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Fiscal Engineers' Investment & Risk Committee

Winter 2023/24 Output

Fiscal Engineers held its latest Investment & Risk Committee meeting (IRC) on 28th November 2023. This commentary provides an insight into some of the areas of discussion held and decisions taken.

A message to our clients

2023 ended up being a strong year for investment returns driven by the US market and higher bond yields than in recent years. Just a handful of US mega-cap companies – dubbed the 'Magnificent Seven' by the media – accounted for around three-quarter of the US market's return. Market returns are covered in more detail in this commentary.

UK inflation (CPI) has fallen back from around 10.5% at the start of 2023 to 3.9% in November. There is, however, still the risk that global geo-political events place upward pressure on global prices and that the UK falls into recession. Policy risk exists from the decisions the Bank of England makes going forward. It certainly feels like there is a high level of uncertainty in markets not least due to the continued war in Ukraine, the unfolding events in the Middle East, and forthcoming 40 elections taking place around the world including in the US and the UK in 2024. The important thing to remember is that these and other events are already baked into today's market prices. As ever, our best defence against this uncertainty is to remain well diversified and to own high-quality defensive bonds to the extent that they allow us to stay invested in tough times.

With the benefit of hindsight, it is always tempting to wish that one had owned more of one asset class than another, but that is not a luxury that we have.

That is the role of IRC. It is focused on making sure that the portfolios it builds for clients are as robust as possible at both the asset allocation and fund levels. To this end, the new fully global portfolios – whose evolution from concept to reality has been well documented in previous minutes – are launched. It is important to bear in mind that the changes provide incremental efficiency benefits from the ground up. All clients will have the opportunity to discuss these changes and what a transition to the new models looks like for them at their next review meeting, prior to any changes being made.

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

The Team at Fiscal Engineers

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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

The formal IRC meeting took place on 28th November 2023 and a quorum was present.

Attending the meeting were: David Jones (Chair), John Clark (CIO), Frazer Edwards, Hazel Manlove and Dave Till of Fiscal Engineers, and Ben Edwards of Albion Strategic Consulting (Albion). Apologies from Shane Mullins (Fiscal Engineers) 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:

Key decisions summary

- Systematic vs. judgemental approaches: the data available to us continues to support avoiding making judgemental tactical market timing and stock selection decisions. The Committee agrees there is no change to the underlying philosophy, namely that active management outcomes are inconsistent over time and no new data suggests a reliable way to pick winners in advance. It continues to believe that a systematic approach offers investors the best likelihood of a successful investment outcome. An insight into the SPIVA report discussed by the Committee, looking at active manager performance, is provided later in this document.
- Product due diligence: the Committee concluded that the current range of funds are capturing the markets and asset class characteristics intended and, subject to the planned changes in progress, no other fund changes are required. The next full product screen and due diligence review is due at the end of Q3 2024. All current funds and portfolios will be monitored in the interim on a regular basis.
- Portfolio review: the new global portfolios, which are now available, were reviewed and it was agreed by the Committee that the portfolio structures were robust and that they are capturing the market exposures – and thus expected returns - sought.
- Asset class research: the IRC confirmed that it remains comfortable with all the asset classes in the portfolios at present. Structured products (and structured deposits) were discussed in the meeting and the Committee continue to believe they do not have a place in our clients portfolio due to their layers of risk, complexity and cost, which do not translate into adequate rewards for investors compared to investing in wider equity markets directly or, for short-term known liabilities, using a combination of cash and short-dated high-quality bonds.
- Asset class assumptions: the Committee agreed that the current asset class assumptions, which generate our overall portfolio assumptions, remain reasonable starting points for investment discussions with clients.

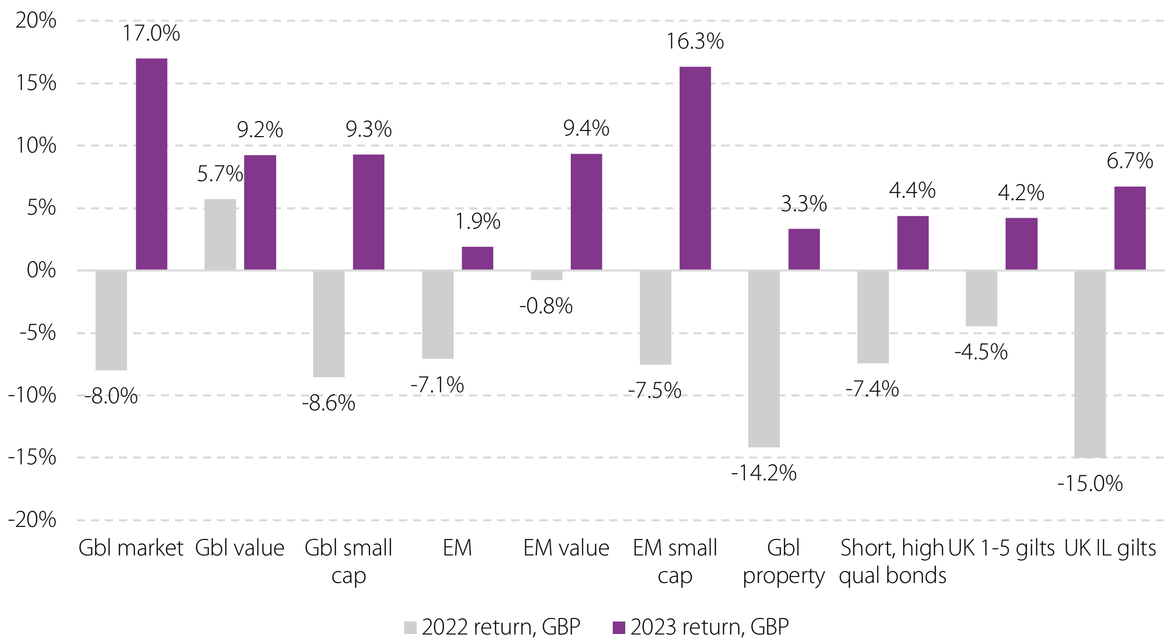
- Strategy affirmation: After detailed discussions and reviewing the available research and due diligence, subject to the planned changes, the Committee concluded that there is no reason to change the evidence-based, long-term systematic strategy.

3. Market overview – 2023 (to 31st December)

In 2023 all core assets delivered positive returns. The US market – and in particular the 'Magnificent Seven'[1] – regained the losses they suffered in 2022. In fact, they contributed around three quarters of the return of the US market over the year. As a consequence, global developed market returns were very strong, given that the US weight in global markets is around 63%. Value companies underperformed in the US (largely because of the overwhelming impact of the 'Magnificent Seven') but made a strong contribution outside the US. Both value and smaller companies outperformed strongly in emerging markets. Global commercial property (REITs) also delivered a positive return.

On the defensive side of portfolios, high quality, short-dated bonds have recouped over half of the falls suffered in 2022 - largely on account of the higher bond yields that caused the pain in 2022 - delivering returns similar to cash.

Figure 1: Global investment returns – asset class returns 2023 compared to 2022

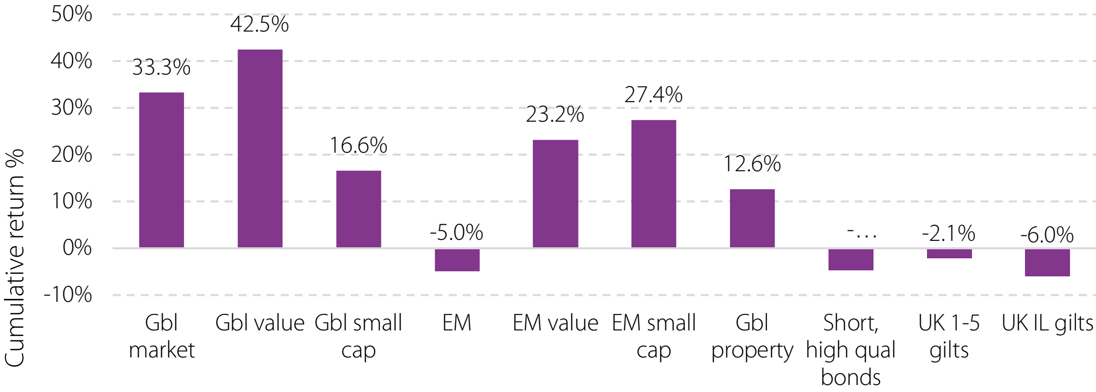


Data: Funds used to represent asset classes, in GBP. See endnote for details

Looking at three-year cumulative returns helps to illustrate the benefit of remaining invested through tough years such as 2022. Bond returns have been poor due to yields of around 0% at the start of the period followed by subsequent yield rises (and thus bond price falls) in 2022, but these headwinds were more than compensated for by strong growth asset returns.

[1] This includes: Apple, Alphabet (Google), Microsoft, Amazon.com, Meta Platforms, Tesla and Nvidia.

Figure 2: Cumulative global investment returns – three years to the end of 2023

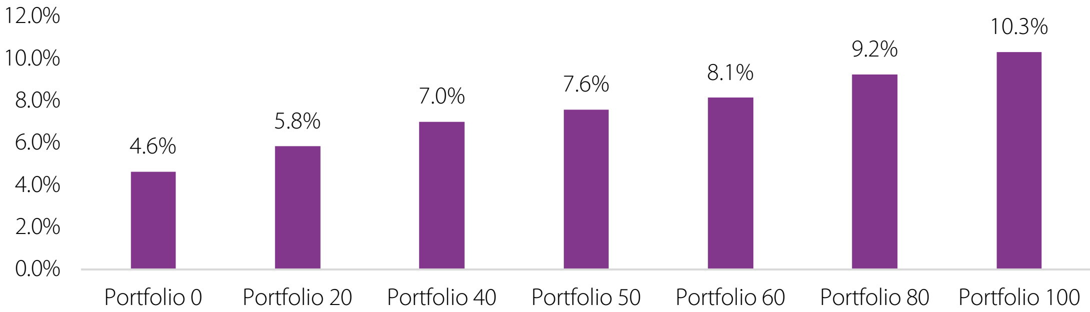


Data: Funds used to represent asset classes, in GBP. See endnote for details.

4. Fiscal model portfolio returns

At the model portfolio level, portfolios have delivered positive returns across the risk spectrum (to 31 December 2023), as the figure below reveals.

Figure 3: Fiscal Engineers Model Portfolio - 2023 [2]



Source: Fiscal Engineers. December 2023

The table below provides cumulative performance data to the end of December 2023 from inception.

Table 1: Fiscal Engineers Model Portfolio – cumulative performance Dec-2005 to Dec-2023

Cumulative	P0	P20	P40	P50	P60	P80	P100
1-Year	4.6%	5.8%	7.0%	7.6%	8.1%	9.2%	10.3%
3-Year	-5.3%	0.9%	7.4%	10.7%	14.1%	21.1%	28.3%
5-Year	-0.8%	9.6%	20.5%	26.2%	32.0%	44.0%	56.5%
10-Year	12.0%	30.1%	49.4%	60.0%	71.0%	95.0%	120.3%
Since inception	56.4%	91.9%	129.4%	150.3%	172.0%	219.0%	267.8%

[2] These represent fund level model portfolios (after fund OCFs and trading costs) but before any other costs for the year to 31st December 2023. They reflect all portfolio changes made over the period including the new global asset portfolio structures from November 2023. Note that individual client 'live' portfolio performance may vary due to actual holdings, last rebalance date, interim cash flows and adviser and platform costs.

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5. Outlook for the economy and inflation

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

Inflation has primarily been driven by explosion in the quantity of money as a pandemic response since March 2020. The velocity of circulation of money in the UK, eurozone and US which collapsed in the aftermath of the pandemic has recovered broadly to the pre-Covid trend so he would expect weakness in monetary growth to soften nominal GDP growth. This this could cause inflation to fall sharply and undershoot the Bank of England's target. Whilst the UK sits on the brink of recession the risk still exists that this could occur.

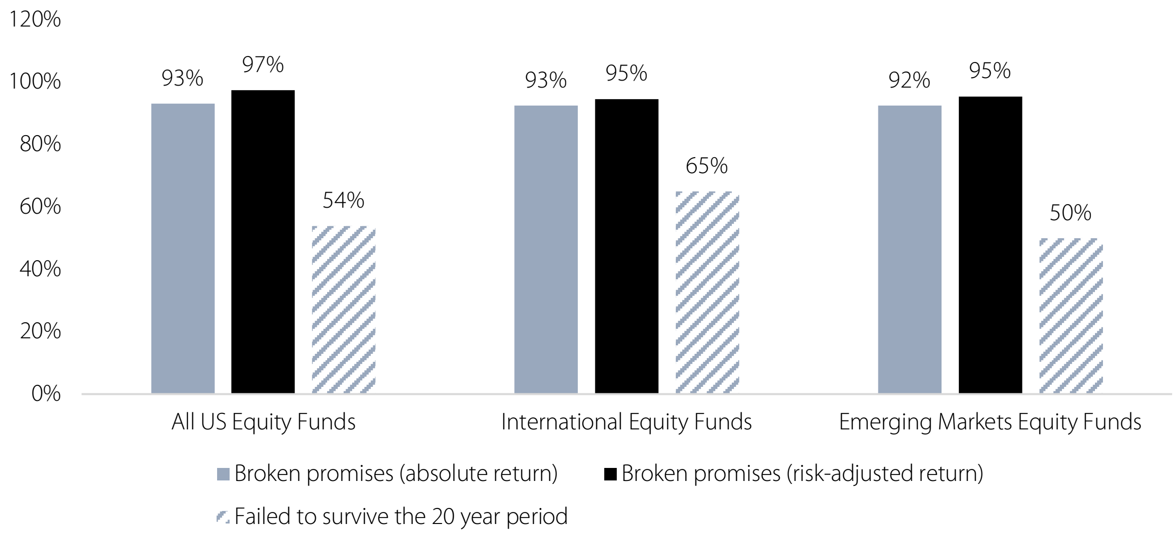
Lower inflation and interest rates could benefit gilts, highlighting their value and should be good for equity markets. The impact of global tensions (e.g. the recent conflict between Israel and Hamas in Gaza), continues to suggest that portfolios should be built for the long-term and knee-jerk reactions to short-term volatility, and trying to make tactical predictions, should be avoided.

6. Judgmental active managers failing to meet their market beating promises.

All active investment managers promise that through their insight and judgement they will deliver returns above their reference market benchmark index after the costs they incur, which include their own fees and costs (Ongoing Charges Figure or 'OCF' for funds in the UK) and the costs of trading assets in the portfolio.

The SPIVA® US Scorecard study has been undertaken for more than 20 years in the US and provides us with insight into what proportion of active managers break this promise after costs, or even simply survive the period. The latest US mid-year 2023 study was reviewed in the IRC meeting. Their record is not good. Take a look at the figure below.

Figure 4: Percentage of active managers breaking their promises over 20 years



Data source: SPIVA® US Scorecard - Mid-Year 2023 © All rights reserved.

Other studies tell the same story[3]. There are two key reasons why these results are so poor. The first is that active investing is a zero-sum game, meaning that every winner needs to be funded by a loser. After costs (usually between 1% to 1.5% for active funds), the majority of fund managers will deliver a return below

[3] Examples include Dimensional The Fund Landscape 2023, and Vanguard Research: The case for low-cost index-fund investing 2022.

the market. That is not supposition, simply the maths of the zero-sum game. The second reason is that markets do a pretty good job of reflecting new information into prices quickly and accurately. Prices will only move on the release on new information, which is by definition random.

Hoping to pick the few active managers that deliver on their promise of delivering skill-based returns is extremely challenging: some may simply be lucky, and so discerning and picking the skilled managers at the start of the period, without the luxury of 20/20 hindsight, is extremely difficult. The legendary investor Jack Bogle used to encourage investors not to try to pick the needle from the haystack, but to just buy the haystack!

The SPIVA® US Persistence Scorecard Year-end 2022 seeks to quantify whether good fund performance persists across time. As is evident in the chart below, only 20% of funds previously in the 1st quartile in green (i.e. top 25% best performing funds) remain in it in the second 5-year period. Even by chance alone you would expect 25% to remain in the top quartile.

Figure 5: Performance fails to persist (two non-overlapping five-year periods to end 2022)

1,892 equity funds 5 years to Dec-2017	What happened over the next five years? (Dec-2022)					
	Top	2nd	3rd	Bottom	Changed Style	Closed/ Merged
Top quartile	20%	18%	11%	12%	29%	10%
2nd quartile	14%	14%	11%	14%	34%	14%
3rd quartile	11%	14%	14%	13%	31%	17%
Bottom quartile	7%	8%	13%	13%	31%	28%

Data source: SPIVA® US Persistence Scorecard – Year end 2022 © All rights reserved.

Whilst it is very difficult to identify a truly skilled manager in advance of when you need them, it is actually quite straightforward to identify a good index fund today that is, in all likelihood, going to be a good fund over the years ahead. Systematic funds require a bit more analysis, which is undertaken in combination with Albion Strategic Consulting who sit on the IRC.

It is worth noting that Dimensional Fund Advisers revealed that over the past 20 years to 30 June 2023, of their US-domiciled equity and fixed income funds, 100% of their funds survived and 77% outperformed their benchmarks compared to 46% and 16% respectively for the industry[4]. That is a pretty good outcome.

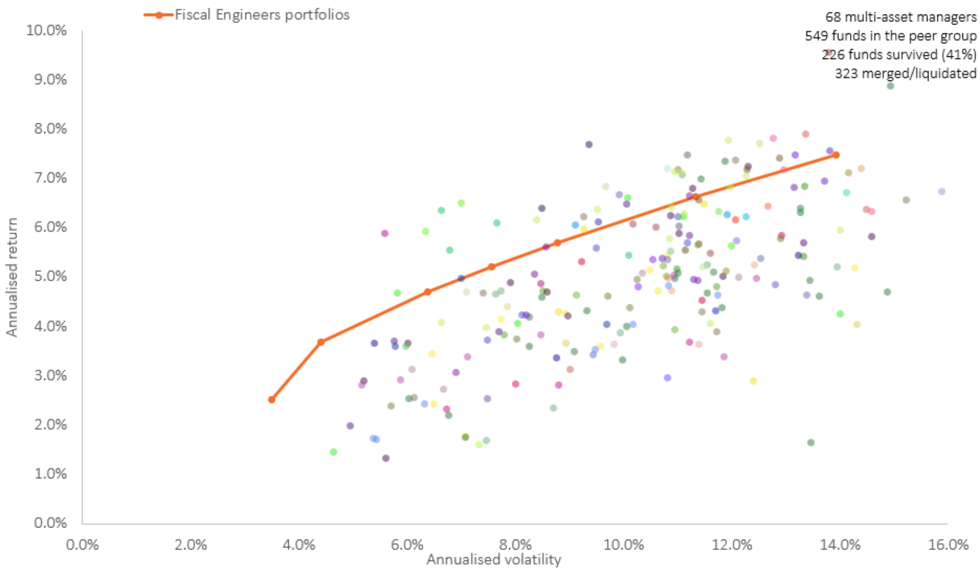
The chart below shows how Fiscal Engineers' systematic model portfolios have performed against a peer group of professional fund management firms offering multi-asset funds to UK investors along the risk spectrum, since Fiscal's model portfolios were first offered in December 2005. It reflects changes that have been made to model portfolios over time. The Fiscal performance track record is net of fund OCFs for suitable comparison purposes to this third party professional peer group of multi-asset funds. Client financial planning fees and platform charges are excluded to allow for an apples-to-apples comparison.

[4] Dimensional Fund Advisers. (2023). Pioneering Systematic Active Investing. Evaluating a Systematic Manager Series

Figure 6: Multi-manager peer group comparison Dec 2005 – Dec 2023

Performance vs peer group:

Portfolio	Funds beaten*
Portfolio 0	73%
Portfolio 20	95%
Portfolio 40	96%
Portfolio 50	95%
Portfolio 60	93%
Portfolio 80	92%
Portfolio 100	89%



Note: Risk-adjusted performance calculated using Sharpe ratio. Data source: Morningstar Direct © All rights reserved.

7. In conclusion

The IRC continues to remain supportive of the systematic approach adopted to managing client portfolios, the asset allocations of the portfolios and the funds used to implement them.

Process rigour and discipline contribute to delivering sensible market returns for the risks taken on in client portfolios. Diversification, rebalancing, low costs and the fundamental belief that markets – not people – deliver returns.

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

Fiscal Engineers' Investment & Risk Committee – February 2024

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

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