MAZARS WEALTH MANAGEMENT INVESTMENT NEWSLETTER

Summer 2020

> "Visibility on the short term direction of either the economy or markets is very limited given the dependency on the course of the coronavirus."

Global stock markets staged a remarkable comeback in the second quarter with the MSCI World Index up nearly 20% in Sterling terms. Whilst not recovering all of the losses from the high point in March prior to widespread lockdowns, global equities are nonetheless at higher levels than at the start of the year. Given the absence of any meaningful advances in the treatment of or vaccination for COVID-19 and that the corporate world is temporarily being held together by a variety of hastily created measures of government support, this optimism could be regarded as being somewhat misplaced.

Visibility on the short term direction of either the economy or markets is very limited given the dependency on the course of the coronavirus. In such circumstances, as investors, we must reassure ourselves of the appropriateness of long term strategies which in most cases involves a diversification of holdings within a portfolio. Never has this mix of assets been more important than in recent times as our holdings of Gold and short term debt have provided support during turbulent times. Moreover, the diversity within asset classes should not be ignored. When we write about 'global stock markets' we mask a huge divergence in performance between different sectors and geographies. In the first half of the year, a UK based investor holding the technology rich US market would have returned over 3% compared to minus 17% provided by the FTSE All-Share with its exposure to the Energy and Financial sectors and the uncertainty over Brexit arising once more.

As lockdown measures continue to be relaxed we will look carefully at the rate of resumption of consumer expenditure. Inevitably there will be some pent up demand, but it is difficult to imagine a return to pre-pandemic levels whilst caution around the virus and fears in the labour market remain. As economies reopen, the support measures from governments will contract with no chance of a frictionless resumption for businesses or the people they employ. The question will be how much of a gap remains and how quickly might it close. The answer lies of course in the path of the virus, and we should have learnt by now, about this we know very little.

At our June meeting the Investment Committee voted to reduce our exposure in longer term Gilts and add to our positions in higher yielding corporate bonds. Although an increase in risk during uncertain times, we feel that we are adequately compensated for this risk particularly given the very low returns currently available on Gilts.

I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on 020 7063 4259, or by email on david.baker@mazars.co.uk.

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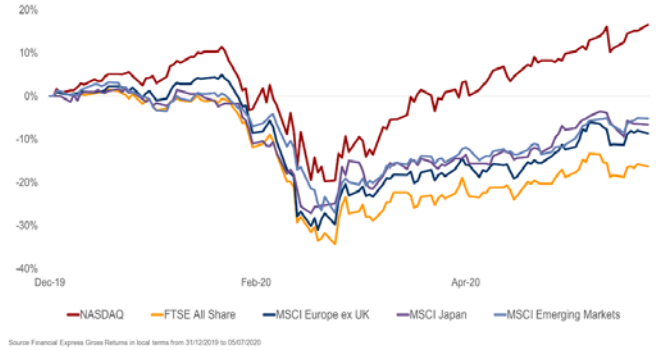
Economies and markets in brief

Speed of market rebound almost unprecedented

In the previous Newsletter we commented on the unprecedented speed of the fall in equity markets, with the S&P500 falling 34% from 19 February to 23 March. Well the reverse has been true this quarter, with equity markets reversing these losses at a remarkable rate. There hasn't been one definitive reason for the speed of the rebound, however massive central bank stimulus has certainly reassured markets, especially credit markets which came close to grinding to a halt in March. Optimism about the speedy development of a vaccine and the faster than expected, and possibly faster than prudent, re-opening of economies have seen markets largely 'look through' this year's earnings as an aberration, so justifying current equity prices on more normalised profit levels. Time will tell whether this optimism is warranted or whether a further wave, or waves, of the virus prove the rapid recovery to be market hubris. US Tech stocks have been particularly resilient, with the NASDAQ now positive for the year. Other indices haven't yet recovered all their losses, but UK equities aside, have reduced losses to around 10%.



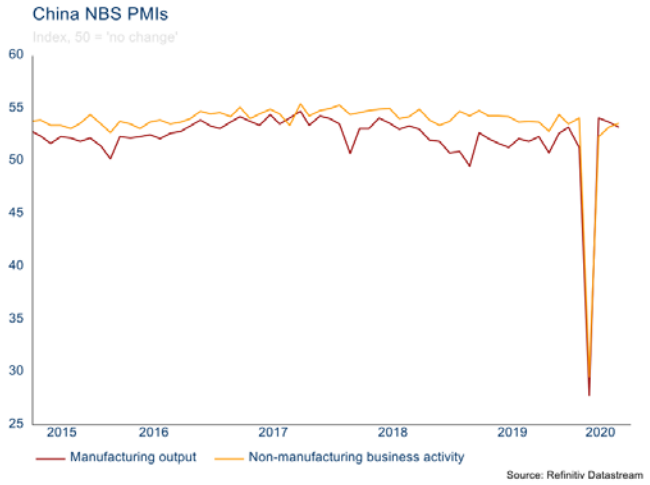
China's V-shaped Recovery

China was the first country affected by COVID-19, so it stands to reason that it has arguably been the first country to experience an economic recovery from the crisis. Both manufacturing and non-manufacturing PMIs have rebounded to their pre-COVID levels, suggesting that the country won't face a prolonged period of reduced output, as would be the case in a U-shaped or L-shaped recovery. Official figures show a GDP fall of -6.8% YoY in Q1, and while there are no estimates yet available, the figure for Q2 may well have improved significantly. Could this be the trajectory for other countries who have managed to limit COVID-19's spread? The issue for China now is not so much its internal economy, but the propensity of other regions, which are in earlier stages of the crisis (and have had mixed success in managing the crisis), to purchase exports, which is likely to drag on growth for some time.

JARGON BUSTER

V-SHAPED RECOVERY

A V-shaped recovery describes when an economy recovers quickly from its trough back to the previous level of output. A U-shaped recovery describes the same process but where the recovery takes longer. An L-shaped recovery implies semi-permanent damage to an economy since the level of output remains reduced for some time.



Office and Retail Property

It has been said by many commentators that the crisis has not so much caused upheaval in the way we consume, rather that it has quickened the changes that were already happening. This has especially affected the property sector, where working and shopping from home were already dampening returns in the office and retail space, while areas such as warehouses and logistics were benefitting on a relative basis. With almost all office workers forced to work from home and much of the hospitality industry yet to re-open, rents have been left unpaid which feeds through to lower capital values. And it is the same sectors benefitting as consumption hasn't stopped, but just moved further on line. The graph below shows YTD performance for the UK REITs with the least office and retail exposure (Segro and Tritax) and those with the most (Shaftesbury and Workspace Group).

WHAT'S BEING SAID ON TWITTER

Why it pays to think long term and remain invested:

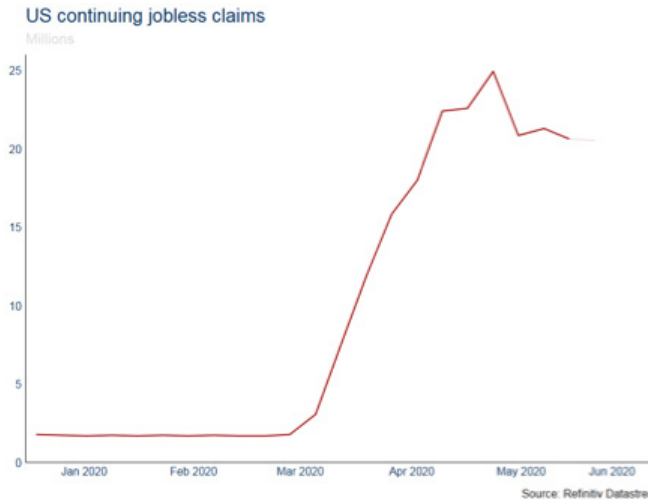
In the book **"The Art of War"** Chinese military strategist Sun Tzu wrote
"Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat."

In the current investment climate we are reminded how important it is to follow a long term investment strategy and not to be distracted by the noise of greed and fear cycles. While medium-term tactical asset allocation calls can frequently add value, the long term returns an investor is able to achieve are mostly driven by their portfolio asset allocation and their ability to remain invested, even when the desire to sell and "get out before losing any more money" is at a maximum. The individual instruments we employ to grow wealth, our "tactics", are secondary to our long term strategy.

In this piece we explore the merits of employing a long term investment strategy and holding a diversified portfolio of financial assets, even throughout a crisis.

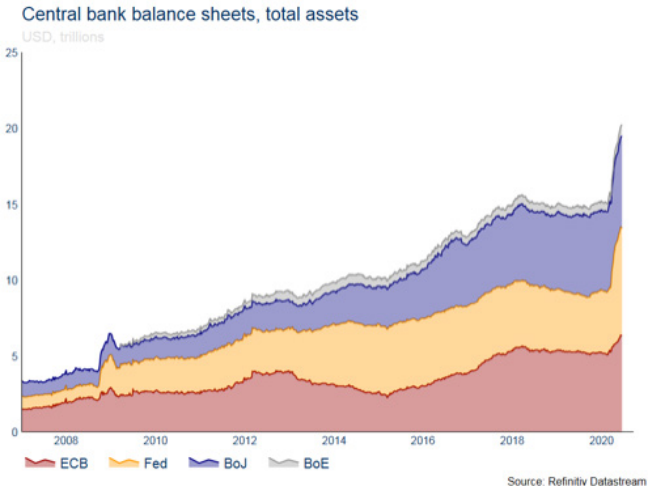
Financial assets do not equal the real economy:

The COVID-19 crisis has brought the global economy to its knees. The travel & tourism sector has collapsed as the population obeys social distancing measures and governments ban non-essential travel, unemployment has sky-rocketed and consumption on goods and services has dropped, bringing output down to levels last seen in 2002 in the UK.



However, the financial markets, and thus the constituents of a financial asset portfolio, are not the economy. In fact, financial markets are operating under different principles of cause and effect, with many indices already trading near all-time highs again!

Why has this happened? Firstly, the monetary stimulus employed by central banks in 2020 has been unprecedented. The BoE, the Fed and the ECB have all anchored their policy rates close to zero. When you pair this with rapid balance sheet expansion as central banks buy government bonds, raising prices and supressing yields, debt holders have earned a nice capital gain on top of their coupon payments. Even these "unconventional" measures of QE have proved insufficient in the eyes of the Fed, who have purchased corporate bond ETFs, and now individual corporate issues. Thus QE inflates financial assets through simple increased demand.



This stimulus also causes a reach for yield, as often investors still have an absolute income requirement that they must meet. IG bond yields prove insufficient, pushing the investor to allocate more towards HY debt or EM debt, and then ultimately, into equity products.

Hence, a long term investor able to hold onto their equity portfolio throughout a crisis has been able to reap the rewards of this aggressive monetary policy which tends to fuel financial asset prices.

The world is becoming a "winner takes all" game:

In a world characterised by the internet, globalised markets and the rise of AI and robotics, mega corporations are well placed to win by employing innovative and modern technology solutions. FAANG companies are spending billions each year on R&D and this is likely to provide a huge competitive advantage in decades to come. A large portion of S&P 500 returns can be explained by these stocks alone. Often the best way to profit off this growing trend is to be a common shareholder of these innovative companies and then hold for the long term.

Time out of the market is costly:

Market timing is incredibly difficult. The set of factors affecting security prices is large and often contains unexpected elements that are only clear after the fact. Furthermore, it is common for equity indices to jump 5-7% in a single day after market participants have digested new data or political news and realised their initial estimates were too pessimistic. Missing a few of these daily returns can reduce the client's holding period returns dramatically. Studies show market timing isn't effective on average after deducting associated costs and instead, tactically adding or reducing risk at opportune moments, while still remaining close to one's strategic asset allocation, is the most effective approach to wealth management. It pays to think long term, remain invested and stick to a time-tested strategy.

High Yield Bonds – In Focus

What are High Yield Bond funds?

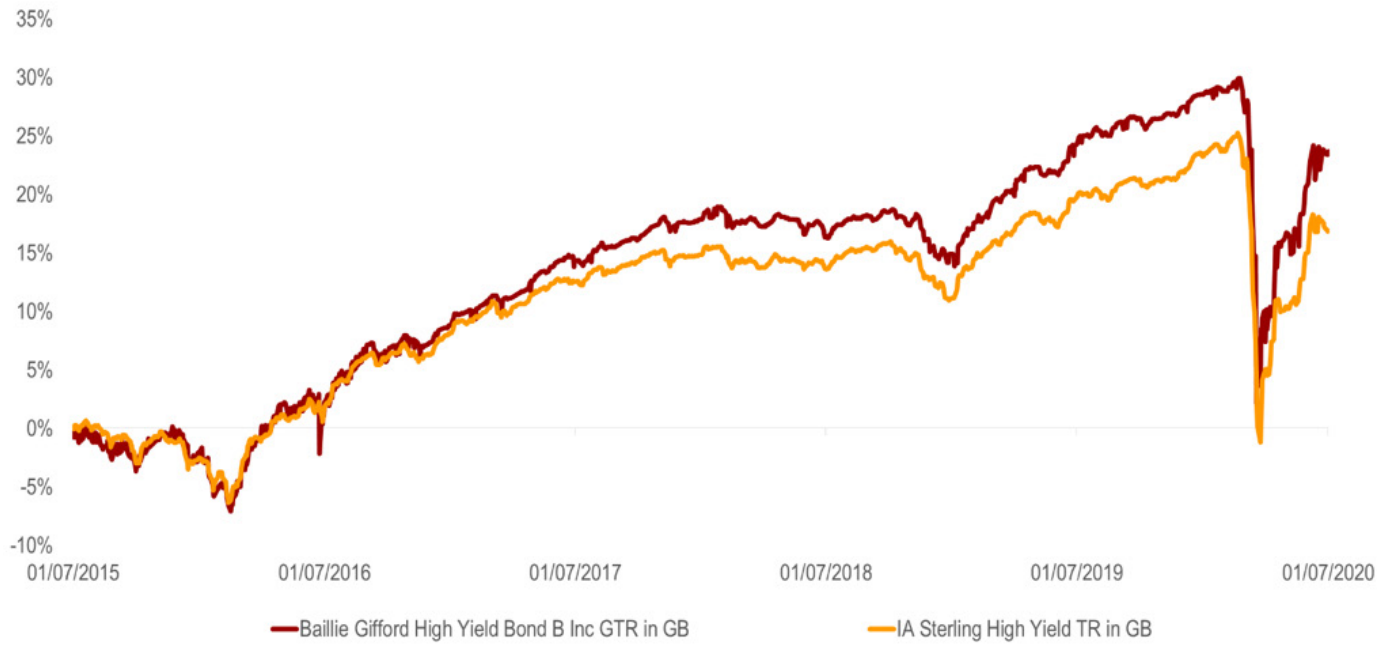
These funds invest mainly in bonds that have a credit rating, as determined by ratings agencies (Moody's, Standard &Poor's and Fitch), below Investment Grade. These rating agencies have different ways of expressing ratings, however the most commonly cited coding is for High Yield bonds to be BB or below (moving down in credit quality to D status), with Investment Grade BBB and above (moving up in quality to AAA status). A lower credit rating means a bond has a higher chance of default, and so a more risky investment versus higher rated bonds. However the risk remains lower than investing in equities.

Why do we use them?

Why would anyone choose to invest in bonds that have a higher chance of defaulting? The simplest reason is because the yield received in coupon payments is higher, which depending on the level of corporate defaults can more than offset any losses from defaults. Other reasons are that these assets offer a better inflation hedge than Investment Grade credit or Gilts, and are less likely to be negatively affected in the event of rising interest rates.

Our approach

We use Baillie Gifford High Yield Bond, run by Robert Baltzer and Lucy Isles. The managers take a relatively cautious approach to managing the portfolio, focusing on the fundamental health of companies in which they invest rather than the level of yield that a position offers. As such we expect the fund to lag a little when credit markets rally strongly, but offer increased protection in periods of market stress.



Source Financial Express Gross Returns in Sterling from 05/07/2015 to 05/07/2020

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