Beckford · James

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Portfolio Review

As we enter August and many investors go on their summer holidays, this time of year traditionally sees daily trade volumes decline, meaning even small buying or selling trades can have big effects and can cause liquidity to drop out of the market. This year though, thanks to extraordinary interventions from central banks, capital markets are reasonably liquid. And, notwithstanding a recent dip, for equities over the last few months, the rising tide has lifted all boats. The latter was a result of Germany disappointing markets in its growth figures, coming in 1% worse than expected. GDP data is often inaccurate on the first release – especially so in the current circumstances – so we should take this with a pinch of salt. Nevertheless, equity markets took a bit of fright and worst hit was the UK market, which saw the FTSE 100 drop back below the 6,000 level.

Those bank interventions have also restored investor sentiment from apocalyptic lows in March. As such, the stock market rally from early April has been as extraordinary as the nosedive that came before it. But with harsh economic realities now setting in, and what appears to be the deepest global recession in generations, equities can only run so far on positive feelings. For markets to continue upward, attention must turn to the actual economic data.

While we believe the worst is behind us, we think the path ahead will be bumpy as the economy battles to re-open without leading to a reacceleration in infections. The most recent data show the difficulty in achieving that balance; the pace of the recovery appears to have slowed in July as consumers are cautious of going out and spending amid high infection levels. In the US for example, 18 million Americans are still out of work and the enhanced unemployment benefits have now lapsed as of the end of July but the economy is far from ready to stand on its own two feet, and hence the importance of political agreement on a new support package is clear.

In early June the market was pricing in a V-shaped recovery from the pandemic-driven economic contraction. We expect the recovery to be more gradual, with a few stop-starts along the way. Extremely low interest rates will help, but unemployment and corporate deleveraging could be a drag on growth. However, more market volatility could well be generated by the extent of near-term covid uncertainty, not to mention the rising political risk as we approach the US election.

For individual market sectors, the outlook depends on the path of the pandemic. If a full and sustainable reopening of the economy becomes possible, we may see a further rally for the most hard hit sectors. Activity remains weak, but there are signs we are past the worst and a bounce back in activity is expected in Q3.

However after, Q3 uncertainty abounds. Forecasting the economy has become a judgement on the speed with which lockdowns are lifted around the world and the subsequent path of the virus as epidemiologists stress the risks of a second wave of infection.

Meanwhile, governments need to rein in fiscal support and after the initial pent-up demand has been satisfied, the pandemic is also likely to make households more cautious. Business is also expected to be hesitant in resuming capital spending and like government will look to reduce debt levels.

On the back of covid, July also saw the EU take a significant step towards full fiscal union. One of the longest ever EU leaders' summits ended after four days of intensive talks with an unprecedented agreement. The club of 27 member states agreed to create a €750 billion EU recovery fund, which will be made up of €390 billion of grants and €360 billion of loans to be distributed amongst member states to aid in the recovery from the coronavirus pandemic.

The size of the grant component was reduced by the more frugal members from the originally proposed €500 billion to €390 billion, though the overall size of the fund was unchanged and the gap filled by increased loans.

The European Union is used to re-distributing income (Structural and Cohesion funds) and the provision of aid, but what makes this an evolutionary step is that it will mandate the European Commission (its civil service) the ability to borrow €750 billion that would be jointly guaranteed by all member states. Where the European Stability Mechanism (ESM) was set up in 2012 to help bailout countries, this will be the first time jointly issued debt will be used to finance regular fiscal policy.

Whilst debt has not been mutualised, and the sum (around 5.4% of GDP) remains small in comparison to the aggregate size of the EU's balance sheet, the taboo of jointly-issued debt has finally been overcome, which potentially paves the way for additional future use of the mechanism. It may yet take a few decades and several crises, but the first steps towards a fiscal union have been taken.

Portfolios

With the strengthening Euro, talk of the second 'spike' and resurgence of the 'B' word (Brexit), sentiment weighed on UK equities in the second half of July. The "whipsawing" of markets left the FTSE down c4% by the end of the month and small caps fell c2%.

Strong performance in a focused number of technology stocks had fuelled the US markets. Growing US-China tensions showed through as the main index also fell towards the end of the month. Emerging Markets continued their recovery adding 2.5% and the 'safe haven' of gold rose a further 2%.

Portfolios generally showed sound resilience protecting investors from the extremes of volatility. The socially responsible trend continued to lift the ethical portfolio slightly over 1%. The next highest return being the most cautious growth portfolio (risk profile 3/10) which gained approximately 0.2%. The remaining portfolios were flat with the highest risk portfolio (Risk 10/10) holding the decline to within -1.2%.

Dividend suspensions continued to apply pressure to the equity income portfolio which fell just under -2% over the month. Considering the exposure to higher yielding UK equities, this was relatively good news, especially considering the UK Equity Income index fell approximately 6%.

July highlighted the value added by active managers both in adding performance and helping to offset market falls. The leading 25 funds of the 63 held across portfolios were actively managed. The Baillie Gifford Emerging Markets fund delivered the highest return at 3.4%, riding the crest of the emerging markets wave.

The Amati UK Smaller Companies fund delivered significant outperformance relative to its benchmark rising 2.9% against the FTSE small cap index which had fallen -1.2%.

Within the UK funds specifically, which tend to account for the larger weightings, the Lindsell Train UK Equity fund supported portfolios with positive performance of +0.5%. Of greater significance was the positive performance delivered by the Unicorn and Miton UK equity income funds. Whilst the equity income index tracking fund managed by Vanguard fell -6%, these actively managed portfolios delivered positive performance of 0.9% and 1.6% respectively.

We are occasionally questioned over why certain funds remain in portfolios. The length of time investors hold shares has been falling for decades. According to Reuters, in the US the average holding period for shares is just 5½ months now. In Europe this has fallen to less than 5 months. But this short-term performance chasing approach does not necessarily translate into positive performance in portfolios where consistency and quality are key. Reviewing funds monthly, there are always examples where relative lacklustre performance in the rising markets 'could' justify removal of a fund from portfolios. However, many of these funds are now providing the support to portfolios and helping to dampen volatility and protect investors. For us, it is always important to distinguish poor relative performance as opposed to negative or non-correlated performance.

One such example is the Troy Trojan fund. From 9th March 2009 to the 31st December 2019 the fund returned c114% relative to the FTSEs rise of c222%. Yet, 7 months on and looking at the 2020 performance alone, the return from the FTSE stands at down 18.5% whilst the Trojan fund stands up at 6.5% positive. This is where our selection of specialist funds for different conditions plays its part. The removal of property fund suspensions will prompt our next opportunity to enhance the stable. Conversations optimistically suggest this could be within the next month or two.