FTSE All World All Emerging Markets Index returning -4.5%. The FTSE Japan Index also moved into negative territory, with the local currency return on the FTSE Japan Index moving from +0.4% to -0.4% in sterling adjusted terms.

Unusually, bonds and equities moved in the same direction. Taking ten year government bonds as the benchmark, the gross redemption yield on the UK gilt fell by 28 basis points to 0.56%, on the US Treasury bond by 41 basis points to 1.22%, on the Japanese Government Bond by 8 basis points to 0.01% and on the German Bund by 26 basis points to -0.46%.

In the foreign exchange market, sterling was generally stronger. Against the Australian dollar, sterling rose by 5.7%, against the Canadian dollar by 2.1%, against the euro by 1.9%, against the yen by 1.0% and against the US dollar, by 0.6%. Against a strong Swiss Franc, sterling fell by 0.2%.

In the commodity markets, oil, as measured by Brent crude, continued to strengthen, rising by 13.0%. Gold was slightly firmer, rising by 3.8%.

ECONOMICS

With the pandemic around eighteen months old, it clearly still has to dominate investors' thinking, but the stories around it change. Without being in any way complacent about the course of the virus and its various mutations, it is becoming noticeable that investors and economists are increasingly considering how the world will emerge from the pandemic, with particular emphasis on the economic pathway to some sort of normality.

The good news is that after last year's Covid-19 driven recession, economic recovery is well under way. The IMF has just released its latest economic projections in its July World Economic Outlook update. Overall, it sees no change in world economic growth for 2021 compared with its April 2021 forecast, which was for 6.0% growth. However, the composition of that growth has changed. Advanced Economies are forecast to grow more quickly. The IMF now sees growth of 5.6% in 2021 against its April forecast of 5.1%. The USA's projection has been raised from 6.4% to 7.0%. The uplift for the eurozone is more modest, up from 4.4% to 4.6%. Within that, the German growth forecast is unchanged at 3.6% as is that for France at 5.8%. Italy's forecast has been raised from 4.2% to 4.9% but that for Spain has been reduced from 6.4% to 6.2%. Japan has also seen a reduction from 3.3% to 2.8%. The largest increase is in the UK with a rise from 5.3% to 7.0%. For Emerging Markets and Developing Economies, the projection has been downgraded from 6.7% to 6.3% and, within that, there has been a particularly large reduction in the forecast for Emerging and Developing Asia. China has seen its growth forecast reduced by the IMF from 8.4% to 8.1% and India, very sharply, from 12.5% to 9.5%. Elsewhere, in the Emerging Markets and Developing Economies sector, there have been upgrades for Brazil from 3.7% to 5.3% and for Mexico from 5.0% to 6.3%.

Looking at 2022, the IMF has raised its forecast for world economic growth from 4.4% to 4.9%. Within that projection, the forecast for Advanced Economies has moved up from 3.6% to 4.4%. The USA's projected growth rate has been raised from 3.5% to 4.9%. The figure for the eurozone is now 4.3% against 3.8%. Within that area, the forecast for Germany has been moved up from 3.4% to 4.1%, whilst that for France remains unchanged at 4.2%. Italy's figure has been raised to 4.2% from 3.6% and that for Spain from 4.7% to 5.8%. Japan's projected growth rate has been raised from 2.5% to 3.0%. The forecast for the UK has been reduced to 4.8% from 5.1%. There has been a slight uplift in the forecast for Emerging Market and Developing Economies from 5.0% to 5.2%. Within that area, the forecast for Emerging and Developing Asia has been increased to 6.4% from 6.0%. The forecast for China is marginally higher at 5.7% against its previous forecast of 5.6%. India's forecast has been raised from 6.9% to 8.5%. The projection for Brazil has come down from 2.6% to 1.9% and for Mexico it has been increased from 3.0% to 4.2%.

The reason for the recalibration of the IMF's forecasts for this year relates to the roll out of vaccines, which has been much faster in Advanced Economies than in the Emerging Markets and Developing Economies. The IMF says that those with a good vaccination rollout can look forward to a normalisation of activity later this year, whilst, elsewhere, those which face resurgent infections and rising Covid-19 death tolls will lag behind. The effect of these "fault lines", as the IMF calls them, can be seen in the changed individual country or regional forecasts compared with last April in the context of an unchanged overall forecast for the year for the world economy.

The economic recovery so far this year is starting to be reflected in corporate earnings and dividend announcements. This can be seen in the forecast price/earnings ratio for this year on Bloomberg. If we look at the most important market, the USA, the forward price/earnings ratio is showing at about 22.3. In the case of the Euro Stoxx 50, the figure is 17.9, and, in the case of the FTSE 100, the figure is 13.0, as some of the big loss making companies, for example in the banking and oil sectors, return to profit this year. Of course, earnings forecasts for this year, even as we enter the second part of the year, must still be very tentative as we do not know the course of Covid-19 for the rest of this year. What is clear is that corporate earnings and dividends are recovering sharply and these have helped to support confidence amongst investors, which we are currently seeing. Looking at day to day movements in the equity markets, it is clear that corporate earnings are one catalyst, with more positive than negative movements reflecting a strong balance of positive surprises for both revenue and earnings. For example, companies in the banking and energy sectors, badly hit for different reasons by the pandemic last year, are now seeing a big swing in their profitability. Banks in the UK and Europe are returning to paying dividends and those in the USA are now allowed to make bigger returns to their shareholders. In the energy sector, there has been a big swing in cash flows and Royal Dutch Shell, for example, has raised its latest dividend by 40%, more significantly than expected, and resumed share buy backs. Mining shares have staged a spectacular rebound from last year as commodities like iron ore and copper have risen considerably in price, and two of them, Rio Tinto and Anglo American, are paying special dividends. Larger regular dividends, special dividends and buybacks are now a feature of the sector. The trends in economic activity, profits and dividends are therefore very helpful to equities, but these drivers of share price growth cannot be looked at in isolation.

Investors have to look at the relative attractions of competing assets, mainly bonds and cash. In certain circumstances, gold may have its attractions, as well as property, but, here, we will consider the attractions of bonds and cash. Dealing with the latter first as a main asset class, its value at the moment is that its nominal value will not change and one has certainty of that value, but, as a long term investment, it is almost certain to be a very poor one, losing value in real terms, even with interest payments being received. With international equity markets having performed well, we have been building up some cash from dividend payments ready for possible opportunistic purchases, but this reflects only a small percentage of the assets in a portfolio and is not held as a main asset.

So, as so often in recent reviews, we come back to fixed interest securities and the way yields have been suppressed by central banks. The real yields, which investors would normally have been looking at when they consider investment in fixed interest securities, have been replaced by negative real yields. The real negative yields may look distorted by the comparisons with a subdued inflation figure a year ago, but they are still startling. The latest consumer price index in the USA shows a year on year increase of 5.4%, whilst the yield at the time of writing in early August on the 10 year US Treasury bond is just 1.17%, a negative real yield of about 4.23%. In Germany, the relative figures are 2.3% and -0.49%, a negative real yield of 2.79%. In France, they are 1.5% and -0.15%, a negative real yield of 1.06%. In Italy, they are 1.3% and 0.55%, a negative real yield of 0.75%. In Japan, they are 0.2% and zero, a negative real yield of 0.2%, and, in the UK, they are 2.5% and 0.15%, a negative real yield of 1.99%. Everywhere in the above numbers, there is a negative real yield, even though, in the case of Japan, it is a very small one.

Why should investors be prepared to accept negative real yields when the long term objective of an investment portfolio is surely to provide positive inflation adjusted returns over the long term, so that the purchasing power of a portfolio increases? Here, we must distinguish between the different objectives of the various classes of buyer of fixed interest securities. Central banks' current monetary policy means that, if they are pursuing a policy of quantitative easing (QE), they are price insensitive buyers. Large swathes of government bonds are now owned by central banks and their objective is to suppress interest rates and provide liquidity. There are also institutions which have to buy fixed interest securities for matching purposes. But, for investors with a satisfactory long term real total return objective and no constraints, the considerations may be different. Those with a very short term investment outlook may not be too concerned about negative real yields. Their time horizon may be so short that they think that they can make a turn on movements in yields such as we have seen in the latest quarter, even though the longer term fundamentals are poor, and hope to exit their positions before yields start to rise. Others may feel that there remains validity in the balanced portfolio policy such as a 60:40 equities/bonds split. The 40% allocation to bonds, unless they were in higher risk securities, could well provide a lower yield than the equity section and almost certainly would if they were in the high quality government bond sector. The other part of the rationale, namely that fixed interest securities dampen down the volatility of equities, may also not be true. For example, a sharp reversal of yields, especially further along the yield curve, would have a serious effect on bond prices. It is difficult to see how those with the normal investment objectives of satisfactory long term real total returns, however achieved, can expect to achieve this with fixed interest securities at their current yield level. In our investment policy, whenever the mandate permits, as it does in the large majority of cases, we have been avoiding fixed interest securities. This could, of course, change in the future if the circumstances change, but, at the moment, this looks a long time away.

We were interested in an article in the Financial Times on 12th July by its distinguished chief economic commentator, Martin Wolf, entitled "Equities are the only sensible foundation for private pensions". In it, he quoted the well known works of Elroy Dimson, Paul Marsh and Mike Staunton for successive Credit Suisse Global Investment Yearbooks, confirming the enormous outperformance of equities over bonds over the last 120 years. The article quotes the figures from this publication, showing that a pound invested and reinvested in the UK equity market in 1900 would, in inflation adjusted terms, at the end of 2020 be worth £572. Over the same period, a US dollar invested and reinvested in the US equity market would have been worth US$2,291 on the same basis. The respective figure for UK government bonds were £10.40 and US$12.50. Of course, Martin Wolf qualifies his comments by emphasising that equities are more volatile than bonds and that, within a long time cycle such as the one mentioned above, prolonged bear markets can occur, meaning that an investor has to take a truly long term view. Nevertheless, the difference in the long term performances of equities and bonds is startling.

We do not mention this interesting article to suggest that we would exclude bonds indefinitely from our thinking, but rather to relate it to the relevance which current extreme monetary policy might have on future returns from equities and bonds. It must be a given that neither interest rates at this level nor QE can be a fixed part of the monetary landscape for ever. The consequences for inflation and trust in money would be very severe. What these very low interest rates mean is that there is a theoretical justification for shares being on higher ratings than normal. The earnings yield, the reciprocal of the price/earnings ratio, is exceptionally low at present. If we say that the forward twelve month price/ earnings ratio on the U.S. equity market is, say, around 22 at present, the earnings yield is around 4.5%, but that compares favourably with the yield on the ten year U.S. Treasury bond of about 1.17% at the time of writing. But, if we took to be what we might consider in other circumstances a more normal ten year U.S. Treasury yield, given current inflation levels in the U.S.A. of, say, 5%, the relationship would change dramatically, and it would be hard to justify share prices at current levels. In the long term, however, share prices would have the edge over bonds. In the first place, once bonds reverted to more normal yield levels, it is unlikely, although not impossible, that they would return to current levels. Therefore, the losses or opportunity costs which bond investors would suffer as yields revert towards their mean are unlikely to be recovered. Given how far below average yield levels on bonds currently stand, equities are unlikely to remain unscathed as the competition from bonds would increase significantly. However, even against a background of more normal interest rates, one would expect the "e" in p/e ratio to be rising most years, thus bringing down the p/e ratio on an unchanged share price. The danger of investing at current bond yields is that the bond investor will never be able to make up ground, whereas the equity investor can, as it would be a reasonable expectation that, over time, company earnings and dividends will increase.

We are in the realms of high theory here, but it is our belief that the extreme nature of current monetary policy increases the relative attractions of equities against bonds over the long term and the traditional concept of a balanced portfolio with bonds mitigating the volatility of equities and also providing a better income (which they now don't) is outdated and could be detrimental to long term performance. That might not be the case in the future when bonds stand on more realistic yields and one can, as it were, start again, but we are a long way from that time. However, it is difficult to argue with the headlines over Martin Wolf's article in the Financial Times, even though the detail is bound to be more nuanced, as touched upon in the article.

One of the surprising aspects of securities markets in the latest quarter was that both bonds and equities rose in price. QE makes price signalling, through its effect on bond prices, weak. However, the fall in bond yields, as shown in our table at the beginning of this review, would normally suggest that economic activity was weakening and, with it, inflationary pressures also. This would not normally be good for equities as it would imply a weaker outlook for corporate earnings. Yet, as we can see from the table at the front of this review, they too, enjoyed a positive quarter. They cannot both be right. There may be technical reasons with institutions which have to hold bonds being wrong footed by the fall in bond yields and feeling that they have to participate, but this can only be a short term phenomenon.

As our discussion on bond yields implied, we are well into negative real yield territory, with nominal yields falling and inflation rising. Central banks seem relatively relaxed about the outlook for inflation believing that the sharp spike in some of the inflation numbers is due to temporary factors, such as supply shortages, which have driven up costs which will then settle down. In the labour market, there is evidence, particularly in the USA, of recruitment difficulties, which are driving up costs, with the hospitality industry a notable example. The UK is seeing the same phenomenon. The danger is that, once inflation is in the system, it is not easy to shake it off, and it feels, from a host of indicators, that inflation will not be easy to subdue when the economies of the world move to some sort of normality. Whilst central banks have indicated that monetary policy will remain very easy, there is more talk of the timing of the start of tapering QE, which seems more likely to be the first stage of monetary policy tightening rather than interest rate increases. However, the course of inflation is likely to be the main influence on stock markets, particularly bond markets, and it does not seem likely that bond markets, even with all the QE taking place, will treat poor inflation figures with the insouciance seen so far. Once the inflationary genie gets out of the bottle, it is difficult to put back. It is a very difficult balance for central banks as the economic recovery, although generally strong, is still fragile.

At the moment, investors' attention is focused on how economies emerge from the economic consequences of the pandemic, and short term economic indicators are the ones they are looking at. In this respect, the news is encouraging, with corporate earnings and dividend increases above expectations on the back of some encouraging growth figures, at least in the developed countries, as shown by the recalibration of the IMF's economic projections earlier in this review. In time, and this will be the focus of future reviews, no doubt, the focus will be on how countries decide to repair their finances and the investment consequences of this since tax rises are almost certain to be on the table. What has been happening in China will certainly be discussed. Investors have lost a lot of money in certain sectors as the Chinese authorities strengthen their grip on industries with actions which have decimated share prices, causing investors large losses. The consequences of this are yet to work through the system and, as with Covid-19 and the supply chain difficulties which arose as a result of this, there may be moves to reshore more work to avoid being caught up in a political dispute or at the mercy of unexpected events like pandemics.

All this is for the future. Shares remain our favoured asset and geographical diversification remains of paramount importance. Shares are showing signs of being more responsive to day to day news, good and bad, and, as we have said in our recent reviews, we must expect some quarterly volatility after such a strong run, with negative results inevitable. We take the long term view and it would take something very serious for us to consider disinvesting because of the dangers of incurring a significant opportunity cost as shares recovered. The lessons of March 2020 for those who sold out should be a warning about being intimidated out of markets by current events and the importance of taking a long term view. Those figures quoted earlier for equity and bond returns over the long term should never be far from one's mind.