Your investment update

Q1 2025

Succeeding together

7IM

Capital at risk

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Contents

The best laid plans of mice and men...

Martyn Surguy

Chief Investment Officer

During World War II, Nobel laureate Kenneth Arrow joined a team of statisticians in the US Air Force to prepare medium-term weather forecasts. Shortly after, he tendered his resignation, disappointed at the inaccuracy of his work.

His Commanding Officer refused his request, saying he knew the forecasts were no good but still needed them for planning purposes. The same might be said for financial market forecasts... except they are not much help for planning purposes either.

Once again, the brightest market soothsayers failed to predict 2024 (ironically, this failure is one prediction we are usually right on): the trend was similar to 2023, which few professionals suggested.

Trying to determine the future precisely is a fool's errand. Years like 2024 sometimes make it feel it would be better to assume trends will continue and recent history provides the most reliable guide. However, trends rarely continue, in the long term. And when the music stops, the falls and damage to wealth can be brutal.

If a year were primed for a trend reversal, it was 2024. The geopolitical climate was febrile. More people voted in elections than ever before, and all incumbent governments were bruised (India) or ejected from office (US and UK). Key central banks had moved to rate-cutting mode, but the bond markets didn't seem to share their optimism on inflation as yields rose on the year.

Yet equities delivered - as long as they were US tech stocks: huge companies were best, and well over half of returns came from the Magnificent 7, like in 2023. Concentration won in a way few could predict – meaning diversification looked poor.

In recent years, we've done our best to ignore market predictions and avoid making too many ourselves. Instead, we've focused on building a sensible spread of assets to withstand any events. Don't ignore any region, sector or asset class; hold them *all* in controlled size.

This approach can come up short in years of extreme concentration, but it offers protection against the inherent market uncertainty and unpredictability. For us, missing out on some additional return from the short-term continuation of some pretty extreme trends is outweighed by the knowledge that sudden reversals will not be irrecoverable. Of course, we have a view of what "might" happen in markets, but positioning for that will never come at the expense of a well-diversified portfolio fully invested through time.

This course offers genuine underpinning and stability for our clients' futures. We don't want the unexpected or unpredictable to derail our clients' plans – after all, the impossible seems to happen increasingly frequently.

Next, you'll find my review of the year in markets and portfolios, then Ahmer digs deeper into the biased psychology of forecasting, and Sam reflects on what the fast food industry tells us about the world.

Enjoy reading!

Performance review: Calm in the storm

The serene progress of financial markets looked highly unlikely at the turn of 2024.

Never was there a bigger year for domestic elections with the political climate highly changeable. New governments seemed likely in many major economies with the return of the maverick President Trump a real possibility. Conflicts in Ukraine and the Middle East raged on. Global economic growth was challenged by a protracted period of higher rates. Inflation was proving stubborn, keeping bond yields elevated. Equity markets had just seen the narrowest leadership in history in 2023 with 40% of global equity markets, coming from seven primarily technology-related companies.

Fast forward to the end of the year and many, if not all, of those fears proved unfounded. Governments *have* changed, populism *is* at the fore and President Trump *will* be in the White House for a second term. Wars *have* continued, growth *has* slowed, and inflation *remains* stubborn.

And yet, financial markets have remained calm. Equity markets have delivered again with those same seven US companies again accounting for half of the entire global equity return.

Bond markets have delivered lacklustre returns with, unusually, yields rising in response to falling interest rates signalling an unwillingness to celebrate the conquering of inflation just yet. Crypto was a standout performer, and returns became supercharged at the end of the year with the prospect of a supportive President Trump – although it should be noted that there's still a lot of speculation involved.

Against this backdrop, encouragingly, absolute gains were the norm across all strategies. In real terms, wealth grew. Portfolios with higher allocation to equity tended to perform better, given the disparity between equity and bond returns. However, what proved rather more difficult was to beat broad market-related indices and benchmarks. >>

Martyn Surguy

Chief Investment Officer

"Against this backdrop, encouragingly, absolute gains were the norm across all strategies. In real terms, wealth grew. Portfolios with higher allocation to equity tended to perform better, given the disparity between equity and bond returns."

At the risk of repetition, it's worth restating the key drivers of investment performance. They are:

01 The opportunity set presented by financial markets.

02 The overall style and approach of the investment manager.

03 Manager skill in correctly interpreting market behaviour.

On the equity side for 2024, returns from US equity far outstripped any other region. It now represents over two-thirds of the global equity market. Within that, the Magnificent 7 were responsible for over half of those returns and, by themselves, now represent over one-third of the entire US equity market.

In performance terms, unless about a third of your portfolio was committed to those seven stocks, it's extremely improbable that portfolio returns could keep pace with underlying indices. Our overall style effectively prevents that occurring, as diversification lies at the core of what we do.

We're uncomfortable with skewing portfolios to one specific area or sector, let alone just seven companies regardless of recent history, or their undeniable quality.

In recent years, the rise in bond yields has seen fixed income investments become more attractive for multi-asset class investors. Overall returns, though, were, at best, pedestrian in 2024 as the spike up in yields on inflationary concerns at the end of the year dented returns. This proved to be a dampener for returns to multi-asset class investors – but fixed income remains the best diversifier available.

Manager skill should be an important driver of returns for more active mandates, and it is disappointing that we were unable to add the value we would have liked in this area. Our strong belief in diversification was compounded by a tactical belief that a more equally weighted approach to an element of the US equity exposure would be prudent. This is a belief we continue to hold, along with a number of other diversifying tactical sector allocations.

We completely acknowledge the frustration which can accompany periods of high concentration, but looking forward, we remain absolutely committed to a diversified investment approach. For the vast majority of history, diversification has proven to be the most sensible way to manage money – missing out on some of the very good years in order to avoid the pain in very bad years. We're confident that our positioning and style will be well rewarded from here as returns broaden out and interest rates continue to head down.

We welcome your feedback on our investment update and look forward to keeping you fully informed in 2025.

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Profiting from the expected and unexpected

Ahmer Tirmizi

Head of Fixed Income Strategy

What do engagement rings, wine lists and digestive biscuits all have in common? How about if I include an anchor as well?

Confused?

Let me explain. Most people are familiar with the idea of spending a month's salary on a ring[1], many will have all experienced the temptation to avoid the cheapest bottle of wine on a menu[2], and *everyone* is aware that digestives aren't as big as they used to be[3]!

What they have in common is being real-life examples of *'anchoring bias'*. We take the first piece of information we come across, and that becomes our baseline. I *should* spend *x* on a ring, this second bottle of wine *should* cost *y*, a digestives packet *should* be this price, whatever its size.

And, as ever with human behaviour, it crops up in the investment world too. As we enter 2025, it's hard not think about year-ahead projections as an obvious culprit. Use what happened last year as an anchor for what will happen in the next 12 months. Politics a little volatile this year? Expect the same. Growth slowdown? Tough times ahead. Good year for markets? Expect another.

The trouble with this line of thinking is that it belies the way markets actually work. While markets tend to deliver an *'average return'* (e.g. people tend to think of equity returns as an 8% average over the long term), there are some *huge* swings around this average. And these swings are driven by surprises – which, by definition, you don't see coming (see 'Equity returns aren't stable' box)!

The nature of surprises

First, let's consider equities to see this.

For markets to deliver *more* than the elevated expectations, the possible drivers of this are endless. It could be something on the horizon – a borrowing binge, or maybe Trump's new administration decides to turn on the stimulus taps. Or it could be something less obvious – perhaps a new technology makes energy incredibly cheap, or something like Putin retreating. All are plausible. >>

[1] The idea that we spend a portion of our salary on an engagement ring is surprisingly recent https://www.theatlantic.com/international/archive/2015/02/how-an-ad-campaign-invented-the-diamond-engagement-ring/385376/

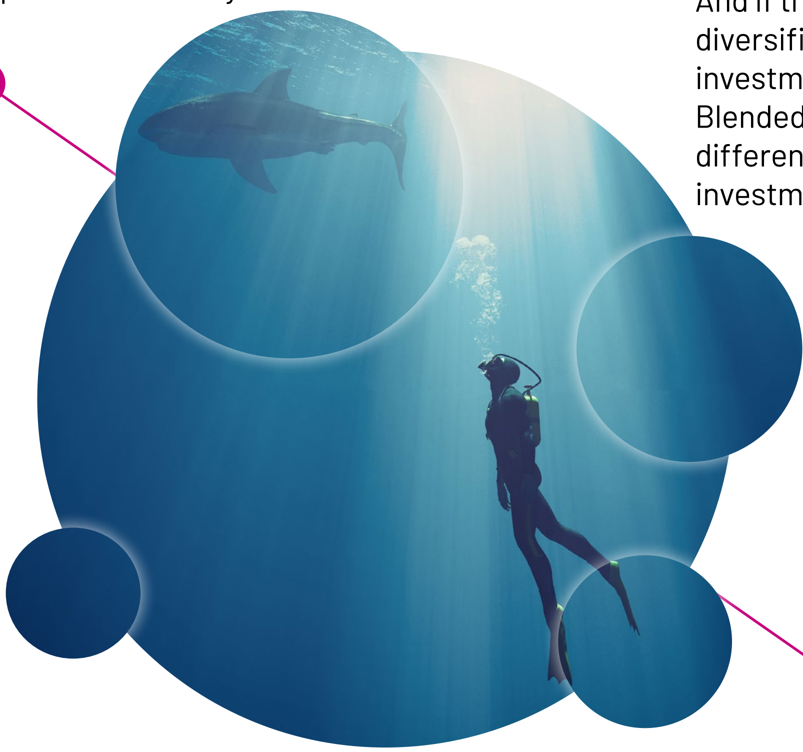
[2] We use the first bottle as a baseline, but don't want to look cheap

[3] Shrinkflation in digestives is rife. Since 2014 the size of digestives has reduced by up to 28%! https://www.bakeryandsnacks.com/Article/2024/09/05/5-uk-products-hit-hard-by-shrinkflation/

And for markets to fall from here? Maybe higher interest rates finally start to bite. Or perhaps the anti-trade policies coming from the US eat away at profit margins. But there are less obvious outcomes too – tech regulation comes in or maybe Putin expands even further. The possibilities can become endless.

And how about bond markets? While bond markets swing around less than equities do, are the actions of central bankers any more predictable? It can seem tempting to believe that they are – after all, if you knew the mind of Andrew Bailey, surely there'd be an advantage?

Well, unfortunately the same anchoring problems apply – you've just moved them onto someone else's plate! Central bankers are as human as the rest of us, and therefore just as susceptible to surprises. Maybe inflation takes off again, as tariffs bite. Or maybe growth slows so much that rates need to fall. Or a war. Or a food crisis. Again, there are too many possibilities to lay out.



The point is that worrying about the *causes* of big swings is less important than accepting that they will happen from time to time. And most important of all is to understand how portfolios might react when those surprises do happen. We want to avoid anchoring on what *has* happened (and why), and think about what *might* happen, and what it would mean.

Profiting from the expected... and the unexpected

If market returns are driven by surprises which are inherently difficult to predict, then how should we build portfolios?

First, it is important to remember that even if nothing surprising happens that's not too bad an outcome! Equities should appreciate a little, and pay a bit of a dividend, while bonds will pay a coupon. If the world goes exactly how markets are expecting, it still pays to invest.

And if the surprises come? Portfolio diversification is the best weapon. Different investments are affected by different surprises. Blended carefully, they can push and pull in different directions, leading to a smoother investment journey. >>

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So, in average periods, everything should do ok. German government bonds, and Japanese industrial shares, and British energy company debt, and Indian tech firms (etc., etc.) all chug along nicely. During periods of upheaval, some investments may falter, others will thrive, and others may hold steady – the good and the bad cancel each other out; and the whole portfolio should end up at average (or ideally just above).

At 7IM, we assemble portfolios with this principle in mind. We incorporate Alternatives into the mix, broadening the range of responses to unexpected events. By combining asset classes that react differently to different surprises, we aim to smooth client returns over time.

Anchoring is a natural tendency; markets often extrapolate recent trends, making unexpected outcomes difficult to anticipate. As we enter 2025, we acknowledge the challenges the year will bring.

There's political upheaval at home and abroad, there's technological upheaval everywhere, and higher interest rates still pose a challenge. Any of these forces, plus others, could lead to surprising outcomes. But rather than trying to predict surprises, we focus on building portfolios designed to perform, no matter what the future holds – and no matter where our brains might have anchored!

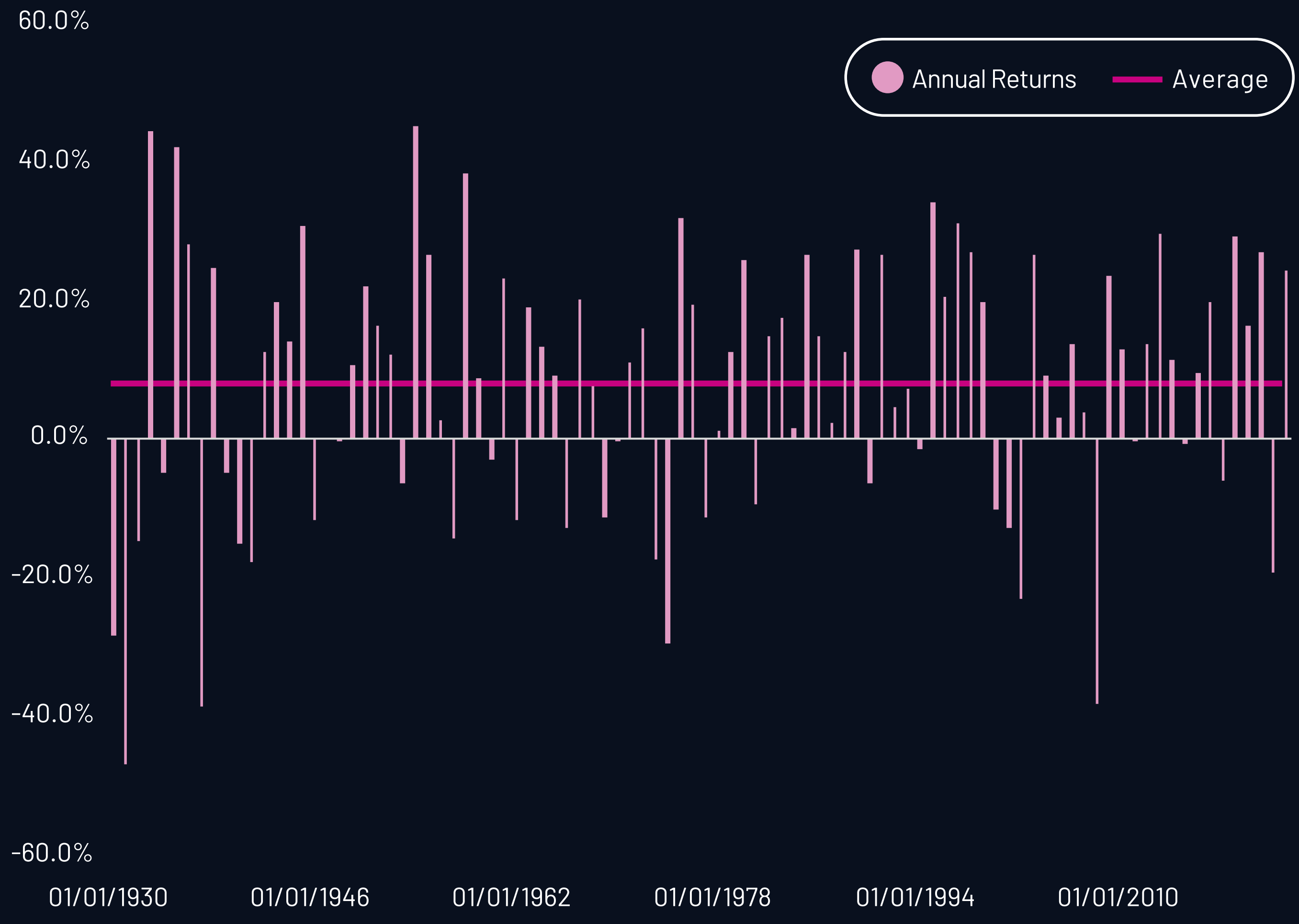
To try and circumvent our brains' tendency towards emotion, we build statistical models which strip the psychology away. We let these models (built without reference to short-term noise) tell us when there might be chances to move portfolios significantly. At the moment, they're suggesting that there's nothing too extreme out there in the world, so accordingly portfolios shouldn't be extremely positioned. Hence a reasonably neutral equity and bond allocation, spread around the world. We're letting the market currents do the work for now and keeping an eye out for opportunities. >>

Equity returns aren't stable

Markets can swing wildly away from the historical average. Take the S&P since 1930. It has delivered an average annual return of 7.7%, but it very rarely delivers this return. Out of the 94 years on record, almost one-third were negative years, while over half were double-digit returns, way in excess of the average.

FIGURE 01

S&P Annual Returns vs Average



Source: Bloomberg Finance L.P.

Fast food economics

As a native of South-East London, I was basically raised on pie and mash. As I got older, that habit morphed into an addiction to the local fried chicken shop, especially after closing time at my grandparents' pub...

Sam Hannon

Investment Manager

And I'm not alone. Fast food is part of modern life, now more than ever. The first McDonald's arrived on our shores in 1974 (in Woolwich, just round the corner from me – I never had a chance!), and since then high streets across the UK have become saturated with ways to get fed fast.

This rise in popularity has led to lots of controversies about fast food: the role it plays in the obesity crisis; the sometimes-poor working practices, or simply the culinary offence it causes some people! And now, the fast food industry is *even* getting some heat in its spiritual home, the USA. Health secretary-elect Robert F Kennedy has personally vowed to clean up American diets, although I do wonder whether shifting the president away from his daily burger might be too tough a task...

Of course, behind the chips, double-stacked burgers, and those mysteriously delicious "nuggets", fast food is a huge industry that both shapes and is shaped by the way we live. Forget business school – hit the high street on a Friday night and you'll see a streetwise masterclass in menu psychology, profit margins and advertising. >>

So, with my ~~Burger King crown~~ investment hat on, I thought I'd take a deeper dive into what we can learn about the world from the front line of consumption culture. Let's tuck in!

The increases in the price of food post-Covid have been some of the most tangible signs of the inflation problem (alongside petrol and heating). Our weekly shops have skyrocketed, with the average spend for a family of four rising from £82 to over £115 in the past two years.

And yet, 45% of UK consumers eat at a fast food outlet at least once a week. Because people tend to buy MORE fast food when they have less money. People see fast food as a **necessity**, rather than a luxury good.

Why is that? Why not stay at home, cook for themselves, and save the pennies for a future day? The answer lies as much in our minds as it does in our pockets. I think of it as the three Cs: convenience + consistency + cost.

Let's start with **convenience**. We all know there are limited hours in the day. The average total time spent at a fast food outlet equals 5 minutes and 43 seconds (the exact length of *Imagine* by John Lennon). The average time spent doing a weekly shop being around 43 minutes (the same length as Taylor Swift's entire *Fearless* album). And that's without factoring in the cooking time. That ease, that speed, that convenience is hard to ignore, especially with delivery services making it easier than ever.

The **consistency** effect is also key, because our brains hate surprises. We like reality to match our expectations, and fast food is incredible at doing that. Whether you buy a Big Mac in Beijing, Rotterdam or Woolwich, you *know* you are getting the same thing (see Big Mac Index section on p. 13). People tend to have their 'order' which they stick to throughout their lives – and when fast food firms change things, it usually backfires; McDonald's changed its chip recipe in 1992, and certain members of my family are still livid. >>

"And yet, 45% of UK consumers eat at a fast food outlet at least once a week. Because people tend to buy MORE fast food when they have less money. People see fast food as a necessity, rather than a luxury good."

Lastly, there's **cost**. Most people don't apply full budgeting to every purchase. Instead, they rely on instinct. And our brains are wired to feel amazing when we get a discount, which silences the devil on our shoulder. This behavioural instinct is pounced upon by fast food businesses; with every item a 'mega-box' or a 'combo-discount' deal.

And importantly, it isn't just the cash price that's the "cost". It's the cognitive cost of doing something else; ever had a long discussion with your family about what to cook, and then ended up agreeing on a takeaway?

That's at play every time you're staring at the neon menu board.

Fast food knows how to keep things simple and takes advantage of our lack of processing ability. A frictionless transaction vs half an hour chopping onions and garlic? No brainer.

Taking each part of the fast food equation into account, you can see why people turn to the local chicken shop or drive-thru when they are pressed for time, strapped for cash or just *done* with thinking for the day.

As a £22 billion industry, fast food isn't going away – even in the face of higher living costs. Eat-in restaurants will struggle when pennies are pinched, but chicken shop psychology means their takeaway equivalents will be just fine. >>

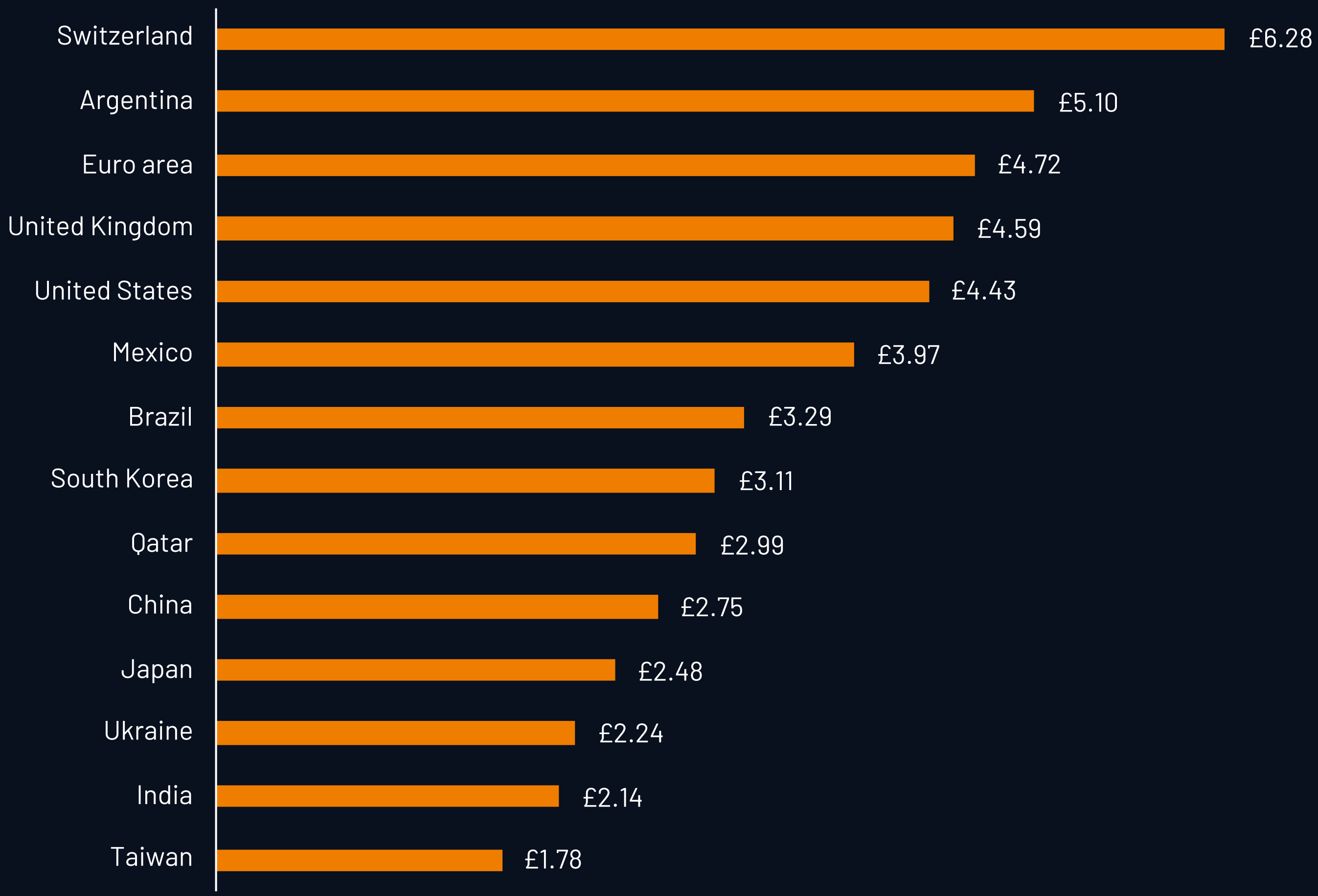
The Big Mac Index

The consistency of fast food across the world has some benefits (not just to our stomachs). Since 1986, The Economist has published the Big Mac Index, comparing the price of this iconic burger across the world.

You can do all sorts of fun economics analysis using the Big Mac as the "standard" – but here we'll just show you where's pricey, and where isn't. Taiwan is where you want to go to get the most bang for your buck, and Switzerland should be avoided.

FIGURE 02

Price of a Big Mac in Sterling



Source: The Economist/7IM. Data as of July 2024

Meet the teams

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ACA Chartered Accountant, MCSI, CISI Level 4, 37 years of industry experience.

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