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Portfolio and Market Review
1st Quarter 2020

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FINANCIAL
PLANNING

We are indeed in unprecedented times. A short while ago COVID-19 was only affecting China, and no one was too concerned; a bad cold, all but an inconvenience together with the unenviable prospect of a few days of daytime television were the virus' only perceived consequence. Unfortunately, now, no quarterly review would be complete without a discussion of the virus and its impact on financial markets. Investors have suffered psychologically and financially over the last month, as markets, driven by the uncertainty and fear surrounding the virus, reacted. Markets seemed to drop and rise daily, with each new movement being more extreme than the last. It was a roller-coaster of a ride for even the most seasoned investor, and it doesn't look like the ride is over yet.

Governments' reactions to the virus, both to reduce its spread and mitigate the impact of their own containment policies, served only to increase market volatility. Across the world, governments have enacted unprecedented measures; effectively closing their economies and locking away their citizens in an attempt to prevent the forecasts of hundreds of thousands of deaths becoming a reality. The impact of such policies, that of economic recession, would have been clear to any government economist, so one can argue such decisions were not made lightly.

As dire as the situation currently seems, the virus will be beaten, and the economy will rebound. However, the potential speed of the recovery is what concerns governments and markets across the globe. The fear is that "scarring", long lasting economic damage, will occur due to the severity of the recession and recovery will be drawn out. In all recessions, some weaker firms fail, but most are able to weather the storm and bounce back when the economy improves. The current situation is unprecedented, fundamentally sound businesses have been destroyed overnight by their own governments' policies. Hence the rationale for central banks slashing interest rates and governments announcing spending sprees akin to those of wartime. We are of course in the midst of a health war, so this is understandable.

If these policies work as intended, thereby providing the necessary support to both businesses and households, we see no reason for economic activity not to increase rapidly once the shock has passed.

The total cost of funding these policies will of course increase government debt, and this could have long term implications for the future. However, failure to support businesses until the crisis is over would result in an even deeper economic downturn.

The question everyone is asking is: how long will this pandemic last and how long will it take for things to get back to normal? Now, as Niel Bohr, the Nobel Prize winner in physics so eloquently put it, **“…prediction is very difficult, especially if it’s about the future”**.

The chart below provides an excellent visual representation of the time and trajectory of recovery for investments in previous bear markets. Although, none of the past scenarios refer directly to pandemics, it still provides a fascinating insight into how markets respond to negative shocks, how long it took for the UK market to return to its pre-shock level and the subsequent peak in value in the following bull market. The most important learning is that markets have always rebounded, and the subsequent peak is invariably higher than the initial investment.

Data indicates that the coronavirus will cause the world economy to fall into recession in the first half of 2020, but early evidence from China provides hope of a rebound once the outbreak is contained. Economists are forecasting that global GDP growth will fall by -1.2% in the first quarter of this year. To put this in context, at the point of maximum pain of the Global Financial Crisis in 2008, quarterly GDP fell by -1.6%. In other words, the scale of the current crisis is not out of line with anything we have seen before, in economic terms at least.

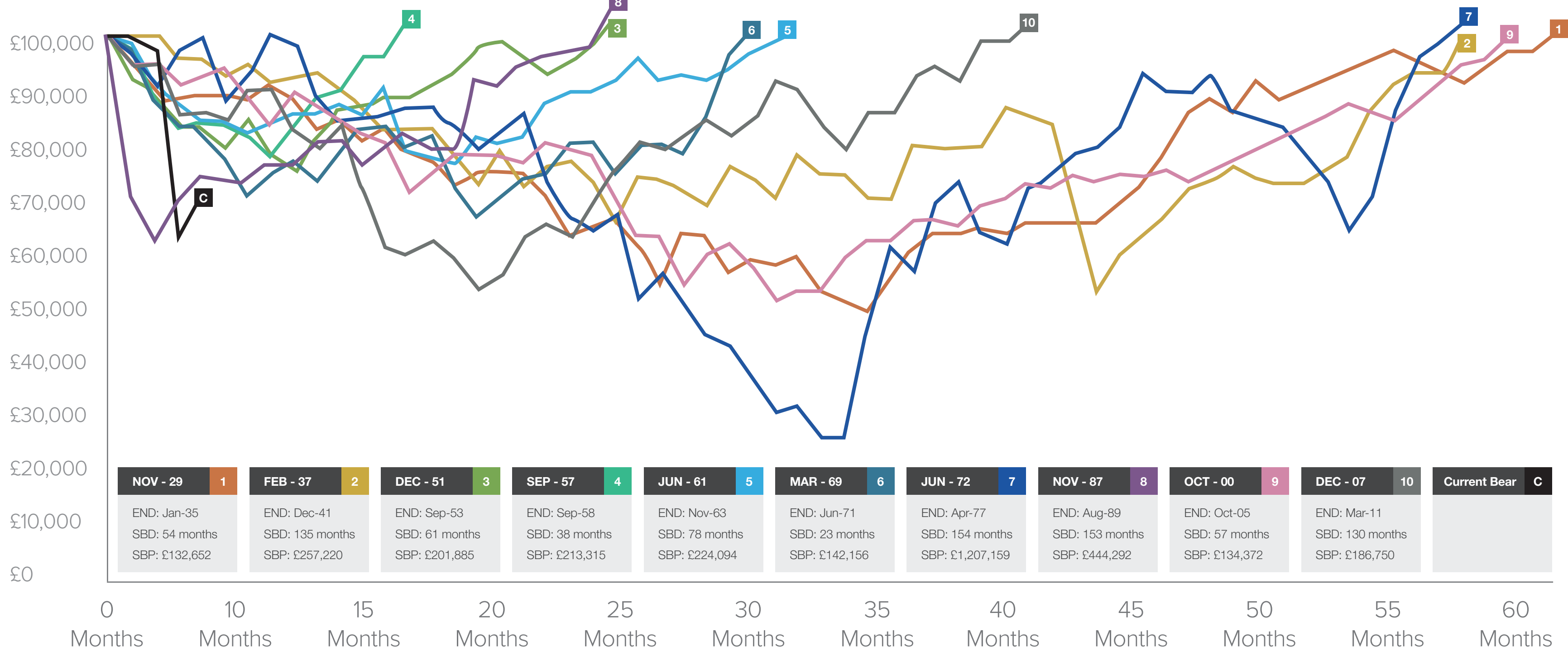
We remain confident that a fully diversified investment strategy, positioned for the long-term, is the optimum way to ride through the ups and downs of the market cycle, whatever the cause of volatility. Situations like these reinforce the importance of maintaining a disciplined approach to investing by not responding to short term events.

As markets fall and the plethora of negative news almost overwhelms investors, the temptation to withdraw funds become understandably strong. The media focus on attention-grabbing stats, **“…FTSE 100 drops10% in a day”** and unfortunately some investors will incorrectly believe the best course of action is to sell out of their positions to limit any further loss. As painful as it is to see one’s savings falling in value, monetising losses is not the best course of action.

Some investors take an opposite position and see the fall in prices as an opportunity to acquire securities far below their intrinsic value. Overconfidence in their ability to forecast market movements results in a belief that they can time the bottom of the market and profit when markets rebound; buy low and sell high. Academic research does not support market timing as a route to superior returns, instead those trying to time their entry and exit more often than not miss the bounce and ultimately harm their long-term returns[1] (see appendix). Therefore, as difficult as it may be, the smart investor must remain disciplined, hold their nerve and stay the course even in the most extreme market conditions. Don’t do anything, stand there.

1 See: Clare and Motson (2010), Kinnel (2010) and Schneider (2007)

UK Bear Market Recovery[2]



The Recovery Chart shows the evolution of an investment that starts in a bear market until the value off the investments equals at least its initial value. The Initial Value of the investment £100,00. The data range is January 1926 to April 2020. This chart is for illustrative purpose only; it does not constitute investment advice and must not be relied on as such. The value of investments and the income from them can go down as well as up so you may get back less than you invest. Past performance is not a guide to what might happen in the future. No transaction costs or taxes are included. Please note, END represents the Date of the Recovery, SBD represents the duration of the subsequent bull market and SBP represents the peak of the subsequent bull market. Data suggests: UK Equities: FTSE All Share Return Index (with GFD Extension).

2 Source: Timeline (2020)

The year began with much optimism following a copious 2019. Despite the forecasts of major market corrections in 2019, multiple US interest rate rises and a no holds barred trade war between China and the USA, markets rallied. More extraordinarily, cyclical investments that tend to do well when the economy is accelerating, such as stocks and commodities performed well alongside more defensive assets, such as government bonds and gold. This is an unusual occurrence and we would argue the interest rate increases in 2018 followed by subsequent cuts in 2019 explain much of these asset class returns.

As 2020 began, the threat of an escalation of the trade war looked to be subsiding; an initial trade agreement, whereby the Chinese agreed to purchase more US goods and services in exchange for tariff reductions was signed in January. If the agreement held, this was to increase US exports by approximately $260bn in 2020. Forecasters were also looking forward to the positive impact of new trade deals between the US, UK and Europe providing further stimulus to global economic growth. Moreover, numerous countries including Germany, India and Japan had mooted in the second half of 2019 of their intention to increase spending and decrease taxes in their 2020 budgets, providing more economic stimulus in the global economy.

As always, some forecasters had predicted a less idyllic 2020, the IMF cut its forecasted global growth rates from 3.4% to 3.3%[3] and urged caution with regards to future trade tensions and the reliance on underperforming emerging market economies to drive global economic growth. The World Bank raised concerns of a slowdown in productivity, a precursor for increasing economic growth and living standards.[4] Concerns of a regional conflict in the Persian Gulf following the assassination of a prominent Iranian General by the US and a subsequent retaliatory attack by Iran in early January caused the price of oil to spike and markets to slide.

No one could have had the foresight to predict the impact of a virus originating from Wuhan, a then largely unknown city in central China. As the virus spread, so did the fear and governments responded by taken drastic actions to mitigate the spread, no matter the economic impact.

This is reflected in the asset price returns on the following page. As one would expect, cumulative returns to equities have suffered, particularly the 1-year and 3-year return horizon, due to the sharp falls in equity prices across the globe in the last month.

It is interesting to note the difference in performance of various geographical regions. While US equities have fallen in value by 3% over the last year, European equities are down -8% and UK equities have fallen by 18%. Not every market is at the same point on this trajectory, reflecting the benefits of global diversification.

3 IMF (2019)
4 World Bank (2020)

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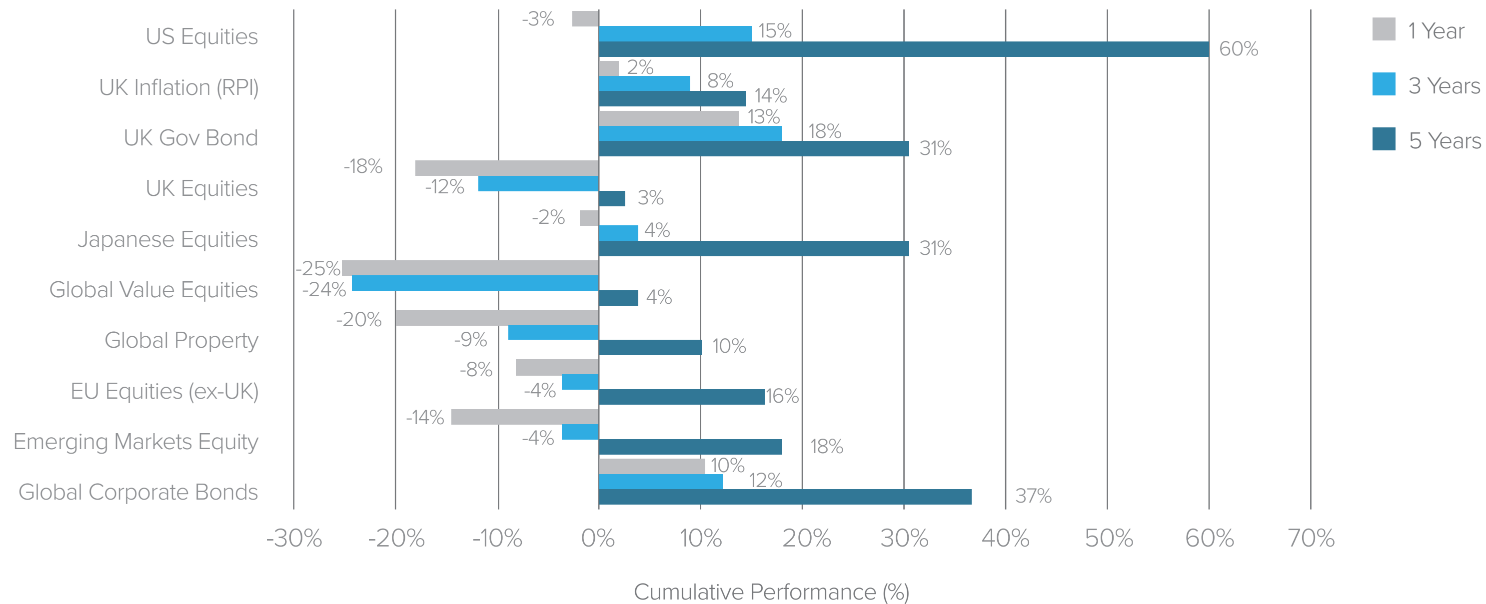
Asset Class Performance[5]



As expected, bonds have fared far better as equity values have suffered. Again, this supports our philosophy of diversification, reducing exposure to risk by investing across a variety of uncorrelated assets.

Examining the correlations of the major asset classes over the last 6 months provides further insight into the importance of diversification in times of crisis. The matrix below illustrates that the returns of bonds and equities have been negatively correlated and bond holdings have protected overall portfolio value as equity markets have sharply declined.

Holding a mixture of assets in the portfolio provides an investor with a certain degree of protection – which leads us to our favourite quote from Nobel Prize winning economist, Harry Markowitz: **“diversification is the only free lunch in investing”**.

5 Source: FE Analytics (2020) Corporate Bonds: Bloomberg Barclays Global Aggregate, UK Gov Bond: Bloomberg Barclays Global Aggregate UK Government Float Adjusted, UK Equities: FTSE All Share, Global Property: FTSE EPRA Nareit Global, Emerging Markets Equity: MSCI Emerging Markets, EU Equities (ex-UK): MSCI Europe ex UK, Japanese Equities: MSCI Japan, US Equities: MSCI USA, Global Value Equities: MSCI World Small Value, UK Inflation (RPI): UK Retail Price Index.

Correlation Matrix[6]

	Global Bonds	UK Gov Inflation Linked Bonds	Developed Equities	Property	Global Equity	World Gov Bonds (Short Dated)	Emerging Market Equities	World Value Equities
Global Bonds								
UK Gov Inflation Linked Bonds	0.82							
Developed Equities	-0.67	-0.52						
Property	0.03	0.31	0.59					
Global Equity	-0.55	-0.23	0.88	0.62				
World Gov Bonds (Short Dated)	0.95	0.72	-0.84	-0.24	-0.76			
Emerging Market Equities	-0.84	-0.77	0.72	-0.04	0.54	-0.79		
World Value Equities	-0.81	-0.59	0.96	0.51	0.83	-0.92	0.78	

6 FE Fundinfo (2020) Global Bonds: Bloomberg Barclays Global Aggregate Float Adjusted Hedge, UK Gov Inflation Linked Bonds: Bloomberg Barclays UK Government Inflation Linked Bond Float Adjusted, Developed Equities: FTSE Developed, Property: FTSE EPRA/NAREIT Custom Developed Midday, Global Equity: FTSE Global All Cap, World Gov Bonds (Short Dated): FTSE World Government Bond 1-5 Years Hedge, Emerging Market Equities: MSCI Emerging Markets, World Value Equities: MSCI World SMID Value.

The world is undergoing an extraordinary crisis, one that hopefully will never be repeated. Events that seemed unimaginable a month ago are occurring on a daily basis.

There is no denying, we will all continue to be challenged over the next few months. Whether it's dealing with the psychological impact of remaining in lockdown or being directly touched by the virus. Things will be hard.

However, stories of great humanity shine through; from the health workers risking their lives to care for the sick, to plucky engineers more used to building vacuum cleaners and F1 cars designing lifesaving ventilators in under a week. It will be hard, but we will win through.

Stay safe, stay sane and remember we are here for you.

Appendix - Market Timing Research

Data by Morningstar effectively demonstrate the ineffectiveness of market timing in its research on the ‘performance gap’, which is the difference between the return of an average mutual fund and the return the average investor in that fund experiences. Morningstar found that the typical diversified US equity investor lost 0.61% due to timing over a 10-year period. This is attributed to attempts by investors to chase winners, moving into well-performing funds after their periods of strong performance and dumping funds that haven’t performed as well (Kinnel 2018).

Clare and Motson (2010) lend further credence to the importance of adopting a long-term perspective, finding that poor timing decisions by UK retail investors cost them, on average 1.2% per annum over an eighteen-year period. Furthermore, Schneider (2007) showed that the performance gap was as much as 2.43% per annum for UK smaller company funds and 2.06% per annum for growth funds over an 11-year period between 1992 and 2003. The plausible explanation is that investors are chasing past winners and therefore end up buying high and selling low.

It is very difficult to predict the best time to enter or exit the market. The speed at which markets react to news means stock prices almost immediately absorb the impact of new developments. When markets turn, they turn quickly. Those trying to time their entry and exit may miss the bounce.

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