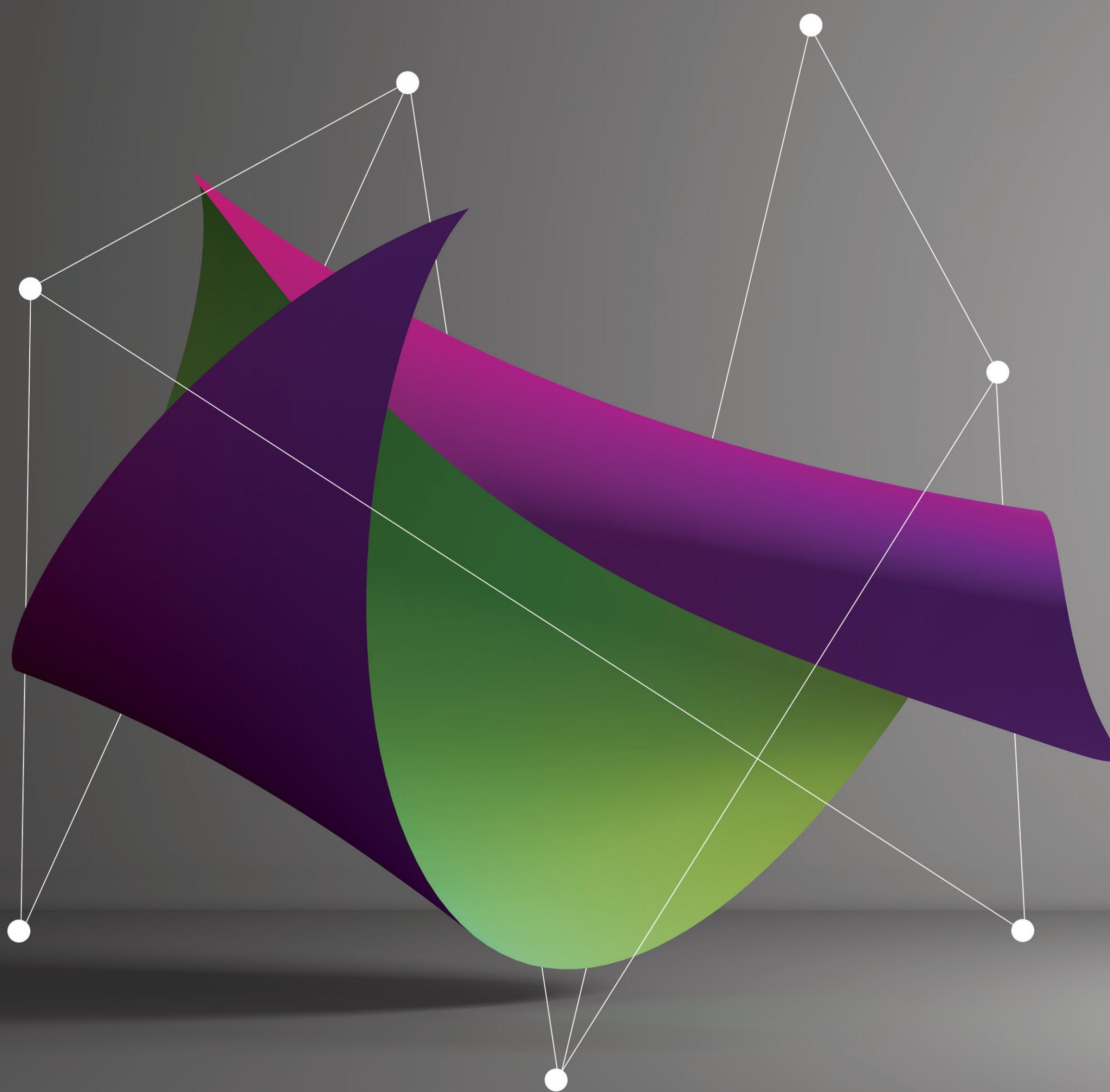
Your investment update

Q1 2022



Succeeding together

7IM

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Contents

04 **Welcome**
Martyn Surguy
Chief Investment Officer

06 **Strategy**
The outlook for the next ~~year~~ cycle
Ahmer Tirmizi
Senior Investment Strategist

12 **Portfolio implementation**
Manager selection; process not luck
Uwe Ketelsen
Head of Portfolio Management

14 **Featured topic**
Inflation; this time, it's personal
Ben Kumar
Senior Investment Stratgist

Visit us at **www.7im.co.uk** to find out more about our latest news and views.

Welcome

MARTYN SURGUY

Chief Investment Officer

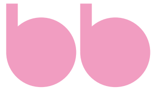
At the end of our second year living with coronavirus, the worst-case scenario does seem to have been avoided. Rapid and substantial economic support measures from governments gave time for incredible scientific and medical achievements, culminating in the development and production of multiple vaccines.

However, although the period of maximum danger is past, the world is still struggling to work out what the future will look like. What will be the new norms for social behaviour, the changed roles of governments and of course, the outlook for financial markets?

The outlook for economic growth is better than many expect, for longer than many expect. Later in this publication, Senior Investment Strategist, Ahmer Tirmizi, discusses our belief that the next few years will see not simply a recovery from COVID-19, but the beginning of a sustained expansion as the scars of the 2008 financial crisis finally heal.

Of course, such an environment is likely to encourage policymakers to raise interest rates and remove the punchbowl that's been in place since 2008. We saw the Bank of England take the first step in that direction in December 2021, when they hiked interest rates from 0.1% to 0.25%.

Rates and bond yields will surely rise in 2022. Changing interest cycles are inevitably associated with periods of market dislocation and volatility. This provides further support for our decision to avoid the most expensive and vulnerable areas of global markets, many of which will have been the best performers through the pandemic, and through the last decade of low rates.



We're ready for those challenges and remain extremely confident that our portfolios are built to last."

Inflation is a hot topic at the moment in all of my conversations with our clients, as well as with colleagues and friends. Our view is that inflation is likely to settle at higher levels than the last decade, but not troublingly so.

In his article, Ben Kumar looks at some of the oddities in the UK inflation basket, and quite sensibly encourages all of us to work out our own inflation estimate allowing for our individual spending habits and needs.

We often mention the importance of a rigorous process in all parts of our investment approach at 7IM. Since he joined us at the start of 2021, Head of Portfolio Management, Uwe Ketelsen, has been adding clarity and structure to all areas of our manager selection process – and he talks through two very simple principles in his piece.

As ever, as an investment team, we see our key role as preparing for what the future may hold rather than trying to predict it. Certainly 2022 will see further challenges from the virus, a changing interest rate environment and lower corporate earnings. We're ready for those challenges and remain extremely confident that our portfolios are built to last. Enjoy reading and may I wish you all a happy, prosperous and, above all, healthy 2022.

Strategy

The outlook for the next ~~year~~ cycle

Too much can happen in any given year

It's a new year, so here come about a thousand lists of things that will certainly happen over the coming 12 months. However, there is only one *certainty* about these outlooks – they're wrong. Mine, yours, his, hers, theirs. All wrong. Not one of them will correctly predict the events of 2022.

And it's because they'll be looking at the wrong thing. We don't invest based on the calendar, so why would we write outlooks by calendar year?

Too many unforeseeable things can happen in any given year, which can make any outlook written on 1 January look outdated as soon as 2 January. Over short time periods (and a year *is* a short time period), *anything* can happen.

For example, the long-run assumed return for equities is around 10% – which is why so many outlooks state this as the likely return of equities every year! But averages don't give the whole picture (as Ben looks at in a different way a bit later).

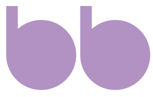
Of the fifty-one years between 1970 and 2021, how many times do you think US equity returns were between 8% and 12%? Just three! Even more interesting is that returns were under -10% or above 30% in over a quarter of those years. Try writing an outlook for that!

How can we invest for the future if the range of outcomes is so wide? One way is to stretch out the time horizon you're investing for. So, we think in terms of cycles rather than calendars – multi-year periods where lows follow highs, and vice-versa. Thinking in this way means you can position for the bottom of a cycle with the confidence that a high should follow, as long as you give it enough time... i.e. more than twelve months.

The outlook for the next cycle

Here's a reiteration of what we are expecting... but we are *not* suggesting that by 31 December 2022, it will all have happened.

Austerity is over: The last economic cycle was defined by austerity and low growth. Governments, individuals, business and banks all experienced their own version of it. Pretty much all of these headwinds have faded. Governments are more relaxed about spending, households have lots of cash on hand and banks are part of the solution, rather than part of the problem. The result should be a self-reinforcing period of spending, lifting growth above the levels seen in the previous cycle.



So, we think in terms of cycles rather than calendars – multi-year periods where lows follow highs, and vice-versa."

There will be a housing boom: Very few houses were built in the last cycle. The financial crisis left huge *oversupply*, and homebuilders with burnt fingers weren't in a rush to get out the shovels. But natural household formation has since eaten into that hangover, meaning we now have *undersupply* in many countries! And, once we factor in people willing to borrow and banks willing to lend again, we believe we are at the bottom of a construction cycle with prices shooting up rapidly. Those homebuilders' scars have now healed, and people are looking to build again. A construction boom across developed economies is likely, lifting growth even further.

Emerging markets will take the lead again: The low growth of the last cycle made investors jittery. So, they tended to put their money into the safest places they could find. This saw money flowing from emerging markets and into government bonds (the safest asset class), the US dollar (the safest currency) and US equities (one of the safest equity markets).

But now, after a decade of lean times, emerging markets are far more robust than they were in the last cycle and much more attractively priced. This should see a return of foreign capital, leading to self-reinforcing growth in the emerging world once again. >>

AHMER TIRMIZI

Senior Investment Strategist

Strategy
Continued

Inflation will remain sticky: The inflation outlook for the next year is unlikely to have a major bearing on markets, as there will still be some strange COVID-induced comparisons. Instead, inflation should be viewed over the medium term. Stretched out over the cycle, it looks like inflation will settle at a higher level than it has done over the last decade. The growth headwinds mentioned above are fading fast, lifting inflation. Encouragingly, lower-end service worker job-hopping is widespread since COVID, meaning this cohort is enjoying high-single-digit wage gains.

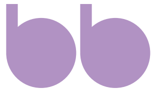
Interest rates will be higher than they are now: Low growth and low inflation over the last decade meant that central banks didn't need to rush to raise rates. Most held rates at or around zero from around 2008. Even the US, which raised rates all the way to 3%, found that it had to reverse course quickly and was back at zero a year later. The self-reinforcing cycle in growth and inflation we see coming will allow central banks to raise rates more sustainably over the coming few years, with huge implications for markets and investors.

We are positioned for the next cycle

Putting it together, we believe that the coming cycle will be very different to the last – the chart adjacent shows what we mean by that. Higher growth, higher inflation, higher rates. How can we use these insights when we invest? Part of the answer is to not see cycles with defined beginning and end points but rather one leading to the next. This means using the last cycle to give clues as to what will do well going forward.

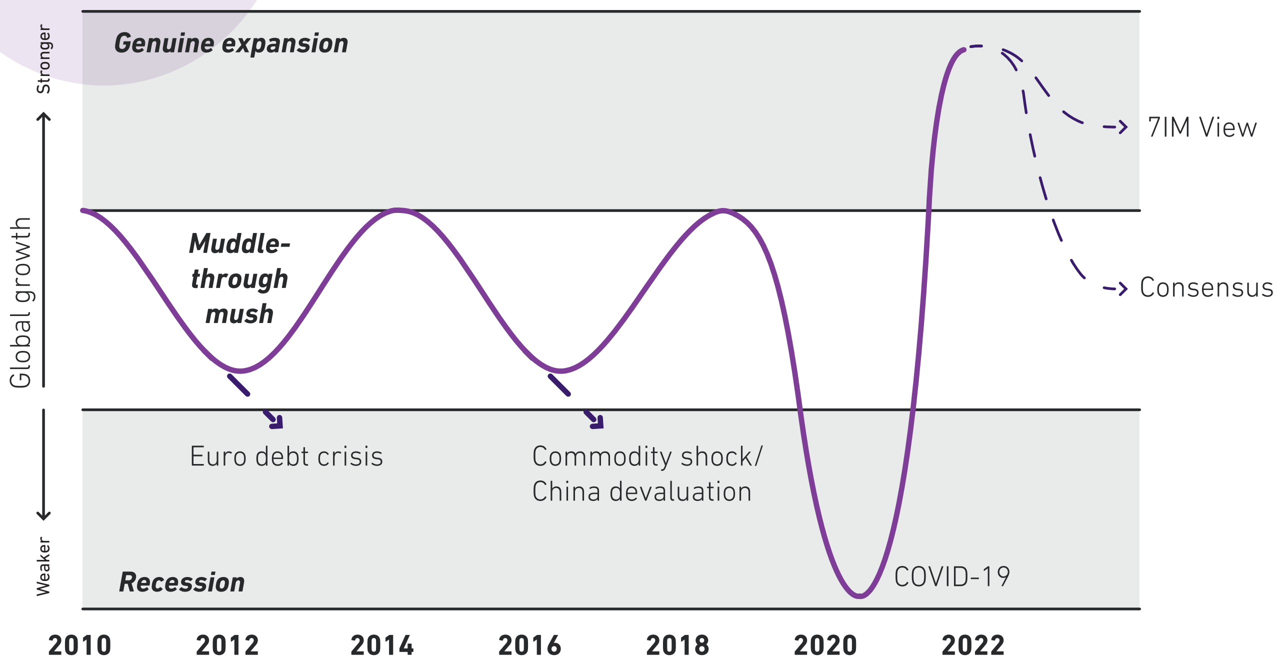
We have found it worthwhile looking for the sectors which benefitted during the last cycle, but were unrecognised by the nervous market: European bank debt has become one of the safest sectors to invest in; US mortgages have benefitted from frugal US households; and emerging markets have learned to live with less.

Thinking in this way has also led us to look for the asset classes that experienced the strongest headwinds over the last cycle: cyclical sectors hurt by slower growth; smaller companies struggling for pricing power in a low inflation world; and value companies underperforming in a world of zero rates. Now that those headwinds of the last cycle are turning to tailwinds, these investments should lead the way over the next year but, more importantly, over the next cycle.



Higher growth, higher inflation, higher rates. How can we use these insights when we invest?"

Global growth since 2010



Source: 7IM

Circumstances are also important. Consider someone's view on house prices. Are rising prices a good thing? Well, it depends on whether you're buying, or selling, or staying put – all of which can and will change over time."

Ben Kumar, Senior Investment Strategist

Portfolio implementation

Manager selection; process, not luck

Actively managed funds are typically more expensive than passive alternatives such as index funds or exchange-traded funds (ETFs). Also, evidence suggests that many actively managed funds will underperform their benchmarks over time.

But we firmly believe that good active managers *do* exist; investors who can reliably beat the passive index and generate 'alpha'. So, how do we *find* them? There are two vital things we must think about to give ourselves the best possible chance.

First, we have to know where to look. And second, we have to know what we're looking for.

The table to the right illustrates the first point, showing what percentage of all active managers beat their benchmark over a ten-year period. It highlights that some markets are far more 'efficient' than others, so tend to be more difficult territory for fund managers to pick mispriced companies. Broadly speaking, there is little room to find an edge for a fund manager in large US equities, but UK or emerging markets, or less widely researched small companies, are more fertile ground for active fund management.

Category	10-year Success Rate (%)
UK Large-Cap Equity	33.1
UK Mid-Cap Equity	77.8
US Large-Cap Blend Equity	8.8
US Large-Cap Growth Equity	1.5
US Large-Cap Value Equity	7.2
US Small-Cap Equity	27.5
Asia Pacific ex Japan Equity	8.6
Global Emerging Markets Equity	35.5
Global Large-Cap Blend Equity	9.1
Global Large-Cap Value Equity	13.9
Latin America Equity	31.4
Japan Large-Cap	16.9
Japan Small/Mid-Cap Equity	36.4
Europe ex-UK Large-Cap Equity	25.0

Source: Morningstar, 2019

Ideally, they should have 'skin in the game' and an interest in the long-term success of the firm, as opposed to the short-term success of their portfolio."

Our first step in populating portfolios with active managers is to pick the right battles. We'll spend a lot of time looking in Europe, the UK, emerging markets and Japan, but we will always choose most or all of our US equity investments to be low in cost and passive in nature.

Now we're looking in the right places, what are we looking for?

Often a well-executed strategy will be characterised by low portfolio turnover. The manager shouldn't be chopping and changing the whole time; but instead conducting thorough research, having confidence in the underlying analysis and more patience to wait for investment ideas to play out.

By the same logic, we would expect the fund manager's conviction to be reflected in the way the portfolio is structured: a high conviction portfolio would have a small number of positions; and those holdings with the highest level of conviction – say, the biggest discount to fair value – would form the 'top 5 or 10' holdings.

Such an investment strategy would also likely be characterised by a high tracking error, i.e. would differ substantially from its benchmark. It might also achieve this via a high active share, i.e. a large proportion of its holdings would not feature in the strategy's benchmark (as opposed to sticking mostly to benchmark constituents but just with different weights).

And finally, the incentive structure for the fund manager and supporting analysts is a key consideration. Ideally, they should have 'skin in the game' and an interest in the long-term success of the firm, as opposed to the short-term success of their portfolio. A material equity stake, slowly vesting over years, would be preferable to a performance fee crystallising every year.

None of the above are hard-coded rules, nor do they guarantee investment success. But they help impose discipline on a manager selection process that is exactly that: a process, rather than a game of luck.

UWE KETELSEN

Head of Portfolio Management

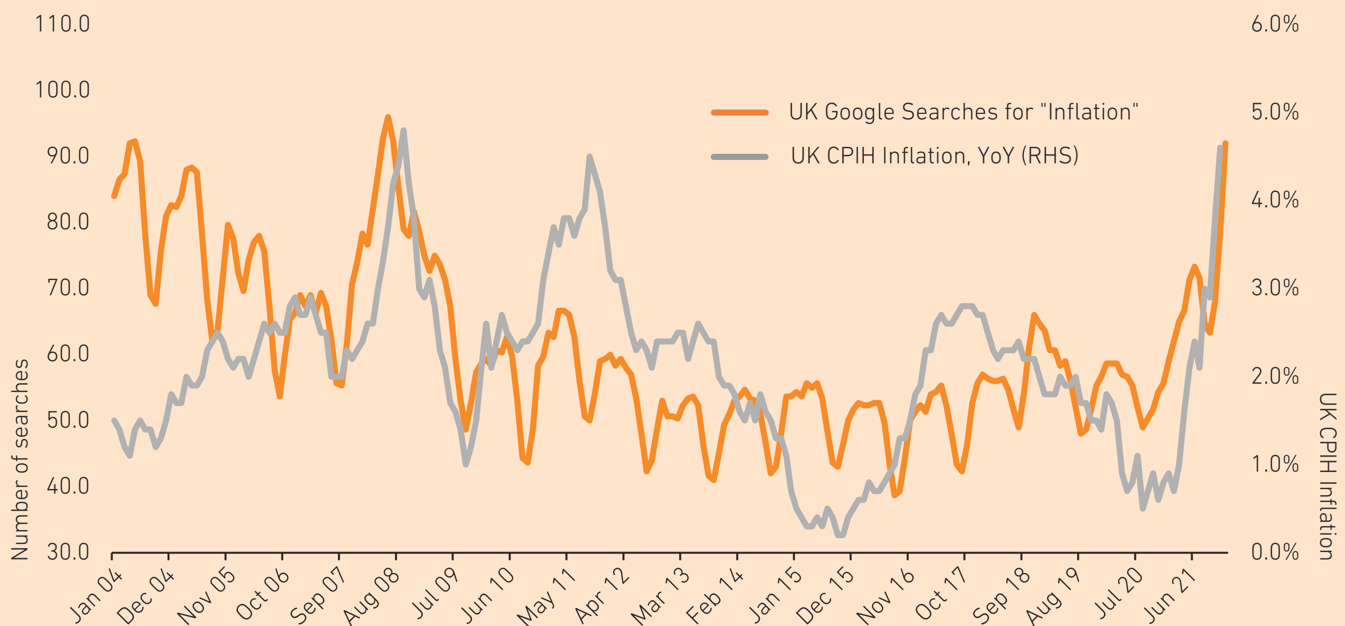
Featured topic

Inflation; this time, it's personal

Have you thought much about inflation recently?
If so, you're not the only one!

The orange line in the chart below shows the Google searches for '*inflation*' in the UK – the general population hasn't been this interested in inflation since the chaotic summer days of 2008. And the grey line will have a lot to do with that, with year-on-year UK inflation also hitting its highest since 2008, at 4.6%.

UK 'inflation' Google searches vs UK inflation rate



Source: Google Analytics/Bloomberg Finance L.P.

But that's not all the above chart tells us. It also shows that there's a difference between *measuring* inflation and *public interest* in inflation. The two don't necessarily go hand-in-hand; public interest comes and goes, depending on what else is going on in the world.

For example, UK inflation was high in 2011/12, but the general population wasn't particularly interested – understandably more concerned with the aftermath of the financial crisis.

Or, looking at the orange line, each year the searches go through seasonal peaks and troughs. No-one is interested in the summer months, but searches start to pick up as winter comes. Maybe as people start noticing those energy bills...

Economic inflation

Pretty much every nation calculates some sort of inflation figure, aiming to track the change in prices of goods and services in an economy over time. In the UK, the Office for National Statistics uses the *Consumer Prices Index including owner occupiers' housing costs (CPIH)* – other countries' approaches have similar snappy titles.

And inflation indices are all constructed in a similar way; by regularly monitoring the cost of a basket of commonly bought goods, representing the general atmosphere of pricing across the nation. When we hear on the news that inflation is at x% in January, it means that the total price of buying the basket of goods has changed by x%. >>

No-one is interested in the summer months, but searches start to pick up as winter comes. Maybe as people start noticing those energy bills..."

BEN KUMAR

Senior Investment Strategist

Featured topic
Continued

Which is all very useful if you're an economist looking at national accounts, and overall populations, and theoretical models. You'll have lots of lovely numbers to dig into, produced every month, going back decades. You can look at inflation numbers every single day, if you have the inclination.

Psychological inflation

But most people aren't economists (thankfully). For most of the population, inflation isn't represented by the official index – it lives in our own heads. It's personal, and emotional, and based on intuition rather than calculation[1].

Typically, people aren't great at thinking about abstract concepts. But give us something to latch on to – the cost of filling a car, or our weekly shop, or a pint at the pub, or a Freddo bar – and suddenly, our brains come to life. I reckon almost everyone has said the words *"I remember when this used to cost..."* at some point in their lives!

Even the way inflation is described produces different responses in individuals[2]. Ask how 'inflation' is impacting someone, and the answers tend to be amateur economics – reasonably short, perhaps mentioning the official number. Ask about how 'prices in general' are affecting that person and they will list out a whole bunch of personal experiences – *"have you seen petrol prices recently?"*

Circumstances are also important. Consider someone's view on house prices. Are rising prices a good thing? Well, it depends on whether you're buying, or selling, or staying put – all of which can and will change over time.

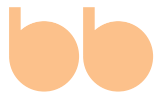
Economists don't like this sort of uncertainty. But they can't just wish it away. If the economic measure of inflation isn't tracking what people *actually* experience as inflation, then the models used to shape policy aren't going to give a useful output. In fairness, central banks are trying to introduce more relevant measures of prices[3], but they're still some way off.

[1] Shiller, R.J. (1997). *Why do people dislike inflation?* National Bureau of Economic Research

[2] Bruine de Bruin, W., van der Klaaw, W., & Topa, G. (2011). *Expectations of Inflation: The Biasing Effect of Thoughts about Specific Prices.* Federal Reserve Bank of New York.

[3] https://www.federalreserve.gov/econres/notes/feds-notes/index-of-common-inflation-expectations-20200902.htm

[4] https://www.ons.gov.uk/economy/inflationandpriceindices/articles/consumerpriceinflationupdatingweights/2021



That's the problem with a basket of the average person's spending. None of us are the average person."

The **basket isn't** ***your*** **basket**

So, for now, the inflation number you see on the news will almost certainly not describe your personal experience of prices. How could it, when the UK CPIH basket *definitely* doesn't reflect the things you spend your money on?

For example, in the CPIH basket[4] at the moment, 'recreation and culture' makes up 11% of spending. That might be true for you at a headline level – or it might be a lot more, or a lot less. But dig a little deeper into the constituents: camper vans; boats; acoustic guitars; livery for horses; barbecues; football season tickets; evening classes; games consoles; hamsters; the list goes on and on. You might have spent money on a few of these, but certainly not all of them.

The same is true of university / school fees at 3% of the basket. For some families it might be a lot more than that, for others, it could be zero. And that spending will change over time. Or health spending at 2%; as people age, that number could be significantly higher.

Looking through the basket, there are lots of things that might seem odd to you, but perfectly acceptable to someone else. That's the problem with a basket of the average person's spending. None of us are the average person.

For our investors, the goal is to ensure their savings keep pace with inflation. But it's worth taking the time to work out what that inflation level really is for you personally. Protecting against the 'official' rate of inflation might not be enough – or it might be more than ample.

Sitting down and working out what you *really* spend your money on is the only way to really know what inflation means for you. It's worth doing!

Meet the teams

Investment Management Team

Martyn Surguy
Chief Investment Officer

ACA Chartered Accountant, MCSI, CISI Level 4, 35 years of industry experience.

Matthew Yeates
Deputy Chief Investment Officer

BA Economics, CFA, 10 years of industry experience.

Uwe Ketelsen
Head of Portfolio Management

MEcon, CFA, 26 years of industry experience.

Terence Moll
Head of Investment Strategy and ESG

MPhil, PhD. in Economics, 30 years of industry experience.

Duncan Blyth
Senior Investment Manager

BSc Actuarial Mathematics & Statistics, CFA, 24 years of industry experience.

Christopher Cowell
Senior Quantitative Investment Strategist

MSc, PhD, CFA, 6 years of industry experience.

Fraser Harker
Investment Analyst

MA in Economics & Accounting, CFA, 6 years of industry experience.

Tiziano Hu
Junior Quantative Strategist

MSc in Financial Technology, 1 year of industry experience.

Salim Jaffar
Investment Analyst

BA in Economics, IMC, 1 year of industry experience.

Ben Kumar
Senior Investment Strategist

CFA, MsC Behavioural Economics, 10 years of industry experience.

Tony Lawrence
Senior Investment Manager

CFA and CAIA, 20 years of industry experience.

Stephen Penfold
Senior Investment Manager

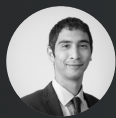
BSc in Economics & Computing, 36 years of industry experience.

Camilla Ritchie
Senior Investment Manager

IMC, 32 years of industry experience.

Peter Sleep
Senior Investment Manager

30 years of industry experience.



Ahmer Tirmizi
Senior Investment Strategist

MSc in Economics and Finance, 15 years of industry experience.

Jack Turner
Investment Manager

CFA, 12 years of industry experience.

Hugo Brown
Investment Analyst – Alternatives

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Alex Mitsialis
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Haris Slamnik
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MSc, 2 years of industry experience.

William Wood
Investment Risk and Performance Analyst

BSc in Physics, 3 years of industry experience.

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