# Fiscal Engineers' Investment & Risk Committee

Meeting Summary Points Summer 2020

Fiscal Engineers held its latest Investment & Risk Committee meeting (IRC) on 28th May 2020. These notes provide an insight into some of the areas of discussion held and decisions taken.

## A message to our clients

At the end of our previous message to you in January 2020, we stated:

'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.'

How timely that reminder turned out to be! The global pandemic that has engulfed us all, sent markets tumbling in Q1 2020, but with very substantial global government support most markets have recovered strongly by the end of the second quarter, as they look towards a post-Covid recovery.

Fortunately, due to the broad diversification of the growth assets held in portfolios and the high-quality bonds held in the defensive assets component, most clients were pleasantly surprised by how resilient their portfolios were, particularly in contrast to the UK equity market.

In an era of low interest rates – where government bond yields have fallen to around 0% before inflation – the prospects for future portfolio returns are subdued. The IRC has undertaken a full review of its forward looking, longer-term asset class assumptions and has, to be prudent, reduced them across all asset classes. This may have an impact on some clients' financial plans and in some cases, this might mean taking on a little extra risk to meet financial goals, where this is appropriate. The impact of these changes will be discussed with individual clients – where necessary - at their next meeting, along with any actions that might be needed.

While the highly defensive nature of the bonds held in portfolios has helped portfolios to maintain their value through the recent severe market fall and subsequent recovery, is it worth remembering their ability to act as an 'income reserve' in the event of a prolonged market downturn, possibly even over multiple years. These bonds are liquid and will allow essential spending to be met, without the need to sell equities when they are down (one of the cardinal sins of investing). Thinking about bonds in this way, and the comfort it brings, may help allow some clients to take on a little more risk, where this is appropriate.

Over the past three years in particular, value companies and to some extent smaller companies have lagged the performance of growth stocks and in particular US technology stocks, which are now trading at very high multiples. The IRC has undertaken a comprehensive review of these premia and it remains confident in the value and size tilts held in client portfolios for longer-term investors with patience and discipline. These long-term expected premia are valuable, particularly in a lower return environment, for investors who will rely on drawing on their portfolios in the years ahead. Being swayed by what has happened in the recent past risks falling into the rear-view mirror investing trap. Remember, if a premium materialised every year, there would be no risk and, by definition, no need for a premium!

We hope that you enjoy your summer and that the weather remains good if you are going on a 'stay-cation'.

As ever, if you have any questions or comments, please do not hesitate to call us.

## The Team at Fiscal Engineers

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## 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. Two core meetings and two interim meetings are currently held each year and meetings can be called on an ad hoc basis if circumstances warrant it, such as a material market fall. 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 28th May 2020 and a quorum was present.

Attending the meeting were: John Clark (CIO and Chair), Shane Mullins (Executive Chairman), Ian Rodger, Dave Till and Frazer Edwards of Fiscal Engineers, Tim Hale of Albion Strategic Consulting and Neil Wright.

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/conclusions were made/drawn:

### 2.2. Key decisions summary

- Systematic vs. judgemental approaches: the evidence still supports utilising a low cost, diversified systematic, buy-hold-rebalance approach. It was noted that the trend of assets moving from active to passive/systematic strategies continue to grow apace. 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. Updated Due Diligence Dashboards for Fiscal Engineers' current fund recommendations were provided by Albion in April and reviewed by the IRC. The next full review of all asset class product screens and due diligence will be available for review and discussion at the November IRC meeting and the IRC will report back thereafter.
- Portfolio review: from February to April 2020, the global markets fell rapidly in response to the Covid pandemic and associated shut down of large swathes of the global economy. Volatility was extreme and markets recorded some of the largest daily falls and rises ever. By the end of April, the UK market was down around 22% for the year (it was down 34% at its worst in peak-to-trough terms), yet a Fiscal P60 was down around only 9%, and by the time of the IRC at the end of May the same portfolio was down only 6%, or so. High-quality bonds (Fiscal P0) delivered a positive return of around +3% by the time of the IRC. As is often said*: 'you don't need bonds until you need them!'*.
- Asset class research: the IRC confirmed that it remains comfortable with all the asset classes in the portfolios at present. Momentum, as a diversifier to the value premium, was discussed and placed 'on watch' (see later).
- Asset class assumptions: the IRC has decided to revise its asset class assumptions downward, in light of the continuing prospect for low yields on cash, which drive all other

premia. It has revised the expected long-term central case return on cash by 1% from +0.5% p.a. above inflation to 0.5% p.a. below inflation. The impact of this and the options facing clients will be discussed at their regular meetings with their advisers. See below.

- Strategy affirmation: the reduction in the allocation to UK equities from 40% to 25% agreed in previous IRC meetings continues to be implemented across client portfolios. No other changes were deemed necessary at this point. It was felt that the allocation to index linked gilts remains valid, especially in light of the risk of higher inflation down the line due to the rapid growth in the money supply currently occurring.
- Sustainable investing: as part of the ongoing project to build a set of sustainable investment portfolios, a comprehensive review of the product opportunity set will be undertaken as part of the product screening and due diligence service provided by Albion. The outputs will be discussed in detail at the next IRC in November and this will allow the IRC to complete the construction of some *'steps in the right direction'* sustainable portfolios.

## 3. Market overview

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

Table 1: Nominal returns to 30 June 2020[1]

| Date | World equity (dev.) | UK equity | Emerging market equity | Global large value | Global small | Global REIT | Short-dated bonds | Index-linked gilts |
|---|---|---|---|---|---|---|---|---|
| Asset role | Return drivers | | | | | Diversifier | Defensive | |
| 10 years | 12.1% | 5.9% | 5.3% | 9.3% | 11.1% | 9.0% | 1.6% | 5.4% |
| 5 years | 12.2% | 2.4% | 7.9% | 6.3% | 8.0% | 6.6% | 1.4% | 5.0% |
| 3 years | 8.5% | -2.3% | 3.6% | -1.6% | 1.2% | 0.0% | 1.7% | 4.0% |
| YTD 2020 | 1.0% | -17.7% | -3.3% | -17.5% | -10.0% | -15.4% | 2.5% | 5.0% |

Data source: Dimensional Returns Program 2.0

Clients have benefited substantially from the high degree of overseas diversification of portfolios away from the UK market, which has lagged most other markets over the past decade.

## 4. Notes from the latest review of the evidence

The IRC reviewed the latest research input from Albion Strategic Consulting (*Albion Governance Update 19 – April 2020*), which covered a number of interesting and relevant topics. Some of the key highlights are summarised below.

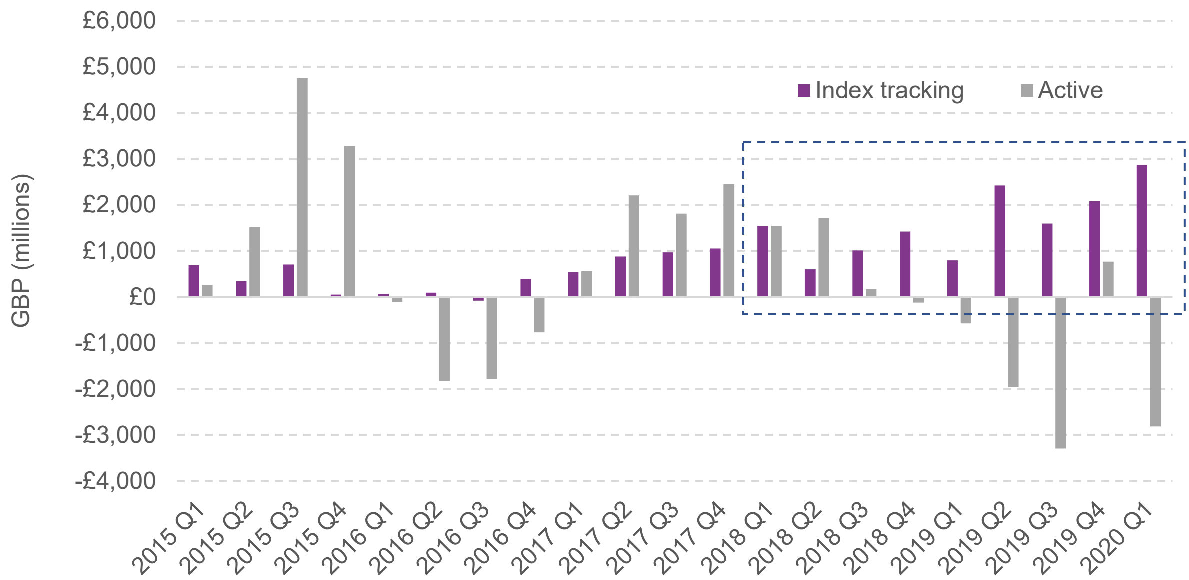
### 4.1. The judgmental (active) vs systematic (passive) debate

The latest SPIVA scorecards – which report the percentage of managers failing to beat the market - continue to demonstrate how difficult it is to win at active management. Around 90% of all US managers failed to beat their benchmarks in the 15 years to the end of 2019.

[1] 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; global large value - Dimensional Global Large Value Index; global small - Dimensional Global Small Index; short-dated bonds – FTSE World Government Bond Index 1-5 Years (hedged to GBP); index linked gilts - Bloomberg Barclays Govt. Inflation Linked 5-15 Year bond Index. All in GBP.

In the UK, fund flows into index-tracking equity strategies have been strongly positive from Q4 2019 to Q1 2020 with an almost equal and opposite outflow from active funds. The low cost systematic approaches a journey that Fiscal Engineers has been on for over a decade.

Figure 1: UK investor net flows into active and index-tracking strategies Q1 2015 to Q1 2020




Data source: Calastone 

### 4.2. Rebalancing – checking tolerances

Rebalancing is an integral part of the investment process discipline implemented at Fiscal Engineers. The IRC reviewed recent research that continues to support the efficacy of running an annual rebalance and having a 10% tolerance limit on the split between growth and defensive assets. During the market falls in Q1 2020, the team at Fiscal Engineers were monitoring this 10% tolerance limit on a daily basis and an ad hoc meeting of the IRC was called to discuss the situation. The team were prepared for an interim rebalance, but the market rebounded by around 10% in a short period, easing the pressure on this tolerance band. Client portfolios will continue to be rebalanced regularly and if market volatility returns, the team will move back to daily monitoring.

### 4.3. Not all bonds are made equal – a fresh example

The recent sell-off in global equity markets has provided a new set of data around how bonds behave. We know that the high-quality bonds recommended in client portfolios provide limited returns in a low yield environment. Yet those picking up pennies in front of the steamroller – by owning lower quality, higher yielding bonds - were hit severely, with high yield bonds down 14% or so in GBP terms. If the Federal Reserve had not stepped in to buy these bonds, prices could have fallen considerably further. The IRC continues to believe that high-quality bonds provide the best insurance policy.

Figure 2: Performance of the UK fixed income marketplace - 19/01/20 - 23/03/2020

| | Maturity (years) | | | |
|---|---|---|---|---|
| | 1-5 | 5-10 | 10+ | All |
| Gilts | 0.9% | 1.8% | 8.5% | 5.6% |
| Sovereigns & Sub -sovereigns | 0.5% | 0.3% | 1.4% | 0.6% |
| Collateralised | -1.6% | -1.5% | -4.4% | -0.9% |
| Corporate AAA | -2.7% | -9.9% | -7.4% | -6.2% |
| Corporate AA | -3.2% | -6.7% | -9.8% | -6.4% |
| Corporate A | -4.3% | -8.8% | -13.6% | -9.3% |
| Corporate BBB | -4.7% | -9.1% | -14.4% | -9.9% |
| High yield | - | - | - | -13.6% |

| | |
|---|---|
| UK equity market | -34% |

Data source: Morningstar Direct.  Indices: Markit iBoxx GBP index series, FTSE 100 TR GBP & ICE BofA Sterling HY TR GBP.

### 4.4. Cross-sectional momentum strategies

This sounds complex, but in essence these are strategies that overweight stocks that have performed well relative to other stocks and underweight those that have performed poorly on a relative basis. The academic evidence for the momentum premium is strong but it goes against the efficiency of markets and is best explained by investor behaviour, where investors over and under-react to news. An appealing aspect is that momentum appears to be negatively correlated to the value premium, thereby smoothing the combined premia capture. One challenge has been a lack of product available; a few have now been developed and are building track records and assets. The IRC has this ‘on watch’ and will discuss further evidence and potential investable products at future IRC meetings.

### 4.5. The current status of the value premium

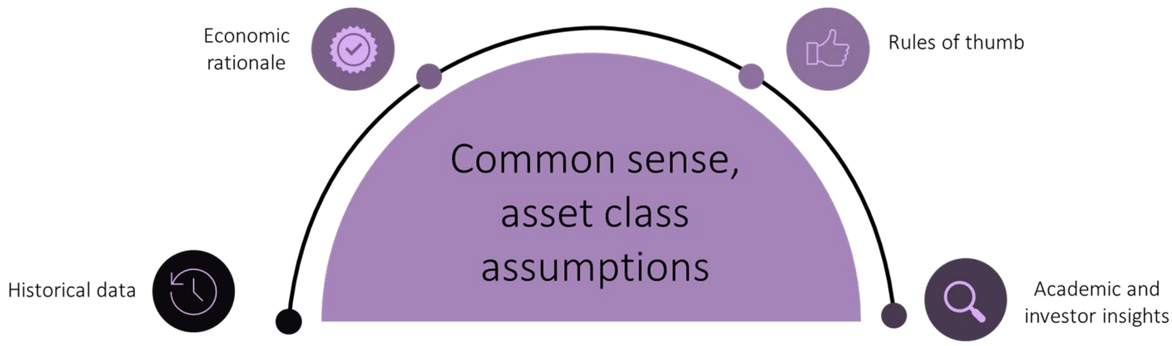
Albion’s Governance Update 19, reviewed by the IRC, provided high-level highlights from three papers by Fama & French, Research Affiliates and AQR. The latter two papers, in particular, reviewed a number of criticisms of value investing for which they find little supporting evidence. Amongst these criticisms are that price-to-book (the measure of value used) fails to consider the intangible assets of more ‘new economy’ companies. This turns out to make little difference. In fact, the over-riding conclusion of these papers is that the divergence between growth and value stocks is due to a revaluation of growth stocks: in plain English, investors in growth stocks have been willing to pay increasingly higher prices for each £1 of book value, whilst paying the same multiple for that of value stocks. On almost every metric, value stocks look cheap today and growth stocks expensive, relative to history. The IRC continues to believe that maintaining the value allocations in portfolios to be sensible for longer-term investors.

## 5. Revising our asset class assumptions

A challenging aspect of financial planning is defining a sensible central case for the returns that a portfolio might be expected to deliver over the longer term. The portfolio return derives from the individual asset classes that make up the portfolio. Assumptions need to be made for returns, correlations between asset classes and the volatility of each asset classes. We can be guided by history, use sensible rules of thumb, review what other such as leading academics, fund managers, and regulators think and then combine this with a good deal of common sense.

The central case is an estimate at quantum and a recognition that this ‘central’ position is simply that. It sits in a range of possible alternative futures. Fiscal Engineers uses a process called Monte Carlo simulation in its financial modelling, which allows it to model the range of potential futures around this central case. It provides advisers and clients with insight into the likelihood that a certain plan will achieve its goals and where any vulnerabilities lie.

Figure 3: Forming reasonable asset class assumptions




Source: Albion Strategic Consulting

During this IRC meeting, Albion's recent paper *Governance Update 19b: Asset Class Assumptions* was discussed. In this paper, it was recognised that the long term is made up of a series of short-term time periods. In the present environment of very low nominal (before inflation) yields and negative real (after inflation) yields on cash - known as the risk-free rate - and government bonds, it was felt prudent to reduce the long-term cash rate from +0.5% p.a. to -0.5% for a 20-30 year horizon. The latter assumes that real cash returns revert to 1% above inflation over the 30-year period.

Other return premia – such as that for owning equities - are made relative to cash. We still consider that equities have an expected return around 4% above cash over the long term, but given the latter being at estimated at -0.5% p.a., this gives an after inflation (real) return of around 3.5% for developed market equities. We estimate that high quality short-dated bonds have an expected real return of around 0.5% over a longer-term planning horizon.

The broadly 1% p.a. prudent reduction in expected returns for all asset classes might mean that in some cases advisers will need to work through a client's plan and discuss the impact that this might have on meeting their goals or changes in the likelihood of doing so if no action was taken. Actions might include taking on a little more risk in portfolios, tweaking the expenditure goals or a combination of the two. The impact and options will be discussed at upcoming client meetings.

The IRC is happy to share the asset class assumption process in more detail if anyone wishes to delve a little deeper.

## 6. Fixed income assets as a liability match

From an investment perspective, high-quality, generally short-dated bonds provide a good insurance policy against periods of large equity market falls, helping portfolios to fall less far, which means they have less far to recover. Remember, a 50% fall needs a 100% rise to get back to the same place, whereas as 20% fall requires only a 25% rise.

The amount of fixed income held in a portfolio is the outcome of a deep discussion around what constitutes a suitable level of risk to take. That discussion is informed by understanding a client's risk tolerance (as measured by FinaMetrica), their financial capacity to suffer losses and their need to take on risk in the first place to meet their goals.

However, one overlooked lens through which to view fixed income is that it represents an income reserve that can meet future liabilities, whatever happens to equity markets. The falls and quick bounce back of 2008-9 and Q1 2020 are common, but the real risk to investing is a prolonged fall and recovery – say over a decade – back to a similar level of purchasing power. The fixed income reserve can be thought of as a multiple of how many years of essential spending is required to feel comfortable and perhaps a multiple of annual discretionary spending that would be nice to hold back too. Even in a prolonged downturn all of this spending will still be possible, and the growth assets can remain intact to recover purchasing power. Thinking of fixed income in this way should provide a high degree of comfort and possibly even allow some clients to assess more clearly if they wish to take on a little extra risk. Advisers are very happy to talk to clients about this issue.

## 7. In conclusion

The IRC meeting was very productive, and a lot of ground was covered. The IRC feels comfortable that its clients' portfolios remains well-structured and are pleased – but not surprised – that they have fared well in the difficult first half of 2020.

Please feel free to contact your adviser if you have any questions or comments arising from this document.

It just remains for us to wish you and your family a happy and safe summer.

Fiscal Engineers' Investment & Risk Committee

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