<u>Post Summer Update: Recession risk increasing</u>

As most readers know, our approach to investment is very much long term in nature. We felt, however, that an update was warranted given recent changes in the macro-economic environment and the resulting alterations we are making to client portfolios.

Back in January we highlighted a challenging outlook for traditional asset classes. Our longer term expected returns for a 60/40 global equity/bond index were in the mid-single digits, and we highlighted five key themes which formed the backdrop to our investment decision making:

1. Higher interest rates, in time, depressing future asset price returns, though in the shorter term we believed interest rates would remain roughly where they are.
2. An increasing risk of a recession in the US in the next 24 months. Global asset prices would likely react ahead of it occurring. Arguably (at the time of writing) they had already factored in a reasonable probability of one occurring.
3. Political risks were not likely to reduce anytime soon. This made the kind of global co-ordinated response we saw in the last financial crisis less likely to occur with governments now more inwardly focussed than in the past.
4. China's slowdown and associated macro issues would be a long-term problem and consequently we are cautious on emerging market allocations on a long-term basis.
5. Brexit uncertainty would result in attractive opportunities. We believed some were emerging already and we favoured defensive assets which would be resilient whatever the outcome of Brexit.

Despite very strong equity market returns in the first half of 2019 (MSCI All Country World Index up 16.5% in USD terms), the macro outlook has worsened quite noticeably, most clearly evidenced by the collapse in developed market government bond yields as investors flood into safe haven assets. We were correct that interest rate rises would likely be limited but we did not anticipate such a rapid and sharp fall. Political risks, as evidenced by the failure of the US and China to strike a suitable trade deal in addition to general global instability (delayed Brexit, Italian coalition collapse etc) have continued to concern investors. There is an array of charts/data we could display, but three key ones are below:

Figure 1: Government bond yields have collapsed to record lows in Europe and US yields are close to record lows as risk aversion has taken hold

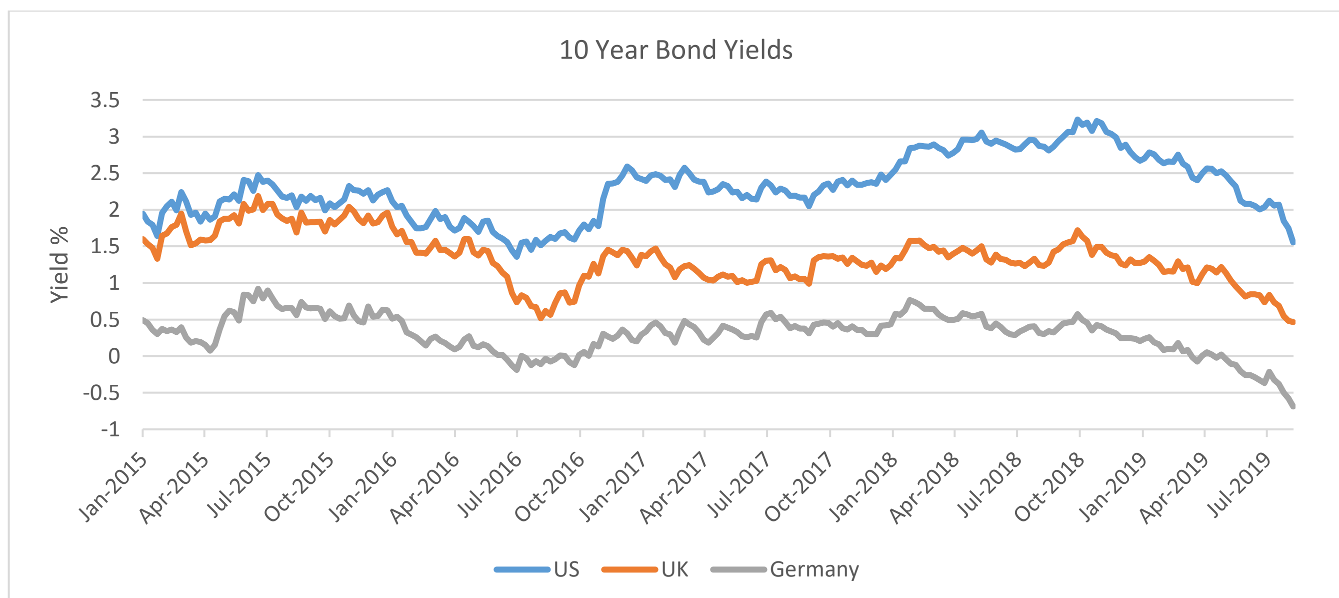

Figure 2: Yield curves remain extremely flat, which leads to risk aversion as investors are not compensated for investing in the longer term

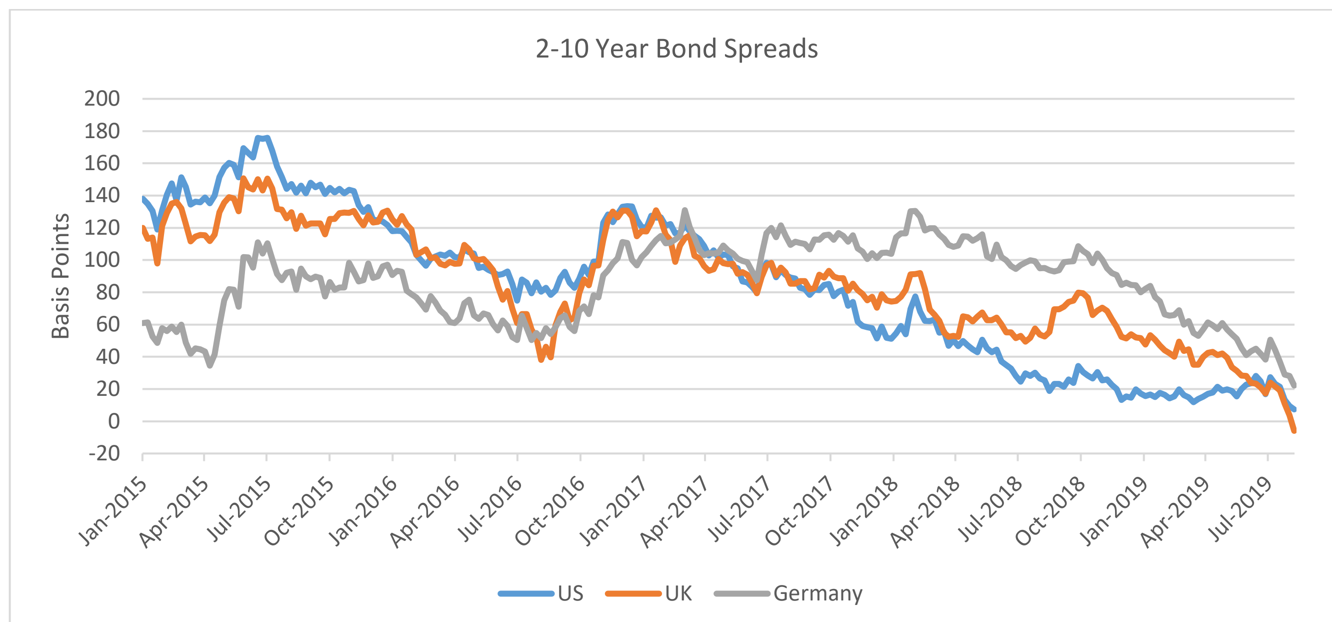

Figure 3: Global Composite PMIs continue to indicate weakness and are trending lower – a reading below 50 indicates economic contraction. Most experts now believe Germany is already in a recession.

	United States	Eurozone	Germany	France	Italy	United Kingdom	China	Japan	Australia
30/06/2016	51.2	53.1	54.4	49.6	52.6	52.6	50.3	49.0	54.9
30/09/2016	52.3	52.6	52.8	52.7	51.1	53.8	51.4	48.9	54.4
30/12/2016	54.1	54.4	55.2	53.1	52.9	56.5	53.5	52.8	55.8
31/03/2017	53.0	56.4	57.1	56.8	54.2	54.8	52.1	52.9	58.3
30/06/2017	53.9	56.3	56.4	56.6	54.5	53.9	51.1	52.9	57.2
29/09/2017	54.8	56.7	57.7	57.1	54.3	54.0	51.4	51.7	53.1
29/12/2017	54.1	58.1	58.9	59.6	56.5	54.8	53.0	52.2	55.5
30/03/2018	54.2	55.2	55.1	56.3	53.5	52.4	51.8	51.3	55.4
29/06/2018	56.2	54.9	54.8	55.0	53.9	55.1	53.0	52.1	52.9
28/09/2018	53.9	54.1	55.0	54.0	52.4	54.1	52.1	50.7	52.5
31/12/2018	54.4	51.1	51.6	48.7	50.0	51.4	52.2	52.0	52.9
29/03/2019	54.6	51.6	51.4	48.9	51.5	50.0	52.9	50.4	49.5
28/06/2019	51.5	47.6	45.0	51.9	50.1	48.0	49.4	49.3	52.0

Sources: Bloomberg for Figs 1-3.

The current environment can, therefore, be summarised as the tail end of long financial asset bull market fuelled by a decade of low interest rates and central bank liquidity creation. This has depressed returns on safe assets such as government and investment grade bonds which has forced investors to migrate further out on the risk curve to meet their return targets. We are now seeing signs, if not of irrational exuberance of previous eras, then certainly examples of trade-offs that we don't think are smart (e.g. private credit managers raising long-lock funds targeting only a 7% return, covenant-lite leveraged Private Equity deals, a flood of money into Venture Capital funds run by teams with very limited experience, IPOs of large loss making companies etc).

However, we also note valuations are not so extreme, and companies in general continue to perform and deliver solid results as seen in the most recent quarterly company earnings. Consequently, our central view is best described as continuing to move forward, but with greater care, more defensively and with an awareness that the risk / return trade-offs and margin of safety in many asset classes are less in our favour at the moment. This is best summarised by Howard Marks of Oaktree in his memo in late 2018 which we think remains applicable today:

"I'm absolutely not saying people shouldn't invest today…Oaktree's mantra…continues to be move forward but with caution. The outlook is not so bad, and asset prices so high, that one should be in cash or near cash. The penalty in terms of likely opportunity cost is just too great to justify being out of the markets. (However), investors should favour strategies, managers and approaches that emphasize limiting losses in declines above ensuring full participation in gains."

To build an investment "game plan" for the current environment requires two investor mindset shifts. Firstly, a willingness to look beyond traditional asset classes. If one lives in a two-asset class world (equities and bonds) then the only tool available is to flex the portfolio's equity percentage up and down and hope for the best. Secondly, as Howard Marks indicates, this environment also requires the prudent investor to concede that the conditions are not as favourable for return generation and so the target return should be reduced for the benefit of reducing tail risk. This is not to say that the return expectation must remain lower forever, it is merely a reflection of the current climate. As conditions improve and become more favourable (generally as asset prices fall – counter-intuitively) then the rational and sophisticated long-term investor will increase allocations to riskier assets and return expectations normalise.

There is a range of tools or strategies at our disposal to counter the current conditions. We see them in four main areas:

1. Tactical asset allocation – this the biggest single driver of overall portfolio return. There is no surer way to reduce portfolio volatility than cutting the allocation to equity-like investments (albeit while sacrificing upside). We would encourage any individual or family with public listed equity exposure in excess of 50% to think how much tolerance they would really have for a full-on market downturn (in the order of 30-40% as in 2008-09) and whether they would buy more, hold, or sell.

2. Move to a quality bias – leverage is the enemy of capital preservation in difficult times so it is always wise to hold shorter duration bonds or loans of higher quality with modest gearing, strong covenants and/or security packages, and higher quality developed market equities (i.e. companies with limited leverage, and stable earnings growth). We would encourage clients to review their allocations and think carefully about the level of small cap and cyclical exposure in portfolios.

3. Adding uncorrelated / less correlated asset classes – we look for strategies that add similar or higher levels of returns to equities but with low correlation to equities. These types of investments typically exhibit one of the following characteristics:

   - A contractual income stream where a premium is paid in return for a low probability of default or break risk – e.g. catastrophe reinsurance, merger arbitrage.

   - Skill based strategies - where returns are driven by a computer model or a human trader – e.g. statistical arbitrage, event driven.

   - "Alternative alternatives" – return streams and strategies which are idiosyncratic and uncorrelated with both traditional equity and credit markets and mainstream alternatives – e.g. life settlements and litigation funding.

   - Assets which historically perform well in downturns – we have not historically been proponents of Gold in client portfolios, but we do feel there is now an argument for a small allocation (e.g. of up to 5%). We view an environment of exceptionally low interest rates and elevated (geo) political risk to be supportive of higher Gold prices. In particular, a number of experts now believe the effects of traditional monetary policy have reached or maybe gone past the point of being effective and instead fiscal stimulus may now be the next tool that governments turn to in order to re-stimulate economies. Were this to be the case we think this will also strengthen the case for Gold if Government debt balances expand from already high levels.

4. Allocating to private / illiquid managers with a capability in distressed / turnaround investing – most wealthy families are biased towards the large cap buyout universe for their illiquid holdings as they derive comfort from scale and brand recognition. We still believe the top quartile managers within this space will deliver strong returns (in the region of 10-14% net of fees), but the best outcomes will likely come from smaller and mid-size funds with a specialism in distressed investing and potentially secondaries funds, as some overallocated LPs may become forced sellers of good assets at the wrong time (from their perspective).

Model Portfolio (for non-taxable, USD based client)

Asset Class	Long Term Strategic Allocation	Jan 2019 TAA	Sep 2019 TAA	Themes taken within asset classes
Cash / Money Markets	2%	15%	10%	Yields on money market funds and other near cash investments have dropped and are continuing to fall so we reduce cash but retain a sufficient amount of "dry powder" for now
Government Bonds	13%	0%	0%	We do not recommend longer duration bonds given their already low or negative yields in some cases. While prices may well rise and yields go lower we do not think this is a risk worth taking
Credit	20%	20%	20%	Within Credit we have become more cautious - particularly on higher duration investment grade and high yield bonds. We maintain our allocations but skew to more defensive areas: • Short Duration High Yield Bonds • Private Asset Backed Credit with strong protections • Mortgages
Absolute Return	10%	15%	20%	We favour alternative strategies that earn returns that are lowly or uncorrelated to wider financial markets. These include: • Life Settlements • Catastrophe Reinsurance • Litigation Funding • Actively managed market neutral strategies, e.g. Merger Arbitrage, Low Net Long-Short Equity
Public Equities	30%	30%	25%	Our skews are • US large cap stocks with a bias to quality names • Neutral on Emerging Markets • Underweight Europe, UK and Japan due to structurally weak growth in these areas.
Private Equity	20%	15%	15%	We are wary of the significant dry powder in the private equity industry and are avoiding the large buyout funds due to excessive competition for assets. Elsewhere, allocations are very much manager and opportunity dependent. We have a preference for: • Co-Investment Funds and Secondary Funds - both are lower fee, have less of a "J-Curve" and in secondary area we could see some interesting opportunities as a result of dislocations • Special situations, distressed, turnaround funds • Venture Capital within our trusted partner network
Real Estate	5%	5%	5%	We expect generic real estate to underperform against a slowing global growth backdrop and in time higher rates / cost of capital. However, we like lowly geared, defensive assets, e.g. care homes, nurseries, waste

				management facilities, social / affordable housing given their economic resilience. Again, our allocations are opportunistic.
Gold	0%	0%	5%	Given the decrease in real rates globally, increased geo-political risks, and our increased concerns over recession risks we have added some Gold to portfolios.
Total	**100%**	**100%**	**100%**	
Gross Long Term Expected Return	**6.5%**	**6.7%**	**6.3%**	
Volatility	**10.3%**	**9.1%**	**8.9%**	
Expected Sharpe (2% Risk Free Rate)	**0.43**	**0.50**	**0.48**	

In summary we have re-oriented portfolios more defensively as we viewed the probability of a US recession in the next 12-18 months to be at its highest point since the last financial crisis of 2008/09. Our main actions taken have been to reduce equities and add gold and uncorrelated strategies.

In our year-end letter we will further discuss what other tools policy makers have at their disposal to stimulate economies, the potential longer-term investment implications, as well as other tactical changes that may be necessary to prepare portfolios for a more challenging market environment.

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