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Global Matters | Weekly

Annual Compendium 2023

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With us, investing is personal

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Foreword

As another year draws to a close, we share our annual compendium of Global Matters articles with you. As well as being interesting and educational reads, the articles offer insight into our approach and showcase the diversity of thought that the individual personalities in our investment team bring to the table, which we value greatly. With a wide range of industry and financial markets related topics covered, we hope this compendium can be useful for future reference, even if perhaps it doesn't quite make the festive reading list.

A scan through the topics serves as a reminder of the key themes in markets and our industry, from the US mini-banking crisis in Q1, the AI powered dominance of the so-called 'magnificent seven' in equity markets, and continued volatility in rates markets, while we also covered many other more niche topics, such as the regulatory backdrop for Investment Trusts or responsible investment considerations in the fast-fashion industry.

No doubt, it's been another challenging year in markets, as was widely expected a year ago, but it is ending on a more positive note and with growing optimism for the year ahead. While the volatile and often negative returns across many equity and fixed income markets over the past couple of years has presented a challenging backdrop for our industry, we are reassured that the transition to more 'normal' interest rates and the robust economic conditions behind it sets investors up for a more favourable environment going forward. Global Matters will be back again in 2024 to provide our take on the key issues and events that we are focusing on.

We've been writing these articles every week for eight years and are pleased to continue to receive excellent feedback from our readers. We were also delighted to have been awarded the 'Best Blog' award by Investment Week this year, fantastic recognition which we are proud of and very grateful for!

We hope you find them useful and would always welcome specific feedback or questions. If you're itching for more and aren't already receiving our monthly Global Matters and Chart of the Week updates, then please email us at distributionservices@momentum.co.uk.

We would like to use this opportunity to thank all our clients for their continued support, and from the whole team at Momentum Global Investment Management, we wish our readers an enjoyable and relaxing holiday season and all the very best for 2024.

Momentum
Investment Team

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9 January 2023

Divine inspiration

Alex Harvey, CFA

The month of January takes its name from the Roman god Janus, whose two opposing faces depict duality and transition, endings, and new beginnings. This god of gateways looks both backward and forward, and if ever there was a January to excite him (he is generally depicted with a beard), then this is surely it. As he looks backward, then by any measure 2022 was a horror show for most investors, as it was in the real world for the many oppressed people around the world. The Great Rate Reset led to a sharp repricing for most financial assets, leaving few places to hide. Cash was king, and only really pockets of less directional alternative strategies and some commodities made any meaningful gains. Anyone wanting a quick lesson on how interest rate 'duration'[1] affects bond prices needs to look no further than the Austria 100 year 'century' bond (issued in June 2020) which fell 55%[2] in 2022. It would take 65 years collecting the €0.85 annual coupon to recoup that loss! In fact, since its €139.3 peak price in December 2020 it has fallen by a full €100, ending 2022 at €39.3[2]. That's a 72% decline in two years, not far off Tesla's 2022 calendar year performance I might add, demonstrating somewhat simplistically how growth stocks are long duration assets.

On a brighter and less Tyrolean note, and with Janus looking forward, 2023 presents us with a fuller palette of investment opportunities than we've seen for some years. Within fixed income, yields have risen so much that for the first time in a while, there is something of a buzz around the asset class. Of course, inflation is the root of all bond evils and inflation-adjusted yields are still firmly negative and real returns will only be forthcoming if inflation does fall back. Importantly though, higher yielding investment grade bonds once again provide some ballast in portfolios with scope for capital upside, something only possible in the negative yielding world when there was a 'greater fool' to sell to (who could usually be found, to be fair). On that point, last week we saw the stock of negative yielding debt fall back to zero for the first time since 2014 and whilst it's possible we flirt back into negative territory in the year ahead, the slow drain of liquidity from the financial system resulting from quantitative tightening will continue to exert an upward pressure on yields. A slam dunk year for bonds is far from guaranteed, but fixed income is just that and a very bad year like 2022 mathematically improves the following years' prospects.

Equities offer an attractive entry point after the pain of last year. In the UK, the main market trades on less than 10x next year's earnings (or greater than 10% earnings yield)[2]. The more discerning active buyer can pick up high-quality, dividend growing companies for even less. The growthier small-cap names trade at a similar valuation in aggregate and only twice in the last 30 years have they underperformed the blue-chip UK index by more than the 22% they trailed by last year. Other regions now offer similar value. US equities remain optically the most expensive market, although valuations have reverted considerably over the last year, and paying up a little for the quality and resilience of that market doesn't seem unreasonable. The question Janus needs to consider when assessing 2023 is whether the current implied earnings are fair, or risk falling short as the global economy slows, as is now widely expected. If the latter eventuates then the true (and trailing) earnings multiple will be higher, the earnings yield lower, and the relative attractiveness over now higher yielding corporate bonds – the equity risk premium – will be eroded. With corporate margins being squeezed, that is a valid concern and one reason why equities are not being hoovered up today, but the uncertainty is reflected in the price.

It is quite possible that the market lows are retested at some point this year, but as long-term investors we, like Janus, have to look further ahead than what lies immediately before us. If policy rates do top out in the summer this year, as is currently priced, then we could see risk appetite returning more quickly than one might otherwise expect. Equities typically bottom out before the real economic pain ends and the end of the hiking cycle is often a precursor to this. Having been positioned through most of 2022 with low bond exposure and higher allocations to real assets, alternatives, and cash, 2023 will hopefully present opportunities to recycle last year's relative winners into cheaper equities, credit, and more esoteric discounted investments that will lay the foundations for real compounded capital growth and income into the future. When Janus looks back on 2023 let's hope his face is smiling.

Sources: [1] Bloomberg Finance LLP., [2] MSCI World equity annualised returns from 31 August 1993 to 10 August 2023; price return 5.5% total returns 7.8%.

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16 January 2023

Well that wasn't expected...

Richard Parfect

Having booked my first skiing holiday in 11 years with some friends in Chamonix towards the end of January, I'm seeing news articles showing temperatures approaching 10c and zero snow on the ground. When I booked the trip for my group, of all the things I considered that might scupper the trip; no snow in the Alps, in January, was not one of them.

Investing is far from immune to such tales of the unexpected.

At Momentum Global Investment Management (MGIM), one of the areas we focus on are specialist REITs, where we select asset managers to operate in specific areas of the property market that we feel offer the best opportunities for risk adjusted returns. When combined with tactical timing, we have found success with examples that include AEW UK REIT and LondonMetric. However, this does not come without risk.

Risk is integral to investing; it is ultimately what determines returns. Nevertheless, the actual risk sometimes diverges from the risk that would reasonably be expected from the strategy or asset type and it's by monitoring this that active management on our part can add value.

A very recent example is our recently exited investment in Home REIT. We had been very supportive towards this REIT as it apparently ticked many boxes: inflation linked rental income supporting a progressive dividend; increasing the supply of accommodation for various types of homeless individuals and families; reducing the financial burden on local authorities that traditionally pay for expensive, poor quality, temporary B&B accommodation.

Despite these optical benefits and strong share price performance, we initially became concerned by personnel changes at the asset manager and poor disclosure of financial difficulties being faced by one of its tenant Community Interest Companies (CIC) "Circle Housing". A few months back one of our team members, Gary Moglione, then performed some in-depth analysis of the various CIC and charitable tenants of the REIT.

It was an expansive project, but in summary, our concerns grew significantly when we discovered connections between different tenants that raised questions over effective diversification. The quality of the tenants failed to match our previous expectations. Finally, a meeting with the manager failed to satisfy any of our concerns. If anything, they were deepened.

The risks we were uncovering were far exceeding what we had initially anticipated for the asset type. The often quoted "government backing" as tenant of last resort felt inadequate for the risks that would be faced in any resolution process upon failure. Furthermore, with the general sell off that had occurred across various asset classes amidst the Gilt and government crisis of the Autumn, we felt there were better opportunities elsewhere. Our initial reductions were commenced at the start of November and as our concerns grew, we accelerated the program and finally exited on the 18 November when the shares were still trading around 75p.

We have watched with dismay (and significant relief) as subsequent to our exit there was a published "short report" by Viceroy Research LLC in the US[1]. This triggered a chain of events that saw the shares collapse to 38p, the publication of the annual results has been delayed, and the shares suspended from the market. While we cannot pre-empt the investigation by the auditor, this could be a sad example of a failure of public markets to achieve a stated financial and social objective. It is also a reminder to us that the greatest risks sometimes lurk in the least expected places. Furthermore, it shows that it is not just skiers that take a gradual climb followed by a steep descent; assuming there's some snow around.

Source: [1] Home REIT - No place like Home REIT... thankfully | Viceroy Research, Home REIT Regulatory News

23 January 2023

No stress

Matt Connor

I have recently returned from a holiday to Cape Verde, where the country's motto of "No Stress" suits the tropical island lifestyle. After returning to (a much colder) reality it has dawned on me that investors ought to take a leaf out of the Cape Verdean's book and try not to stress and act in haste when making investment decisions.

After a torrid 2022 for markets and an increasing likelihood of a recession coming this year[1], you would be forgiven for thinking "No Stress" is an oxymoron when applied to how investors should currently think – but heightened emotions often cloud judgement and can lead to irrational decision making.

Warren Buffet's famous quote that investors should be "fearful when others are greedy, and greedy when others are fearful" is touted so often that it has become somewhat of a platitude, yet it effortlessly describes the opportunistic mindset investors should have in turbulent markets. Data, however, proves that investors tend to do the opposite. UK retail investment funds suffered a year of outflows[2] as selloffs in financial markets pushed investors to withdraw their investments. As Buffet implies, at volatile times, opportunistic entry points are often available to investors to make further investments, even allowing an investor to lower their average cost on holdings that may have fallen in price.

So, why do investors tend do the opposite of what they should do in a bear market? Fear! Fear that their investments could continue to drop in value if they don't sell now and fear that the markets will never recover. Bear markets will happen and that can be a scary thought, especially after a decade long bull run where it seemed like financial markets did nothing but go up. History tells us that bear markets have historically been shorter-lived than bull markets and ultimately, markets have always recovered from even the steepest of selloffs, meaning that a bear market provides an opportune time to invest[3].

Well-diversified, multi-asset funds such as Momentum's own fund range can also help reduce the impact a bear market has on an investor's portfolio due to the inclusion of defensive assets that can be uncorrelated to equity markets.

For example, within our UK Equity portfolio at Momentum, we have taken advantage of the volatile market conditions to add high-quality holdings to our roster of stocks, such as Games Workshop, Cranswick, and Next15 Communications. We have fully embraced the Cape Verdean "No Stress" mindset in staying calm and logical when analysing new opportunities which we believe will pay off handsomely.

Hopefully after reading this article, you remind yourself of the "No Stress" motto when you see a panic-inducing headline about further pain in the stock market and realise it could be a good opportunity for a long-term investor. At the very least, it may prompt you to book a holiday so you can forget about your worries. I'm sure my suggestion of a company-sponsored trip to Cape Verde to fully immerse myself in the "No Stress" mindset is 100% less likely to happen in the future than a market rebound.

Sources: [1]Financial Times: 'US Stocks sink after disappointing retail sales data, [2]Financial Times: 'UK funds set for first year of net outflows in over a decade', [3]Fidelity: 'Bear market basics'

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30 January 2023

Turning away from the glass-half-empty mentality

Gregoire Sharma, CFA

As we turn the page on 2022 and look with cautious optimism at 2023 for some respite in markets, investors are appraising the investment landscape with an understandable degree of trepidation. Indeed, following the macroeconomic and geopolitical events of 2022, losses in fixed income markets were on par with those in equities making it one of the worst years on record for balanced portfolios. Conflating this with the prospects of a global recession, the amplitude of which is yet to be fully appreciated, pessimism in markets has led investors to position themselves incredibly bearishly at the end of 2022. This was demonstrated by recent spikes in the Chicago Board Options Exchange Put/Call Ratio which went haywire in November before spiking to its highest level on record in December. This normally contrarian indicator might therefore be pointing to a significant regime shift and things might in fact not all be doom and gloom.

Let's start with the good news. It seems, inflation has likely peaked and is expected to fall materially this year. Looking at the data in the US, the contribution to headline Consumer Price Index from prices of goods has come right off, as the supply and demand shocks from the global pandemic recovery have dissipated. In addition, commodity prices have fallen significantly from their peaks in 2022, some to pre-invasion levels. The one thorn in the side is core inflation, which strips out food and energy prices, and is expected to remain sticky, in part due to a resilient labour market (low unemployment and unwavering wage growth) coupled with a robust consumer.

Turning to monetary policy the US Federal Reserve (Fed) has already hiked rates to a range between 4.25% and 4.5% with expectations for terminal rates at around 5%, so arguably, the majority of hikes have already been priced in[1]. Monetary policy operates with a lag, with services, jobs, and inflation being in general the last to respond to policy impulses. However, the early effects of last year's tightening on activity and inflation are clear. Growth in the US is cooling as illustrated by a raft of economic data. In fact, the latest flash Purchasing Managers Index's for January, while showing a slight improvement from December, still indicated a seventh consecutive month of contraction in the private sector. The one outlier is the strong US labour market, but even there we are seeing signs of weakness starting to materialise. High frequency indicators are flashing recessionary signals as evidenced by the growth over the last six months of weekly jobless claims. Additionally, looking at the rate of change of the (admittedly high) job openings over the last six months reveals a clear contractionary trend. Qualifying all of this with the decline in hiring intentions, as suggested by the National Federation of Independent Businesses survey data, one can only expect an imminent cooling in the labour market. This would vindicate the market pricing of a Fed pivot as illustrated by the Fed Funds futures and the Fed dot plots. However, risks remain as the Fed will absolutely want to regain credibility after previously beating the 'transitory-inflation' drum for so long and in doing so, will tolerate an economic slowdown and higher unemployment to bring inflation down to its 2% target.

So, how have markets reacted? Focusing on valuations, these have rerated substantially last year with equity markets having returned closer to their long-term averages and bond markets now offering attractive yields without the need to take on significant interest rate or credit risk. Interestingly, strongly inverted yield curves are signalling an imminent recession, but credit spreads aren't pricing this in at all. What the higher yield levels do afford is a greater degree of reassurance as investor bearishness has been baked-in to prices, effectively discounting a substantial level of downside potential. Similarly, whilst equities aren't yet discounting a significant earnings recession, we can perhaps take comfort in the realisation that last year's equity market drawdown was exclusively driven by multiple contraction resulting from higher interest rates, whilst earnings growth remained positive. Given markets imply we are about 50bps from peak rates in the US, we can therefore reasonably expect a mild earnings recession to have a less dramatic effect on markets, especially if the outlook is more positive for 2024. Finally, if we consider a best-case scenario where fixed income markets are right and we do see a true Fed pivot this year, we could then reasonably expect a reversal of the multiple contraction seen last year.

Wishful thinking? Perhaps, but investors should turn away from the glass-half-empty approach and instead take solace in the fact we are entering a new regime where government bonds are offering positive 'risk-free' rates once again. Whilst a mild recession seems the widely expected outcome this year, markets have repriced closer to fair value (with some cheap valuations in areas) hence, we are starting the year from a more attractive base to generate long-term returns. Something positive to look forward to, then, amongst all the doom and gloom?

Sources: [1]Federal Reserve 14 December 2022. Unless stated, all data from Bloomberg Finance L.P.

February


DCA
More
High / Low
Volume
Bids
Offers
964.1
964.0
960.6
964.6
964.7
965.0
+3.0 (+0.31%)
963.9
+2.4 (+0.25%)
964.3
964.4
964.5
963.7
Multi Order

6 February 2023

AI: is your job safe?

Jackson Franks

Artificial Intelligence, otherwise known as AI, is becoming ever more prominent in our day-to-day lives, both personally and at work. The market size of AI is gaining momentum. According to Precedence Research, the global AI market size was estimated at USD 119.78bn in 2022 and it is expected to be USD 1,597.1bn by 2030, with a forecast Compound Annual Growth Rate (CAGR) of 38.1% from 2022 to 2030[1]. So, what's driving this growth?

The rapid penetration of digital technologies and internet has significantly contributed towards the growth of the global AI market in the past few years. The heavy investments by the tech giants in research and development are continuously fuelling the technological advancements in various industries. The growing demand for the artificial technology among the automotive, healthcare, banking & finance, manufacturing, food and beverages, logistics, and retail is expected to significantly drive growth in the forthcoming years. But the real question is, does AI have the ability to take our jobs?

I wanted to put this to the test, so before writing this blog I signed up to OpenAI, an AI research and deployment company. OpenAI have trained a model called ChatGPT which interacts in a conversational way. So, to see if AI has the ability to take my job, I put this to the test and asked ChatGPT[2] to write my blog. Within less than 30 seconds it was done. Here's how it went.

Question 1: Provide an update of the UK commercial real estate market from 01/02/2022 to 31/01/2023

'The UK commercial real estate market experienced a slow recovery in the first half of 2022 following the COVID-19 pandemic, with declining demand and rental values in many segments, particularly in the retail and office sectors. However, by the end of the year, there were signs of improvement as vaccine rollouts and pent-up demand fuelled a rebound in activity levels, with the industrial and logistics sectors leading the way. Nevertheless, uncertainty remains high, and the market is expected to remain cautious in the near term.'

Question 2: What are the forecast trends for 2023 in the UK commercial real estate market?

'The following are some of the forecast trends for the UK commercial real estate market in 2023:

Continued demand for logistics and industrial space: The trend of e-commerce and the rise of online shopping are expected to continue driving demand for logistics and industrial space, as companies seek to optimize their supply chains and meet the needs of an increasingly digital consumer base.

Adaptation to new working patterns: The COVID-19 pandemic has changed the way we work, with more remote and flexible working arrangements. This trend is expected to continue in 2023 and is likely to result in changes to office space requirements, with companies seeking more flexible and cost-effective solutions.

Resilience in the residential sector: The UK residential market is expected to remain robust, driven by low interest rates, a shortage of supply, and high demand. This sector is likely to continue to attract investment and provide stable returns for investors.

Continued uncertainty in the retail sector: The retail sector is expected to face continued challenges in 2023, with the rise of e-commerce and changes to consumer habits affecting demand for retail space. However, the sector is expected to adapt, with the development of new models of retailing and the emergence of new formats and uses for retail space.

Increased focus on sustainability: Sustainability is becoming an increasingly important factor in the real estate market, and this trend is expected to continue in 2023. Investors and developers are expected to focus on environmentally friendly and energy-efficient buildings, and to seek out opportunities to reduce their carbon footprint.

These are some of the key trends that are expected to shape the UK commercial real estate market in 2023. The market is dynamic and subject to change, so it is important to stay up to date with developments and to remain adaptable in the face of changing circumstances.'

So, what are your thoughts? For me, the output is outdated, albeit insightful. Reference to low interest rates is misleading considering the sharp increase in rates over the last 12 months, so please ignore the contents in the above sections. My conclusion? My job is safe for now but with AI having the ability to process data and learn 10x quicker than humans, this may be a different conversation in a couple of years. In the interim, I will use AI to enhance my productivity!

Sources: [1]Precedence Research, [2]ChatGPT (openai.com)

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13 February 2023

Love Actually? Disappointment actually

Lorenzo La Posta, CFA

A few weeks ago, during the Christmas period, I treated myself to the ideal night in. I was sat on my comfy sofa, blanket on my legs, my girlfriend by my side, hot chocolate in one hand, and TV remote in the other. The lights from the Christmas tree were too bright to enjoy a proper televised experience, but that didn't bother me. What did bother me was the exhausting job of selecting a movie to watch on Netflix, especially for a rom-com junkie like me who's probably seen 99% of the platform's genre. Then it struck me: I hadn't watched Love Actually, supposedly the masterpiece of Christmas movies and a true showcase of top-tier British actors. And what a disappointment that was, to see such a great cast interpret (in my opinion) a poorly-written story. It could have been a new holiday tradition, but now I don't think I'll watch it again.

What does this have to do with investments, you may ask? Well, this was just another example of Tom Magliozzi's formula: happiness equals reality minus expectations. I had massive expectations, but the reality was only mediocre, though if I'd have watched it without any expectation at all, I might have liked it. This is precisely the risk that highly valued growth stocks face constantly.

Adidas, the second largest sportswear manufacturer in the world, lost more than 12% overnight as they warned shareholders of a potential major impact on their profits after ending their partnership with Kanye West following his anti-Semitic comments, and that they would take a €500m hit to profits if the entire stock of Yeezy sneakers got written off. At the time of writing, Lyft (the fast-growing Californian ride-sharing platform) is heading for its biggest single-day decline ever (about -35%), after forecasting dramatically lower profits than expected, and saying they will cut prices in an attempt to attract and keep customers. Electronic Arts, one of the longest standing American video game companies (who remembers "E-A-Sports, it's in the game!" when playing FIFA 98?) plummeted around 10%, as it announced to investors that they were killing the mobile versions of two popular games, laying some employees off, and announcing disappointing earnings forecasts. Intel tumbled more than 8% after the semiconductor giant reported Q4 results that missed expectations and indicated further weakness in their cloud computing, data centre, and AI-related revenues. Nintendo's stock price dropped more than 7% after they cut their full-year earnings and revenue outlook on weaker demand for their aging Switch console, expected to be lower than initially targeted by one million units. Netflix, the largest online streaming platform with more than 220 million subscribers worldwide, lost more than 50% in April last year after showing that this number had shrunk for the first time in more than 10 years.

What all these companies have in common is undeniable quality, strong market position, and leadership within their sectors. Few people out there would question whether these are great companies, but at times great companies might not be great investments. Assuming that a good investment is one where you pay a little for something that is worth a lot, the issue with great companies is that everyone recognises their worth, uniqueness and leadership, and many are willing to pay up for quality, sometimes too much. When a stock is priced for perfection, or for eternal double-digit growth, markets are extremely susceptible to any obstacle (or a reality check) that might come along the way. Whilst we believe that it's only fair to pay up for those rare gems, the fast growers, the disruptors and the dominants, a certain valuation discipline is always necessary. This discipline encourages investors to be realistic about their assumptions, investment thesis, and expectations and disappointments become less common.

I certainly wasn't very disciplined when I decided to watch Love Actually, my expectations were excessive, and the movie underperformed the benchmark (which is Home Alone!)

Sources: Bloomberg Finance L.P. for all stock-level information.

20 February 2023

Insights from rate markets

Richard Stutley, CFA

This is the first chart[1] I look at each day: expectations for future US interest rates. I include the view of the technocrats at the Federal Reserve Bureau (Fed), updated quarterly, plus that of investors, inferred from live Treasury prices:

One only has to look at last year to understand why US interest rates or 'the risk-free rate'* (*I prefer the phrase 'lowest risk investment' because US Treasuries are not without risk, a view shared by the ratings agencies) matters: the more investors can earn on dollar cash, the less they are willing to pay for all other investments.

As can be seen from the chart, there has been a meaningful shift in investors' interest rate expectations so far this year, with investors gravitating towards the Fed's view from December (they are set to update their forecasts next month). As a result, interest rate expectations for the end of 2023 are up by 30 basis points and Treasuries are looking more attractive.

Both sides agree that interest rates are going to peak fairly soon and then come down, implying that monetary policy is in restrictive territory at current levels of around 5%. Longer term, 5% nominal interest rates do look high when aligned to a ~2% inflation target, implying a real yield on cash of 3%. This would take serious impetus out of a US economy which can only grow at around 2%[2] if history is anything to go by: why take a chance on a business in a low-growth economy when you can earn a higher real yield on cash?

If this view is proven to be correct, it will have been a moderate tightening cycle by historical standards: using the past ~25 years as a guide, US inflation topping 9% should require materially higher interest rates than 5% to arrest[3]. This leads to uncomfortable comparisons with the 1970s when the initial hiking cycle was eventually proven to have been too timid. On the other hand, the amount of tightening we've seen (i.e. where interest rates are today compared to where they started) looks more on par with this same history, suggesting policymakers have in fact made decisive moves.

At the start of the year, investors were predicting an imminent pivot by the Fed. Without trying to be too precise – overconfidence in forecasts is a pitfall in our view – we felt imbalances could take longer to work out, as was the case post the financial crisis, which will ever be remembered for its 'looser for longer' monetary policy. Add to that the fact that inflation is the enemy of any investment that pays a fixed amount in nominal terms, and it's clear we should be patient and wait for yields to price in this risk. Yields remain below their peaks from last year, but with inflation slowing, they are starting to look attractive.

Sources: [1]FEDL01 Index, YCGT0025 Index and DOTS <GO>, provided by Bloomberg Finance L.P., [2]GDP CYOY Index, provided by Bloomberg Finance L.P. Average since 2000., [3]FEDL01 Index and CPI YOY Index, provided by Bloomberg Finance L.P. Data since 1996.

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27 February 2023

Is active management dead?

Gary Moglione

In recent years, there has been a growing shift towards passive investing at the expense of active management. Passive funds have outperformed active funds and achieved this within a lower fee structure. This creates a compelling proposition that has been difficult for investors to resist. Should we accept that active management is dead, and passive is the future? Alternatively, is there evidence to suggest that active versus passive is cyclical and highly influenced by the macro environment?

Let's begin by looking at the drivers of passive outperformance over recent years. Following the financial crisis of 2008, quantitative easing saw the market flooded with liquidity as interest rates moved toward historic lows. This increased the valuation of growth stocks significantly, as the present value of their future cash flows were discounted at lower interest rates. Large-cap technology stocks, such as Apple, Amazon, Microsoft, and Facebook were key beneficiaries. These stocks have driven much of the performance of major indices, such as the S&P 500, and these have been the most heavily weighted stocks in passive funds covering the US and Global markets. Many actively managed funds have been underweight or have avoided these stocks due to concerns about their valuations, or regulatory risks. Over the last decade, this environment has resulted in strong and continual outperformance by lower fee passive products. The result of that outperformance has been significant capital moving from active to passive. It is difficult to quantify the exact amount of capital that has moved from active funds to passive, but in the US alone it is in the trillions. This has created a headwind for active portfolios and a tailwind for passive, compounding the cycle even more. By choosing to invest in a passive product, you are effectively choosing to skew your portfolio to the strongest performing stocks, regardless of valuation. From a factor exposure perspective, you are long momentum and short value. The past decade has been perfect for that factor exposure. From 2010 to 2020 the Morgan Stanley Capital International (MSCI) World Momentum outperformed by almost 5% per annum. The MSCI World Value underperformed by over 2% per annum.

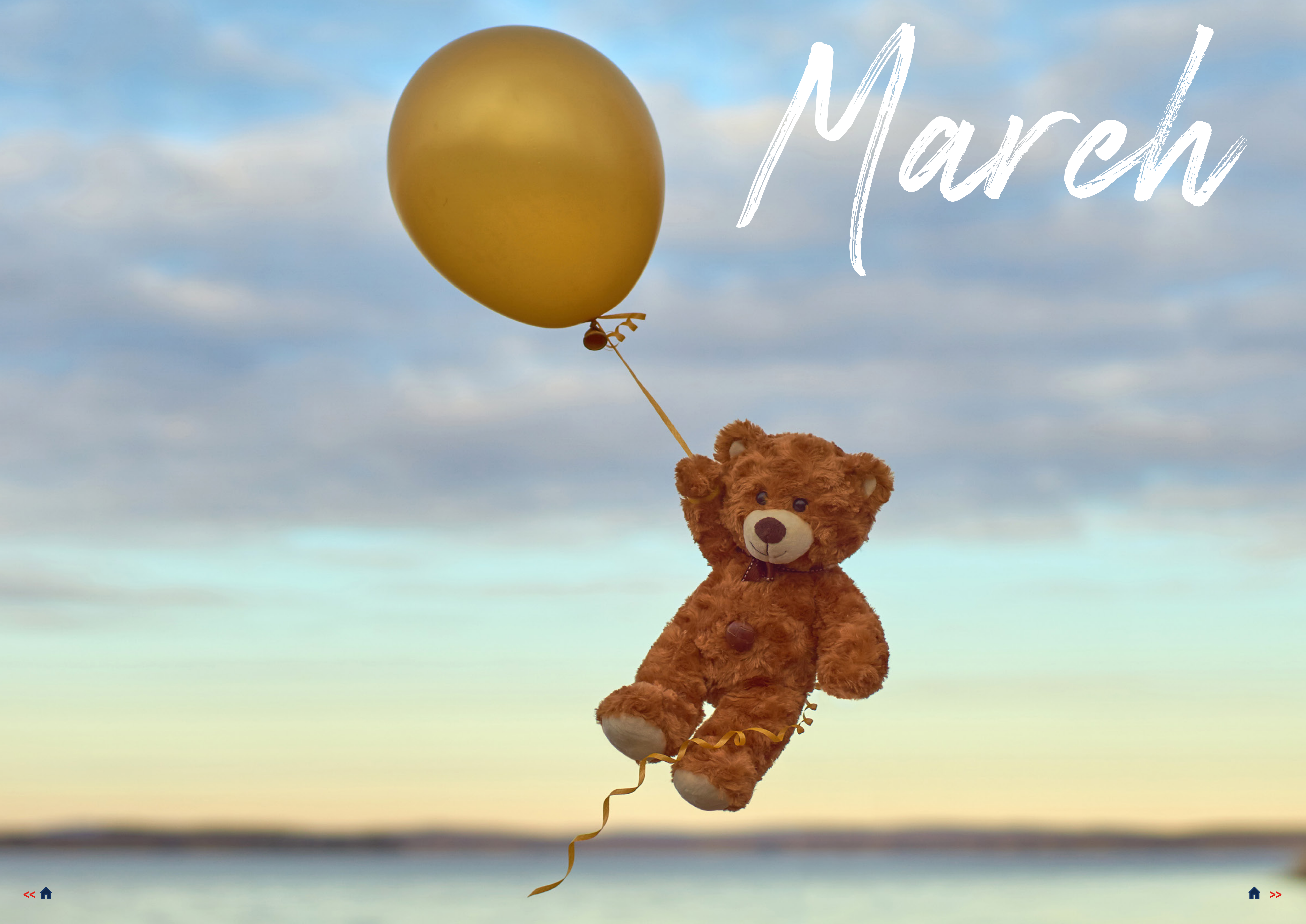
That's pretty compelling evidence of how much better passive has been over the past decade. But let's have a look at what happens when the environment is less supportive. The momentum-driven market in which the most expensive stocks keep outperforming has recently reversed and we are seeing more valuation discipline. The dominant index stocks are having a much tougher time and have been bringing down overall index returns. Historically, active managers have tended to outperform in market drawdowns*. This change in environment is already having a positive effect on active managers. If we look over the past year to the end of January 2023, MSCI World Momentum Index underperformed by 2.5% and the MSCI World Value outperformed by 6.5%. A clear reversal of the factor exposures driving passive performance. My database of 1,138 US Equity managers (the world's most efficient market) shows 57% of active managers have outperformed[1]. Hardly conclusive proof of a paradigm shift, but an indication that passive may have already moved out of its sweet spot. What if this environment persists? Will the wave of moving capital from active to passive reverse, creating a compelling cycle for active managers?

The second element here is that the active/passive debate is usually evidenced by the percentage of active managers that beat the benchmark. The active market is saturated with poor-quality products that have high fees and low tracking error that have merely been created to satisfy demand. These funds are easily identified and filtered out by a robust screening process. When you focus on talented managers with a clear philosophy and portfolios that deviate significantly from the index, the percentage success rates of active managers increases meaningfully.

Overall, I do believe there is no clear winner between active and passive, and results will vary as the economic environment changes. The key is to understand the drivers of each and construct a portfolio that contains both based on your own risk and cost appetite.

*Sources: [1]Momentum Global Investment Management. Unless stated all data from Bloomberg Finance L.P. *Past performance is not indicative of future returns*

March



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6 March 2023

Bursting bubbles

Gabby Byron

Investment bubbles have occurred throughout history when the prices of certain assets rise to extremely high and unsustainable levels driven by a variety of reasons, including raw speculation. Eventually, these bubbles "pop" causing prices to plummet, and investors are left with significant losses. Echo bubbles (often referred to as a dead cat bounce) are post-bubble rallies which can occur for a similar variety of reasons, including investors' failure to learn from past mistakes or a view that the market has corrected itself and is now undervalued.

Investment bubbles are often driven by speculation; when investors are confident that an asset is going to increase in value, they start piling in, pushing prices higher and ultimately to further and further beyond the intrinsic value. This pattern can continue until something causes the bubble to burst. The cryptocurrency market is a recent example and has experienced several bubbles, with prices rising and falling dramatically. In late 2021, the price of Bitcoin surpassed $60,000 per token, driven by speculation and hype. However, the bubble eventually burst falling over 70% from its peak in November 2021 to end 2022 at around $16,500.

Additionally, investor psychology also plays a huge role in the forming of investment bubbles. When people see others benefitting from a rapid increase in an asset's price, they can get 'FOMO' (fear of missing out), creating a herd mentality or self-perpetuating cycle, where one invests in an asset simply because others are doing it, which then pushes prices even higher.

Some bubbles have a recognisable 'pin' that bursts the bubble, forcing investors to reconsider the value of the asset. For example, many technology and consumer discretionary stocks benefitted enormously during the pandemic following the stay-at-home trend and valuations of these stocks reached extreme highs. As economies returned to normality, and central banks began addressing more persistent inflation by raising interest rates, investors became spooked by the much more aggressive monetary and fiscal tightening paths (growth stocks are more sensitive to interest rate rises as investors expect higher earnings further out in the future, so the higher the interest rates used to discount their future earnings are, the more the present value of those earnings then decreases). We saw a sharp sell-off in this cohort of stocks in 2022 with the NYSE FANG+ index falling -40% and MSCI World Growth down -29% in US dollar terms.

There was a sharp rebound across most riskier assets in January 2023 with investors seemingly taking a more bullish view, particularly on the path of interest rates. Markets were boosted by growing confidence that we were past peak inflation in the US and Europe, leading investors to moderate their rate hike expectations. Growth stocks outperformed value stocks and the technology sector started bouncing back with the NYSE FANG+ index up more than 20% over the three months to the end of January. However, recent data released in the US has shown that economic activity remains robust, with ongoing tightness in the labour market meaning that inflation is proving more resilient than expected. This raises the probability of higher-for-longer policy rates which potentially forced investors to reappraise their positioning and as a result investors have experienced a bumpier ride throughout February.

So, how can investors avoid getting caught up in the effects of an investment bubble? As the saying goes, "You never know you're in a bubble until it bursts", so it is best to remain prudent and having a strong valuation-based approach will alleviate some of that risk. At Momentum, we take a disciplined valuation approach when it comes to appraising investments – with decisions underpinned by estimates of the intrinsic/fair value of any given investment opportunity in order to focus on those with underappreciated return potential and avoid those where their current market price suggests expectations are too ambitious. This helps us make informed, disciplined decisions about whether to buy, hold or sell an investment based on its future expected return potential. It also helps us avoid making emotional and impulsive investment decisions based on short-term market fluctuations and trends.

We continue to see a lot of opportunities in value stocks and the current environment of high inflation and higher rates should be supportive for many of the constituents. Diversification is critical to help manage risk – by investing in a variety of asset classes and investment styles at attractive valuations, investors can spread their risk and reduce volatility whilst minimising drawdowns. Building in additional diversification levers to further smooth the investment journey is an approach that we have always adhered to and have implemented successfully over the decades.

Sources: Bloomberg Finance L.P. for all stock-level information.

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13 March 2023

Life in the old dog yet

Mark Wright, CFA

Capita might not be a household name, but most of you will likely have used their services, whether it be to pay your TV license or when entering a car park with automatic registration plate recognition.

The company was founded in 1984 to take advantage of increased outsourcing opportunities created by Margaret Thatcher's Conservative Government. Capita floated in 1989 and flourished to become one of the Government's largest contractors, as successive Governments embraced the larger role private companies could play in the provision of public services. Interestingly, Labour Governments have actually been the largest source of outsourcing work, as opposed to Conservative Governments.

Contract wins came in thick and fast across industries including defence, education, health, and transport. Recruitment contracts for the British Army and customer service contracts from private companies, such as Carphone Warehouse, fuelled growth at seemingly impressive margins. As Capita expanded, overzealous management went on a merger and acquisitions (M&A) spree to accelerate growth even further.

Everything seemed rosy and Capita's share price rocketed. The shares were a darling of the market; £100 invested at IPO (initial public offering) in 1989 was worth £36,900 at their peak on 20 July 2015[1]. Revenues reached a heady £4.7bn and Capita's market capitalisation climbed to £8.8bn[2]. But they do say that the bigger they are, the harder they fall.

Fast forward seven years to 20 July 2022 and Capita's market capitalisation was just a mere £493m[3], despite having tapped shareholders for £700m in the interim, in order to repair its stretched balance sheet. That equated to a total shareholder return of minus 96% over those seven years[4].

Capita was generating a lower but still healthy amount of revenue (£3.2bn in 2021), had a new management team, and a clear plan to further strengthen its balance sheet, stabilise revenues, improve margins, and generate cash flow. Needless to say, that perked our interest.

Our analysis was relatively simple but suggested significant upside to the share price. Importantly, we thought there was a high probability that Jonathan Lewis (the new CEO) could successfully execute on the Board's turnaround plan. We believed there was life in the old dog yet.

On 20 July 2022, the last reported net debt figure (ex-leases) was £431m, but the company had declared disposal proceeds of £203m since then, and an undisclosed sum for the sale of a specialty insurance business (we assumed £18m which was six times profit before tax). This alone meant that net debt (ex-leases) actually now stood somewhere in the region of £210m and the company still had businesses earmarked for sale that were generating revenues of £338m.

If Capita could achieve a price to sales multiple of 0.7x then this would generate £237m of further disposal proceeds and leave the company with no net debt (ex-leases) if it chose not to accelerate scheduled deficit pension payments that totalled £105m. If the company chose to accelerate those pension deficit payments, then net debt (ex-leases) would still only be £78m. Last reported leases stood at £448m and assumed to be just £387m after planned business disposals.

Prior to Capita's share price collapse in 2015, the business generated operating margins of 13.7%. These proved to be unsustainable, but in our analysis we assumed operating margins of just 6% were achievable. On a revenue base of £2.6bn (after business disposals) this meant Capita should have been capable of producing operating profits of £156m.

Placing an undemanding 12x multiple on those profits yielded an enterprise value (equity plus net debt and leases) of £1.9bn. Subtracting the negligible £78m of net debt (ex-lease) and £387m of leases left the equity theoretically worth £1.4bn in the future. This represented upside of 209% on the current market capitalisation of £493m.

Since our investment, Capita have completed several disposals, some at very attractive multiples. Revenue has started to grow and was £2.85bn in 2022 (£2.6bn post disposals), whilst management for the first time reported that in the medium term (three years) the company should be able to achieve at least double the operating margins it did in 2022. Capita generated operating margins of 3.0% in 2022 and so our assumption of 6.0% in the future will likely prove conservative.

There have been no material positive earnings surprises since 20 July 2022 (we first invested on 22 July 2022), yet the shares have rallied 41%[5], already making good progress towards the 185% upside we believe there ultimately is. All that has actually happened since 20 July 2022 is that the company has started to deliver on the strategy it had previously laid out.

We undertake rigorous fundamental analysis on all of our new investments and often find the best opportunities present themselves when others are fearful and sentiment has forced share prices adrift from their fundamentals. This was evidently the case with Capita. There's life in the old dog yet.

Sources: [1]Bloomberg Finance L.P. 30/05/89-20/07/2022, [2]Bloomberg Finance L.P. 20/07/2015, [3]Bloomberg Finance L.P. 20/07/2022, [4]Bloomberg Finance L.P. 20/07/2015-20/07/2022, [5]Bloomberg Finance L.P. 20/07/22-08/03/23. All Capita figures from Capita PLC Financial Statements and RNS releases. Calculations are Momentum Global Investment Management, 2023.

20 March 2023

Wu Wei

Tom Delic

With the sun setting over The Hundred Acre Wood, Winnie-the-Pooh and Christopher Robin perch themselves on the branch of a beech tree at the top of a hill. They are deep in conversation about their day together:

Christopher Robin: "Pooh Bear, there's one thing we didn't do today."

Pooh: "And what thing might that be?"

Christopher Robin: "Mm, nothing."

Pooh: "Nothing? Christopher Robin, what exactly is "doing nothing"?"

Christopher Robin: "Well, I'm told it means going along, listening to all the things you can't hear and not bothering."

The need to do something, rather than nothing, is a trait we all share. Perhaps to pick action over inaction lies deep within our evolutionary development, with the former favouring survival in the gene pool over the latter. As is often the case, our behavioural biases can lead us astray in the modern age. Investing is a case in point.

Analysis by Reuters found that in the 1950s, a typical investor would buy shares in a company and hold them, on average for eight years[1]. That has fallen to just six months, with an acceleration of the trend downwards since the 1980s. While the technological revolution at the end of the 20th century has changed our lives for the good in many ways, the instantaneous access to every conceivable piece of news relating to financial markets, economic conditions, and geopolitical events, seems to have swept investors into a whirlwind of activity.

On Good Friday of 1930, BBC Radio's 15-minute news segment contained two items; the first was the news announcer stating, "There is no news", followed by the second item, a piece of piano music for the remaining time[2]. While over 90 years have passed since then, it feels outlandish to suggest there are now newsworthy events taking place at a frequency to fill every waking minute. A correlation seems to exist between the patience of investors and access to information.

"Doing nothing" and "not bothering" at first glance, feel negative and fatalistic. "Doing something" implies a positive decision with greater control, and we see this action bias manifest itself all the time. A 2007 study[3] by the Ben-Gurion University of the Negev analysed 286 penalty kicks in professional football, finding goalkeepers decided to jump right or left 94% of the time, when in fact, 29% of penalties were kicked at the centre of the goal. It is much easier for a goalkeeper to explain away a conceded goal through action rather than inaction. By jumping right or left, they can at least say they did something. Telling thousands of angry supporters you stood a better chance of saving the penalty by standing fixed in the centre of the goal is a much more challenging task. The world is bias to "doing something" over "doing nothing".

There are clearly moments in time when action in investing is the best choice, but I view these as much less frequent than the modern world would have you believe. Instead, "doing nothing" is often the best course of action you can take. A 2015 study[4] by Martijn Cremers found that the best performing investment managers were those that had a combination of high active share and a longer-term holding period for their average stock selections. As Warren Buffett said, "Lethargy bordering on sloth remains the cornerstone of our investment style". So, the next time you feel the urge to action because of breaking central bank news or a quarterly earnings update, hum this song "busy doing nothing"[5] and be more like Winnie the Pooh.

Sources: [1]https://www.visualcapitalist.com/the-decline-of-long-term-investing/, [2]https://www.bbc.com/news/entertainment-arts-39633603, [3]Bar-Eli, Michael, Ofer H. Azar, Ilana Ritov, Yael Keidar-Levin, and Galit Schein (2007), "Action Bias among Elite Soccer Goalkeepers: The Case of Penalty Kicks," Journal of Economic Psychology, 28(5), pp. 606-621., [4]Cremers, K. J. Martijn and Pareek, Ankur, Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently (1 December 2015). Journal of Financial Economics (JFE)., [5]Busy Doing Nothing - YouTube

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27 March 2023

Managing uncertainty: a question of weighting?

Andrew Hardy, CFA

Surprisingly there have been 563 bank failures in the US since 2001[1], far more than I think most would have guessed. Less than a third of those occurred during the worst of the Global Financial Crisis (GFC) in 2007-2009. Nonetheless, the two most recent collapses, Silicon Valley Bank and Signature Bank, have led to much concern, not least because they represent the second and third largest US bank failures over that period based on total assets ($209bn and $100bn respectively). But what's motivated investors and moved markets most has been the question: What comes next? The immediate answer of course was Credit Suisse's collapse and controversial rescue; an entirely separate and unrelated event on a different continent. However, with three very large bank failures in a week, it is natural to draw comparisons to the GFC which resulted in huge, and in some cases, permanent losses in risky assets. We think the circumstances today are very different and that those truly systemic risks are largely absent (discussed in our recent note on the subject here), but amidst such uncertainty, the common response for many end-investors is so often the wrong one; de-risking their portfolio after the event. Helping to keep clients invested during times like these is arguably the most valuable service our industry provides.

The legendary investor Peter Lynch said "Far more money has been lost by investors trying to anticipate corrections than has been lost in all the corrections combined. One of the worst mistakes you can make is to switch in and out of stocks or stock mutual funds hoping to avoid the upcoming correction." Surely wise words, but the track record of his investors provides much more powerful support for his suggested approach. As manager of the Magellan Fund at Fidelity Investments between 1977 and 1990, he delivered a 29% annual return, double that of the S&P 500 equity index and making it the best performing mutual fund globally[2]. However, studies suggest that the average investor in that fund actually lost money during their holding period![3] Part of the explanation is that on average, investors bought after periods of good performance (prior to periods of poor performance), and vice versa. The 700-fold increase in asset size from when Peter took the helm to when he stopped running the fund is also a key factor in explaining a very different outcome for the average dollar invested.

A more recent and similar example comes from Cathie Wood's ARK Innovation Exchange Traded Fund (ETF). As the poster child of the boom in US speculative growth stocks, her actively managed strategy delivered phenomenal returns up until mid-2021 around the turn in the US monetary policy cycle, since when the fund is down by over 75% in US dollar terms. Despite an impressive since inception return of 114% or 9.5% per annum, the average dollar is estimated to have lost 27% because most investors piled in late, after the best returns had been generated[4].

What these examples highlight is how extreme the differences can be between time-weighted and money-weighted returns. End-investors should only worry about the latter for themselves, because it takes account of cash flows into or out of the portfolio which changes the amount of capital invested. If for example one only adds to a portfolio when markets are low ahead of a rebound, then the money-weighted return would exceed the time-weighted return. However, most people focus on time weighted returns, because that is what gets reported in market news and by professional fund managers; rightly so given they often cannot control the timing of cash flows in or out of their strategy, nor realistically track the money-weighted return for each individual investor. Time-weighted returns reflect the average compound growth rate of a strategy over time, so unless assets under management change so much as to force fundamental changes in that strategy, it's a good yardstick to evaluate a manager by, based on the factors they can control.

While the Magellan and ARK funds are high profile and more extreme examples, they are by no means isolated. The persistent tendency through time for the masses to buy high and sell low should give all investors serious pause for thought when reacting to short-term events.

But beyond just recognising how much value destruction happens due to short-term behaviour, asset managers and financial advisers must focus on helping clients narrow the gap between time-weighted and money-weighted returns. As Peter Lynch pointed out, market timing (specifically de-risking through periods like now) is the biggest factor explaining that gap and so helping clients avoid that should be the priority. That can be achieved in many ways, including through a combination of careful fund selection and portfolio construction (thereby reducing the need for forced portfolio turnover and creating less volatile returns) and through communication and education to encourage better behaviour (thereby avoid those usually damaging attempts at market timing).

These parts of the value proposition are particularly relevant today, given the huge uncertainty in markets, but even more so in the UK during a year when much of the industry is grappling with new Consumer Duty regulation[5]. An overarching focus of this regulation is the need to contribute towards better customer outcomes, as far as possible across the entire value chain, as well as measuring and evidencing the value of services provided. While it's encouraging that this regulation focuses on value rather than simply cost, the tendency is still to only include that which can be measured easily. Keeping clients invested and delivering better money-weighted returns is not as easy to quantify as fund performance or costs from a factsheet, but it's far more relevant and perhaps one of the best ways to evidence the value of good advice. We recognise the significant risks facing the global economy and markets presently, and wouldn't discount further challenges and volatility ahead, but in the long sweep of history these periods have usually proved the time to be buying rather than selling.

Sources: [1]Deutsche Bank, March 2023, [2]Wikipedia, https://en.wikipedia.org/wiki/Fidelity_Magellan_Fund, [3]Forbes, Fidelity Investments, [4]Financial Times, Factset, [5]FCA, https://www.fca.org.uk/firms/consumer-duty

April

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3 April 2023

Lessons learned from the bank-run playbook

Gregoire Sharma, CFA

So far this year we've had very little respite from the relentless pace in markets. Russia continues to wage its atrocious and unprovoked war in Ukraine, a global recession looms, and the first quarter is ending with a bang as the dissolution of Credit Suisse into UBS has gripped investors' attention for the past two weeks. Still, just a couple of weeks ago*, you'd have been hard pushed to add another banking crisis to the list of market woes. Indeed, since the Global Financial Crisis, regulators have imposed a series of stringent checks and balances to ensure the health of the banking sector and avoid a repeat of 2008. Recent fears of 'national champion' bank solvency have certainly been overplayed, but whilst the systemic risks of 2008 remain improbable, liquidity risk has always been and will remain banks' proverbial 'monkey on the back'.

Banks constantly face liquidity risk given deposits held are subject to constant and sometimes unpredictable change. Terry Smith, manager of the Fundsmith strategy, recently recounted an anecdote whereby in the eighties, a local bank in China saw a group of people gather under an awning outside its building as they sought shelter from the rain. This led passers-by to believe that was the start of a bank run, which turned into a self-fulfilling prophecy. It doesn't take much to spook the markets, even if the fundamentals don't warrant it – an oft-reoccurring theme in the bank run playbook.

With the failure of Silicon Valley Bank on March 10, the global banking sector was shaken to its core, and nervous investors, long frustrated by Credit Suisse's poor performance and lack of profitability, started selling equity and debt, culminating with the Swiss National Bank (SNB) intervention which saw US$17 billion of Credit Suisse Additional Tier 1 (AT1) bonds getting wiped out. AT1 bonds (otherwise known as Contingent Convertibles or CoCos) are a tier of regulatory capital which itself is an amount designed as a buffer to absorb losses that might otherwise adversely affect the issuing firm and its creditors. Make no mistake though, the initial selling was not the result of savvy investors' fundamental analyses of Credit Suisse's business, but rather based on poorly informed and panic-driven inferences.

Yes, Credit Suisse had long been tarnished by a series of controversies (losing two Chief Executive Officers in the course of two years, suffering billions of dollars in losses – think Archegos and Greensill – and even getting marred in a drug cartel scandal!) which saw wealthy customers jump ship. And yes, Credit Suisse was the least profitable bank in the Euro Stoxx Index (the only one to have negative return on equity for the last five years), but its board of directors had begun a vital overhaul process involving changing the culture of the bank and raising sufficient capital to restructure the business (namely by spinning off its investment banking division). Despite all this, in the runup to the Swiss regulator's intervention on Sunday 19 March, the bank was very solvent, and even very liquid. In fact, its liquidity coverage ratio jumped to 190% following the 50 billion Swiss Franc injection by the SNB. Banks' liquidity positions are stress-tested every year by regulators and there were no concerns on this front. Unfortunately, this was not enough to reassure markets, hence the Swiss government forced through UBS' acquisition of Credit Suisse.

These events should serve as a stark reminder that it's easy to fall into a state of complacency from overly relying on quantitative indicators, but we cannot shun the importance of qualifying these with rigorous qualitative risk assessments. Indeed, fear and panic can rapidly take hold of investors, causing them to act irrationally, ultimately dismissing fundamental analysis and common sense. Importantly though, the market dislocations that result, often make for attractive valuation arguments and if coupled with solid fundamentals can produce compelling investment opportunities.

**at the time of writing (24/03/2023)*

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17 April 2023

In changing of the seasons we (investment) trust

Richard Parfect

It is the time of year when we, in the northern hemisphere, emerge from winter, welcome new life, and even start a new UK tax year. Our gardens sprout new growth and rediscover colourful displays, it is in many ways an optimistic time of year. Investors might be tempted to have similar feelings towards the investment trust market.

To recap, recent years have seen what feels like an unprecedented period of "issuance" where new investment trusts were formed to invest in a variety of assets such as property, infrastructure and even esoteric things such as music royalties, that have typically been out of reach of many investors. The shares of such vehicles typically traded at premiums to Net Asset Value (NAV) which afforded them to issue further equity and expand their portfolios of assets. With the odd exception, returns were good, dividend income was earned, investors diversified their portfolios beyond simply holding equities and bonds, and UK plc benefitted from a new source of financial capital to help address the almost overwhelming need for investment in its physical capital. All was going well and then the season changed…

It started with the Autumn "fiscal event" which set bond yields reaching for the stars, with a resultant negative impact on NAVs which take some of their reference point from the plunging value of "risk free" government debt. Even though some normality returned to gilts under Jeremy Hunt, the damage was done; it has been an embarrassing lesson for enthusiasts of backward looking "risk" models.

The situation was made worse by what can only be assumed were unintended consequences of the application of cost disclosure regulation for investors in Europe. The problems raised by these rules are too expansive to cover here but have been commented elsewhere in the investment press. However, in simple terms they have created an uneven playing field that has unfairly penalised holders of these specialist investment trusts versus ordinary equities. By making funds that hold investment trusts such as Greencoat UK Wind optically (but crucially not economically) more expensive than other investors that hold listed equities such as SSE plc, the rules on cost disclosure have removed a key "marginal buyer" of investment trusts.

The price of anything that is traded is set by the marginal buyer and marginal seller, that is where the last available seller will supply an asset and the last available buyer is prepared to buy an asset at a given price. Once you remove one of those market participants, the price resets to find the next marginal buyer/seller. The motivation to buy or sell is driven by a multitude of factors, only one of which is the price.

In the case of investment trusts, investors who were buying in the years leading up to mid-2022 will have been drawn to income paying credentials, diversification benefits, ESG attractions, their own investment inflows and outflows to name a few; the premiums to NAV implied there was more buying demand than any need to sell investment trusts. However, in the last six to nine months those marginal buyers have either walked away or even become sellers; possibly spooked by falling NAVs, needing to finance outflows from their own investor base, or reluctant to have to report their optically (but not economically) higher cost of holding investment trusts.

The result of this descent into winter has resulted in discounts to NAV opening up of 10-20% in some infrastructure names; up to 30% in property REITs (despite solid evidence of rental growth in many sectors), whilst private equity is suffering discounts of over 50% in some names.

It is true that the sector has not helped itself with scandals such as HOME REIT shaking investor confidence, and private equity allowing itself to get carried away with some deals in the period of low interest rates. Greed also resulted in an excessive number of trusts being launched that has resulted in too many being sub-scale. Self-help is required with Boards instigating consolidation; yes, an ironic test for a quality Board is its preparedness to put itself out of a job.

With valuations being where they are, it is hard to believe that marginal buyers will not return, particularly if catalysts for value discovery occur. Furthermore, common sense could be restored as a result of the packaged retail investment and insurance products and UK Retail Disclosure consultation papers from the Government and Financial Conduct Authority in March. Selling investment trusts at this time does not feel economically rational.

24 April 2023

Football versus Soccer

Matt Connor

The city has been abuzz with chatter recently after a very public, scathing attack on the unfriendliness of the UK stock market to new listings. Although the comments could be seen as an ego-massaging exercise to divert attention away from a floundering business, therein lies some truth that the UK stock market is evidently less attractive than our cousins across the pond.

The UK government is desperately trying to stem the bleed of British businesses favouring the US, with UK Prime Minister Rishi Sunak encouraging a relaxation of the London Stock Exchange's listing rules. Over-regulation of the markets has contributed to London's decline as a financial powerhouse, and despite Mr. Sunak's lobbying for de-regulation, little has been done to date.

The allure of looser regulation is not the only thing tempting businesses to make the transatlantic trip, it is the valuations they can achieve with a US listing versus the UK. The US has seen a decade of immense wealth creation, with the number of new Initial Public Offerings (IPO) reaching all-time highs in both 2020 and 2021[1] as a result of founders and private capital cashing in on lunatic valuations. Some businesses, such as DoorDash, achieved a whopping 11x sales multiple on its IPO that rocketed to 21x upon its stock market debut. Did I mention DoorDash hasn't turned a profit yet and lost $1.2 billion last year?

Although in the last 12 months, a reality has dawned on many investors which has tempered such irrational exuberance, it does not hide the fact that the US can still be a much more attractive place for companies to list that have significant operations in the country and want to achieve a richer valuation for their private backers. The darling of British innovation, ARM, is seeking a US listing, and is it any wonder why when the NASDAQ trades at a Price-to-Earnings ratio of 25x versus a measly 11x for the FTSE 100. But what can the UK do? De-regulation can only go so far, and the ever-increasing depth of the US market commanding high valuations will only serve to further compound the problem of businesses choosing a new home stateside.

Although low valuations in the UK may dissuade new listings, it can also offer the opportunity to acquire high-quality businesses at a discount. The FTSE 250 trades on a Price-to-Book ratio of 1.4x versus its 10-year average of 2.0x, signalling that many UK companies (and in particular mid-caps) are an undervalued opportunity, one we are taking advantage of with a significant allocation within our multi-asset portfolios. Such opportunity has not gone unnoticed by private equity in their well-documented 'raid on corporate Britain'. Time will tell whether irrational exuberance will lead to unjustifiably high valuations of unprofitable, non-cash generative businesses again, but for now, some CEOs ought to focus on turning a profit rather than rueing what could have been.

Sources: [1]Statista.com, Unless stated, all sources are Bloomberg Finance L.P.

May

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15 May 2023

Carolean carousel

Alex Harvey, CFA

May is one my favourite months. Not only is it my birth month (the excitement fades a little each year), but the cherry blossom, lighter evenings, and smell of freshly cut grass mark the seasonal transition. Spring has sprung I like to say. In the UK we also get bookended bank holidays on the first and last Mondays of the month. This year however, we got a third, and who could avoid the spectacular pageantry last weekend of the coronation of King Charles III, beamed into our homes as never before in HD. Three four-day weeks in a month – hurrah, three cheers for the King! There is probably no better example of stage-managed succession planning than the coronation of a new British monarch.

There is a natural linkage between the concept of success and that of succession. Derived from the Latin word successus, success literally means advancing or climbing, or following after. Thus, it seems fair to equate success with effective stewardship, and in order to maintain success over the longer term you must have succession planning. At Momentum, this is something we look for in the managers with whom we invest; to ensure continuity of an investment process – and to ensure its success – the business should ideally be structured in a way to promote and incentivise the next generation of leaders. This also helps ensure there is an alignment of interests between the employees and the business, which in turn helps align their interests with those of our clients. We employ several third-party managers whose founders have built successful investment businesses and who are now looking to facilitate a smooth transition to their protégés. In the investment world this is probably most well recognised with Warren Buffett and Charlie Munger, aged 92 and 99 respectively, who have anointed Greg Abel as their heir apparent at Berkshire Hathaway, although at 60 he should maybe start to think about his own successor!

As well as looking outward to those we choose to partner with, it is equally important to our own investment process to reflect this internally. The success of our clients is inextricably linked with the success of our own firm, and that of our selected investment managers. I have highlighted in a previous blog[1] how at Momentum we like to 'grow our own timber' and have recruited some exciting young prospects into the team over the years, such that one of the first interns we took in is now head of the investment desk (and considerably younger than Mr Abel too).

The concept of stewardship applies as much to investing as it does to 'The Crown' and is fundamental to the bond of trust that exists between investment managers like us and our clients, and to companies and their investors. As custodians of other people's assets there is a fiduciary duty to act in the interests of the clients or beneficiaries. Often there is an inter-generational transfer of wealth and effective stewardship is required to ensure that happens successfully. Last week I attended a conference hosted by one of our managers who pride themselves on not only being effective stewards of their clients' money, but also in identifying companies that embody the concept of sustainable investing. This is qualified through the lens of generating sustainable earnings over time, often investing alongside the founding family, where effective stewardship is guided by a sense of moral purpose which spans the environmental, social and governance issues that encompass today's 'ESG' debate. Investing in this way is more likely to achieve sustainable earnings that can be passed on to the next generation.

As we usher in a new Carolean era, and to coin a luxury watchmaker's slogan, King Charles will do well to remember that you never really own the crown and sceptre, you simply look after it for the next generation.

Source: [1]Jassy: Jeff's Fresh Prince. August 2021

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22 May 2023

Richest match in football

Jackson Franks

On Saturday, the most lucrative match in world football unfolds, and surprisingly, it is not the Champions League final or the World Cup final, but rather the Championship Play Off final. In case you are unfamiliar, the Championship is the division just below the esteemed English Premiere League (EPL). While the top two teams from the division secure automatic promotion, the teams that finish third, fourth, fifth, and sixth engage in the playoffs, competing for the last available promotion spot to the EPL. This year, Coventry City and Luton Town, which pains me to say as a Watford fan (as Luton happens to be our greatest rival, known as the M1 derby), face off in the final. This one-off match, held at the iconic Wembley Stadium, carries an astonishing value of approximately £265million1.When Coventry City get promoted on Saturday, preserving the financial prosperity of the EPL will undoubtedly be at the forefront of their mind. The crucial element in upholding their EPL status, and the riches that come with it, will be the investment of those funds.

While I do not have a personal fortune of £265million to invest right now, it sparked my consideration about how I would strategically allocate such funds if given the opportunity. Given my focus within commercial real estate, I have outlined below the areas where I would seek to invest these resources, aiming for sustainable long-term returns in today's ever-changing macro environment.

Offices. Despite the rise of remote and flexible work arrangements, office spaces remain an essential component of the commercial real estate market. Investing a portion of the capital in prime office locations can yield stable returns. However, it is crucial to focus on high-demand areas with robust rental markets, such as central business districts and hubs. These locations are likely to continue attracting companies seeking collaborative spaces and physical presence for their operations. Especially for those businesses with a younger workforce, enabling a space for personal development, culture adoption and welfare.

Industrial and Logistics. The ongoing growth of e-commerce continues to present high demand for industrial and logistics facilities. Investing in warehouses, distribution centres, and fulfilment hubs can prove profitable, given the ever-increasing need for efficient supply chain management. With the continued growth in online retail, companies require strategically located facilities to expedite last-mile deliveries. Allocating a substantial portion of the capital in this sector offers attractive long-term prospects.

Mixed-Use Developments. Mixed-use developments that combine commercial, residential, and entertainment spaces have gained significant traction in recent years. These developments create vibrant communities and offer a diverse range of amenities, making them appealing to both tenants and residents. Investing in well-planned mixed-use projects, particularly in urban areas experiencing growth, can provide a steady stream of income from commercial leases while benefiting from residential property appreciation.

Healthcare Real Estate. The healthcare sector is expected to witness steady growth due to an aging population and increased demand for medical services. Investing in healthcare real estate, such as medical office buildings, outpatient facilities, and specialised clinics, can offer stability and potentially attractive returns. It is essential to focus on locations with established medical infrastructure and proximity to hospitals and research centres.

Data Centres. With the digital age in full swing, data centres have become the backbone of modern technology and cloud computing. The increasing reliance on data storage and processing necessitates substantial investments in these facilities. Given the constantly evolving technological landscape, targeting data centre developments in regions with favourable business climates and robust connectivity can yield long-term gains as demand continues to rise.

Hospitality and Leisure. While the hospitality industry faced significant challenges during the pandemic, it is gradually recovering and poised for growth. Investing in hotels, resorts, and leisure facilities in popular tourist destinations or emerging markets can be a prudent choice for medium and long-term investments. Careful consideration of the local tourism landscape, accessibility, and demand patterns is crucial to capitalise on this sector's potential.

Considering the evolving macro environment, several sectors within commercial real estate still present promising long-term prospects. Offices in high-demand areas, industrial and logistics facilities to support the continued e-commerce growth, well-planned mixed-use developments, healthcare real estate, data centres, and hospitality and leisure properties in strategic locations all offer avenues for sustainable returns. But, more importantly, and to conclude, come on Coventry City!

June

5 June 2023

The many dimensions of sustainability

Lorenzo La Posta, CFA

I am writing this piece from a wet and cold Italian countryside in early June, quite unusual for what should instead be “the good season” already. Last year on this very day, I was on holidays with a friend in Puglia, it was really hot and we were cooling down in the Adriatic sea. There’s climate change for you! But that is only one of the many things that worries me. There’s climate change, social inequalities, human rights, justice, environmental preservation, poverty and (unfortunately) a lot more.

From an investor’s perspective, I’m twice as worried though. What’s the impact that all these dynamics are having on my investments? What’s the impact my investments are having on these dynamics? How do I devise a win-win plan for my portfolios?
When it comes to incorporating sustainability considerations into investment decisions, there is a growing consensus on the importance of doing so, both from a responsibility perspective (position your investments to have an impact) and from a financial return perspective (position your investments to benefit from sustainable characteristics). However, there is still ongoing debate and little agreement on the best approaches to do so and several different methodologies are being used, each with its own pros and cons.

The first method is sector exclusions, that involves excluding specific industries or sectors from investment portfolios based on their negative environmental or social impacts. For example, investors may choose to avoid companies involved in tobacco, weapons, or fossil fuels. The advantage of sector exclusions is that it provides a straightforward way to align investments with sustainability values, but it can limit diversification and potentially restrict opportunities for engagement and positive change within those industries.

Controversy exclusions represent another approach. This methodology involves excluding companies that are involved in controversies related to environmental or social issues, such as child labour or human rights violations. By avoiding those, investors aim to promote responsible practices. However, determining the extent and severity of controversies can be subjective, and there may be challenges in obtaining accurate and timely information.

Environmental, Social, and Governance (ESG) risk mitigation revolves around considering and quantifying how ESG factors can materially impact a company’s financial performance. This approach provides a comprehensive assessment of a company’s sustainability performance and its potential impact on investment returns. However, there may be challenges in accurately measuring and quantifying these factors, as well as variations in methodologies used by different investors and data providers.

Another methodology is centred around reducing the environmental footprint of the investment companies, seeking to minimize carbon emissions, waste generation, and water usage, for example. By investing in companies that actively work towards environmental sustainability, investors can contribute to positive change but setting reduction targets and accurately measuring environmental impacts can be complex and require ongoing monitoring and verification.

Measuring and increasing impact towards the United Nations’ Sustainable Development Goals (SDGs) is gaining traction as a methodology for sustainable investing. This approach aligns investments with specific SDGs, such as poverty alleviation, gender equality, and climate action. By directing capital towards companies that contribute to these goals, investors aim to generate positive social and environmental outcomes. However, defining measurable impacts and assessing the alignment of investments with the SDGs can be challenging, even more than with ESG risks.

Lastly, voting and engagement play a crucial role in sustainable investing. This methodology involves actively using shareholder rights to influence companies’ practices and policies through voting on resolutions and engaging in dialogues with management. It allows investors to drive change from within and hold companies accountable for their environmental and social performance. However, it requires dedicated resources and expertise to effectively engage with companies and promote sustainable practices.

Incorporating sustainability considerations into equity investment decisions can be approached through various methodologies, each with its own advantages and challenges. I firmly believe that by integrating them all, in a measured, holistic and risk-managed way, one can achieve substantial results and benefit through better long-term risk-adjusted returns. After all, sustainability is just another dimension of quality. Sustainable companies should face lower costs of running their business (less carbon taxes, fines, renovation costs etc…), improved market sentiment, lower cost of capital and ultimately better returns.

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12 June 2023

Safe as houses?

Richard Stutley, CFA

Contrary to that saying, property has been anything but a safe bet so far this year: the S&P Global Property Index is up 1.9%[1], positive yes but lagging far behind the MSCI All Countries World [equity] Index, up 10.4%. That is despite dividend forecasts for 2023 being revised up by 3.2%, better than the 1.4% upward revision in equity dividends – in other words the outlook for property companies has improved relative to equities so far this year, and for that investors have been rewarded with a swing of almost minus 9% in performance. Counterintuitive to say the least.

To help explain this disparity between fundamental performance and share price performance, I’ve paraphrased one of my colleagues:

‘The market is worried about write-downs to the value of assets, which poses a risk to businesses looking to refinance: higher loan-to-values (LTVs) compound the impact of an already higher base rate.’

They go on to offer some encouragement however:

‘In 2008/09, many REITs were forced to recapitalise. Since then, average LTVs have come down significantly, hence comparisons to that time are overstated. While companies in many industries are affected by the current tough economic environment, long leases (typically 3-5 years) mean property is better insulated than other sectors and hence general equities.’

A related risk preoccupying investors is funding risk. While property companies are looking less creditworthy due to the higher base rate and higher LTVs, the banks that traditionally lend to them are having problems of their own, as highlighted recently by several high-profile collapses. Here, however, I agree with our active property manager Catalyst Fund Managers, that a distinction needs to be drawn between private property companies and publicly listed ones, in which we invest. According to data compiled by National Association of Real Estate Investment Trusts[2], publicly listed property companies have less than a quarter of the exposure to the office sector (which remains under pressure) of their private counterparts, at just over 5%. They are also less highly indebted on average and have more diversified sources of funding beyond the banking sector, according to Catalyst.

While all that sounds positive, we need to bear in mind that listed property companies don’t operate within a vacuum, and hence contagion from the private sector remains a risk. Fundamentals for listed property companies are still intact. Rental growth remains high across most sectors, with the exception of offices, and even the sharp slowdown in the apartment sector (following a swift supply response) only brings rental growth back in line with its pre-pandemic norm[3]. With respect to balance sheets, companies are less indebted than pre 2008/09, and they have taken advantage of low interest rates to lock in cheap debt out to 2030 on average[4].

The continued derating so far this year has pushed dividend yields above historic averages, implying that either something is different this time, or else current prices are attractive. One thing that is clearly different is the interest rate environment, and we note that property only looks roughly fair value when compared to the yields on offer from US Treasuries and Treasury Inflation Protected Securities (TIPS)5, although considerably better than equities.

Looking at analysts’ expectations on Bloomberg, it is striking how much growth they expect from the sector over the next 12 months. Part of this is clearly to do with higher inflation but looking at the pricing of 12-month Treasuries and TIPS, forward-looking inflation is in fact expected to be benign. Estimates ranging between 6 and 8% growth for the next 12 months, and in excess of 4% annualised for the next 4 years[6], are in stark contrast to the outcome over the past 10 years or so (dating back to April 2013). Since that time, the S&P Global Property Index has delivered dividend growth of only ~2% per annum[7]. Where is this higher growth going to come from? The increased proportion of high growth subsectors in the index is obviously key – areas such as laboratory space and retail parks, which we specifically target in our portfolios. We also expect to see the lagged effects of inflation coming through, plus the strong rental growth catalysed by the aftermath of the pandemic, when a boom in demand met constrained supply at the time.

Adding all this together: fundamentals look good, in particular balance sheets which are in better shape compared to 2008/09 on average. Valuations have improved year to date but are not yet super compelling and there is likely to be an overhang from private markets. Overall, property is still not that attractive compared to certain areas of the fixed income markets in our assessment, but it warrants a place alongside equities within our basket of growth assets.

Sources: [1]Bloomberg Finance L.P. (index closing levels between 30/12/2022 - 07/06/2023). [2]Reit.com REITs Offer Diversification and Timeliness, 30 March 2023. [3]Reit.com Core Property Sector Fundamentals Generally Solid in 4Q22, Some Evidence of Softening, 20 March 2023. [4]Reit.com In 2023, REITs Are Likely to Remain Resilient to Higher Interest Rates, 15 December 2022. [5]Treasury Inflation Protected Securities. [6]Forecasts from Bloomberg Finance L.P. and Catalyst Fund Managers. [7]Bloomberg Finance L.P. (SPBMGPTU Index; trailing 12 months dividend per share; April 2013 to May 2023).

19 June 2023

Dare to be different

Gary Moglione

The UK is currently experiencing a scorching heatwave, with temperatures reaching 28°. While it may not be extreme for some of our international readers, it's a significant event for us in the UK. During such heatwaves, consumers tend to rush out and buy fans to keep cool. Last year, fan sales increased by a staggering 1300% as prices surged and stocks ran out. It's interesting to draw parallels between the scarcity of fans during these hot times and the behaviour of investors in the stock market. When temperatures soar, demand for fans skyrockets, much like how investors flock towards popular stocks, driving up prices and leaving little room for bargains. This behaviour sets the stage to discuss contrarian investing.

Contrarian investors understand the value of going against the crowd. Just as contrarian investors would purchase fans in the winter when they are abundant and discounted, they seek undervalued opportunities in the market when others are focused on the hot stocks for the current economic backdrop. Currently, about half of this year's gains in global equities can be attributed to seven stocks, leaving ample room for contrarian investors to find opportunities in other areas of the market which may be overlooked.

Contrarian investing has witnessed remarkable success stories over the years. One noteworthy trade was made by Michael Burry of Scion Capital, who bet against the subprime mortgage market when property prices were continually rising in 2005. Despite facing significant underperformance, client pressure, and criticism, Burry remained steadfast in his view. His conviction paid off in 2008 when the subprime mortgage market collapsed, resulting in substantial gains.

Another example is Sir John Templeton, a legendary investor. During the depths of the Great Depression, Templeton invested $10,000 to purchase stocks trading below $1 on the New York Stock Exchange. Although considered reckless by many, his contrarian mindset enabled him to uncover hidden value and capitalize on the eventual market recovery. Within four years, his investment grew fourfold.

Being a contrarian investor is challenging. It requires the ability to withstand social pressure and the emotional turmoil of seeing investments temporarily out of favour. However, the potential rewards are significant. Contrarian investing allows investors to acquire undervalued and underappreciated assets, presenting opportunities for substantial long-term gains.

Contrarian investors possess the unique ability to detach themselves from herd mentality and think independently. They understand that markets are driven by emotions, often leading to overreactions to short-term news and events. By maintaining a long-term perspective and having the patience to wait for opportunities, contrarian investors can identify undervalued assets that others have overlooked.

In a world where the majority succumbs to the allure of hot stocks during market frenzies, contrarian investing stands as a steadfast and disciplined approach. Just as purchasing fans in winter offers discounts and savings, contrarian investors seek out undervalued opportunities when others are distracted by short-term market trends. While the mental challenges are undeniable, the potential rewards make it worthwhile. By having the courage to swim against the tide and patiently seek out hidden gems, contrarian investors can position themselves for long-term success in the ever-changing world of investing. With markets currently exhibiting high levels of valuation dispersion akin to the tech bubble and COVID-19 periods, diversifying capital away from the herd is prudent for any investor.

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26 June 2023

Momentum investing at Momentum

Stephen Nguyen, CFA

Last week my colleague Gary Moglione shared his thoughts on the advantages of adopting a contrarian stance or going against the crowd when it comes to investing, which can be very rewarding if investors can exercise patience and take a long-term perspective. This approach is commonly referred to as value investing, where the underlying concept involves seeking undervalued assets. However, there are other approaches to investing which can also generate strong returns if you have the required skill set and mentality. Simply put, the converse of the contrarian approach is known as momentum or growth investing. Both investment styles aim to harvest factor risk premia, whether it be value or momentum. Over the long-term, both approaches have generated above market returns but they are cyclical in nature. For instance, in 2021 and 2022 we saw value outperform its growth counterpart, while in 2020 and for most of the previous decade we witnessed phenomenal performance of momentum and growth stocks. So, which approach should investors adopt?

As with all equity styles or factors there are multiple approaches to momentum investing. The most basic is price momentum. Price momentum involves buying stocks that have already experienced price increases based on the belief that stocks which have performed well in the past will likely continue to perform well and vice-versa for underperforming stocks. This strategy is effectively buying past winners and selling past losers – fairly straightforward.

The other common approach to momentum investing is to focus on company fundamentals, such as earnings growth. The emphasis on growth is the reason momentum investing is often used interchangeably with growth investing. Typically, these strategies look to identify companies with sustainably high earnings that are also growing at an accelerated rate. These companies would also tend to exhibit positive earnings surprises or revisions.

The momentum risk premium or the momentum effect is well documented and has been around for decades. Momentum investing challenges the conventional wisdom of the Efficient Market Hypothesis (EMH), which broadly states that stock prices at any given time should reflect all publicly available information and assumes that all investors are rational, meaning that garnering additional returns is nigh on impossible. However, this belief in efficient markets doesn't hold, as this type of strategy has proven to reward investors with above market returns consistently over the long-term.

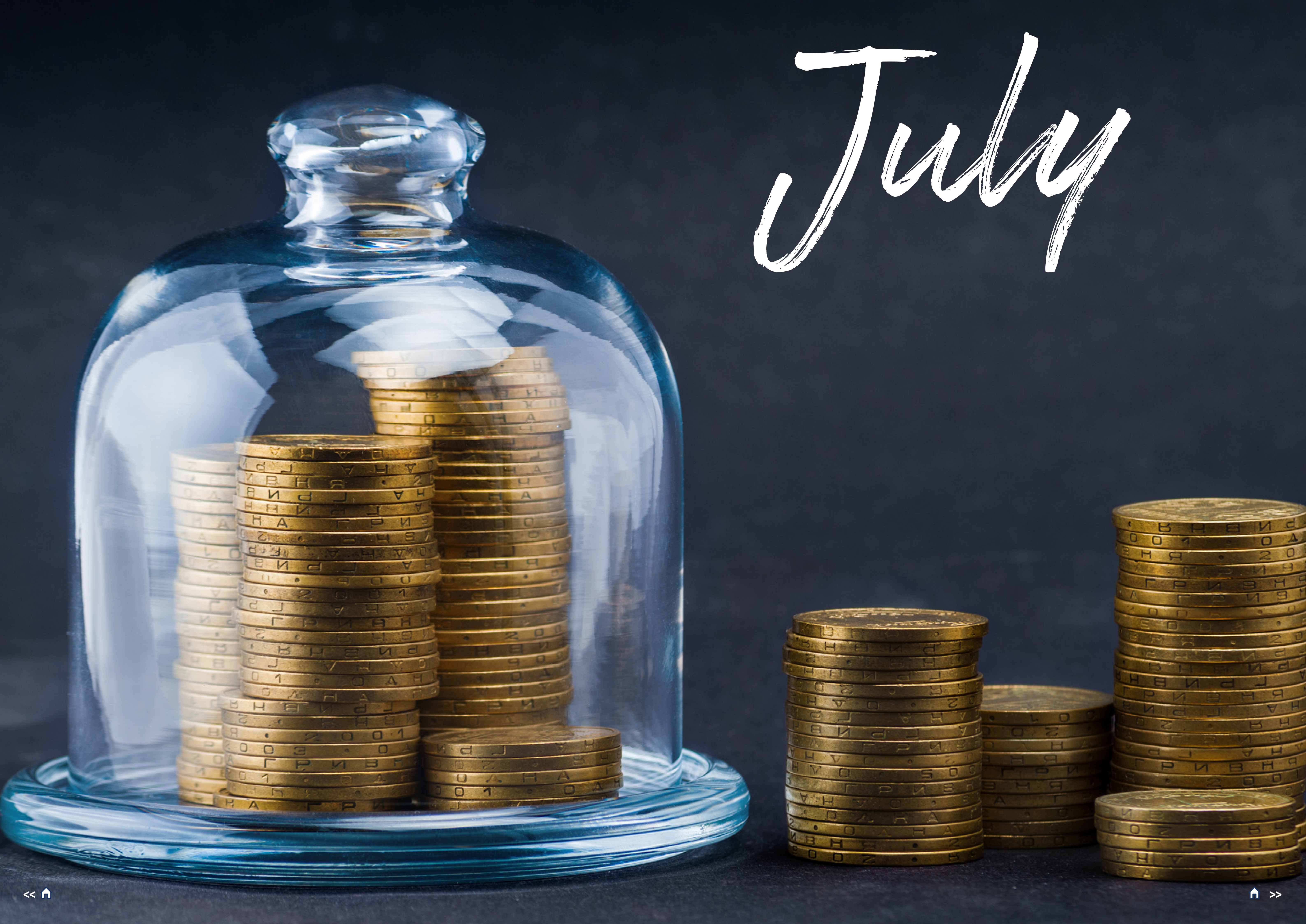
Why does it work? Many explanations are offered for why this phenomenon exists; however, most can be explained by behavioural biases. Investors either overreact or underreact to information in a way that is remarkably consistent through time. The underreaction effect causes information to take longer to be fully priced in, as analysts fail to revise earnings forecasts sufficiently in response to new information. Overreactions to market events can result in excessive declines in prices following bad news, while underreactions lead to miserly increases following positive news.

The so-called disposition effect is another popular theory – it says that investors' fear of potential losses causes them to sell winners too early whilst holding onto losers longer in the hope of an eventual recovery – this relates closely to the concept of loss aversion. Lastly, herd mentality or fear of missing out (FOMO) is another phenomenon which can spur stock prices to gather momentum, as investors jump on a rapidly rising trend, something we've seen recently with AI-related stocks.

Momentum investing often sounds simple to exploit, but in reality, it is a highly nuanced strategy with a high propensity for crashes. This added risk is another reason cited for momentum investing's success: it is a reward for accepting higher levels of risk. Identifying trends and catalysts in stocks requires skill and experience – but it is equally important to recognise when the momentum or trend has waned, as knowing when to exit positions is crucial to capturing the full momentum effect. It is therefore operationally challenging due to its inherently high turnover nature, hence not one for the novice investor. We advocate gaining exposure through third-party specialists and we have invested with some of the best momentum and growth managers for many years.

As with any equity style or factor, there are better and worse times to adopt a momentum strategy, but, in our view the best way to ensure a smoother investment journey is to hold a blend of different styles through the cycle.

July



3 July 2023

Roll on recession

Mark Wright, CFA

Last December I professed that 2023 would likely be a good year for UK mid-caps. Many would have found it difficult to envisage that at the time, given how poorly the UK mid-cap equity market performed in 2022. It felt the full brunt of the inflationary spiral that was turbo-charged by Russia's invasion of Ukraine, finishing the year down over 18%. My projection isn't looking too clever now, with UK mid-caps having been modestly in the red last week since the start of the year.

All was looking good up until 6 March 2023, with UK mid-caps up 8% and our own UK equity portfolio up 12%[1]. But then Silicon Valley Bank (SVB) got itself into a spot of bother, soon followed by other questionably managed mid-sized banks, Signature Bank and First Republic Bank. Credit Suisse's demise didn't help sentiment.

Whilst one was unlikely to have foreseen such banking failures that brought into question the health of the entire US banking system, it also wasn't that surprising in hindsight, given the record-breaking speed at which the Federal Reserve had raised interest rates. However, authorities were quick to react to the crisis. The US Federal Deposit Insurance Corporation (FDIC) quickly moved to guarantee all deposits, whilst Union Bank of Switzerland (UBS) was strong-armed into acquiring Credit Suisse. These prompt actions significantly reduced the risk of contagion.

Since then, UK mid-caps are now down 9% and our own portfolio has suffered too[2], despite some good earnings releases and healthy share price performances from the likes of Games Workshop (the fantasy miniature games manufacturer), and household name Marks & Spencer. Ironically, both are exposed to the UK consumer, the outlook for whom is arguably now what is holding the stock market back.

There's one thing that markets don't like and that's uncertainty. Where and when interest rates will peak has been a big source of uncertainty this year, made worse by the UK's most recent inflation print (core inflation was up for the fourth month in a row), swiftly followed by a "surprise" 50bps hike in interest rates by the Bank of England.

That said, the market now has much better visibility on this than it did 12 months ago.

Arguably, it is the prospect of a recession and what that means for the UK consumer that occupies the mind of equity investors the most, especially investors in UK mid-caps.

As perverse as it may seem, an imminent recession could actually be good for UK mid-caps. There are plenty of companies reporting decent current trading, but the problem is that the market often has the attitude of "things might be okay now, but what about this time next year or even in six months' time". They do say one should sell on the rumour and buy on the news.

Companies are therefore not being rewarded for delivering in-line results or even results that are ahead of expectations. A great example was Marston's, the national pub operator, when it delivered a healthy set of interim results in May. The shares opened higher but then quickly sold off and have continued to do so since. They are now trading close to where they were in the depths of the pandemic in March 2020.

Back then, its pubs were shut and there was no sign of them reopening any time soon. It also had much higher debt levels than it does today, having since sold some property assets and 60% of its brewery business to Carlsberg. The valuation It achieved when selling the 60% stake to Carlsberg means that the remaining 40% of the brewery business that Marston's still own is valued at around £250 million today3. That compares to a market capitalisation for Marston's of just £190 million[4] and I strongly believe somebody will look to buy that remaining 40% ownership stake from Marston's in the future.

Also, bear in mind that Marston's has close to £1.8 billion of freehold property with just £1.2 billion of debt against it[3], i.e., £600 million of equity in its property estate which dwarfs the market capitalisation of the whole business. The entire pub estate should also be able to generate earnings before interest and tax of more than £170 million in the near future[5]. In my opinion, it is obvious that the shares are currently massively mispriced.

If it was clear we are currently in a recession, then the market could look through an imminent drop in profits and start to price in a subsequent recovery. However, the economy has been remarkably resilient so far, which is complicating matters. Roll on a recession, allowing UK mid-caps and the likes of Marston's to rally.

Sources: [1]Bloomberg Finance L.P. 31.12.22-06.03.23, [2]Bloomberg Finance L.P. 06.03.23-23.06.23, [3]Marston's Interim Results for 2023, [4]Bloomberg Finance L.P. on 29.06.23, [5]Bloomberg Finance L.P., sell-side analyst consensus forecast of £177 million on 29.06.23.

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10 July 2023

Lessons in extremis

Tom Delic

I'm sure a common problem I share with readers is the enjoyable struggle of choosing from the long list of TV shows and movies that get recommended to me. Like the Hydra, as soon as one is ticked off, two more appear. Five years in the making, I finally got round to watching Oscar-winning documentary Free Solo[1].

The film follows American rock climber Alex Honnold, in his bid to complete a climb of El Capitan, a vertical rock formation in Yosemite National Park. Honnold's area of specialty is 'free soloing', which is technical rock climbing without ropes or any other protective equipment. As you can imagine, this is the extreme of extreme sports.
People at the pinnacle of their field, performing unimaginable feats, can often appear alien to us. While a genetic component to their ability is usually found (an MRI scan revealed little-to-no activity in Honnold's amygdala, a part of the brain that plays a vital role in our fear response), I have found that life's outliers often share insights into their personality and methods that are much more common and applicable to us mere mortals.

An activity that involves the highest level of risk-taking may not seem the most appropriate place to identify traits to look for when searching for good fund managers to partner with. However, we know that only a small fraction of fund managers are able to outperform their benchmark over time. We are looking for another kind of outlier. While we don't want the complete 'free soloing' fund manager version of Alex Honnold, there are other characteristics that do appeal.
Finding managers with a sound process that is consistently carried out, even when the proverbial fingers are slipping, is a very helpful trait for a fund manager. The ability to follow an investment approach is much harder during a disappointing period of performance. We need managers who can take Honnold's perspective: "I'm not thinking about anything when I'm climbing, which is part of the appeal. I'm focused on executing what's in front of me."[2].

Honnold's climbs are real life experiments in the human ability to withstand fear and pressure.
While an equity bear market or failed stock pick may not bear the same consequences as losing your footing halfway up El Capitan, the same fight or flight reaction is firing. In Honnold's words, "I've done a lot of thinking about fear. For me the crucial question is not how to climb without fear, that's impossible, but how to deal with it when it creeps into your nerve endings.'[3].

Free solo climbing also requires a level of risk management that is difficult to comprehend in everyday life. Still, while Honnold's actions hit levels of risk taking that are very uncommon, his methods to manage the dangers faced, reveal a useful tool for fund managers. He says, "I've walked away from more climbs than I can count, just because I sensed that things were not quite right."[3].
Mistakes made by a fund manager are inevitable, but we look for a highly disciplined approach to stock selection, grounded in the avoidance of a permanent loss of capital.

Finally, I was struck by Honnold's passion for the sport he loves. Fame and fortune have enabled him to turn his hobby into a career, but these clearly play second fiddle to why he has pushed the boundaries of rock climbing beyond his peers. A common trait we see in successful fund managers is their passion for the job beyond the material. This can't be quantified but is often easy to spot through a fund manager's words and actions. I'll leave the final word with Honnold, "...climbing without a rope, gear or a partner - I did it because it seemed like the purest, most elegant way to scale big walls. Climbing, especially soloing, felt like a grand adventure, but I never dreamed it could be a profession."[4].

Sources: [1]Free Solo (released 2018. Directed by Jimmy Chin and Elizabeth Chai Vasarhelyi). [2]Interview, Will Chancellor, 4th August 2014, [3]Alone On The Wall, Alex Honnold, [4]The New York Times - The Calculus of Climbing at the Edge, Alex Honnold, 19th Nov 2014.

17 July 2023

Music royalties offer ‘sound’ returns

Ben Drysdale

According to my Spotify, I spent an astonishing 51,000 minutes of 2022 listening to music. For those without a calculator handy that’s a combined 35 days of listening to everything from ABBA to Zadok the Priest. Given all that time spent listening to music, you might think I’d have an idea about what it is that makes a good song.

Is it a catchy and memorable melody that lingers in my mind long after I’ve finished listening? Could it be profound and emotive lyrics that stir strong emotions within me? Or is a truly great song one that can generate steady cash flows through a variety of different income streams over several decades?

That last option might seem like an absurd way to characterise a song, but at the narrow intersection between investing and music, an asset class based on the revenues generated by the purchasing of music catalogues has emerged to potentially provide a fascinating opportunity for investors looking for something slightly different. But what does music investing actually involve and what makes a song a good investment?

As mentioned, investing in music royalties involves gaining exposure to the revenues generated by a song, which come from three main sources: performance royalties, which are paid (as the name suggests) when the song is performed. Whether it’s being streamed, played over the radio, or just on in the pub, the purchase of a licence needed to play that song is a source of revenue. Mechanical royalties, which are paid when a physical copy of the music is bought in the form of a CD or vinyl. And finally synch royalties, which are paid when the song is used in another form of media, like an advert or a film’s soundtrack.

So, now we have an asset class that is generating returns, as investors we want to know how to identify songs that will provide the best returns. Just like an equities investor might separate stocks into buckets of quality, growth, and value, a similar method can be applied to songs. Quality firms tend to be established and popular businesses with profits that stand the test of time, and likewise there are songs that have continued to produce royalties for decades. These evergreen songs are a safe and predictable source of revenue. Alternatively, there are popular songs that might not have the long-term track record that classic songs do. These are songs that an investor believes have instantly become culturally influential, just as classic songs might have done decades ago. Finally, we have songs that are considered under-valued. These are songs that a manager believes may be well suited for an advert or film soundtrack and so have the potential to generate large, albeit unpredictable, synch returns. All three categories have the potential to provide good returns.

Here at MGIM, our conviction in the potential of music royalties to be a diverse source of returns has resulted in investments into two separate listed investment trusts that combine extensive experience in both the music industry and in investment management, to specialise in royalties investing. Hipgnosis Songs Fund with a catalogue of over 65,000 songs, and Round Hill Music with over 120,000 songs are both key investors in an asset class supported by the growth of the music industry following years of decline. The QR codes below will take you to playlists of the best songs in their catalogues, both of which I highly recommend.

The emergence of the internet, falling physical sales, and widespread piracy, saw music revenues drop steadily until 2014 when streaming services provided a legitimate way for fans to easily access music. Industry revenue is now dominated by streaming services, replacing physical sales. However, unlike physical sales, streaming revenues are far less cyclical with relatively cheap subscriptions to services such as Spotify or Apple Music being treated more as utilities by consumers than discretionary purchases. The popularity of streaming is expected to continue rising with revenue from other platforms like TikTok also contributing to broader industry wide growth.

However, while secular trends are expected to boost returns for the funds, both Hipgnosis and Round Hill suffered from last year’s aggressive rate hikes. Higher discount rates have dampened sentiment regarding the net asset values (NAVs) of both funds’ catalogues to levels that we believe are overly pessimistic. With both funds trading at wide discounts to NAV and dividend yields at around 6-7%, our conviction regarding the asset class has only strengthened and we have added to our positions in the funds across several portfolios[1].

Investing in songs may seem somewhat strange, but the asset class offers exceptional opportunities to those who are best positioned. It also means that next time someone asks me what my favourite song is, I’ll tell them that it’s the one that generates the best return for investors. I’m sure that will go down really well.

Round Hill Music Royalty Fund: Top 50 earners 2022:

Hipgnosis Top Songs:

Source: [1]Bloomberg Finance L.P.

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24 July 2023

“I’m from the government and I’m here to help”

Richard Parfect

President Reagan referred to those words as being the “nine most terrifying words in the English Language”. August 1986 feels like a distant era and in many ways it is, however the debate over what any government’s role should be in a capitalist free market system is as relevant today as it was back then. The primary and most important function of an elected government is the defence of the realm; I doubt President Zelenskyy is spending much time thinking about reform of Ukraine’s education system or how to pay for public health programs. Therefore, how and to what extent government should reach into these other areas is something of a philosophical political debate.

Central governments, not least that of the UK, do not have a fantastic record when it comes to efficiently allocating taxpayer capital into physical projects. However, perhaps that is a little harsh as it depends upon what the objective is. Is it simply to make a profit, or alternatively is to try and influence the course of events in altruistic ways; with the expectation that money is likely to be lost in the process? The problem is that the objectives of such spending are rarely communicated.

Climate change is an increasingly hot topic (pun intended). One of the problems in addressing that is how to help developing nations adopt clean energy, when dirty energy may be more accessible or cheaper. It is therefore in addressing this conundrum that the Foreign, Commonwealth and Development Office (FCDO) decided to support the Initial Public Offering (IPO) of a new investment trust in 2021 with $32 million of taxpayer capital. Thomas Lloyd Energy Impact Trust (TLEI) had the laudable ambition of investing in various construction ready infrastructure and renewable energy assets in Asia, India, Philippines, Vietnam, Bangladesh, and Indonesia (countries that are on the front line of climate change impacts). Targeted returns to investors were for 10-12% per annum[1] At the time of the IPO, a key hook offered to investors was that they would be investing alongside the UK Government, the implication being (deliberate or otherwise) that could provide a degree of comfort on the due diligence already carried out and execution risks had been appraised by them. We decided not to invest at the time, as despite the laudable aims, the targeted returns (given the risks) did not compare favourably against proven operating assets of a similar nature closer to home. Furthermore, the “attraction” of the UK Government having done rigorous due diligence felt far from compelling. Unfortunately, things have not gone well for TLEI. The shares were suspended in April 2023 due to “material uncertainty regarding the fair value of certain of its assets and liabilities”, the issue surrounded problems over the proposed construction of a 200MW solar plant in India that could cause a $8.2 million impact.[2] An update on 12 July 2023 brought to light a number of non-completion liabilities facing the investment that could amount to $33.5 million; quite significant for a trust that last reported Net Assets of $142 milion.[3] The shares remain suspended and are yet to publish their report and accounts for December 2022.[4]

Investing in investment trusts is not risk free (we previously wrote about the collapse of Home REIT). Due diligence needs to be conducted at every level and an assessment made of whether the valuation and returns on offer are sufficient compensation for those risks. However, when good quality management teams are found, they can deliver compelling value; there have been various success stories raising primary capital for renewable energy (and other assets) in the UK over the last decade, for example the £3.9 billion Greencoat UK Wind.

It therefore remains a significant frustration for us that the Financial Conduct Authority (FCA) (the regulator, and by extension, an arms’ length branch of government) has in place retail cost reporting guidelines that results in mis-leading over reporting of costs to investors of investment trusts (see link here to our previous comment on this). The result has been a loss to “UK plc” and increased risks for retail investors. Those guidelines are resulting in multi-asset investors, such as ourselves at MGIM, having to reduce the allocation given to investment trusts in portfolios in order to reduce our optical “look through” costs. Consequently, retail investors who wish to gain access to specialist investment trusts are being forced to conduct their own due diligence. Given recent examples of some trusts permanently losing shareholder capital, it is indeed terrifying that the government (via the FCA) has provided “help” to retail investors resulting in cost (mis) disclosure.

Sources: [1]Thomas Lloyd Energy Impact Trust PLC 2022 Interim Report [2]24 April 2023 Thomas Lloyd Energy Impact Trust RNS, [3]Net Asset Value, Dividend, and Operational Update 3 November 2023, [4]12 July 2023 Thomas Lloyd Energy Impact Trust RNS. Unless stated all other sources are Bloomberg Finance L.P..

Taking the fixed income tack in multi-asset portfolios

Gregoire Sharma, CFA

31 July 2023

The last two years have seen their fair share of volatile events, including, amongst others, an ongoing and tragic geopolitical travesty in Russia's invasion of Ukraine, the fastest central bank policy rate increase in recent memory, China's protracted zero-COVID-19 policy, a banking crisis which led to the subsequent tightening of lending standards, and to top it all off a tense debt-ceiling drama. For many investors, who were left scarred by last year's worst annual total return in the bond market's history, it still feels too early to add back to fixed income assets.

Yet as these bouts of volatility ebbed away, the discussion has turned once again to the debate of a hard landing versus a soft landing, with the latter seemingly getting the upper hand as demonstrated by the latest inflation numbers. Indeed, focusing on the US, Goldman Sachs now predicts only a 20% chance of a recession over the coming year. Consumer sentiment has reached a near two-year high, unemployment has barely ticked up, and economic activity has remained resilient despite the 500 basis points of Federal Reserve Funds target rate rises over the past 18 months.

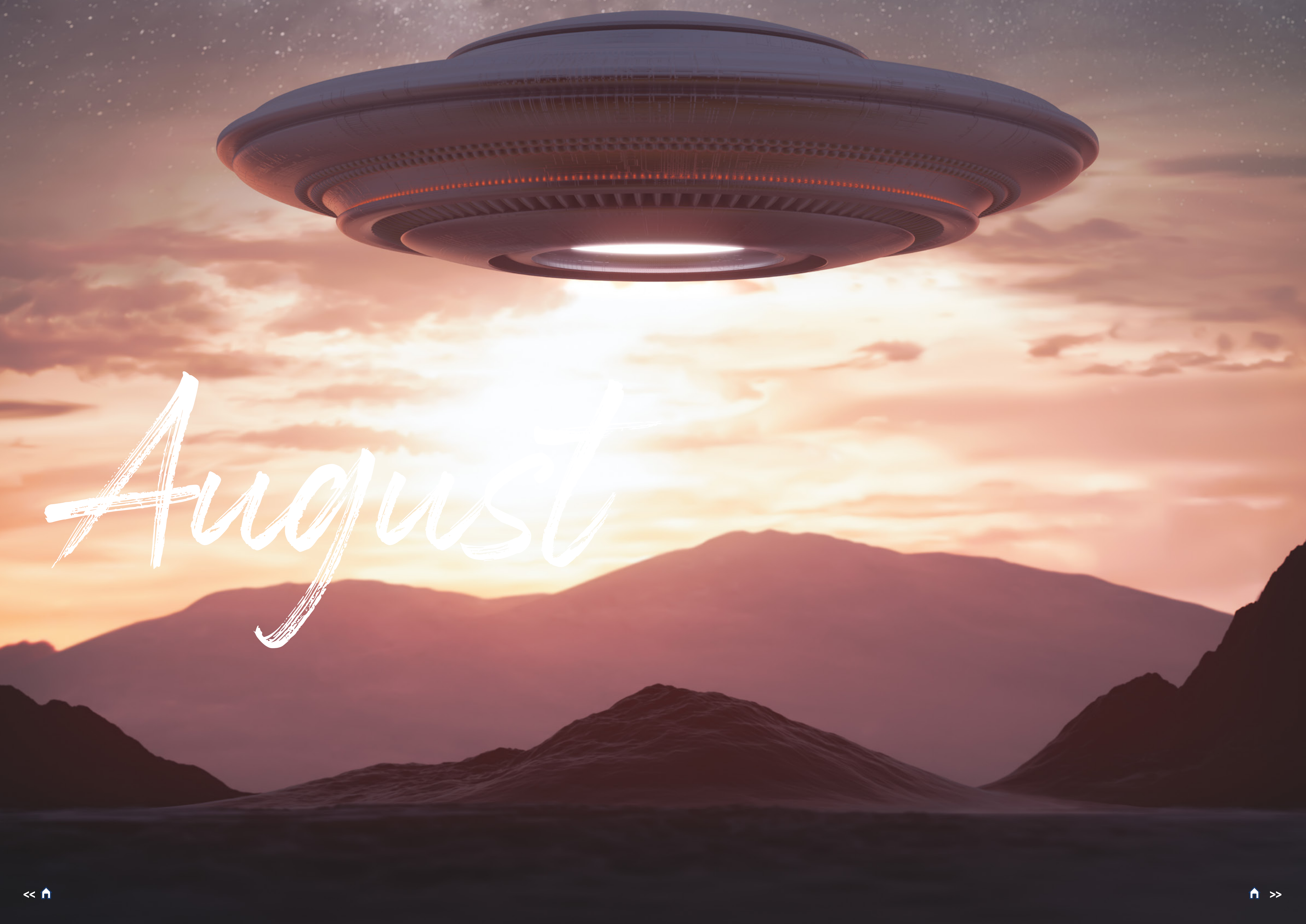
Whilst inflation has been slow to come down from this cycle's historic highs, we may very well be seeing a turning point in recent data releases. However, this is still from a very high base and inflation is expected to fall back to levels higher than the pre-COVID-19 pandemic era. This has consequences as central banks look to tackle high inflation with higher policy rates and are keen to do so having been proven wrong during COVID-19 when they stubbornly pushed the "transitory" rhetoric. In theory this should lead to diminished economic activity and slower growth, in turn crimping the credit cycle. So, why hasn't this been the case yet and should we be adding to risk assets rather than positioning portfolios more defensively?

Firstly, throughout the COVID-19 pandemic, a lot of weaker issuers had been weeded out and those that remained in the weaker cohort, were able (for the most part) to term out their debt, meaning the dreaded 'maturity wall' has not been a concern. In addition, corporate fundamentals have improved drastically since the global financial crisis with leverage ratios close to historical lows and interest coverage ratios close to historical highs. Whilst it's true that we are seeing defaults pick up, they remain some way below the more conservative levels forecast by economic analysts and even the harbingers of doom have been revising their default forecasts down.

Secondly, as the lagged effects of such a rapid and significant policy tightening begin to take hold, inflation will naturally start to fall, and central bankers will need to react by pausing rate hikes. Whilst it's true there are still a few more rate hikes ahead of us, we are certainly closer to peak rates now than we were eighteen months ago. In addition, it is not yet clear how fast and to what degree central banks' rate rises will pass through to the real economy, but as activity declines, so too will inflation and ultimately interest rates. Furthermore, as earnings releases start disappointing, we can expect investors to flock to safe-haven government bonds. In essence, bond investors can look forward to a significant capital gains boost from the lower interest rates that could follow the anticipated fall in inflation. Whilst we wait for this scenario to play out, it's hard to argue against locking-in the attractive yield levels we are seeing currently, certainly via short-dated government bonds and to a certain degree corporate credit, but increasingly to longer-dated bonds to benefit from the capital gains element.

This brings me to my final point. Whilst we do expect the credit cycle to turn negative, corporate credit year-to-date has delivered positive total returns, mainly thanks to the high level of income generated. Higher quality investment grade credit has suffered due to its inherent higher interest rate sensitivity compared to lower quality credit, but whilst yields are elevated, spreads don't seem to be compensating for the risks of an economic slowdown.
It is worth noting, however, that corporate credit yields are now above their equity counterparts' dividend yields. Hence, the case can be made for a risk-managed high yield credit allocation from equities, given the former's historically lower drawdowns and higher recovery speeds coming out of a recession.

In conclusion, whilst we patiently decipher the latest data releases, there is a strong case for allocating to fixed income in multi-asset portfolios, locking in high levels of income whilst positioning for the potentially significant capital gains element. It would certainly be a shame to miss that boat!


August

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7 August 2023

Undervalued Forgotten Opportunities: UFO's in your asset allocation

Matt Connor

Last week the world watched on as a congressional hearing was held in the US with the goal of exploring Unidentified Flying Object (UFO) sightings and trying to establish whether alien life-forms do exist. Sightings of UFOs in the investment world, however, are less elusive - with many 'Undervalued Forgotten Opportunities' floating around an asset allocator's atmosphere.

Over the last decade or so, one would be forgiven for forgetting that an investment universe still exists outside of the S&P 500 and FAANG* stocks. Tech stocks have recently enjoyed another stint in the limelight thanks to the surge of interest in Artificial Intelligence (AI); so why look outside of what is hot right now? Diversification. Diversification is central to portfolio construction and allows investors to reduce unsystematic risk and capture other sources of return. Currently, where should an asset allocator look to diversify their portfolio?

The UK market is one that embodies my commandeered definition of a 'UFO', in that it is certainly undervalued, indeed forgotten, and thus, an opportunity. The FTSE 100 currently trades at a discount to its 20-year average on a price-to-book basis and far below its peak reached in 2007[1], with valuations hampered in the UK since Brexit. The valuation gap is even more pronounced in the mid-cap space, with the FTSE 250 trading on a wider price-to-book discount versus its 20-year average than the FTSE 100 is. Our direct UK equity portfolio has a mid-cap bias and therefore fishes in the value-rich waters of the UK mid-cap universe, boasting a lower price-to-book ratio and better return on equity than the index at our Q2 asset allocation meeting.[2]

Japanese equities have been thought of as undervalued since before I was born, but after underdelivering on returns that have definitely not been 'out-of-this-world', the market has since become forgotten; investors burned by what could've been. So, what makes Japan attractive now? In recent years there has been an overhaul in corporate governance within corporate Japan due to the introduction of the Stewardship Code and Corporate Governance Code. Due to increased shareholder activism and more appropriate incentivisation, management teams are now focussing on delivering shareholder value by utilising inefficient balance sheets to boost returns through increased dividends and share buyback programmes. Morant Wright, MGIM's Japanese manager, targets companies that are trading below book value, but have inefficient balance sheets that can be utilised to provide shareholder returns.[3]

Sticking with Asia, the small-cap universe may be one that has been forgotten in the gold rush for technology stocks in recent years. Chinese mega-caps such as Alibaba and Tencent have enjoyed expensive valuations as their popularity exploded along with their western counterparts. Samarang, MGIM's Asian small-cap manager, searches for value in less-trodden ground such as Vietnam, Malaysia, and Indonesia – as well as searching for value in Japanese and Chinese small-cap stocks. Samarang have outperformed the MSCI Asia Pacific universe by over 2% per annum since inception[4], and the Asian Prosperity Fund's current portfolio seems undervalued – trading at less than its book value, despite boasting a 16% return on equity and a 4.5% dividend yield[5].

Maybe one day humans will be able to co-invest alongside aliens on a stock market located on a galaxy far, far away. However, in the meantime, investors can seek value in the UFOs of the UK, Japanese, and Asian Small-Cap equity markets, which can be accessed through MGIM's specialist managers used throughout its multi-asset range of funds.

*Note: FAANG stocks are Facebook (now Meta), Apple, Amazon, Netflix, Google (now Alphabet).

Sources: [1]Bloomberg Finance L.P. 3rd August 2023, [2]Momentum Global Investment Management (MGIM), MGIM Q2 Asset Allocation Meeting – UK Equity Portfolio Characteristics 15th May 2023, [3]MGIM Research, Morant Wright Research Note, July 2019, [4]Samarang Asset Management, Samarang Funds Review Presentation, June/July 2023, Page 1, [5]Samarang Asset Management, Samarang Funds Review Presentation, June/July 2023, Page 33.

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14 August 2023

Decision time

Alex Harvey, CFA

On Thursday last week I was presented with two looming Friday deadlines; producing the Global Matters Weekly blog and selecting a fantasy football team before the new season kicks off. Should I forego a season's worth of sporting entertainment and punditry in pursuit of the perfect blog, or click the auto-select button (but rue my decision in a few weeks' time)? If you are reading this, then I will have achieved at least one of those Friday goals (no pun intended). My fantasy team may have taken the back seat, but the auto pick selection may in the end prove better than my own.

Ultimately, my desire to field a team comes down to the mentality that you need 'to be in it to win it', which applies as much to investing as it does to fantasy football. The choice to be in the market, or not, is probably the single most important investment decision a person can take. Stock markets do go up over time, as the underlying companies grow their earnings through a combination of both sales growth and/or improving margins, with a proportion of these earnings finding their way back to equity investors through dividends (the 'payout ratio' on the MSCI UK and MSCI World indexes is around 42%[1] today).

Those dividends are a crucial component of total returns, boosting returns to global equities by an annualised 2.3%[2] per annum over the last 30 years, which when compounded more than doubles the simple index price return over the same period. In fact, the contribution to global equity total returns from dividends accounts fully for the 10 best days' returns since 1993. In other words, if you'd missed out on the 10 best trading days for global equities over the last 30 years – an often highlighted investment statistic - your annualised return would be 2.5% lower. 'Time in the market', not 'timing the market', as the old adage goes. Sitting it out can also be painful, waiting for a lower entry point as the market rallies higher. This fear of missing out, or 'FOMO', acts as a siren call. Eventually the investor capitulates, buys in late in the rally, and helps to give it that last hurrah. A classic human behavioural bias.

Granted, the stock market journey can be bumpy as earnings and valuations oscillate with the business cycle, but long-term investors can wear this shorter-term volatility – and in some cases benefit from it. In most markets, and the US in particular, there is a strong correlation between forward total returns and starting valuation, and buying cheap historically has yielded higher returns. Today however, with a prospective price earnings ratio of 20.6x, the S&P500 does not look particularly cheap. The 4.85% earnings yield that backs out from that valuation does not look so enticing when Treasury bills pay north of 5%. The S&P500 equity risk premium is wafer thin today, and we see better long-term opportunities elsewhere, as my colleague Matt Connor discussed last week.

What companies may have though, which cash does not, is pricing power: the ability to pass on an increase in the cost of providing a good or service. As such, companies can shield themselves (and their investors) from the effects of inflation, which remains the key macro investment risk today. Equities arguably offer investors the best long-term inflation protection so they might just be worth paying for, and with cash rates expected to fall back next year, the lure of equities – and other risky assets - will become more appealing.

Inflation continues to trend lower in most countries, which is unquestionably a good thing for markets and ordinarily should encourage adding to portfolio risk. However other indicators, most notably labour markets, which remain tight and seemingly unaffected by the last 18 months of Federal Reserve hikes, would suggest more caution. At Momentum Global Investment Management, we have added meaningfully to our government bond allocations over the last year, and likely have not finished, as valuations in those markets continue to rerate. As policy rates near their endgame though, we would expect to see more rotation into risky assets, and any periods of weakness provide an opportunity to do that. So, in football parlance we're probably more '4-4-2' today. Which reminds me, I'd better get on with that team selection!

Sources: [1]Bloomberg Finance LLP., [2] MSCI World equity annualised returns from 31 August 1993 to 10 August 2023; price return 5.5% total returns 7.8%.

Build in ESG

Jackson Franks

According to the International Energy Agency (IEA), real estate generates 40% of global CO2 emissions. The sector is therefore critical to global efforts to meet the Paris Climate Agreement's target of limiting average temperature rise to well below 2°C. With two-thirds of global building stock expected to endure into the 2040's, significant investment in decarbonisation efforts across existing infrastructure is required, alongside increasingly stringent (and capital-intensive) new-build regulations. Here in the UK, the Minimum Energy Efficiency Standards (MEES) are set to tighten by 2030, with all tenanted commercial property buildings requiring an Energy Performance Certificate (EPC) rating of at least a B. Meeting these requirements will demand substantial investment as it's estimated that up to 70% of commercial property space could be at risk of non-compliance.

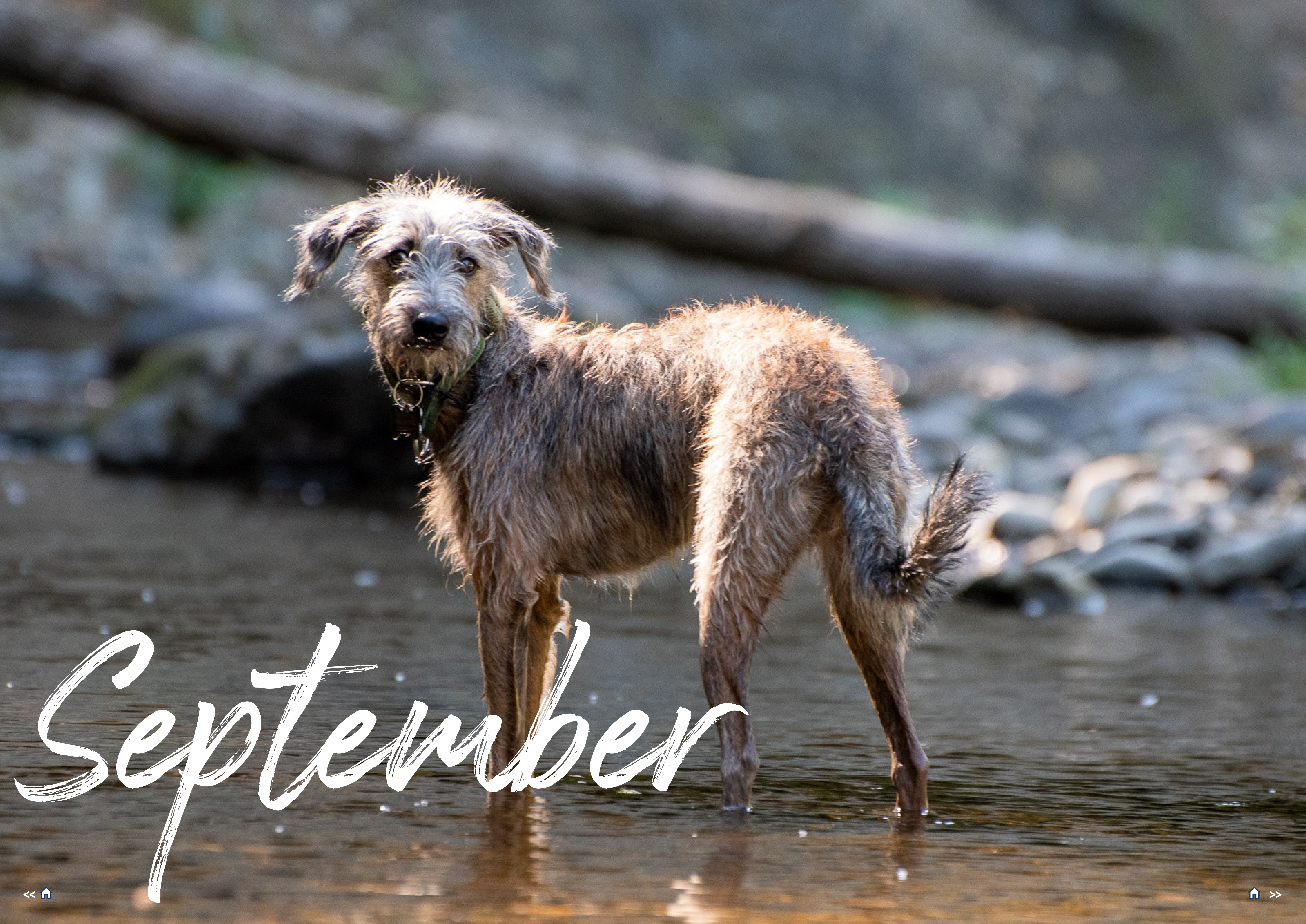
At Momentum we believe it is vital for the sector to manage and reduce these levels. We hold the same expectation for our Real Estate Investment Trusts (REITs) in which we invest, as well as our in-house real estate fund, MAREF (Momentum Africa Real Estate Fund).

Momentum invests both directly and indirectly into the real estate sector via MAREF, a pooled vehicle facilitating investment in African real estate for our clients and REITs. Although these are two different investment approaches, the Environment Social and Governance (ESG) criteria do not differ. Quantifying ESG criteria within the real estate sector is simpler than other sectors due to the tangible living nature of a property. Environmental factors consider water and energy consumption as well as emissions from the building. Social factors consider the societal impact of the development (infrastructure, housing, job creation etc) as well as the health and wellbeing of its occupiers. This has become an even more important factor since COVID-19. Governance factors consider aspects such as diversity and reputation which can be applied to both the landlord (if invested indirectly) and the occupiers. Additionally, safety measures such as fire safety will be applicable towards governance scores.

In MAREF, we uphold stringent ESG standards. This commitment was recognised when we received EDGE (Excellence in Design for Greater Efficiencies) certification for our assets in Ghana in April 2023. EDGE is a green building certification system developed by the International Finance Corporation (IFC). Additionally, we are working towards Leadership in Energy and Environmental Design (LEED) silver certification for our current project in Nairobi, Kenya. Similar to EDGE, LEED was developed by the US Green Building Council to set a benchmark for design, construction, maintenance, and operation of high-performance green buildings. IFC EDGE and LEED are comparable to BREEAM in the UK. In terms of the social aspect of ESG, one of MAREFs core principles is job creation. Throughout the construction period MAREF upskills staff so those with the most basic jobs can be trained in more specialist roles, thereby strengthening their future employability. MAREF prides itself on offering international Grade A standard facilities in developing markets thanks to the expertise of our sister company and developer, Eris Property Group (fellow subsidiary of Momentum Metropolitan Holdings).

The indirect investments, the REITs in which MGIM's daily dealing funds invest, have well-defined ESG policies that they strictly follow and are accountable for. Throughout our investment process, ESG principles hold significant weight as a key criterion. Not only do we expect managers to aim for the highest ESG standards, but also to provide concrete evidence demonstrating their successful efforts in implementing their ESG strategies. This proactive approach involves efficient management of energy, waste, water, materials, and carbon emissions. Such efforts are demonstrated through the day-to-day management of assets, wherein they work to minimise the carbon footprint of their portfolio while maintaining excellent service standards for their occupants.

At Momentum, we are committed to contributing to a more sustainable world, both through direct actions and indirect means. For this aspiration to be realised, it's essential for everyone to actively participate in propelling the implementation of ESG practices forward.



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4 September 2023

Don’t trust the numbers

Lorenzo La Posta, CFA

Mathematics never lies, but our ability to interpret mathematical concepts accurately and honestly is at times limited. Blame our faulty, imperfect, imprecise, biased human brains! Numbers can say a lot and nothing, or sometimes can be well-trained puppets that speak just like the ventriloquist. Numbers should never be trusted blindly: challenge them, poke them with a stick and make sure you fully understand them before drawing any conclusion.

There are many examples of people not using numbers as they should.

Firstly, often people confuse “random” with “chaotic”. “Random” is something that is impossible to predict with absolute certainty, because it follows probabilistic laws, whilst “chaotic” is something that is so complex it appears random whilst being actually described by fully deterministic laws. A coin toss is random, because even in an ideal setting and no external interaction, you can’t know for sure whether it will be heads or tails, but you know that there is 50% probability of one and 50% of the other. However, a person tossing a coin in the real world is a chaotic, yet fully deterministic process, where in fact you can predict with 100% accuracy whether it will be heads or tails based on the force applied by the thumb to the coin, the friction with the air, the weather conditions etc… but since we can’t measure with enough accuracy all these starting conditions, we can’t forecast with enough accuracy the result, thus ending up treating a real-life coin toss as a random event. This inability to distinguish between random and chaotic, damages our forecasting capabilities.

And even when faced with actual randomness, people sometimes distort probabilities with perceptions.

For instance, if I asked a room full of people what the chance is of extracting the number 6 at the national lottery (assume 1 to 90), after having extracted 1, 2, 3, 4 and 5, I’m sure most would tell me “It’s impossible, 1-2-3-4-5-6 is too unusual a combination”, or some might think “It’s rigged”. Well, actually, the probability is 1/(90-5), and the probability of the numbers extracted being 1-2-3-4-5-6 is exactly the same as six more “apparently random” like 3-14-31-60-67-84, which by the way is (6*5*4*3*2*1)/(90*89*88*87*86*85) = 0.00000016%.

Another (and unfortunately not the last) commonly observed mathematical “lie” is also known as data mining, the beautiful art of cherry-picking data until it says exactly what you want it to say. An application of confirmation bias (i.e. attributing more weight to data, confirming our theory rather than disproving it), data mining attracts practitioners with its low p-values and high expected returns, then kills them with its unimplementability. Have you ever read a research paper bragging about a great investment strategy that goes something like “If you had bought stocks when their 23-days moving average was 1.5x higher than the 45.7-days trimmed mean, then you would have returned +100000% over the last 10 years”? Well guess what, run the same strategy using the 22.9-days moving average and suddenly it’s only noise.

The investment world is full of these mathematical “lies” and it takes a lot of experience and focus to avoid the traps these present. Luckily, at Momentum Global Investment Management we have a team of skilled, well-rounded investors that know what to look for, that constantly challenge each other’s and third parties’ views and never (ever) put blind faith in anyone. We take numbers for what they are: a quantified view, a metric that was structured and described by a (sometimes random, but more often chaotic) human mind.

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11 September 2023

Macro matters

Richard Stutley, CFA

As a reminder, macro is only ever an input into our investment process, and it is subordinate to bottom-up company (and government) analysis. Previously, I’ve called this a ‘macro aware approach’ to differentiate it from a macro driven process, and I think that’s a useful way to characterise what we do.

The scope of the macro work we do is twofold: firstly, we aim to formulate a view on key macroeconomic variables, specifically growth, inflation, interest rates and geopolitics (although not strictly a macroeconomic variable…). At times these key macroeconomic variables inform the bottom-up work the team does. Secondly, we reflect on market dynamics and whether any high-quality indicators suggest we should be bullish or bearish in the short term.

With respect to growth, we broadly agree with the International Monetary Fund which is forecasting a weak five-year period for global growth, with the global economy expected to expand more slowly than during the last 20 years and over its longer-term history. Overall, we do not see grounds for any sudden surge in growth. The implication of this for analysts doing bottom-up research is that they should use conservative economy-wide growth assumptions in their models (to the extent that growth in the global economy has a bearing on the particular company they are analysing).

As one would expect, there are big differences between regions: within emerging markets, India (which overtook China as the largest country by population in April) is expected to pick up the baton as the global growth engine, with annualised growth of 6% over the next five years. Meanwhile, in developed markets, growth in the US has surprised to the upside, whereas the outlook for the EU has deteriorated, with the spectre of stagflation re-emerging.

While inflation is highly uncertain, we think central banks are serious about delivering on their inflation targets and therefore, we expect any renewed inflationary pressures to be met by decisive action from policymakers. As such, we caution against the view that we are likely to see a protracted period of either especially high or especially low inflation over the next five years.

Interest rate policy has entered contractionary territory and policy rates are therefore likely to fall over time, consistent with the Federal Reserve’s latest dot plot, which shows forecasts from members of the rate-setting Federal Open Market Committee as to where interest rates will be by the end of 2023, ’24, ’25 and over the longer term. However, interest rates are likely to settle at a level above their lows from the previous cycle. Zero interest rate policy and quantitative easing were a mistake in our view, leading to asset price bubbles and greater inequality; we don’t expect central banks to make the same mistake again.

Finally, with regards to geopolitics, we are currently in a holding pattern in terms of US-China and Russia-Western relations. Next year’s US elections will take on increasing significance, but for now, it’s a case of wait and see, while building resilience into portfolios in order to deal with bouts of volatility ahead.

Taken together, we foresee a relatively tough macroeconomic environment for companies to operate within. Added to that, our five preferred risk indicators, which includes things like the shape of the yield curve, also call for a relatively cautious stance today. Despite that fact, risk aversion – as measured by our proprietary indicator, which looks at key relationships between asset prices – is not far from its median, suggesting that market participants are relatively relaxed currently.

Overall, then, our weak economic outlook is endorsed by our standard risk indicators and does not appear to be reflected in markets. Naturally, this then leads us to be cautious in the short term and to demand a high margin of safety from all our investments. However, any view of valuations/fair value is ultimately driven by detailed bottom-up analysis, from which attractive opportunities are almost certain to emerge in spite of this weak macro backdrop.

18 September 2023

The investment Odyssey: avoiding the sirens of behavioural bias

Gary Moglione

"The Odyssey" by Homer is an ancient Greek epic poem that tells the tale of the Greek hero Odysseus and his challenging journey back home after the Trojan War. It introduces the Sirens, mystical beings who entice sailors to their doom through captivating songs that draw them closer to their island, ultimately causing shipwrecks on the rocky shores. Odysseus' response to the Sirens' threat offers a valuable lesson for investors. He sought to protect his crew by instructing them to plug their ears with beeswax, preventing them from hearing the Sirens' calls. However, he was curious about what the Sirens were saying, so he had his crew tie him to the mast and not release him until they had passed the Sirens' island.

In the world of investing, investors face their own version of Sirens in the form of behavioural biases. These biases constantly sing their hypnotic songs, tempting investors to succumb to these behavioural pitfalls. There are several ways in which the Siren's song can lead your investment portfolio to crash on the rocky shore:

Herd mentality: The Sirens encourage you to follow the crowd, which can lead you to buy overvalued stocks or sell stocks with temporary setbacks. In recent years, message boards such as Reddit have encouraged retail investors to speculate in risky stocks. In 2021, after a Reddit forum called WallStreet Bets encouraged the masses to buy stock in AMC Networks to increase the share price and hurt the hedge funds that had shorted it, the stock price grew massively, attracting more investors. Over the year, the share price moved from $15 to $387. AMC Networks took advantage by issuing more stock. The hype eventually dissipated, leaving remaining holders watching the diluted share price fall to $95 within months, and it has continued to fall since, currently trading between $8 and $9.

Anchoring bias: Sirens will highlight the current environment and make you believe that it will persist. A recent example would be the COVID-19 lockdowns, with the Sirens' call pushing stocks that befitted the lockdowns. Zoom Video Communications, the video conferencing platform, saw its share price move from $67 pre-COVID-19 to $568 prior to the vaccine being announced. It currently trades back around $67, as people return to the office.

Fear of Missing Out (FOMO): This fear has led many investors to participate in asset bubbles throughout history. For instance, during the 1630s, Tulip Mania saw tulip bulb prices rise to astonishing levels, with one bulb even costing as much as a house. Eventually, the bubble burst, resulting in significant losses for those involved.

Unfortunately, you can't simply plug your ears with beeswax or tie yourself to a mast to avoid these behavioural biases. However, you can take steps to mitigate their impact. Strengthen your research, diversify your portfolio, and maintain a long-term investment horizon. By following this advice, you can build immunity to the Sirens' call and navigate the investment world's treacherous waters, arriving unscathed at your financial goals, with a well-earned treasure in your portfolio.

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25 September 2023

A tail of two services

Gabby Byron

The COVID-19 pandemic reshaped our world in many ways, including how we work and live. One of the unexpected consequences of this period has been the widespread adoption of remote work, bringing both new possibilities and challenges to our lives. As we adapted to this "new normal", I found myself faced with the challenge of finding appropriate care for my newly adopted puppy while returning to the office.

Initially, I opted for a large "doggy daycare" service, attracted by its impressive facilities and countless furry attendees. However, my puppy struggled to adapt and socialise in this environment. The overcrowded space left little room for individualised attention, which he needed for socialisation and development. Determined to find a nurturing environment for my pup's growth and happiness, I turned to a local business offering a personalised pet care service. With a limited intake of just a few dogs at a time, my puppy received the individualised attention and affection he deserved.

In the world of investments, boutique investment houses often play second fiddle to larger asset gatherers. Just as my dog benefited from the personal touch of a local sitter, boutique firms specialise in being selective and creative in their investment approach.

One of THE key advantages of boutique firms is their ability to remain nimble, allowing them to respond swiftly to dynamic market conditions, potentially generating enhanced returns. They can take concentrated positions, construct high-conviction portfolios, and move in and out of positions without disrupting the market for those securities. This flexibility allows them to capitalise on opportunities that might be overlooked by larger, more cumbersome investment houses. In contrast, these larger firms may struggle to manoeuvre in the market due to their sheer size. They often need to allocate significant capital to any position, which can influence asset prices and limit their ability to respond quickly to changing circumstances.

Additionally, managers of large funds face constraints as their assets under management grow. Their investment universe shrinks, limiting their ability to invest in smaller companies or less liquid assets. For instance, if a fund has £5 billion in assets, a 1% position would equate to investing £50 million. To maintain a less than 5% ownership stake in a company, they can only consider investments in companies with a market cap over £1 billion. This restriction removes numerous potential investments from their universe, limiting their opportunities.

Larger firms also tend to have lengthy decision-making processes, often leading to a herd mentality where they follow conventional wisdom rather than thinking outside the box. This lack of creativity can limit their ability to seize unique investment opportunities and adapt to changing market conditions.

Those in favour of larger firms would argue that the managers take fewer risks, have extensive research resources and substantial infrastructure platforms supported by cutting-edge technology. However, in our view, they are offering all bark but no bite when it comes to generating alpha. Advocates of boutique firms would point out that managers have to endure less market noise and have more freedom to exercise their conviction.

Ultimately, the performance of an investment fund comes down to the skills of the underlying fund manager. Boutique firms, with their freedom to concentrate on investment performance rather than sales and marketing targets, often take more active roles and managed risks to generate higher returns. In contrast, larger firms tend to have larger risk management teams, which can result in tighter controls to reduce volatility, leading the managers to be less active in deviating away from the benchmark. When evaluating third-party investment funds, we believe it is essential to look for active managers who are willing to take proportional risks to generate better returns.

Just as my dog enjoys his more personalised care, investors who choose boutique firms can bask in the confidence and satisfaction that comes with their more creative and flexible investment strategies. These firms excel at accessing niche investment opportunities and maintaining the nimbleness to act quickly, all of which contribute to a higher likelihood of generating superior returns.

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2 October 2023

Risky business

Stephen Nguyen, CFA

Everyday decisions involve making balanced judgements between risks and rewards and we are essentially hardwired as humans to be natural risk management machines. Whether we realise it or not, we are constantly evaluating risks in every aspect of life, including social and professional settings, yet surprisingly and in spite of its crucial role, risk management is often seen as 'boring' and therefore tends to be overlooked. Whether we're making personal or investment choices, these always come with an element of risk. Therefore, it pays to thoroughly understand the risks involved in any venture, so that they can be managed and minimised.

Risk models are a useful place to start as they provide high-level insights. However, they shouldn't be relied upon in isolation. These models tend to be backward-looking and fail to incorporate future regime changes. It is crucial to assess risk from multiple perspectives; this includes forward-looking assessments, stress testing (what happens if past crises reoccur?) and scenario analysis (how would the portfolio behave under certain pre-determined conditions?). While models and quantitative tools are useful, they do have limitations. It is important to challenge assumptions; for example, how might a portfolio react if correlations were to deviate from historical norms, as was the case in 2022 when long-term correlations between bonds and equites broke down.

Sound risk management goes beyond standard quantitative measures like volatility and diversification ratio. Diversification should also be evaluated qualitatively, to ensure portfolio exposures don't all add up to the same kind of risk - for example, overweighting value stocks while simultaneously underweighting duration within a multi-asset portfolio.

At Momentum, we believe in blending equity style factors to deliver more efficient returns. This process involves more than just investing X% in value, Y% in quality, and Z% in momentum stocks. To achieve a balance between risk and returns, our research team look at minimising unintended factor exposures; for example, the negative value exposure that typically comes with buying high momentum stocks. We construct portfolios by finding the right balance based on various risk and return factors, whether that's reducing tracking error, maximising information ratio, minimising expected shortfall or maximising decorrelation to fully cover all bases.

The risk of overpaying for an investment is clearly important. The best way to mitigate this is to use a robust valuation framework embedded within the investment process. At MGIM we are risk champions, and the entire team constantly assesses a spectrum of risks that could potentially derail good outcomes for our clients.

What sets a great investment manager apart from a good one is the ability to balance expected risk and return effectively to achieve desired outcomes. Investment managers face a multitude of risks, but the ultimate risk is the permanent loss of capital, something quantitative models in isolation will fail to detect.

From a process perspective, it is much better to embrace risk culturally rather than isolate it within a specific team. The risk function should not solely be focused on risk avoidance since taking risks is essential to generating returns. Collaboration between portfolio managers and risk experts is key to understanding compensated and uncompensated risks. Risk management is most effective when it is incorporated into the investment process, with risk experts actively involved in the investment decisions, working closely alongside portfolio managers. Whether we like it or not, risk is part of investing, so let's not make it a taboo subject...

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9 October 2023

Responsible investment: here for good

Jade Coysh

A few years ago, the world of sustainable investment exploded; I couldn't open a newspaper without seeing an article referencing the importance of ESG (Environmental, Social and Governance) and every fund manager's presentation suddenly included slides on how they consider ESG factors in their investment decisions.

Roll forward to today and the narrative looks quite different. Suddenly the media coverage surrounding responsible investment has taken an unfavourable stance (a quick search for ESG news and the first headline I come across is 'ESG exodus') and 'ESG funds' have experienced outflows in the billions over the past two years.

So, what has caused this shift in sentiment in a relatively short space of time? Perhaps the stellar performance of the (traditional) energy sector in 2022 was enough to convince investors that oil trumps renewable energy. Perhaps the anti-ESG regulation in the United States is scaring investors. Perhaps investors are feeling overwhelmed by the amount of information out there and the ever-increasing reporting burden. It's difficult to know, but one thing is certain: the issues that responsible investment seeks to solve are certainly still prominent – it's hard to ignore climate change when you're sunbathing in the UK in early October!

Putting morality and 'feel good' aspects aside, responsible investment can be alpha generative. A strong investment process considers the full spectrum of strengths and the potential risks of an investment, and ESG factor analysis is simply another lens through which one can analyse an investment. For example, an ESG-integrated process will identify that a company is not disposing of waste efficiently (environmental risk that could lead to reputational damage) or has a strong culture that leads to happier employees (social opportunity).

Companies are increasingly redirecting capital expenditure (CapEx) into pro-ESG areas like renewable energy, electric vehicles (EV), employee mental health etc. Taking the example of EV's, it is expected that automakers will spend around $1.2 trillion through to 2030 switching their product lines towards EVs[1]. Taking a backwards looking example, in 2022, global investment in the low-carbon energy transition equalled $1.1 trillion[2] – a significant amount of capital in a single year. In turn, companies that have successfully reduced emissions faster than peers over the last five years have outperformed those in the worst quintile of emissions management by c.3% per annum[3], demonstrating that this CapEx spending is additive to returns. When selecting the long-term winners, it's difficult to ignore these trends.

'Long term' is a phrase that is misrepresented a lot in the investment world. There is no hard definition for the phrase and every fund manager I've met has told me that they are a 'long-term investor'. Responsible investing is genuinely a long-term game because it's going to take years for many of these themes to play out, such as the renewable energy transition or addressing the male-to-female ratio on Boards. It is likely that there will be some short-term volatility and the gains will not be linear, but over the longer term these themes will likely be beneficial. The recent rise in the oil price saw some investors dampening their focus on environmental factors and increasing the carbon footprint of their portfolios in order to chase short term performance. Now it's worth noting that as a firm, Momentum is not opposed to owning carbon-intense portfolios but it's important that fund managers stick to their convictions, consistently follow a robust process, and our preference is that firms are engaging with companies to improve.

The final point that I will make to demonstrate why responsible investment is additive to returns is regulation. Yes, there are 'red states' in the United States (US) that are pushing anti-ESG policies, and the UK has backtracked on various green policies recently, but there is global regulation coming and even in the US we are seeing pro-ESG policies such as the SEC's sustainable disclosure regulation, rolled out in 2022. More broadly we are seeing an increasing number of guidelines, regulation and best practice initiatives being introduced in the UK, Europe, Asia and even in some Emerging Markets. When these policies are brought in, investors will want to own companies on the 'right' side of this change because there is a risk in holding those that have to spend huge amounts in a short time period in order to catch up.

All in all, investors do not have to give up returns in order to invest responsibly and in fact there is evidence that investing responsibly and integrating ESG factors is additive to returns. However, not all responsible investment strategies are created equal and alongside many other factors, one has to assess a fund manager's ability to implement a responsible investment strategy effectively.

Sources: [1] Reuters.com: Automakers to double spending on EVs, batteries to $1.2 trillion by 2030. [2] Bloomberg L.P. Global Low-Carbon Energy Technology Investment Surges Past $1 Trillion for the First Time. . [3] Schroders: Funding the future, investing in climate action.

16 October 2023

Fly me to the moon

Mark Wright, CFA

The term "irrational exuberance" was popularized by former Chairman of the US Federal Reserve, Alan Greenspan, when he referred to the ebullient behaviour of investors towards internet stocks in the mid-1990s. Such behaviour ultimately led to the 'Dot-Com Bubble" and subsequent stock market crash in the early 2000s. He questioned whether central banks should address irrational exuberance by pre-emptively tightening monetary policy. Mr Greenspan presumably concluded that they shouldn't, because the Federal Reserve didn't begin raising interest rates until late 1999.
Investors rarely seem to learn from past booms and busts, and we frequently observe evidence of irrational exuberance across all asset classes. It was irrational exuberance that led investors to buy 30-year UK government bonds on yields of just 0.6% during the COVID-19 pandemic, and still as low as 0.8% as recently as December 2021. The 0.625% 2050 bond I am referring to now yields close to 5% and has fallen a staggering 64% from its issue price – so much for being a safe haven asset.

More reminiscent of the Dot-Com Bubble was the IPO of Moonpig, the online greeting card and gifting business, in February 2021. Ludicrously low yields on long dated government bonds helped fuel undue optimism towards digital businesses exhibiting rapid growth.

We were fond of Moonpig's business model from the outset but were less fond of the lofty valuation at which the company managed to raise money from investors at its IPO. The valuation ultimately reached 52x earnings just a few months after its stock market debut[1].

Moonpig dominates the online greeting card market in the UK with a 70% market share[2], whilst online penetration for greeting cards has been growing faster than many other product categories, such as cosmetics & toiletries, clothing & footwear, and homewares. The company is still gaining market share, as Moonpig leverages its powerful brand, scale and vast customer dataset that it has accumulated over the last 23 years from 266m cumulative customer transactions[3]. Its marketing budget is a multiple of all of its competitors' budgets combined which creates a significant economic moat and barrier to entry.

Moonpig's strategy is simple – grow the customer base, get those customers to order more frequently and get them to spend more on each order, for example by attaching a gift. Moonpig benefits from a loyal customer base that generates 89% of the company's revenue in any one year[4]. The company sends 84 million reminders of special dates, such as birthdays and wedding anniversaries every year to its customer base, helping to encourage them to delve into their wallet and purses to send a card and/or gift to someone for that special occasion.

The average person purchases 23 cards per annum but only 3.3 of those are purchased from Moonpig[5]. At the same time, 72% of those cards purchased are given with a gift[6], but a much smaller percentage of Moonpig customers currently attach a gift. That should improve, following the recent acquisition of Buyagift and Red Letter Days, the UK's largest and third largest gift experiences platforms, respectively. The company also has a presence in Australia and the United States but is yet to "press go" in promoting and expanding the business there.

The growth opportunity for Moonpig is clear. Having sat on the sidelines for the best part of two years, Moonpig shares can now be found in Momentum's direct UK equity portfolio. Earlier this year, the shares had fallen almost 80% from their peak to a much more sensible valuation. This was despite the business trading reasonably well since its IPO. The business model hasn't changed, and if anything, Moonpig is now a more compelling proposition to investors, with expansion in the United States a much closer reality now than it was at IPO. An old colleague of mine used to walk through the office singing "Fly me to the Moon". We are hoping Moonpig does just that.

Source: 1-6 Moonpig Group Plc. Unless stated all other data is sourced Bloomberg Finance L.P.

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23 October 2023

Base effects

Tom Delic

Our everyday lives involve countless decisions made under uncertainty. Incomplete, complex, and often conflicting information can steer our thinking away from crucial underlying factors that are likely to be more beneficial inputs into decision making. One such input are base rates, which can repeatedly be ignored when we perceive new information to be more relevant to our individual situation.

Perhaps the simplest example of a base rate is the flipping of a coin. The likelihood, or base rate, of a flipped coin landing on heads is 50%. With just one event taking place (the coin flip) and two possible outcomes, most people would comfortably get to the correct answer when asked what probability they would assign to the coin landing on heads. Unfortunately, as complexity rises, we quickly start running into difficulties and lose sight of the underlying base rate. It feels intuitively correct to say the probability of getting 10 heads in a row is lower than a random sequence of heads and tails, but we know that both are equally likely.

To take it further, consider a person who would like to test to see if they have a particular virus, in which the prevalence of the virus across the population is 0.5%. The test itself is not completely accurate, with 95% of people who have the virus testing positive, and 90% of people who do not have the virus testing negative. If the person's test results come back positive, what are the odds they do in fact have the virus? The person may initially be filled with fear, believing that, having tested positive, they have a 95% chance of having the virus. The actual probability, calculated using a form of statistical inference called Bayes' Theorem, is much lower at just over 4.5%*.

As the initial base rate moves out of sight (in the above case, the prevalence of the virus across the population), the less it influences decision making and we quickly turn to the qualitative to aid our decisions. When making investment decisions, a compelling narrative, which could be good or bad and often evokes an emotional reaction in us (e.g. excitement or despair), we tend to disregard statistical data such as base rates.

This can compound as we seek out further instances that confirm our newly held beliefs. As investing sits somewhere at the intersection between skill and luck, it makes sense to anchor your decision making with base rates as a starting point, attempting to put the odds in your favour for a good investment outcome.

There is a significant archive of studies across the investment industry which can provide investors with base rate statistics, giving them areas to focus on and others to avoid. Some well-known research areas include the outperformance of stocks in the cheapest percentiles of various valuation metrics, and of funds with both a high active share and low turnover. For equity and fund analysts, this data offers pools of opportunities to begin research, knowing you are fishing in an area that has historically produced good investment returns.

Research also exists to refocus a mind that has been clouded by an exciting investment narrative, such as rose-tinted management forecasts. In an excellent Credit Suisse study[1], the authors found that across 44,000 observations from 1950 to 2014, historic net income growth rates for listed companies had zero to negative correlation with future 1-, 3- and 5-year returns. Consequently, the base rate, which is the median net income growth rate for the universe, is a more reliable starting point for an analyst's forecasts.

Base rates are a useful tool for investors when making decisions that involve factors that can disrupt the balancing of risk and reward, and while we are all susceptible to inadvertently leaving them out of our decision-making, an awareness of them should aid in improving outcomes.

* *Solution: Probability of having the virus given the person has tested positive = P(V/P) = 0.5% x 95% = 0.48%*

Probability of not having the virus given the person has tested positive = P(NV/P) = 99.5% x 10% = 9.95%

P(V/P) = 0.48% / (0.48% + 9.95%) = 4.56%

Source: [1]'The Base Rate Book – Earnings Growth' – Mauboussin, Callahan, Majd, December 2015

30 October 2023

Treasury hunt

Glyn Owen

While the world's attention has been focussed on the horrific events in Israel and Gaza, the storm brewing in bond markets reached a new intensity, with the yield on the US 10-year Treasury bond last week crossing a milestone of 5%, the highest since before the Global Financial Crisis (GFC). This matters a great deal to financial markets globally, its impact shouldn't be underestimated. US Treasuries are the world's greatest safe-haven asset, and the 10-year yield is the world's discount rate. When it moves sharply, as now, it reverberates globally and immediately.

To put the move into perspective, the yield was only 0.5% three years ago, a level which seems distant today. That was at the pinnacle of the Fed's ultra-loose policy regime, with near zero interest rates and massive money printing. We all know what has happened since, and all that remains of what was being hailed as 'the new normal' of low interest rates, low inflation and slow growth is the latter - slow growth.

In the intervening period, policy rates have been pushed up from effectively zero in the US to 5.5% today, and bond yields have largely followed the same path. However, the biggest rises in yields were at shorter maturities, with 1-2 year bonds closely matching the Fed Funds rate. Yields on longer dated bonds rose, but by much less, as investors priced in expectations of a sharp slowdown in growth and lower interest rates. Only a few weeks ago, the yield on 10-year Treasuries was 3.7%, compared with well over 5% on short maturities. That led to a deeply inverted yield curve - a reversal of the normal position where yields are higher the longer the maturity, reflecting their higher duration and interest rate risks.

The big shift in longer term yields relative to shorter dated has come suddenly and sharply, with a rise of over 100bps in the 10-year yield in a couple of months, whereas shorter term yields have fallen slightly. This pace of change is highly unusual and makes the move up from the low point of the cycle one of the sharpest in history. It has been driven by the surprising resilience of the US economy, the stickiness of inflation, the Fed's narrative of tighter for longer, and growing concerns about the fiscal situation of the US and debt sustainability.

Biden's spending splurge, with deficits forecast to run at over 5% of GDP through the rest of this decade, along with a dysfunctional Congress, have begun to alarm markets, faced with the prospect of huge funding requirements, running at around $1.5-2tn per annum, while the Fed continues to withdraw liquidity at the rate of $1tn a year.

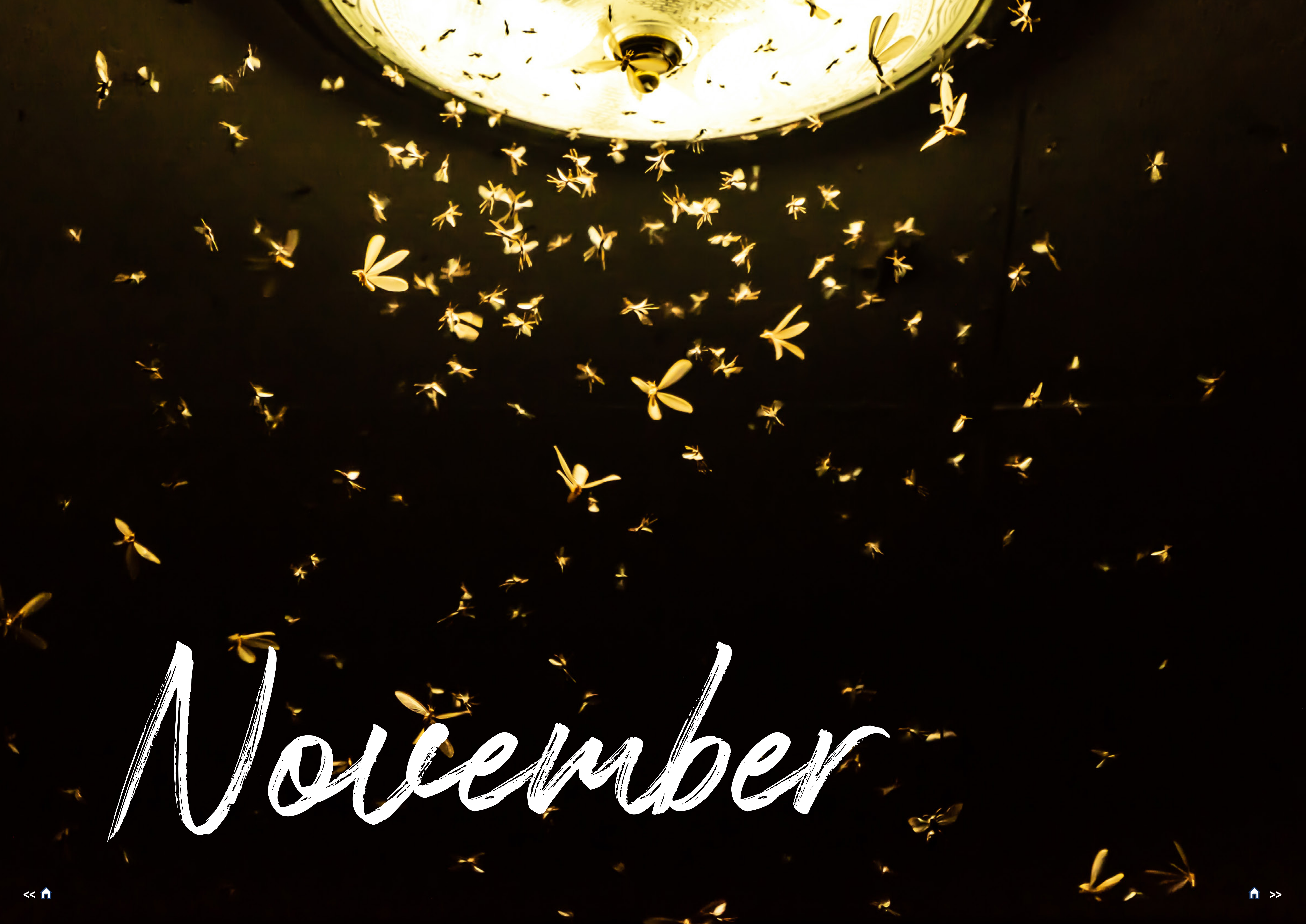
As a result, markets have progressively priced out rate cuts until well into 2024, and anticipate restrictive policy for a considerable time, with the huge supply of bonds in prospect expected to keep yields much higher than those we became accustomed to during the post-GFC era. Nearly all the rise in yields has been due to rising real, inflation adjusted, yields; at 2.4% the highest in over 15 years. It results in tightened financial conditions not just in the US but globally through the dollar's role as the world's reserve currency and the substantial amount of dollar debt outside the US.

Bond markets around the world inevitably followed the path of the US, and by pushing up the discount rate, valuations of all assets were undermined, with future income flows now less valuable. Perhaps most importantly, it increases stresses in the system, exposes vulnerabilities and heightens the risk of a financial accident. Leverage has become yet more dangerous. It's a time for caution and careful security selection, and uncertainty has intensified – reflected in the extraordinary volatility in bond yields, with moves of 10-20 bps a day increasingly common. The term premium - the additional yield which is needed on longer maturities to justify the higher risks and offset the uncertainties around inflation, rates and debt - has moved significantly higher and is positive today (it was irrationally negative as recently as last month and was for most of the last five years). All of this contributes to an increasing likelihood of a sharp economic slowdown or recession in the year ahead.

For now, putting aside the (unquantifiable) risk of a serious escalation of geopolitical instability, bonds have become the principal driver of equities and other risk assets. Bond markets need to stabilise before markets can begin to recover, but with yields of around 5% across the maturity curve, there is now good value available. While cash is attractive as a parking place, it will be necessary to extend duration before too long to lock in the best real yields on offer in safe-haven bonds for over 15 years.

Source: All data Bloomberg Finance L.P., Momentum Global Investment Management.

November



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6 November 2023

Use it or lose it

Richard Parfect

As we bid farewell to another Rugby World Cup, I am reminded how my own rugby playing days are barely visible in the rear-view mirror. As a 'forward' I would frequently hear shouts from the referee of "Use it or lose it" if we didn't pass the ball out quick enough to the 'backs' once it had emerged from a scrum or ruck. Wasting the opportunity to use the ball, being penalised and conceding possession to the opposition is no way to win a match.

A similar call could be made regarding Investment Companies (ICs), or more commonly called Investment Trusts. Such vehicles in the UK are trading at "once in a generation" discount to their Net Asset Value (NAV). The reasons for this are numerous: rising bond yields, investor worries over the validity of reported NAVs, poor asset management performance by some (but certainly not all) management teams; and more recently the introduction of onerous regulatory guidance over the disclosure of costs of such vehicles.

This technical matter of cost disclosure has been covered in past articles, so I won't dwell on it here ("In changing of the seasons we (Investment) Trust" and "I'm from the government and I'm here to help"). However, the unintended outcome of that situation is that the normal balancing forces that could come into play as a market cycle turns are unable to function. The mouth-wateringly low valuations of many investment trusts cannot be bought by many traditional UK based institutional investors for fear of such investors increasing their optical (not economic) fees. The commercial reality for such institutions is overwhelming pragmatic investment decisions.

By reducing the natural pool of investors who can buy such ICs inevitably reduces the share price. However, not all investors are inhibited by such guidelines. Private retail investors can exploit such valuation dislocation; however, it is still imperative they do their own research and avoid ending up in badly managed 'value traps'. The ICs themselves are increasingly introducing share buy-back policies (for example buying back 100p of their own capital for just 70p, which is accretive to NAV, earnings per share and dividend cover). Management teams and Board directors are buying their own shares, often in quite substantial scale.

There is another growing predator seeking to take possession of valued assets on the cheap; overseas investors and/or private capital. We have already seen well run ICs such as Industrials REIT (MLI), Ediston Property Investment Company (EPIC) and Roundhill Music Royalty (RHM) fall to opportunistic bids. More will follow.

There is of course a neat potential solution to this challenge. Back in 2013 the EU law "Alternative Investment Fund Managers Directive (AIFMD)" was introduced. Its' well-meaning objective was to protect investors in lightly regulated funds; certainly not ICs that already have to: comply with listing rules and company Acts; are managed by regulated fund managers; produce audited accounts and are overseen by directors. However, the UK regulator, decided to bring listed investment companies into scope and call them Alternative Investment Funds (AIFs). This regulation brought additional financial cost to running ICs. However, the real impact did not become apparent until the cost disclosure guidance was introduced by the Investment Association (IA) under the watch of the FCA; this guidance brought ICs caught by AIFMD into scope. There is a further insidious impact from AIFMD in 2025, which results in punitive regulatory capital requirements for market makers dealing in ICs, the impact of which would reduce their trading liquidity.

The solution, therefore, is to cease classifying ICs as AIFs and therefore remove them from the AIFMD and even capture a "Brexit" win! So, the urgent appeal to the referee is clear: give damaging AIFMD regulations the red card; this will afford the remaining players on the field the confidence to return to a successful and expansive game plan and score those tries.

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13 November 2023

Interest rate volatility: Transitory or here to stay?

Gregoire Sharma, CFA

Following the start of the US Federal Reserve's belated rate hiking cycle in March 2020, this year has seen a marked pickup in interest rate volatility and a significant increase in the benchmark 10-year yield in recent months, which have contributed to broader economic uncertainty. So, what exactly has been driving this volatility and is this trend going to reverse anytime soon?

Many factors are responsible, some of which are more transitory in nature, but many reflect uncertainty about more structural issues. One factor has been the resilience of the US economy during the third quarter, which has led investors to believe the Fed will maintain rates higher for longer, thereby shifting short-term rates expectations and long-term rates higher.

Another has been the surge in long-dated bond issuance by the US Treasury last quarter which generated a spike in supply, further exacerbated by the fact that the two largest buyers of US Treasuries have simply stopped buying. China and the Fed, in recent decades amassed trillions of dollars in Treasuries, issued to finance the deficits that emerged following the 2008 Global Financial Crisis and the COVID-19 pandemic. China started buying US Treasuries twenty years ago as the economy was booming, to keep a lid on its strengthening currency and ensure competitive exports. Today as the currency weakens, China is no longer buying Treasuries and may even look to sell some of its large supply. In the US, with the Fed's quantitative tightening program (reduction of its balance sheet), the bond market has essentially lost a significant technical support. Indeed, the Fed was a price-insensitive bond buyer. The flipside of losing these price-insensitive bond buyers is that they have been replaced by price-sensitive buyers, such as hedge funds, which has contributed to heightened market volatility.

With long-term rates soaring to the levels they have (10y treasury yields breached 5% last month), Central Bank rhetoric has turned more dovish, with various Fed speakers stating that the resulting tightening in financial conditions could be doing some of the work normally attributed to monetary policy tightening. That helped Treasuries to rally, before their progress was abruptly halted by an underwhelming 30-year bond auction last week, prompting a 15bps rise in long-term borrowing costs on the day. Taken together, these outsized moves in bond yields show just how difficult it is to position oneself in this market currently.

Looking forward, there remains significant uncertainty concerning key inputs influencing long-term rates. For one, nominal GDP growth, which accounts for real GDP growth plus inflation, has experienced substantial volatility lately. There are mixed views on whether real potential GDP will remain muted or whether the burgeoning AI-driven revolution will boost productivity growth, and in turn GDP growth, over the coming years.

Another highly uncertain element is whether inflation will return below target and if so, will it remain there in a sustained fashion. How will climate change and deglobalisation influence this trend? Will inflation need to be engineered higher in order to combat the crippling refinancing costs following the surge in public debt and the sustained large-scale deficit spending implemented during the historically low interest rate era.

Something must give between the uncertain growth/inflation picture; the debt shock that will need to be addressed by Central Banks; and the increasing term premia demanded by investors to compensate for future interest rate and geopolitical shocks. It is of prime importance therefore to carefully watch and assess all of the factors affecting growth, inflation, and fiscal sustainability in coming years. Given the difficulties in identifying structural shifts in each, one would need a crystal ball to ascertain the macroeconomic landscape of the next couple of years. However, one can say with a degree of certainty that we're not out of the rates volatility woods yet.

Stocking fillers for your portfolio

Matt Connor

20 November 2023

It's that time of year again where Mariah Carey and Michael Bublé are defrosted for their annual appearances, Coca-Cola's Christmas truck graces our cities, and sock sales men and women are awoken from their slumber. What a wonderful time of the year.

One would be forgiven for not celebrating this year's misery in markets with profit warnings aplenty due to rampant inflation, rising interest rates, and plunging consumer confidence. There is light at the end of the tunnel however, with growing belief that we have seen 'peak rates,' along with encouraging inflation data. With the future looking that little bit brighter, where should you look to spread Christmas cheer to your investment portfolio? These portfolio stocking fillers will hopefully bring you joy over the next few years.

UK equities are trading at a wide discount to their long run-average on a price-to-book(P/B)ratio basis, as well as trading at a similar level to the aftermath of the GFC on a cyclically adjusted price-to-earnings ratio. The valuation gap is more apparent in the mid-cap space, where the FTSE 250 is trading on a c.20% discount to its 5-year average P/B ratio despite boasting a higher forecast return on equity than it has typically earned and whilst yielding 4.3%. Momentum's own direct UK equity portfolio would probably be Santa's choice of exposure to this opportunity, as it has an even better Return on Equity than the FTSE 250 despite being on a lower P/B rating – all whilst yielding closer to 5%!

Another Great British stocking filler is the world of listed investment trusts. Despite enjoying a recent rally thanks to the drop in bond yields, listed real estate, infrastructure and private equity investment trusts are still trading on wide discounts to their Net Asset Value. Investment trust valuations are currently a "once in a generation" opportunity according to my colleague, Richard Parfect who detailed in his most recent blog Global Matters Weekly: Use it or lose it | (momentum.co.uk). Investment trusts have recently been the subject of tedious cost disclosure regulatory guidance, of which Richard and Momentum have been a leading force in the fight against such measures that unfairly punish those allocating towards investment trusts.

With a solution getting nearer and the issue being debated in the House of Lords soon, the opportunity in investment trusts may be like the hot toy at Christmas, disappearing quicker than you think.

The final stocking filler is like that one distant relative you see at Christmas time, a bit boring. Although a discussion around government bonds usually requires something stronger than a Buck's Fizz to get through, there is a valid argument now we may be at 'peak rates' to increase the duration of a portfolio's fixed income exposure. Duration is an indicator of how sensitive a bond is to interest rates, and as interest rates fall, bond prices increase – offering a capital gain opportunity. Longer maturity bonds have a higher duration, which means these bonds will be most sensitive to a fall (or rise) in interest rates, which could provide an excellent opportunity if we really are at 'peak rates'.

Sources: All data is sourced Bloomberg Finance L.P., Momentum Global Investment Management.

Siren call

Alex Harvey, CFA

27 November 2023

I recently returned from a client trip to Asia, during which I visited Hong Kong for the first time. The 'Fragrant Harbour', to coin its literal name. From my short time there I found it to be a fascinating and vibrant melting pot of 'East meets West', with a can-do and pro-business attitude. Yes, the city has witnessed major politically motivated unrest and change in recent years, which has undoubtedly had knock-on effects, but as an outsider visiting for the first time, I could feel the city's welcoming energy.

Markets have clearly been challenged over the last couple of years as the confluence of post COVID-19 inflation, geopolitical instability and sharp policy tightening have dented investor sentiment and lowered valuations across a swathe of financial asset classes. This has led us to a juncture where cash looks highly appealing, but we'd argue that investors should not succumb to the quick fix of cash, and instead focus on longer term returns. Three-month US treasury bills yield 5.4%; the equivalent maturity UK and German bills yield 5.2% and 3.6% respectively (in sterling and Euro terms). Savers can get instant access deposit rates of 5.2% in the UK; 5.5% on three month notice accounts. Two years ago, these rates were rooted around zero in the US and UK, as well as negative in the Eurozone. In the eyes of many of our clients, 'cash is king' today. And after a year like 2022 – when barely any major asset class made a positive return – who would blame them? Flows into money market funds have surged this year, hitting $722bn through to August end, surpassing 2020's $684bn (which was the best year since 2010)[1]. The clamour for cash has almost become deafening. And when something is so consensus, it is usually time to start moving to the other side of the room.

Beyond this more intuitive feel though, how well has cash rewarded investors after previous rate cycle peaks? Going back forty years (Since 30 June 1983), there have been six observable peaks in the 3-month US Treasury bill yield. In the subsequent post peak twelve months, US treasury bonds outperformed cash on every occasion, by an average of almost 9 percentage points (ppts)*. Three and five years post these peaks treasury bonds outperformed by 4.5ppts and 4ppts, respectively. For equities the picture is slightly different with the average 12 month post peak return being 3.5%** (underperforming US T-bills), and with very wide dispersion (min -25.2% post October 2000 peak, max 25.5% post January 1995 peak).

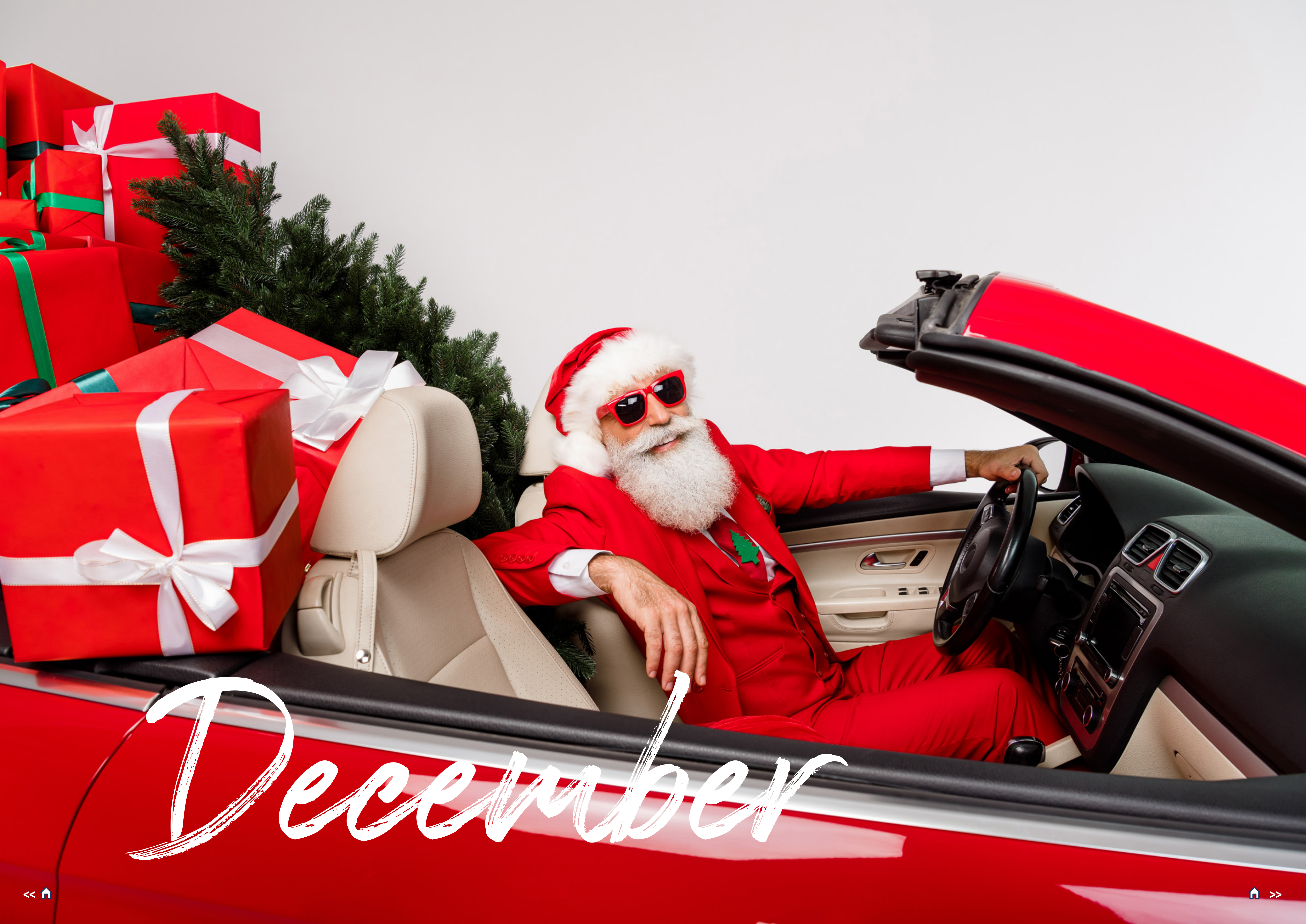
However longer term, over three and five years, global equities outperformed both cash (by an average 5.1ppts) and US treasury bonds (by an average 0.9ppts), as one might expect. So, if we are at or close to peak rates – as many economists are suggesting – then history would suggest cash should be usurped from its throne.

'Reinvestment risk' is the term used to describe the financial risk whereby the proceeds of an investment (in this case a cash deposit) cannot be reinvested at the same rate on a forward-looking basis. After such a big move higher in cash rates over the last two years, and with market expectations that we are near peak levels today, this reinvestment risk is currently very high. It is partly for this reason that in recent weeks and months we have extended the duration of our multi asset portfolios ('duration' being the technical term for increasing interest rate risk, usually through buying longer maturity bonds) to take advantage of the attractive yields embedded into future cash rates before any actual policy easing starts. The 1.375% 11/15/40 treasury bond – one of several bonds added during in the third week of October – has already delivered an 8% return since purchase. This serves not only to add incremental return to the portfolios but also adds ballast to diversify portfolios should higher risk assets such as equities come under pressure.

The siren call of cash is all around us right now. It pulls you in under a veil of comfort and security, but rarely is cash king for long. The average 12 month change in the 3-month US treasury bill yield of those six observable post peak cycles was 2.4ppts lower. And nominal cash returns are of course eroded further by inflation, which remains high by historical standards today. Cash of course has its rightful place in portfolios, and we have flexed our allocation to it over the last few years, but more recently have brought it down and extended duration. As Odysseus told his crew in Greek mythology, block your ears with wax, don't be lured in, and sail on. And if cash really isn't king, then perhaps bonds will sing.

** As measured by the ICE BofA US Treasury index.*
*** As measured by the MSCI World TR index in USD.*

Source: [1]Money market mania! The winners and losers from investors' dash to cash, Citywire Professional Buyer.
All data Bloomberg Financial L.P., Momentum Global Investment Management.



December

Fleece Navidad: falling out of fast fashion

Gabby Byron

4 December 2023

As we approach Christmas Jumper Day this week in the UK, I find myself sifting through the depths of my wardrobe, searching for festive knitwear to raise money for Save the Children. The promise of chilly winter evenings and cosy Christmas gatherings tempts me to add yet another festive jumper to my collection, despite the fact that I already own enough to dress a small woolly army.

Sound familiar? It's a scenario many of us face as Christmas approaches. The appeal of new clothes, especially warm and comfy ones for the winter season, is undeniable. Fast fashion retailers exploit this, tempting us with endless options that won't break the bank due to their ability to quickly produce inexpensive, on-trend clothing that appeals to the masses. These companies churn out new collections at a rapid pace, allowing consumers to stay up to date with the latest styles without burning a hole in one's pocket. However, this convenience comes at a cost to our environment and society.

From an environmental perspective, fast fashion falls short in several ways. The rise of ultrafast online retailers has flooded the market with cheap, poor-quality clothes made from environmentally harmful materials. The production processes, involving copious amounts of water, chemicals, and energy, contribute to pollution and the overuse of natural resources. Additionally, the global supply chain dynamics of fast fashion play a significant role in exacerbating its environmental impact as many of these clothes are produced in countries with low labour costs. This geographical dispersion requires long-distance transportation, resulting in a substantial carbon footprint associated with shipping these goods around the world. The environmental toll extends beyond just the production phase. With many of the items from some fast fashion brands being priced ridiculously cheaply, it becomes more convenient for consumers to buy new than to repair existing clothing or buy second-hand. These items have little to no resale value and end up being incinerated or left to decompose for hundreds of years in landfills, usually in developing countries.

The social aspect is equally as distressing. Many fast fashion brands outsource their production to low-wage countries, where labour regulations are less stringent. This can lead to poor working conditions, low wages, and a lack of workers' rights. This raises ethical concerns about the treatment of workers and the lack of accountability in these global supply chains. Exploitative labour practices have been widely reported in the industry in order to maintain the low prices customers expect.

Fast fashion also raises red flags from a governance perspective. Fast fashion companies aren't always known for their transparency and often management and boards do not scrutinise their supply chain in search of best practices. To make informed investment decisions, one should consider whether a company commits to good governance principles, such as transparent financial reporting and ethical leadership.

Fast fashion may offer cheap and trendy clothing, but at a significant cost to society, the environment and ethical governance. As investors, we can choose to support companies that actively work to reduce their carbon footprint, minimise waste and prioritise fair labour practices. These companies are more likely to make responsible decisions and contribute positively to society and the environment. Many sustainable fashion brands are emerging, with a focus on eco-friendly materials, fair labour practices and transparent governance. Investing in these companies can be financially rewarding while also contributing to a more sustainable and equitable future. Moreover, growth in the market for second-hand clothing might outpace fast fashion as consumers become more aware of the environmental, social and economic benefits of preloved shopping.

As the fashion industry continues to adapt to the climate emergency and resulting consumer demands, it is clear that investors and consumers have a significant role to play in bringing sustainable fashion brands to the fore. At Momentum, we manage three Sustainable Model Portfolios, which align closely with the responsible investing principles of our investment philosophy, offering diversified multi-asset exposure that cater for various risk and return objectives while enhancing the sustainable investment footprint. Our sustainable approach extends beyond fashion retailers, encompassing a comprehensive strategy that considers environmental impact, social responsibility, and ethical governance.

Wall-E Street

Thomas Banks

11 December 2023

The big story this year not only in equity markets but also in society has been Artificial Intelligence's (AI) dramatic entrance onto the stage. Since then, a deluge of headline-grabbing commentaries have flooded in, speculating on various implications of this new technology. The mania left me with some concerns: Will AI pave the way to apocalyptic destruction? What does it truly mean to be sentient? But most importantly, will I lose my job? While predicting the end of life on earth is perhaps beyond my pay grade, I have written some thoughts down on AI's role within the investment management industry and whether I should start looking for a new job.

AI, broadly defined as the ability of a machine to problem solve in ways demonstrated by humans, is nothing new to the world. We have consistently been caught off guard estimating AI's abilities, beginning with the defeat of world-renowned Chess grandmaster Gary Kasparov at the hands of a supercomputer, Deep Blue. Since then, AI has worked its way into everyday life in ways such as providing uncomfortably relevant advertisement recommendations based on past behaviour, employing voice assistants like Siri and Alexa, and now ChatGPT.

AI is also no novelty to asset managers who have been conducting quantitative analysis through complex computer programmes for many years. So, what has changed? Well, in recent years there have been meteoric advancements in computing power, alongside an explosion in both the volume and pace of data output. Consequently, AI models can now analyse larger datasets in a shorter amount of time. By sifting through swathes of data, computers identify patterns and generate enhanced predictions far quicker than mere mortal analysts. The newer models are also able to autonomously adapt to changing market conditions, removing the need for tedious re-calibrations.

Another development has been Natural Language Processing (NLP) – a subset of AI which allows computers to extract meaning from natural language and speech. Such techniques permit access to a broader spectrum of data sets, known as alternative (or unstructured) data, opening possibilities for unique and differentiated insights. This encompasses sources such as tweets, earnings calls, and credit card transactions, differing from traditional data such as financial statements or official economic figures.

The use case is evident: greater diversity and volume of data leads to more-informed investment decisions. However, a crucial aspect of investment management involves cultivating personable relationships with clients, built on trust, but most importantly accountability. The complex nature of AI models makes it tricky for the few investment managers not well-read in data science and machine learning to explain the inferences drawn from them. The inability to explain performance attributions and investment decisions to clients, who entrust large proportions of capital, undermines the fiduciary duty and trust nurtured over many years.

Adopting such complex strategies also entails substantial costs and a shift away from established processes designed to leverage the know-how of the investment team gained from years of experience. One option, however, is to partner with a third-party entity that already possesses the requisite expertise and infrastructure, thereby gaining access to the rewards of such technological capabilities without the additional financial and time-related burden. Beyond the allure of convenient sounding names, this was the rationale behind MGIM's recent partnership with AI-focused fintech company, MDOTM. MDOTM conducts macro, fundamental and price-based data analysis to provide asset allocation insights and suggestions through their proprietary AI engine ALICE (*ominous villain music*) – the newest member of the MGIM team. ALICE will also be able to tailor her outputs to work within client's risk appetite and given asset class weighting constraints. What ALICE lacks in her contributions to office banter, she more than compensates for in her efficient and unbiased analytical skills.

Nevertheless, this primarily serves as a supporting function intended to complement our existing strategic/tactical asset allocation and portfolio construction processes rather than replacing it. Ultimately, the final decision will remain in the hands of human expertise which clients pay fees for and value, something which cannot be replaced by algorithms. In conclusion, for now, I do not foresee ALICE as the evil antagonist poised to forcefully remove me from my desk, rather an amicable colleague, bringing an alternative perspective. So, ALICE, while you may not be on the invite list to my wedding anytime soon, I look forward to our time working together.

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