SAUNDERSON HOUSE

Special Briefing

Asset Allocation Journey: 2005-2017

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The key determinant of portfolio returns is asset allocation, both the broad structure of a portfolio, including the spread between higher risk, capital growth assets and more defensive, capital preservation ones, as well as the timing and quantum of changes between the two. Too little exposure to strongly rising asset prices will leave portfolio returns looking pedestrian relative to market indices and comparators. Similarly, the value preserved by stepping aside or having limited exposure to markets that are undergoing corrections is likely to dwarf any benefits from security selection within that asset class. This note reviews our efforts in this field since 2005; a 12 year time span encompassing an extended business cycle, a severe financial crisis and an unprecedented economic landscape. We hope it demonstrates that, armed with process, patience and a strong value discipline, it is perfectly possible to add value through asset allocation.

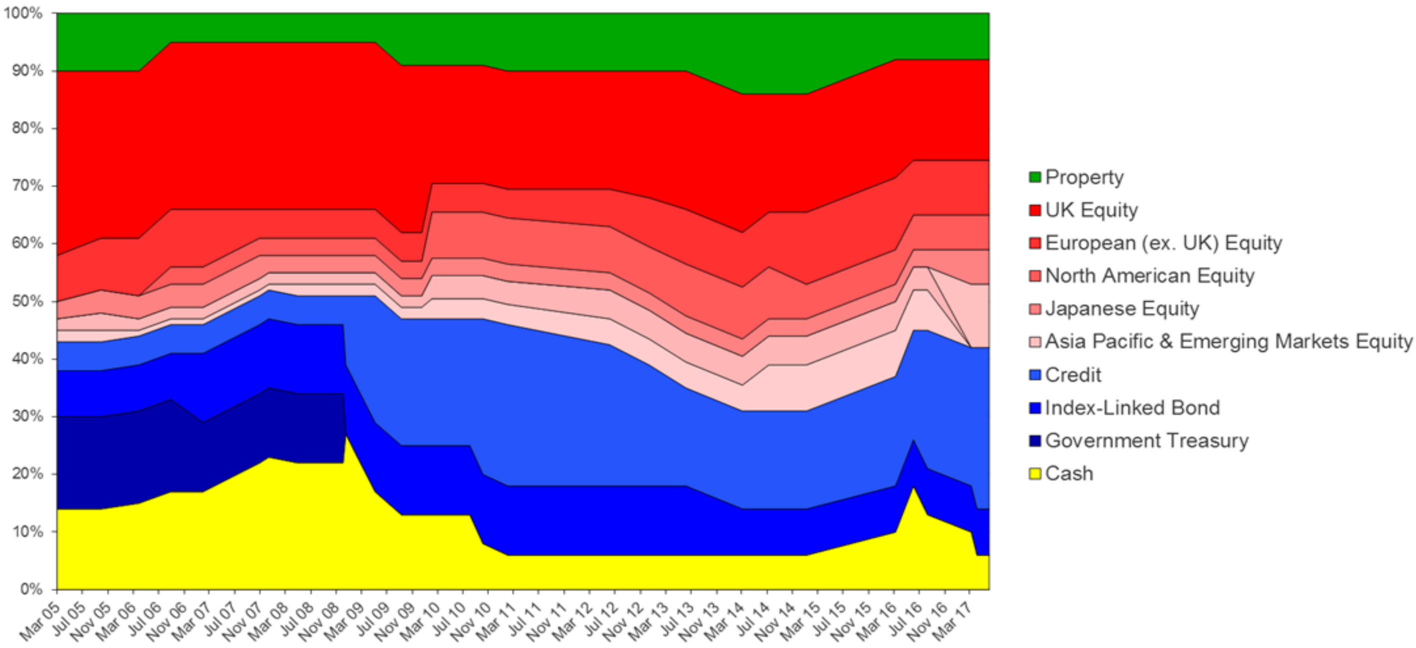
We begin with a point of clarification. Our approach to asset allocation does not involve timing markets - a 'finger in the air' attempt to guess the direction of the next major market shift. Stock market history shows that the chances of such a strategy succeeding are slim, especially when one considers the costs of moving in and out of markets in an attempt to capture rises or avoid falls. Instead, we would argue that there is a wide and profitable opportunity set between, at one extreme, the instinct-driven market timing strategies that characterise speculation and, at the other, the defeatist approach of passive investors who argue that the best thing to do is to do nothing.

The wide and profitable path to which we refer is a research-driven, value-based approach to asset allocation. It seems reasonable to us that careful analysis of the macroeconomic landscape, the aims and intentions of policy makers and, most importantly, close inspection of the value apparent in asset classes, ought to allow an investor to tip the odds in their favour when selecting appropriate asset classes for the market environment. This should give the best chance of capturing the returns, at least to some degree, from rising asset prices and avoiding some of the losses that are incurred by watching helplessly as markets fall.

Rather than write further on how such an approach might work in theory, we propose in the following sections to journey through the highlights of our asset allocation changes over the past 12 years. This, we hope, will demonstrate that, while far from a perfect science, it is entirely possible to add value (or at least preserve it) through active asset allocation. Moreover, this can be achieved without taking excessive risk, without trading aggressively and, most importantly, without ever simply trying to guess what might happen next in markets.

Some perspective on the timing and quantum of our asset allocation moves is provided by the colourful chart below. Perhaps the clearest indicator of the difference active asset allocation can make can be seen from considering the extent to which our allocations to cash, government treasury bonds (gilts) and index-linked bonds were built up prior to the financial crisis. Recommended holdings of these highly defensive assets reached almost 50% of portfolios before being recycled into corporate bonds initially, and then equities as the post-crisis environment provided attractive valuation opportunities.

The Changing Shape of Recommended Asset Allocations 2005-2017



The chart shows asset allocation changes made to the SHL Wealth Management Balanced Model portfolio. Equivalent shifts were made to other model portfolios though the magnitude of these will have varied with risk profile and investment time horizon.

We begin our journey in April 2005 at which time our portfolios were widely diversified, reflecting both the positive outlook for equities, thanks to strong economic growth and the defensive attractions of government bonds and cash; the yield available on 10-year UK government bonds at that time was almost 4.75% while the Base Rate stood at exactly 4.75%. However, 12 months later we took the view that strong performance from emerging and far eastern equity markets had taken valuations to levels that were excessive. This prompted us to take profits, thereby beginning a de-risking of portfolios. This reduction in equities was followed by a halving of commercial property weightings for similar, valuation-driven reasons; commercial property had enjoyed an excellent run spanning more than a decade and, to us, looked fully valued.

The proceeds of both sales went to cash, at the time earning an attractive return. However, around this time we did make an allocation to US equities, in which we previously had no holdings. This proved a mistake as, while they appeared cheap enough to us at the time (particularly in sterling terms), they were of course to get much cheaper as the financial crisis set in.

Further de-risking of portfolios took place in 2007. Once again, this was driven by what we considered to be full or excessive valuations rather than any great insight into what was about to befall the global financial system. Thus, after very strong performance, funds of UK smaller companies were reduced, to be replaced by holdings in more defensive, better-value large cap. funds. European equity weightings were halved in late 2007, to be followed by a reduction in Japan in January 2008. At this point, recommended portfolios were looking quite defensive, with 47% allocated to cash and government bonds. There were, in truth, further reductions in train as valuations, particularly of equity markets, looked high in the light of what appeared to us to be a rapidly deteriorating outlook. However, as equity prices fell sharply, it was clear that the opportunity to move portfolios onto a more defensive footing had passed.

As one of the worst financial crises in history raged through 2008, we certainly had cause to wish we had been more aggressive in our de-risking. However, large holdings of cash, index-linked and conventional gilts, together with more defensive large cap. UK equities meant that portfolios fared reasonably well in relative, if not absolute, terms.

We made no major asset allocation changes in 2008, although we did top back up allocations to areas such as equities where sharp market falls had reduced weightings relative to our intended model allocations. As a research team, we were, of course, extremely busy. Given the parlous condition of the banking sector, we spent a great deal of time analysing the security of banks and cash deposits, resulting in recommendations to clients to exit quasi-cash products such as those offered by AIG (prior to its troubles) and place monies in well diversified liquidity funds and National Savings & Investments accounts. With regard to other asset classes, our research energy was spent developing views on which assets would offer greatest upside for the risk taken on when calm returned to markets.

After detailed research, our re-risking of portfolios began in January 2009, two months before equity markets reached their lows. By this time, conventional government bonds – highly defensive assets in a financial crisis – had risen substantially in value (yields had declined to c3.3% by mid-January 2009, having been as high as 5.5% two years before), and presented an opportunity to take profits. We began selling these in favour of funds of corporate bonds. The latter had suffered severe price falls through the crisis; the yield on the Merrill Lynch index of A-rated corporate bonds hitting 7.6%, from less than 5% in 2007. The timing of this move proved spot on, as the prices of corporate bonds began to recover soon after. This early encouragement reinforced our conviction and, after the Bank of England cut interest rates to 0.5%, we reduced cash in favour of further corporate bond funds in mid-2009. Rebuilding weightings to risk assets continued later in that year, when the 2006 reduction in commercial property allocations was reversed. This took advantage of a one-third correction in UK commercial property prices over the three-year period.

High allocations to UK equities, often the subject of debate with clients, were reduced in early 2010 as we sought a greater geographic spread. The US, emerging markets and Far Eastern equity markets were the beneficiaries. Later in 2010, as our confidence in the effectiveness of the policy response to the financial crisis increased, we took the decision to reduce cash allocations further still, using the proceeds for additional corporate bond fund purchases. We repeated this exercise in March 2011. On both occasions the cash was put to work in bond funds with flexible mandates rather than plain corporate bond funds. These strategic bond funds have the freedom to hedge out unwanted risks – specifically an eventual rise in interest rates. In the period since, we have increasingly focused client bond allocations towards funds that could protect against the negative effects of any eventual normalisation of interest rates. Given the continued fall in bond yields since, this proved an unnecessary piece of portfolio insurance.

In mid-2012, four and a half years after our pre-crisis equity sales, we finally began to increase equity allocations once more, taking advantage of the strong performance of corporate bond funds and a correction in stock markets to recycle profits into attractively valued European, emerging markets and Far Eastern equities. Our timing proved helpful once again; the FTSE Europe ex. UK index had slumped amid a further bout of eurozone turmoil. It has since risen by 82% in local currency terms, and over 102% when expressed in sterling. At the beginning of 2013, we took a bite out of bond fund holdings to increase allocations to UK and, again, European equities. Finally, by mid-year, with the direction of policy clear in our minds and an economic recovery at last unfolding - most notably in the US - we made a third equity increase.

We have spent a great deal of time re-testing our thesis that the world economy is on the path to recovery – even if the progress is painfully slow. We made four asset allocation changes broadly following the re-risking theme as our confidence increased. In April 2014, we took profits from what we considered as fully valued index-linked gilts and directed the proceeds to property funds. Property had begun to perform better in 2013, but with the yields available on property looking attractive relative to cash deposits and government bonds, we believed that higher weightings would prove profitable. In August 2014, we took advantage of the strength of sterling and the continued unpopularity of emerging markets equities, to reweight equity allocations further towards the latter. Then in February 2015, with eurozone QE set to commence and the euro weakening sharply, we took the opportunity offered by the low valuations of European equities relative to the US to shift towards the value apparent in the former.

Since then, however, the tortured question of the UK's future within, or outside of, the EU has reared its head and caused an unexpected turbulence on our journey. In April 2016, while market conditions remained favourable, and exactly two years after increasing allocations, we took profits from commercial property. In the intervening two years it had delivered an impressive 15% p.a. Our timing proved opportune as the impact of the referendum result soured sentiment towards the asset class as investors rushed to sell their holdings.

Additionally, in our view the 'out' in the referendum had materially changed the outlook for the UK economy and investment markets, resulting in us recommending a reduction in equity allocations from both the UK and Europe at the beginning of July 2016. The beneficial effects of sterling's weakness on the value of overseas assets also presented an opportunity to take some profits from our emerging market and Far East allocations.

The proceeds from these moves were, as usual, parked in cash - so that portfolios were well positioned to take advantage of opportunities as they arose. A year further on and, despite further political turmoil in the UK in the shape yet another political own goal from a prime minister, these reductions now appear unnecessarily cautious as equity market have continued to move ahead. In our view, this has proven to be the case in the UK because of the rapid policy response to the referendum decision from the Bank of England, together with the cushioning effects on the economy of sterling's weakness. Looking more widely, equity markets have benefited from a pick-up in global growth, which has led to optimism that the slow growth, low inflation world economy might finally be giving way to a stronger outlook. On both scores, however, we are slightly dubious. We are now seeing a weakening of UK economic data, as the reality of Brexit comes closer, while looking more widely we do not believe that the deep-rooted economic challenges of the post-financial crisis era will dissipate quite so quickly, or easily. Thus we have maintained our cautious positioning though with two tweaks.

In September 2016 we increased allocations to the highly defensive, short dated bond funds in acknowledgement of the slightly more medium term nature of our defensive positioning. Secondly in April 2017, we added to Japanese equities where we believe the structural changes now underway will finally drive improving growth and corporate profits.

Taking the period as a whole, it is abundantly clear that not every asset allocation move has proven correct. We have, however, had the umbrella up, so to speak, in bad weather and the sun hat on in the good. With the benefit of hindsight of course, some of our moves could have been more aggressive. That said, the purchase of corporate bonds in place of gilts in early-2009, for example, or the purchase of European equities in mid-2012 after a very weak second quarter and negative returns in 2011, appeared quite uncomfortable enough at the time. On other occasions moves were overly cautious. The post-referendum sales of equities in late summer 2016 are a case in point. Once again though, strongly positive returns have been achieved despite this prudence, and so it is difficult to have too much regret for a move intended to reduce exposure to a possible bad outcome.

With interest rates now creeping upwards at a slightly faster pace in the US and the first indications of the likely removal of extreme policy accommodation in continental Europe and indeed the UK, we do not believe that now is the time to cast caution to the wind. As we peer into the next business cycle many questions come to mind, not least the impact on the economy of the UK's exit from the EU, rising interest rates or the withdrawal of monetary stimulus from central banks around the world. No doubt, there will also be more surprises and shocks along the way. However, we remain convinced that a diligent and thoughtful analysis of the economic landscape, together with the independence of mind to move towards those assets on offer at attractive valuations, will continue to prove the right way to approach asset allocation.

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