Fiscal Engineers' Investment & Risk Committee

Meeting Summary Points Winter 2019

Fiscal Engineers held its latest Investment & Risk Committee meeting (IRC) on 19th November 2019. These notes provide an insight into some of the areas of discussion held and decisions taken.

A message to our clients

As we start the new year, it is perhaps worth pondering on the last decade for a moment. Ten years ago we were sitting somewhere near the bottom of the Global Financial Crisis – or GFC – as it has now become known. The financial system was in turmoil, the boom of the early and mid-2000s had turned into a deep recession, particularly in the western world and government debt was soaring. Some commentators even questioned the ability of capitalism to survive and the capital markets to function.

A long 10-year haul for the economy and the country - in an environment of austerity - has got us to a somewhat better place, despite the obvious challenges of Brexit, low growth, climate change and various geopolitical tensions. Capitalism and markets have proved to be very adaptive and resilient.

The issue of climate change has at last gained the exposure and momentum it deserves, in part due to David Attenborough and Greta Thunberg. With raging fires in Australia and melting ice-caps, the scale of the issue can feel a little depressing. Yet it is easy to gloss over some of the quite remarkable strides that the UK, for example, has made in reducing its carbon emissions. Greenhouse gas emissions have fallen by around 45% since 1990, according to government statistics[1]. Renewable energy represented almost 40% of all energy production in the UK in 2019, up from around 10% a decade ago[2]. Last year was the first year in the UK that renewable energy sources and nuclear power delivered more electricity than gas and coal-fired power stations.

In that vein, one of the discussions in the IRC meeting – and summarised briefly in this document - explored the opportunities and challenges of taking positive steps in our investing program to offer a more sustainability-focused execution of Fiscal Engineers' portfolios, for those to whom this is important.

Capital markets delivered strong returns over the past ten years, with the world's markets (developed and emerging) delivering around 185% on a cumulative basis and just under 11% on a per annum basis[3]. Fiscal Engineers' P60 balanced model portfolio (i.e. 60% growth assets and 40% defensive assets) returned around 103% cumulatively and just over 7% per annum (net of fund manager charges) in the 10-year period to December 2019[4]. All investors should be extremely satisfied with that outcome.

We never know what the markets will throw at us in the future, but we know there will be bumps along the way. We do know that investing with discipline and fortitude, in a highly diversified, low cost manner is a powerful recipe that provides clients with the opportunity to capture the returns of the markets.

As ever, if you have any questions, please feel free to give us a call.

The Team at Fiscal Engineers

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[1] UK Government: 2018 UK Greenhouse Gas Emissions, Provisional Figures – Statistical Release
[2] https://www.gov.uk/government/statistics/energy-trends-section-6-renewables
[3] As represented by the MSCI All Country World Index. Source: Dimensional Returns 2.0
[4] Fiscal Engineers' model portfolios net of OCF and turnover costs only. Platform and advice fees are excluded.

Contents

1 The purpose of the IRC

The IRC is the formal body that is responsible for the governance of the investment process at Fiscal Engineers. Meetings are currently held twice a year but will become quarterly going forward. The format of the additional meetings is likely to be lighter touch and therefore at this stage, we expect to continue delivering our updates following the summer and winter meetings only; unless of course there are messages that need sharing sooner. Meetings can still be called on an ad hoc basis if circumstances warrant it. To recap, the purpose of the IRC is to:

- Define and implement a risk-focused approach to investing
- Continually test, refine and reaffirm its investment process including: the firm's investment philosophy; the structure of client portfolios; the asset classes (e.g. equities, bonds, commercial property) that it uses or excludes; and the 'pure-asset-class' lower cost funds that provide access to the rewards of desired asset classes
- Employ best-practice fiduciary standards in overseeing the investment program
- Help educate clients about what they own and why they own it

2 IRC meeting proceedings

2.1. Introduction

The formal IRC meeting took place on 19th November 2019 and a quorum was present.

Attending the meeting were: Ian Rodger (Meeting Chair), Shane Mullins (CEO), John Clarke (CIO), Dave Till and Frazer Edwards of Fiscal Engineers, Tim Hale of Albion Strategic Consulting, Steve Collyer (strategic consultant) and Neil Wright (formerly of UBS). Apologies were received from Kevin Bunting of Fiscal Engineers.

The IRC welcomed John Clark, Fiscal Engineers' new Chief Investment Officer, as a new member. Ian Rodger was thanked for his sterling work over the past few years as Chair. This post will be filled by John going forward albeit Ian will remain a member of the committee.

The minutes of the previous meeting were reviewed, previous follow-up actions were discussed, and the minutes were duly signed off by the Chairman. A number of regular agenda items were raised, and the following decisions were made:

2.2. Key decisions summary

- Systematic vs. judgemental approaches: the evidence still supports utilising a low cost, diversified systematic, buy-hold-rebalance approach. A number of challenges to this approach were reviewed but failed to hold water. Highlights are provided below.
- Product due diligence: the funds used in the model portfolios were reviewed and all products are performing in line with expectations. At the previous meeting, the IRC made the decision to engage Albion to assist the Firm with the ongoing product screening and due diligence that is an integral part of the governance process. New product screens against Fiscal Engineers' prudent screening criteria and due diligence on incumbent and potential best-in-class competitor funds has been undertaken by Albion and reviewed by Fiscal Engineers. At present the incumbent funds – which all made it successfully through the screening process – will remain in place. This process will be repeated on a regular basis.
- Portfolio review: markets rebounded in 2019 from the falls in 2018, with a Fiscal Engineers P60 (60% growth assets, 40% defensive assets) gaining around 13%. High-quality bonds (Fiscal P0) delivered a positive return of over 2.5% for the year. At the other end of the risk spectrum Fiscal Engineers' P100 returned around 20%. Again these figures are net of fund manager charges. As ever, we remind clients that Fiscal Engineers does not have any

control over market outcomes! Portfolios were deemed by the IRC to have performed in line with expectations.

- Asset class research: the IRC confirmed that it remains comfortable with all the asset classes in the portfolios at present.
- Asset class assumptions: the IRC has made no changes to the asset class assumptions that the Firm uses in it financial planning models, although this remains on regular review.
- Strategy affirmation: after detailed analysis and discussion over the past few months, the IRC has made the decision to reduce the home bias in model portfolios' growth assets. This will reduce the allocation to UK equities from 40% at present to 25%. The freed-up 15% is to be reallocated 10% to international (i.e. ex-UK) equities and 5% to emerging markets equities. As part of this change, the IRC decided to replace the UK property (REIT) fund, reassigning this allocation to the existing global REIT allocation. Further insight is set out below and our intention is to discuss this matter further at our seminar on 27 February 2019. However, please note that we will discuss this change with each of our clients at our regular meetings (after the seminar) and seek their approval prior to implementation.
- Sustainable investing: climate change and wider sustainability issues have received considerable airtime over the past year or two. In response, Fiscal Engineers has spent material time and energy in 2019 researching how investors might be able to make their own contribution to a wider solution through investing more sustainably. A tension does, however, exist between delivering the capital market returns that clients need to generate to fulfil their financial plans and the impact that investing with a greater focus on sustainability can have.

  The IRC's initial conclusion was that the greater the impact, the further one moves away from a sensible investment philosophy and portfolio construction approach. Fortunately, some systematic fund managers are beginning to offer products that are more consistent with our philosophy. We are in the process of constructing a set of portfolios that take steps in the right direction towards higher levels of sustainability, where we can still protect capital market returns, manage the risks in portfolios appropriately and remain true to our philosophy. We will continue to monitor product developments in this area and we will keep you informed as things progress on this front.

3 Market overview

As usual, the IRC reviewed the market returns delivered to portfolios. Longer-term data provides greater insight into the characteristics of asset classes. Shorter-term data contains considerable noise.

Table 1: Nominal annualised returns to 31 December 2019[5]

Date	World equity (developed)	UK equity	Emerging market equity	Global commercial property	Short-dated bonds	Index-linked gilts
Asset role	Return drivers			Diversifier	Defensive	
10 years	11.7%	7.2%	5.8%	12.7%	1.5%	5.6%
5 years	12.3%	6.7%	9.1%	10.3%	1.0%	3.6%
2019	22.9%	16.5%	14.0%	19.8%	2.1%	3.2%

Data source: Dimensional Returns Program 2.0

4 The latest evidence supporting a systematic approach to investing

The IRC reviewed the latest research input from Albion Strategic Consulting (Albion Governance Update 18 – October 2019), which covered a number of topics relating to the systematic versus judgemental decision. The IRC reviewed and discussed several charges that have been made against systematic investing (of which index tracking is a subset) as part of the process of avoiding confirmation bias and promoting challenge to the status quo. These include the risk of concentration in the asset management business, bubbles in large stock prices caused by flows into indexing, effects on market efficiency/price discovery, governance and common ownership. The Committee found these charges to be easily rebutted with some sensible logic and the evidence presented.

4.1. Concentrated stock holdings could impact governance

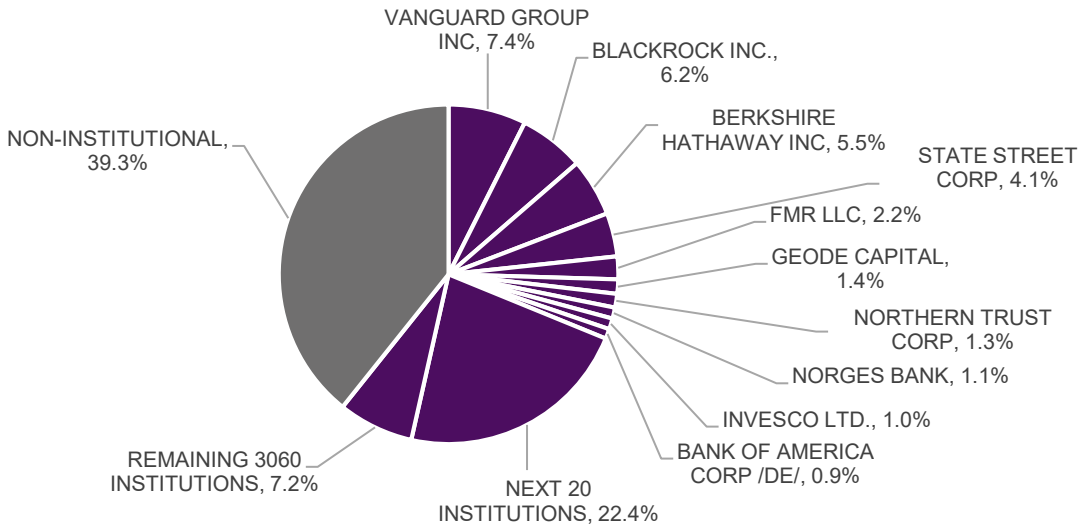
Perhaps the most relevant challenge is summed up in the words of Jack Bogle – the legendary, grandfather of index investing and founder of Vanguard - shortly before he died in 2019:

'If historical trends continue, a handful of giant institutional investors will one day hold voting control of virtually every large US corporation'.

This statement is not directly aimed at index funds and applies to the structure of the industry as a whole. It is a valid concern and is an issue that regulators are beginning to think about and grapple with. It would not be healthy from a governance perspective if this were to become a reality. The chart below illustrates the current shareholder register of Apple Inc. It is evident that we are some way from John Bogle's concern becoming reality. Vanguard owns just over 7% at present.

[5] Data sources: UK equity – MSCI UK Index (net div.); developed market equity – MSCI World Index (net div.); emerging market equity – MSCI Emerging Markets Index (net div.); global commercial property – S&P Global REIT; short-dated bonds – FTSE World Government Bond Index 1-5 Years (hedged to GBP)*. Bloomberg Barclays Govt. Inflation Linked 5-15 Year bond Index. * Source: Morningstar Direct © All rights reserved (see endnote).

Figure 1: Institutional shareholders of Apple Inc.



Data source: Nasdaq. Analysis: Albion Strategic Consulting

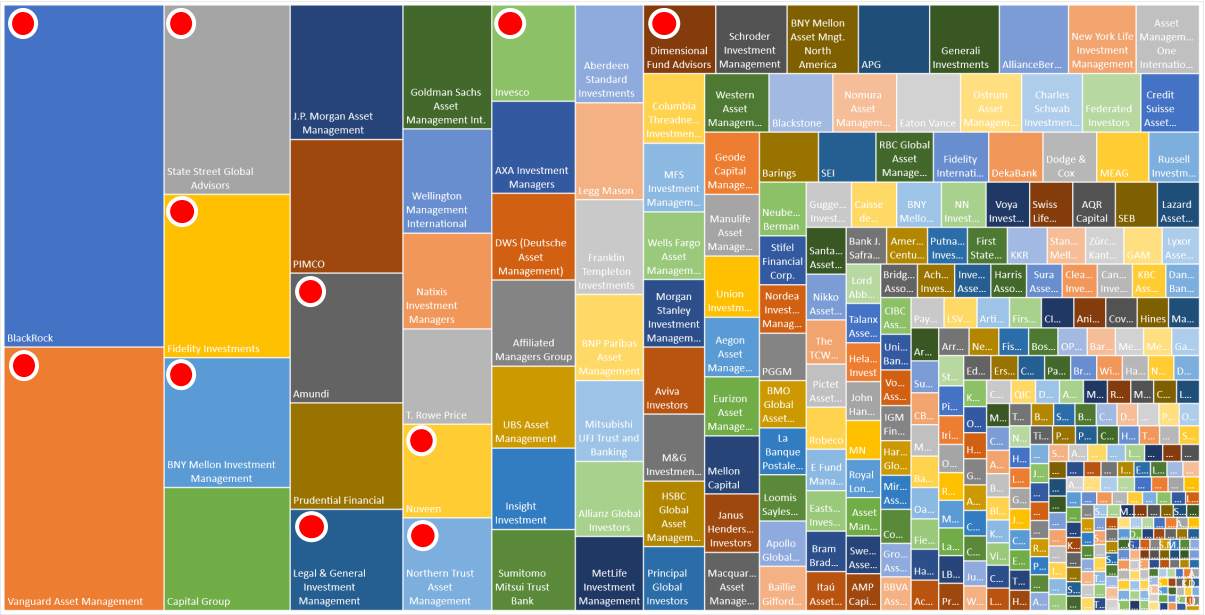
4.2. The investment management industry is well-diversified

One commonly used measure of industry concentration, often used by regulators to understand the impact of M&A transactions on an industry sector, is the Herfindahl-Hirschman Index (HHI). It is calculated as the sum of the squares of the market share of every firm in an industry. If the HHI is less than 1,500 the industry is deemed to be pretty competitive, less so from 1,500 to 2,500 and increasingly uncompetitive beyond that point. Albion calculated this for the fund management industry as at the end of 2018, based on the Top 400 firms; the score was 174, demonstrating that, on this method, competition is relatively high. In comparison, the HHI for the US banking sector was 3,468 in 2017 up from 3,316 in 2006[6] .

The Figure below provides insight into who some of the key players are. Although the major index providers are well represented – as indexing is a scale endeavour where success is driven by low cost products – it is interesting to note the material presence of active managers in the first five columns

[6] Federal Reserve Bank of St Louis (2018), The ABCs of HHI: Competition and Community Banks

Figure 2: World's Top 400 investment managers – US$70 trillion of US$75 trillion in total



Data: IPE "Top 400 asset managers" published in June 2019 and based on AUM as at December 2018.
Chart: Albion Strategic Consulting. Red dot in white circle = major systematic product provider.

Dimensional and Blackrock (iShares) – the two key providers recommended in client portfolios at present – can be identified in the figure above. Blackrock is the biggest manager in the world and Dimensional is ranked 32 (sitting just below the 'US$70' in the title of the chart).

There is no doubt that the asset management marketplace is becoming slowly more concentrated. In mitigation, it is evident that active management still predominates, ensuring that sufficient price discovery exists. Most of the large players offer a combination between active and index products.

5 Fiscal Engineers' approach – the proof of the pudding is in the eating

Fiscal Engineers' systematic approach to investing was first put in place in 2005. Since then, the portfolios have evolved with a small number of asset allocation and fund changes. The figure below provides a comparison between Fiscal Engineers' model portfolios - from P0 (0% in growth assets and 100% in defensive assets) to P100 - and the universe of all professionally managed multi-asset funds available for purchase in the UK with a 10-year track record.

It is evident that the long-term diversified asset allocation strategy implemented using low cost, systematic, rules-based funds is an effective way to invest and delivers against an 'above average outcomes' hurdle. With hindsight some funds have done a little better but picking them 10 years ago would have been a real challenge, if not impossible. We are confident and comfortable with the strategic positions the model portfolios hold and that our overall philosophy for investing will continue to provide strong outcomes over time, whatever the markets throw at them. The majority of professionally managed funds have poorer outcomes than Fiscal Engineers' model portfolios over this time period[7].

[7] Fiscal Engineers' model portfolio track record reflects all of the asset allocation and fund changes that have been made since their inception in 2005. It shows net performance after fund OCFs but before advisory or platform costs.

Figure 3: Fiscal Engineers portfolios vs multi-asset fund peer group (P0 to P100) -10-years to 12/2019

Source: Albion Strategic Consulting. Data source: Morningstar © All rights reserved. Comparison universe: all 68 managers managing 302 multi-asset funds, with a 10-year track record available for sale in the UK net of OCF only. Note: one fund sits below the zero % line and has been excluded from the chart.

The IRC consider this to be a useful way to compare Fiscal Engineers outcomes against the wider opportunity set available to clients.

6 Changes to the growth assets allocation

Over the past few IRC meetings the Committee have looked into the question of home bias i.e. owning a weight to UK equities that is above its global share of market capitalisation. After considerable research effort, and some long debates, the IRC has decided to take a further step towards reducing the home bias from around 40% in UK equities to 25% in Fiscal Engineers P100. The US market allocation increases as a result from 32% to around 40%. There are a number of key drivers behind the decision:

- The first is at a stock level, where the proposed strategy reduces concentration in the largest stocks in the UK market. An example would be HSBC which has a holding at present of 1.4%. This is over twice the weight to Apple, yet Apple is 9 times bigger than HSBC by market capitalisation. In the proposed allocation, HSBC's weight in Fiscal Engineers' P100 (100% growth assets) falls to 0.7%. No stock represents more than 1.5% of the portfolio, providing a high level of diversification against poor performance or corporate failure. The percentage holding of the top ten stocks in the model portfolio falls from around 11% to 7%.

- The second is at the sector level. The UK has some material sector biases and these change over time as sectors wax and wane in each economy. The UK is underweight technology stocks (it has no Apple, Microsoft or Amazon equivalents) and overweight energy and basic materials. The refinement in allocation will rebalance this to some extent, for example raising the technology sector allocation to 10% from 8%.

  The IRC did consider whether the growth assets should be fully global, but due to the market cap weight of the US market (around 60% of developed markets), it felt it was prudent not to

materially increase exposure to this level. This was also a driver – along with marginally higher expected returns – that resulted in the decision to reallocate 5% of the 15% taken out of the UK equities into emerging markets equities, rather than putting the full allocation into international equities. Emerging economies represent somewhere between 40% to 50% of global GDP today, and the current 9% allocation in Fiscal Engineers P100 sits at the lower bound of an allocation to these markets.

- The final decision was to replace the UK commercial property (REIT) exposure moving this allocation into the existing global REIT allocation, again to reduce home bias and stock concentrations.

These structural refinements will be presented to and discussed with all of our clients on an individual basis. Client approval will be sought prior to any changes being made to individual client portfolios as required under the terms of our advisory permissions.

7 In conclusion

The IRC meeting was productive, resulting in an agreed change to Fiscal Engineers' model portfolios by way of the reduction in the home-bias position. It also resulted in a clear direction that the Firm will pursue in researching and delivering a 'steps in the right direction' approach to offering portfolios with a higher degree of sustainability yet one that remains close to its existing, risk controlled and successful investment approach.

John Clark's appointment as CIO and his contribution to the discussion bodes well for the ongoing governance of client assets, bringing – as he does – further knowledge and perspective to the table.

We wish you a happy and productive 2020, whatever the markets might bring.

Fiscal Engineers' Investment & Risk Committee

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