fiscal engineers™
money. life. balance.

Fiscal Engineers' Investment & Risk Committee

Meeting Summary Points Summer 2023

These notes provide an insight into some of the areas of discussion held and decisions taken at the Fiscal Engineers Summer 2023 Investment & Risk Committee (IRC) meeting.

A message to our clients

The year so far has generally been a better one for investors with both global bonds and global equities (developed and emerging) delivering positive returns by the half year point. Whilst the rate of inflation has fallen from its peak, there is still the risk that global geo-political events place upward pressure on global prices.

Where markets go from here in the short-term, no-one knows. As we have long stressed, market prices reflect all public information available making it very difficult to second guess markets in the short term. Fortunately, as your long-term financial planning partners, we can help put your multi-year planning horizons to good use, by building a portfolio strategy to meet your financial goals. Time provides us with the luxury of being able to ignore the shorter-term gyrations of the markets – and the unexpected outcomes that we may experience – and to feel confident in capturing the longer-term returns we require as investors. As Benjamin Graham – the father of modern investing and whose protégé was Warren Buffett – pertinently stated:

'In the short-term the market is a voting machine, but in the long-run it is a weighing machine'

Our role is to ensure that your portfolio remains suitable for you, make sure you remain invested and avoid reacting to market conditions, and to provide high quality governance of your portfolio along the way (the IRC's primary role).

Today's cash rates are a case in point. They may seem tempting, but you are likely to jeopardise your long-term goals by holding cash and trying to second guess when to get back into equities. Cash rates remain below inflation. Keep your focus on the longer-term expected returns from a sensibly structured well-diversified global investment portfolio that are far higher than that for cash.

In terms of governance, the IRC has been busy considering a number of important issues, which we report on in this note. The most important decision made was to take the final steps to a fully global diversified portfolio and confirm the funds that will be used to implement this move in practice.

As ever, please get in touch if you have any questions, comments or concerns.

The Team at Fiscal Engineers

Tel: 0115 9555600

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 at a minimum four times a year. 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

Introduction

Attending the summer meeting were: David Jones (Chair), John Clarke (CIO), Shane Mullins, Frazer Edwards, Hazel Manlove and Dave Till of Fiscal Engineers, and Ben Edwards of Albion Strategic Consulting (Albion). Apologies were given by Tim Hale (Albion) and Neil Wright (member).

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 quorum was present and as well as the regular agenda items, the following decisions/conclusions were made/drawn:

Key decisions summary

- Systematic vs. judgemental approaches: the data available to us (e.g. the latest SPIVA report looking at the number of active managers who beat the market) continue to support avoiding making tactical market timing and stock selection decisions. The IRC considers that its systematic approach continues to represent a robust way to invest clients' money.
- Product due diligence: funds used in client portfolios are regularly reviewed by the IRC. Since the previous meeting in November, the team have spent time undertaking due diligence on a number of new funds in both standard and ESG portfolios. Proposed fund changes are covered below.
- Portfolio review: as stated in the last minutes (Winter 2022), the final steps in moving to fully global portfolios have been confirmed at both the asset allocation and product levels. An overview of the decision rationale and next steps is provided below.

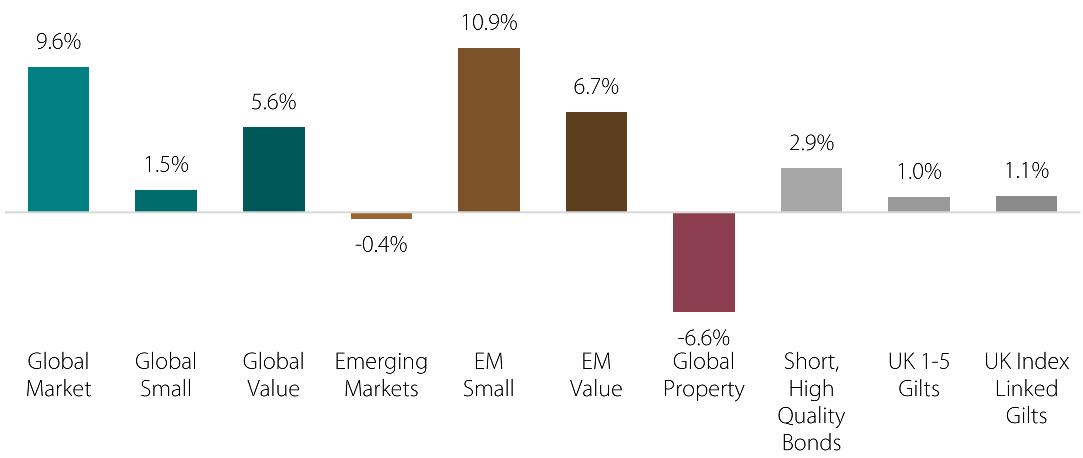
  Note that all suggested changes will be discussed individually and will be sensitive to tax implications. Given Fiscal Engineers' advisory permissions, clients will need to approve any such moves.

- 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 remains comfortable with the long-term asset class assumptions for asset classes used in the financial planning process.
- Strategy affirmation: outside of the proposed portfolio changes suggested in this note, the IRC believes that the well-diversified portfolio structures and low-cost, best-in-class funds that constitute its model portfolios represent a robust framework for proving investment advice.

3. Market overview – 2023 (1 January to 30 September)

2023 so far has seen a bounce back into positive territory after the down markets of 2022 in nearly all asset classes. Global equities (developed markets) and global short-dated bonds, which sit at the centre of client portfolios, have returned around 9.6% and 2.9% in absolute terms.

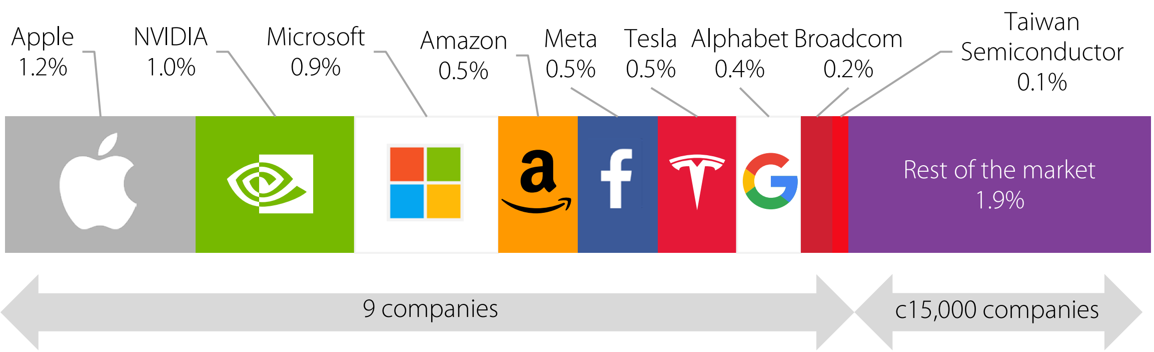
Figure 1: Global investment returns – asset class returns YTD to 30 September 2023



Data: Funds used to represent asset classes, in GBP. See end note for details.

It is worth noting that just nine, mainly US, companies accounted for three-quarters of a 7.2% rise in world equities this year (taking a deeper analysis in underlying company data to the end of June for global and emerging markets). The remaining stocks delivered just a quarter of this rise, emphasising the point that exposure to the whole market is essential in ensuring that returns are captured effectively.

Figure 2: The contribution to the world equity market return of 7.2%



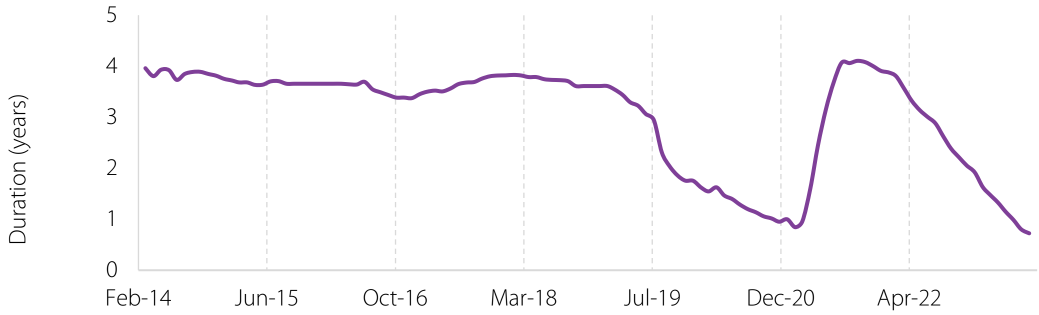
Source: Albion Strategic Consulting (see footnote 1)

On the bond side, the predominant holding in model portfolios is the Dimensional Global Short-Dated Bond Fund. As a reminder, this fund only invests in high quality (AA and above) bonds and employs a systematic variable maturity strategy, where if the yield curve is flat (short-dated bonds have the same yield as longer-dated bonds) or inverted (short-dated bonds have higher yields than longer-dated bonds) as is the case in the major bond markets today, the fund will shorten its maturity. At the end of September, the fund had an average maturity of 0.59 years and yield-to-maturity of 5.58% (about as much as one could get on the best paying deposit accounts). If yield curves steepen (longer-dated bonds have higher yields than shorter-dated bonds) the fund will extend its maturity. It should be noted that the fund is not trying

[1] As evidenced by the returns of Vanguard FTSE Global All Cap Index (£ Acc). For illustrative purposes only.

to guess where rates are going, but employs a systematic process that uses current prices to position the portfolio in terms of maturity. As the chart below shows, the maturity on this fund varies within the 0-5 year space, but no longer.

Figure 3: Dimensional's 'variable maturity' strategy at work

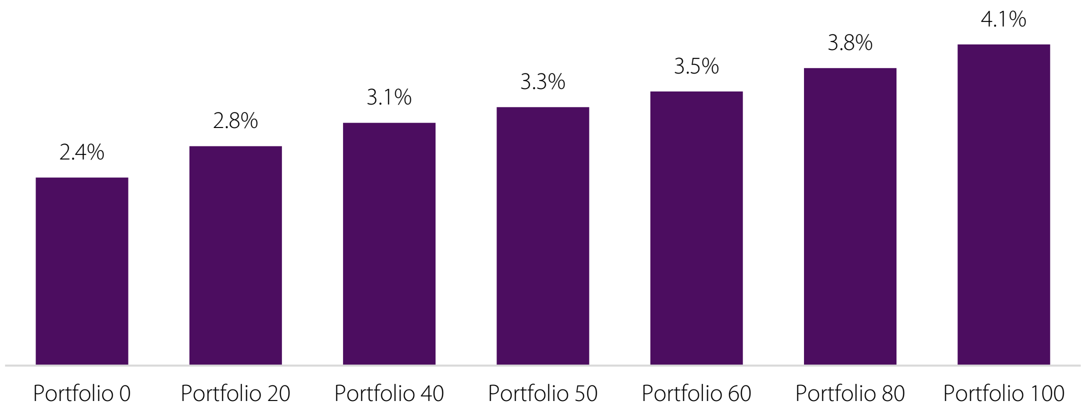


Source: Albion – Due Diligence Dashboard – Sept. 2023. Data: Morningstar Direct © See endnote

Fiscal model portfolio returns

At the model portfolio level, strategies across the risk spectrum have delivered positive returns, as the figure below reveals:

Figure 4: Fiscal Engineers Model Portfolio returns[2] – YTD to 30 September 2023



Source: Fiscal Engineers/Dimensional – October. 2023. Data: Morningstar Direct © See endnote

Outlook for the economy and inflation

Led by CIO, John Clarke, the IRC reviewed the Economic Risk Matrix.

In summary, no evidence has emerged which changes John's view that current UK inflation challenge is rooted in monetary growth from inappropriate quantitative easing during the COVID-19 pandemic. In essence, as he stated, *"the problem was supply, but the response was to stimulate demand".* Whilst UK growth has fallen (which is needed to reduce inflation) it is unclear if growth has fallen enough to sweep up all the excess money in circulation.

[2] These represent fund level model portfolios (after fund charges and trading costs) but before any other costs. Note that individual portfolio performance may vary due to actual holdings, last rebalance date, interim cash flows and adviser and platform costs.

We believe falling money supply should bring GDP growth below underlying productive potential, which should start to reduce underlying inflation. Inflation at the end of September had fallen back a little to 6.7%.

John highlighted that the risk remains that mistakes in responses by the Bank of England and Treasury are likely to make any recession worse than it needs to be. He also pointed out that inflation data lags as an indicator, so it is possible that policy makers will overshoot on the downside.

One scenario is that interest rates may fall next year (2024). Fears of deflation (if policy mistakes are made) could increase demand for government bonds, but the relationship is very complicated. He reinforced that these are views based on the current economic position and some possible outcomes, but there are no indicators from his analysis that the Committee should change its long-term approach at this point. In the event of deflation the nominal bonds should provide protection for portfolios.

4. Product review: inflation linked bonds

In the November meeting, the IRC asked the team to report back with possible alternatives to improve the inflation hedging properties of the inflation-linked bonds it recommends. The current fund has a duration which is longer than we would ideally choose, but due to product availability, our preferred approach was not possible in the past.

The team has subsequently undertaken due diligence work on shorter-dated inflation-linked funds, as new opportunities have come to the market. In order to reduce duration in this asset class, we must look to global inflation-linked funds. A number of these have been on the committee's watch list for some time and have now passed our robust, evidence driven screening process. The result is a proposed change from the current UK inflation-linked fund to a global inflation linked fund with improved defensive characteristics. More details follow in section 6.

The committee remain open to continual review of the available product universe, subject to our screening and due diligence process. As an example, since the summer meeting a shorter dated UK index-linked gilt fund has been launched and another is being set up for launch. If appropriate, these will be added to our watch lists and monitored, but won't be considered for inclusion in portfolios until they have passed through the same screening and due diligence processes.

5. Portfolio structure: taking the final step away from a home market bias

After considerable discussion and analysis, it was agreed in the Winter 2022 IRC meeting that the model portfolios should make the final move to a fully global, broadly market cap-weighted, structure. This is the concluding step of the journey we started back in February 2020 - which we have reported on in previous IRC meeting notes over that period - towards improved diversification through a fully globally weighted portfolio i.e. eliminating the home bias to the UK. Since the last meeting, the team has made final decisions on proposed changes to the model portfolios at both the asset class and product levels, which were approved by the IRC.

As discussed before, global diversification ensures that investors gain exposure to all of the world's sectors and individual companies more broadly in line with their global weightings. This avoids implicit - possibly unintended - positions that arise as a consequence of an overweight UK allocation.

Over the past few years, differences between sector allocations between the UK and non-UK markets have grown, not least because of the major US tech stocks like Apple. The latter's market capitalisation has risen from US$1.2 trillion in February 2020 to around US$2.8 trillion (20/9/2023) which is just shy of the total market capitalisation of the UK stock market! More recently, ARM Holdings plc – a leading Cambridge based computer chip maker – listed on NASDAQ exchange in the US, not on the London Stock Exchange. These sorts of changes reinforce the rationale for taking this final step to a fully global model.

If, hypothetically, only one global stock market existed and all companies were listed on it, it would feel intuitive to use its structure as a starting point for one's equity allocation. This last step will take our model portfolios to that point. In essence the UK will be dialled down to a global market weight and non-UK developed 'international' market dialled up.

Standard models – proposed changes

Growth assets are the drivers of solid, long-term, after-inflation returns that investors need to meet their financial goals. Over the short-term, falls in value can be significant. Defensive assets are present in many portfolios to moderate this impact but are unlikely to deliver returns much above inflation over the medium term. Higher expected returns come from owning more growth assets.

With respect to growth assets, the strategic change to a fully global allocation can be accommodated in existing portfolios by either dialling down the allocations to the Dimensional UK Core Equity (3.25%)[3] and dialling up the allocations to the Dimensional International Core Equity (61.75%) or using a new option, where appropriate, of the Dimensional Global Core Equity Fund, which holds all countries at their market weights (65%). All other growth asset decisions, such as tilts to value and smaller companies, global commercial property and emerging market equities remain unchanged.

With regard to defensive assets, the IRC confirmed the decision to replace the Dimensional Sterling Inflation-Linked Intermediate Duration Fund with a shorter-dated inflation-linked fund; the abrdn Short Dated Global Inflation Linked Bond Tracker fund.

This fund should further improve the defensive characteristics of portfolios by holding inflation linked bonds with a shorter duration than the current fund (0-5 years vs. 0-15 years). Shorter duration means less exposure to interest rate and inflation risks, the expected result being lower volatility. The fund is also better diversified both in number of holdings (c400 vs c300) and geographical spread around the globe, rather than solely holding UK gilts. The weighted credit quality of the bonds in the fund is the same AA rating as the current fund.

The committee also amend the allocation between nominal and inflation linked bonds. The current 70% nominal, 30% inflation linked allocation has been driven by the consideration that the duration of the current fund is longer than we would ideally choose. Because the duration of the abrdn fund is within our ideal range, we will now revise the allocation to 50% nominal and 50% inflation linked bonds.

The trade-off for this reduction in expected volatility is that the protection against unexpected inflation (expected inflation is already priced in) switches from UK inflation to global inflation.

The committee believe this is a worthwhile trade off, best confirmed by reinforcing the primary purpose of defensive assets in your portfolio:

To damp the volatility your portfolio will experience from the growth assets held, to a level you are emotionally comfortable with.

The best likelihood of long-term returns above inflation still comes from the equities and property in your growth assets. The protection against unexpected inflation in your defensive assets is very much a secondary objective to their primary purpose of smoothing your investment journey.

[3] As a percentage of the growth assets held in any portfolio.

ESG Models – proposed changes

The move to a fully global allocation is also proposed for the ESG models. To achieve this, the L&G Future World ESG UK Index allocation will be removed and reallocated equally (32.5%) to the two incumbent global funds being the Vanguard ESG Developed World All Cap Equity Index and Dimensional Global Sustainability Core Equity.

One additional change in growth assets is that the pure index fund used to capture emerging markets exposure (iShares MSCI EM IMI ESG Screened ETF) will be replaced with the recently launched Dimensional Emerging Markets Sustainability Core Fund, which includes valuable systematic exposure to value and smaller company stocks in these markets. This is more consistent with our key investment principles.

We have identified a defensive fund for nominal bonds that employs a sustainability approach to its corporate bond selection, which constitutes another step in the right direction. The Dimensional Global Short-Dated Bond Fund will be replaced by the Dimensional Global Sustainability Short Fixed Income Fund. Both funds sit in the short-dated, investment grade space. As with the non-ESG portfolios, the Dimensional Sterling Inflation Linked Interim Duration fund will be replaced by the abrdn Short Dated Global Inflation Linked Bond Tracker fund. The allocation between the nominal and inflation-linked bonds will also be set at 50/50.

6. Implementing the proposed changes

These proposed changes will be discussed with each client individually and any changes agreed will be sensitive to costs and taxes. On that note, in some circumstances – particularly given the new reduced annual Capital Gains Tax allowance regime – a potential liability may arise, which we will point out and discuss with all clients impacted. We believe it is better to be driven by sensible portfolio structure, rather than the tax consequences of making such a move. Tax will either be paid as CGT when future withdrawals are made or, ultimately, as Inheritance Tax.

In other words "Don't let the tax tail wag the investment dog!"

7. In conclusion

The IRC continues to ensure that the investment approach adopted on behalf of Fiscal's clients remains as robust as it can be. Changes to it are generally pretty rare, and usually as a result of the changing investment world and ever evolving range of solutions. The proposed changes are relatively small, but in the world we operate in, it is these marginal gains that can end up making material differences over longer-term horizons.

Please feel free to get in touch if you have any questions or concerns.

Fiscal Engineers' Investment & Risk Committee – October 2023

Endnote: use of Morningstar Direct© data

Data series used:

Asset class	Fund proxy used for Figure 1
Gbl market	Fidelity Index World P Acc
Gbl value	Dimensional Global Value GBP Acc
Gbl small cap	Vanguard Glb Small-Cp Idx £ Acc
EM	iShares Emerging Mkts Eq Idx (UK) D Acc
EM value	Dimensional Emerging Mkts Val GBP Acc
EM small cap	iShares MSCI EM Small Cap ETF USD Dist
Gbl property	L&G Global Real Estate Div Index I Acc
Short, high qual bonds	Dimensional Global Short Dated Bd Acc
UK 1-5 gilts	iShares UK Gilts 0-5yr ETF GBP Dist
UK IL gilts	Dimensional £InflLnkdIntermDurFI GBP Acc

0115 955 5600
info@fiscalengineers.com
www.fiscalengineers.com

Fiscal Engineers Limited, 22a The Ropewalk, Nottingham, NG1 5DT.