Investment Review

Q4 & Full Year 2021

Q4 2021

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1. Summary

- US shares outperform global markets, again.
- Roller-coaster year for fixed interest ending slightly lower (as expected).
- Inflation rates continue to climb but gold doesn't care.
- High fund flow into 'responsible' investments but are they meeting investor aims?

Unbelievably 2021 has come and gone in the blink of an eye. Investor confidence has continued to grow for the most part as the pandemic gets under control. The effects of the economic disruption though have not yet washed through, with the result being high headline inflation that we hope will prove temporary.

It has paid this past year to take extra risk in markets, as the traditional negative relationship between shares and fixed interest investments has played out, after years of moving in a similar direction. The TINA acronym has emerged (There Is No Alternative) in regards to the limited options available to investors who hold cash or are positioned defensively but also need to target inflation beating returns to protect the real value of their wealth.

2022 may prove to offer more of the same as interest rates rise but the economic recovery continues, the caveat being whether inflation becomes stubborn and impacts on consumer and business demand.

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- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

2. Market Performance (Year to Date)

Asset Class	Index	Q4 2021	Full Year 2021
US Shares	S&P 500	10.4%	29.3%
World Shares	FTSE World ex UK	7.0%	22.2%
UK Shares	FTSE All Share	4.2%	18.3%
European Shares	Euro STOXX 50	4.0%	15.7%
UK Commercial Property	FE UK Property Proxy	5.3%	13.6%
Japanese Shares	TSE Topix	-5.2%	1.7%
Emerging Market Shares	MSCI Emerging Markets	-1.8%	-1.6%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	-1.2%	-2.0%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	0.6%	-3.3%
Gold	S&P GSCI Gold Spot	3.5%	-3.4%
UK Gilts	Bloomberg Sterling Gilts	2.5%	-5.3%

Performance Data: FE Analytics in GBP to 31/12/2021

UK Shares

The FTSE All Share rose 4.2% in Q4 and 18.3% year on year (yoy). With soaring oil and energy prices as well as rising interest rate expectations proving a tailwind to the banks, the index was well positioned to benefit given the weighting of these respective sectors.

October data showed the UK recovery at 99.5% of pre-Covid GDP levels[1], though there may well be a setback as the latest Covid wave led to greater economic restrictions. The economy will no doubt feel friction this year as inflation impacts disposable incomes and supply chain disruptions remain in many industries.

Global Shares

Japan outperformed all major markets this quarter rising +7.2%, which represents the region's entire gains for the year. This is attributed to much improved progress in vaccination rates, with over half of the population now 'double jabbed'. Further, there is a pending change of leadership, expectation for extra economic stimulus and also the country's focus on exports drove higher economic activity as global demand returned.

Asia (excluding Japan) and Emerging Markets have had a difficult time overall as the large weighting within the indices towards China impacted negatively, which we discuss later. The Asia Pacific region is now negative on the year -0.8%, having been one of the strongest markets during the darkest days of the pandemic.

[1] www.ons.gov.uk

Fixed Interest

Q4 was surprisingly positive for UK gilts and corporate bonds, despite the talk of rising interest rates. Over the year though it has been a rollercoaster, with the lowest point occurring in the gilt market in October when values fell -9% before rallying to finish the year -5.3%. The current yield on a UK 10-year gilt is 1.1% (significantly below inflation) compared to just 0.3% a year earlier, but the market is not suggesting rates are going to rise significantly and there is arguably a limit to which they can because of government debt positions. As interest rates rise this year fixed interest could drift lower but we suggest not rapidly as was the case in 2021.

Alternative

There are a couple of alternative investments to briefly mention, both linked to the current inflation story. Physical gold has long been associated as an inflation hedge but the precious metal is lower in value -3.4% over the year (in £ terms) despite inflation being the highest in 30 years. It is hard to see what has changed.

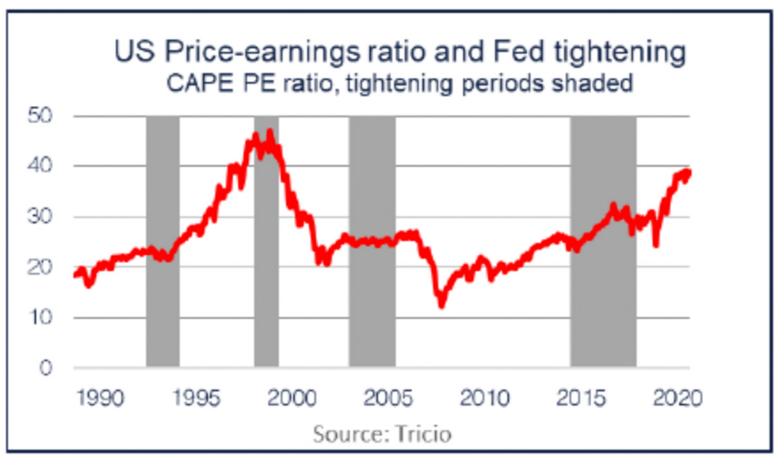
Possibly, various cryptocurrencies, in particular Bitcoin has become the new kid on the block, taking up the role as an inflation hedge as it is being popularised with similar characteristics as gold i.e. decentralised and finite supply. Certainly, the number of people interested in Bitcoin has increased dramatically and during 2021 large gains (+127% from 1 Jan to 9 Nov[2]) have encouraged more folk to get involved. Since the high point though and in just 10 weeks the value has fallen by -42% and the suitability of Bitcoin for private investors is a whole other discussion.

[2] www.coindesk.com/price/bitcoin

3. The US Leads the Way, Again

It feels almost predictable now that US stock markets will continue to lead global markets higher going forward as they did, again, in 2021. Investors can be forgiven for thinking the pattern will go undisturbed given the exceptional outperformance of the US that really became noticeable back in 2015. However, this is of course not the case and merely represents 'recency bias', being a mental shortcut that gives greater importance to the most recent events.

It can get to the point where investors fear missing out on further strong gains and start to consider allocating more to markets that have done well, irrespective of underlying valuations, at precisely the wrong time. The fact is on a relative basis the US market as represented by the S&P500 index, is much more highly valued than most other regions at this point. The chart below shows the price to earnings (P/E) multiple that investors are willing to pay for company earnings along with the shaded grey areas that show rising interest rate periods.



It can be seen that valuations are at the highest they have been since the turn of the century, but that in itself does not mean they are overvalued, especially considering how much lower interest rates are this time around. A side note is that you can see that just because interest rates start to rise does not necessarily lead to a falling market.

However, since the start of the year the S&P500 index has fallen by -7% (in £) at the time of writing, dragging down global based indices in which the US has significant influence. The FTSE All World index for example that we reference in client reviews has a weighting to the US of 59% and of the top 10 constituents 9 are US listed companies, which combined make up 15% of the entire global market (the other company is Taiwan Semiconductor Manufacturing, which supplies most of the other 9!).

So, when the headline states that the US is leading the way, the bulk of the performance is really just down to a few extremely influential companies. As a result, it has become difficult for active fund managers to outperform the index if they in any way consider valuations as a metric for stock selection. It also appears unfair to judge them based upon their reluctance to pay what they deem too much for companies.

Typical FPC portfolios (subject to individual risk preferences) are purposefully balanced to not get too exciting when things are going well, nor too gloomy when weaker periods are encountered and we are unlikely to increase exposure to a market solely because it has recently performed well.

4. Normalisation of Interest Rates

So, what is the new normal when it comes to interest rates? We are certainly past the question of if rates will rise, as central banks have mostly already moved or confirmed that they will, and now we are asking to what extent.

The Bank of England raised interest rates for the first time in December to 0.25% and is expected to do so at least twice more this year, despite the market earlier calling the bank an 'unreliable boyfriend' i.e. saying one thing and doing another.

There does not appear much appetite or sense in raising rates significantly higher when the national debt position is so high post-Covid support measures. The bank did though need to show its willingness to act in the face of rising inflation (annual CPI hit 5.4% in December[3]) but perhaps making small moves and talking about the action it could take will be enough to slow the demand side of the inflation equation. It might well not return to the days of 5-6% interest rates for a long time.

What the bank will not want to do is push the economy into recession by raising rates too rapidly, especially given the potential impact on household disposable incomes. John Calverley of FPC consultant Tricio explains "the UK economy is more sensitive to rising short term rates than the US, with about 20% of mortgages at floating rates, and the majority on fixed terms of no more than 2-3 years, which will gradually reset". Putting undue pressure on household mortgage payments could be extremely damaging particularly as the government has encouraged enhanced borrowing for home ownership through its various policies.

Perhaps the goldilocks solution is really to have inflation settle lower than where it is today and tolerably within sight of the 2% bank target, which would allow interest rates to stay low in a range of say 1-2% but remaining accommodative to allow economic growth. The national debt to GDP ratio will look a lot rosier if the GDP side of the equation rises through a combination of growth and inflation.

[3] www.ons.gov.uk/economy/inflationandpriceindices

5. COP26 & Responsible Investment

In November 2021 the UK hosted the 26th climate change conference in Glasgow. The aim was to keep alive the 2015 Paris agreement of limiting global temperature increases to 1.5c, which was appearing out of reach. The gathering concluded with almost 200 countries signing the 'Glasgow Climate Pact' much of which surrounded the acceleration of previously made de-carbonisation promises.

The increased attention to COP26 furthered the momentum that has gathered around how private investors play a part in the transition to a net-zero carbon economy. We think it fair to say that most investors would wish to achieve positive returns to meet their financial objectives in a manner that 'does no harm'. Then there are investors who wish to go a step further and actively 'do good' with their wealth, allocating funds to companies or projects where they can make an impact but perhaps with greater uncertainty of financial return. To our minds, in the middle of these two positions is an area of complexity that requires a closer eye.

Investors will be familiar with the acronym 'ESG' or the Environmental, Social and Governance factors of investing. Our observations, especially with younger clients, is that climate change is rightly the primary concern and that ideally their investments should make a positive difference. It is of course in all our interests to take effective action to mitigate and reverse the damage caused by human activities and ESG integration has a part to play. But, with this increased popularity the marketplace for investment solutions has come alive and fund management groups have rushed to launch funds that are named, or claim to have processes that embed ESG and invest responsibly, in order to attract fund flow.

However, there are major question marks surrounding the effectiveness of these funds to deliver on their stated objective. The Financial Conduct Authority (FCA) last year expressed concern with the poor quality of ESG labelled fund applications, explaining that to build trust in the sector required greater measurement standards and disclosures, and they expected new funds to do better in outlining their objectives and informing investors of the outcomes[4].

Fund managers largely rely upon external rating agencies to provide companies with scores on their ESG credentials before being included in portfolios. The problem presently is there is no consistent framework determining why a company is awarded a specific ESG score and therefore risks potential misalignment with investor aims. For example, in a well circulated article, MSCI (a large ESG rating company), is said to determine ESG scores not by how a company risks impacting the world, but how the world risks impacting the bottom-line of the company[5].

[4] fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds

[5] Bloomberg: The ESG Mirage, December 10 2021.

5. COP26 & Responsible Investment cont.

Our core investment process uses quantitative and qualitative research for our fund selection, which includes the extent to which managers incorporate ESG factors within their portfolios. It is clear the direction of travel is that managers are considering these risks, regardless of whether they run a fund that is labelled as such. Fund managers recognise that ignoring ESG will lead to losing investors, and company boards realise their businesses may be impacted by a loss of funding. It is conceivable soon that all funds will naturally consider ESG due to the pressures that are building and the distinction will become little to none.

This is only part of the discussion around ESG, but the point here is that to truly decipher the funds that look good, from the funds that are doing good, requires deep resources and expertise. We believe that a truly responsible mandate is one that seeks to make a positive and measurable impact by investing in solutions to the issues we face, rather than just attaching a label to its fund name.

For those investors whose primary objective is to make a positive difference, we have a well-resourced investment solution that can be discussed with your adviser.

6. Looking Forward

2021 did prove to be another exceptional year for stock markets but double-digit returns in the US, UK and Europe should not be expected to be repeated consistently. We would caution not to get too comfortable with such returns and to accept that markets can go down as well as up over shorter periods.

As ever the outlook for markets appears cloudy with many moving parts. Investors never have to look too far to find something to worry about, be it interest rates, inflation, geo-politics or whatever else. We may well see greater volatility this year than last (as already experienced in certain assets) as markets absorb initial central bank tightening but providing inflation comes off the boil, which we expect, then further growth in the economy and in markets is achievable.

After all, rising interest rates are usually a positive sign, indicating that the economy is warm but potentially getting hot and needs to be cooled. Corporate bonds do not tend to fare so well but their inclusion acts as a stabiliser should markets go through a weaker period.

Investors know however that the real value of their wealth is being eroded by higher inflation and accepting some risk to capital is a necessary action to protect real values.

Invest With Confidence

At the heart of what we do is a simple goal – to help you achieve and maintain financial independence, provide for those who rely on you and live life well.

We do that by providing the financial planning and investment advice you need to secure your future.

We recognise that investors with similar risk profiles may have very different objectives, tax positions and personal circumstances so we adopt a bespoke approach in each case. There are no 'off the shelf' solutions.

We focus on choosing the right blend of assets, managing risk, and minimising tax and costs. Our investment philosophy is founded on a number of key principles which have served our clients well for more than 30 years:

- Differentiate savings from investment
- Understand and manage risk
- Get the "investment recipe" right
- Avoid market timing
- Fear inflation
- Manage tax and costs
- Process is paramount

We believe you win by not losing and this core principle lies at the heart of our investment approach. To find out more, get in touch.

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