Your investment update

Q4 2024
Succession Model Portfolios
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Capital at risk

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Changing of the guard

What's laughingly called the British summer has seen several important changes in financial markets if not the relentless pattern of rain and cloud.

Martyn Surguy

Chief Investment Officer

There is a famous saying often used in investment that a portfolio manager's job is not to predict the future, but to prepare for it. For several quarters we have been preparing for a world where interest rates begin to bite, the gloss comes off the Magnificent 7 technology stocks, which were carrying all before them, and proper diversification begins to work.

Many of these conditions began to appear during the summer as economic growth slowed somewhat, technology performance stalled and major central banks began to cut rates. Long overdue, in our view, but encouraging nevertheless. Our core principle that our clients should own a sensible spread of assets and not be exposed to unnecessary concentration risks has been rewarded. Attention has switched to areas of the equity market such as healthcare and a broader array of decent performers.

Bond yields have begun to fall as rates and inflation have both come down – a good environment for our fixed income investments (which Ahmer explores later on through the lens of nursery rhymes).

The good news is that we don't believe this is a flash in the pan. Interest rates will continue their journey down for the balance of this year and next. Inflation is under control. The global economy, led by the US, is slowing but growing. The attractions of a more equally weighted or diversified range of sector and country-based equities should be increasingly evident.

Of course, there is always the prospect of a fly in the ointment. This is most likely to come from geopolitics, given the marked deterioration in news flow across the Middle East. We're watching the situation there closely (as Ben explores in his piece). The US presidential election too has the clear potential to bring some turbulence.

The negative of Trump's tariffs may be offset by a more benign corporate tax and regulatory environment. Kamala Harris offers more stability and continuity with policy.

In any event, the lesson of history is that volatility is likely to be short-lived. A strategy based on the outcome of an incredibly tight race is unlikely to be successful. The sensible spread of assets should win, though.

Enjoy reading!

A steady quarter as turbulence returns

Listening and responding is one of our core values. We like to think we've done exactly that in introducing this section to our quarterly update. The feedback we received was that we talk about everything except the scorecard to judge whether our views actually work!

Martyn Surguy

Chief Investment Officer

The reason for the omission is absolutely not from a desire to conceal or obfuscate, but rather the potentially misleading nature of generalisations. Our clients straddle a variety risk profiles. The more aggressive cohort is keen to solve for outright growth, while clients at the more conservative end of the spectrum prefer a much smoother investment journey with more modest growth. Similarly, while all portfolios are underpinned by a well-established long-term plan (or Strategic Asset Allocation, to use the jargon), there are degrees to which either a tactical or a stock-picking dimension or both are added to the mix. Naturally, that leads to different outcomes for each group.

Notwithstanding some of the limitations, it is right that we respond to feedback and provide some clear drivers for the performance of portfolios. The good thing is that we do believe in complete consistency of views and implementation across the assets we manage, which should help in explaining how we've been getting on. All our clients are exposed to our best thinking – if goals and attitude to risk are the same, then the portfolio should be very similar.

At the outset it's important to recognise that investment performance is essentially a function of three things. First, the opportunity set that is presented at broad market level – i.e., it's difficult to generate positive returns if all markets are going down. Second, the style and approach of the investment manager – our own preference is for highly diversified strategies with no major skew or concentration to any one region or sector. And finally, returns are a function of our skill in correctly reading market and asset class behaviour. Client returns will always be the product of these three factors. >>

> Looking ahead, we believe the outlook for portfolios is positive. Market behaviour has turned. "Rotation and rates" could be our three-word slogan."

In terms of opportunity set, 2024 has been a strong year with global equity markets delivering double-digit returns. The US has been the standout performer, driven by exceptional performance from the Magnificent 7 technology stocks returning over 30%. However, the summer months have produced much more modest returns with the US posting a flat return and the Magnificent 7 actually negative in sterling terms.

Fixed income markets have found the going much tougher, with negligible returns in 2024, and most of that return coming in the last quarter as inflation subsided and bond yields moved down as a result.

It's been an encouraging quarter for our strategies. On the equity side, the headwinds for well-diversified strategies by the best performance being compressed into very few stocks has begun to abate. Our preference for a more equal weighted approach (particularly in the US), together with the attractions of healthcare, has been well rewarded after a protracted period in the doldrums.

On the fixed income side, our conviction in lower interest rates and fading inflation has played out well. This has seen decent gains for our broadly based bond strategies encompassing sovereign, corporate and higher yielding debt.

Portfolio positioning has been successful in the last few months. We've seen returns around the 2% level or slightly better. More conservative, bond-heavy strategies, have been supported by strong bond returns. Higher-risk, more equity focused, strategies have benefited from the broadening out of equity returns and better healthcare performance as mentioned above. On an annual basis, however, there remains some catching up to do.

Looking ahead, we believe the outlook for portfolios is positive. Market behaviour has turned. "Rotation and rates" could be our three-word slogan. Equity returns should further broaden out as the relative growth of the Magnificent 7 approaches its limits. A steady sequence of interest rate cuts with a benign inflation outlook should also support the fixed income side of portfolios.

We would welcome your further feedback on this new section and look forward to keeping you fully informed in the quarters ahead.

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Interest rates – neither up nor down

By the time you're reading this it'll probably be time for Nursery Rhyme Week, the biggest date in the calendar for parents with young kids.

Ahmer Tirmizi

Head of Fixed Income Strategy

It's not often we start an investment view around old nursery rhymes. But it's hard not to think of the Grand Old Duke of York when contemplating monetary policy. The apparent meaning of the rhyme was to express the futility of military action. And as we embark on a new cutting cycle, there are questions over the effects of monetary policy. The Bank of England spent almost two years climbing the interest rate hill, spent a year atop and looks to be marching interest rates back down again.

And for what? By the end of next year, interest rates will be back to where they were in December 2022. Were the set of hikes up to 5.25% necessary? Did holding interest rates at 5.25% for almost a year make any difference? Was any of it required?

These questions are crucial for cautious clients. The actions of global central banks have had material impacts on their short-term performance. As interest rates rise, bond prices fall. And Cautious portfolios hold bonds which during 2022 meant that as interest rates went up by more than expected, portfolio values were impacted by more than expected.

What should those clients do now? It partly depends where on the hill you think we are. To answer that question, we need to look how we got marching up in the first place. >>

01

For years, there was no hill in sight

Not that long ago that rates were close to zero, and it felt like we'd be there for a long time. Since the 2008 financial crisis, the economy had been in repair mode. The result was that the factors that traditionally drove inflation were pushing it down. Consumer confidence was low holding down prices. House prices were stable compared to the buying frenzy of the early noughties. Global trade was still flowing smoothly. Commodity prices had not just fallen but crashed. And governments kept a lid on their own spending. Together, these factors kept interest rates low. And it looked like each of each of these factors would stay as they were. Surely, there was nothing on the horizon that would reverse any of these factors?

02

Covid turned the hill into a mountain

And then Covid. Not only did one or two factors reverse, but they all did. Consumers suddenly found themselves with deep pockets following the initial lockdown and proceeded to spend on anything, on everything, pushing up prices everywhere. The lockdowns drove a new frenzy of homebuying as those living in cities suddenly found the need for a study and a garden. At the same time, lockdowns shut down factories across the world stymying global trade putting up the price of goods in short supply. Despite the price of oil moving temporarily negative, prices climbed higher culminating in the surge around the Russia invasion of Ukraine. All the while governments spent record amounts of taxpayers' money on bailing out economies they thought would be in indefinite lockdowns.

One factor, by itself, will have been enough to push prices higher. But each of these factors came, one after the other, pushing prices higher and higher. And so, up the interest rate hill we went. >>

03

It felt like we'd never come down

The effect of so many things happening at the same time gave the impression that this was structural, or even permanent. Fear of a 1970s-style wage/price spiral gripped investors. There was talk of central banks changing their inflation targets from 2% to something higher (the economists' way of saying higher inflation might be permanent). And some had just resigned themselves to higher rates – after all, we managed it in the 90s.

But this isn't the 90s. The idea that we've gone from near zero to near five overnight is not realistic. Some of the factors on the list might have changed somewhat, the trade war between US and China is ongoing while commodity prices have a long-term carbon transition tailwind. However, wherever interest rates land over the next few years, it's unlikely we need to stay on top of the hill forever.

The Bank of England (BoE) thinks so too, feeling confident that it can start reducing interest rates even with inflation above 2%.

> We started the descent in August and are looking to move down towards 3.5% by the end of 2025. What does this mean for investors? Well, the last year has shown why cash is such a suboptimal investment."

04

Investors like being 'neither up nor down'

We started the descent in August and are looking to move down towards 3.5% by the end of 2025. What does this mean for investors? Well, the last year has shown why cash is such a suboptimal investment. The temptation is to hold cash given it has risen to a generational high, sit it out until it comes back down and then rotate into other investments.

The flaw in this logic is that markets aren't waiting for you to get back in. Apart from fleeting moments of panic, investors are better placed to allocate their capital to investments that are designed to deliver returns above cash. Government bonds, corporate bonds and equities amongst others. These assets are pricing in moves in cash rates before they happen. To illustrate this, look at UK and US long-term bonds the year leading up to the first rate cut by each central bank. US bond yields fell by 1.3% from their highs and UK bond yields fell 0.7%. Remember bond prices move in the opposite direction to yields. So, investors who chose to sit in cash rather than invest have missed out on substantial capital returns.

We wouldn't advocate just investing in one asset, but rather a blend of assets that align with your risk tolerances. Take the AAP Moderately Cautious, which contains a mix of bonds and equities. It returned 9.89% in the year leading up to the first BoE rate cut. That's almost double what a cash investor could have received. It's not surprising that a blend of assets designed to beat cash, did beat cash. >>

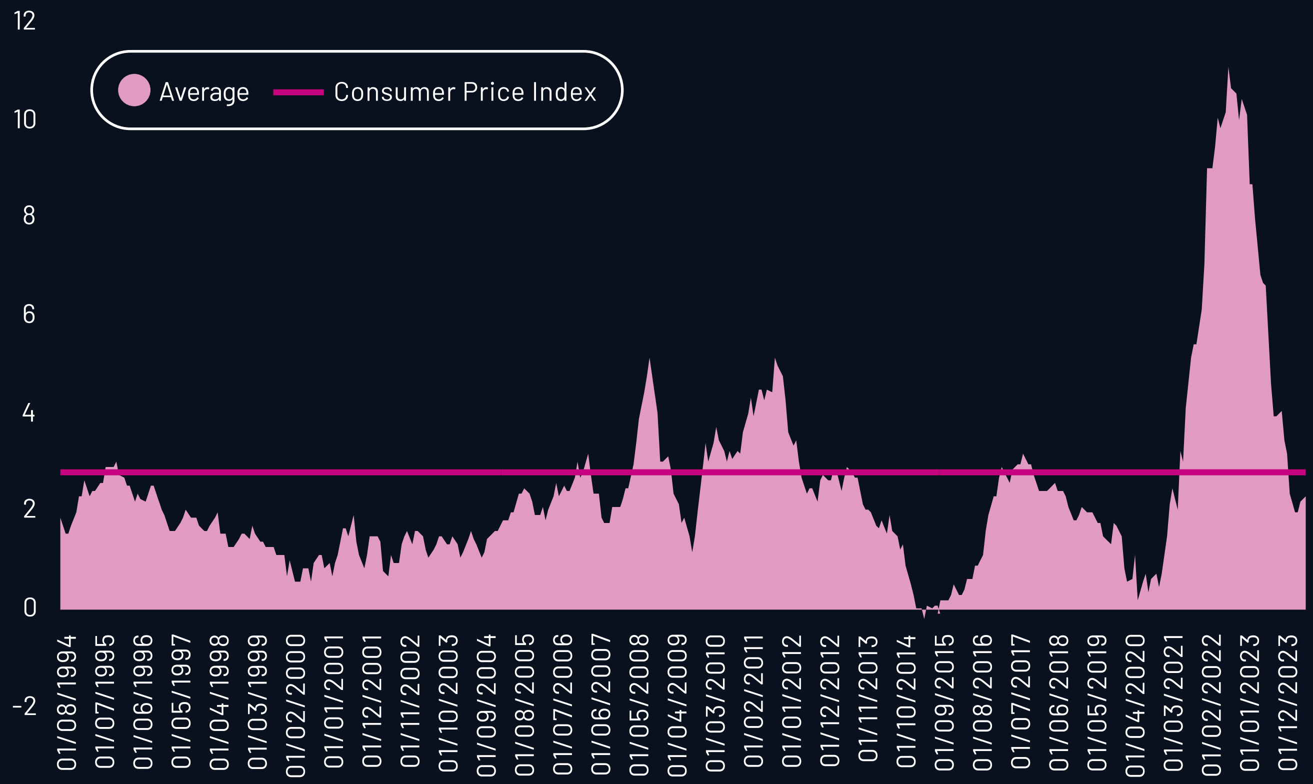
The good news is that it's not too late. Cash rates still have a long way to come down, and as they do other assets will deliver cash plus returns making it crucial for those still holding cash to move into investments. So, it turns out no matter where we end up on the hill, you'll still be better off.

Inflation returning back to long-run average

An extraordinary set of forces conspired to push inflation higher post-Covid. During lockdowns, consumers spent most of their income on goods. Those same lockdowns stymied the flow of global trade. Together these pushed prices higher. House prices rose by double digits. Commodity prices surged. And government stimulus hit record levels. This pushed inflation towards double digits. But two years later, we are now back to long-term averages. The question is how far will the BoE cut interest rates? Whatever the answer, investors shouldn't wait to find out. Those holding cash should consider rotating into investments instead.

FIGURE 01

UK Consumer Price Index (CPI) vs Average



Source: Office for National Statistics

Conflict: buy on the sound of cannons?

Ever since we left lockdown, the world feels like a more violent place. A military coup in Myanmar in 2021, Russia's invasion of Ukraine in 2022 (plus the Taliban retaking of Afghanistan), Sudan and Gaza in 2023, and now further attacks throughout the Middle East.

Ben Kumar

Head of Equity Strategy

With the exception of interest rate movements (and Brexit, back in the day), *nothing* creates more incoming calls and emails from investors than conflict.

It makes sense; we react to what's in front of us. In previous decades it would have been the marching of boots, or the rumbling of tanks – now it tends to be the trails of rockets in the night sky which herald another clash. Pretty provocative.

And there are always two questions I'm asked.

01 The first: *"is the world about to end, and will my portfolio survive?"*

02 The second: *"is it time to buy defence companies?"*

Both ***completely understandable*** reactions – and both worth exploring.
>>

Is the world about to end, and will my portfolio survive?

The glib answer is – of course – that so far, the world hasn't ended.

But that isn't the whole story.

Because there *are* assets which will be affected by conflicts. The sanctions applied to Russia following the invasion in 2022 rendered most Russian investments worthless in international portfolios. Occasionally, currencies will implode as investors lose confidence.

At the same time, other assets might do well. If supply is affected in some key good – wheat, or oil, or semi-conductors – prices might well rise. Or if a certain company is suddenly unable to operate, its competitors might get a leg up. But again, *owning* something, just in case of gunshots across the border isn't a sensible investment strategy.

We make a big thing of diversification at 7IM. The more widely we spread your investments, the less likely we are to be over-exposed in any given area. That comes with a caveat, though – because we invest widely, we almost certainly will have *some* exposure in the affected area.

That's the trade-off. A tiny bit of your portfolios was in Russian assets in 2022 – wiped out, gone, not coming back. But you also had a chunk in large UK oil companies, which had their best year in decades.

We're fighting lots of different battles. And while we might lose the odd one, the aim is to win the war. >>

Should I buy defence companies?

Is there a simple equation? War = Defence Stock Boom?

Well, there's certainly a market. In 2023, the world spent $2.4tr on defence[1]. That was 6.8% more than 2022 – which is an extra $150bn. A huge pool of money, and it's been growing fast. Partly, that's been a response to Ukraine and more recently, the Middle East.

But investing in defence stocks isn't *quite* as simple as buying more when there's more fighting. The real driver of returns is a willingness from governments to increase military and defence spending on a structural basis – securing the funding (i.e., profits for the companies involved) over a decade, rather than just a quick order for a few extra tanks or missiles.

The real route to corporate success is being part of the long-term security infrastructure that supports global peace and stability. And if the rate of growth (6-7%) per year continues, then that's hundreds of billions up for grabs in the next few years. The NATO agreement (and hence US Presidential election) will impact that too.

Now, it's ~~tough~~ impossible to accurately predict specific geopolitical events (hence the diversification point above).

But my simple rule is that governments tend to solve for the most recent past crisis. And recently, the Western world found itself underprepared for three things:

- Pandemics
- Oil supply shocks
- European wars

So guess what... Pandemic planning is being beefed up, energy infrastructure is feeling the love, and defence departments are getting a lot more funding.

Unfortunately, a lot of that news is in the price already – at the time of publication, the MSCI World Aerospace and Defence index is up 55% since the start of 2022, while the broader global index is only up 14%.

That doesn't mean there isn't more to come; and our diversified investment approach means portfolios probably have a *little* more than the industry average in companies like BAE Systems, SAAB (they no longer make cars) and Qinetiq (a UK Ministry of Defence spinout). >>

[1] 2.3% of global GDP https://www.sipri.org/sites/default/files/2024-04/2404_fs_milex_2023.pdf

But going back to what governments are spending money on, there are plenty of other structural opportunities which can be just as interesting. Pandemic preparation needs healthcare companies. Industrial energy transitions need raw materials.

Yesterday's headlines can be just as good an investment opportunity as today's - if you can take the long view.

> The real route to corporate success is being part of the long-term security infrastructure that supports global peace and stability. And if the rate of growth (6-7%) per year continues, then that's hundreds of billions up for grabs in the next few years."

The ethics of defence

One interesting nuance to note is that the recent trend towards ethical investing has led to a little bit of a lack of equity investment in the defence sector. Early ethical screens excluded defence stocks almost without thinking.

That's changing. When he was Defence Secretary, Grant Shapps suggested that it was in fact *unethical* for ESG investors to avoid defence stocks – as world peace relied on them. It's a bit of a stretch to say that view has *fully* taken hold, but signs are that this is changing. European ESG funds have more than doubled their defence holdings since 2022, and a recent study by HanETF[2] found that 94% of wealth managers now consider defence stocks to be eligible for ESG portfolios.

[2] https://hanetf.com/periodic-reviews/thematic-digital-assets-review-h2-2024/

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