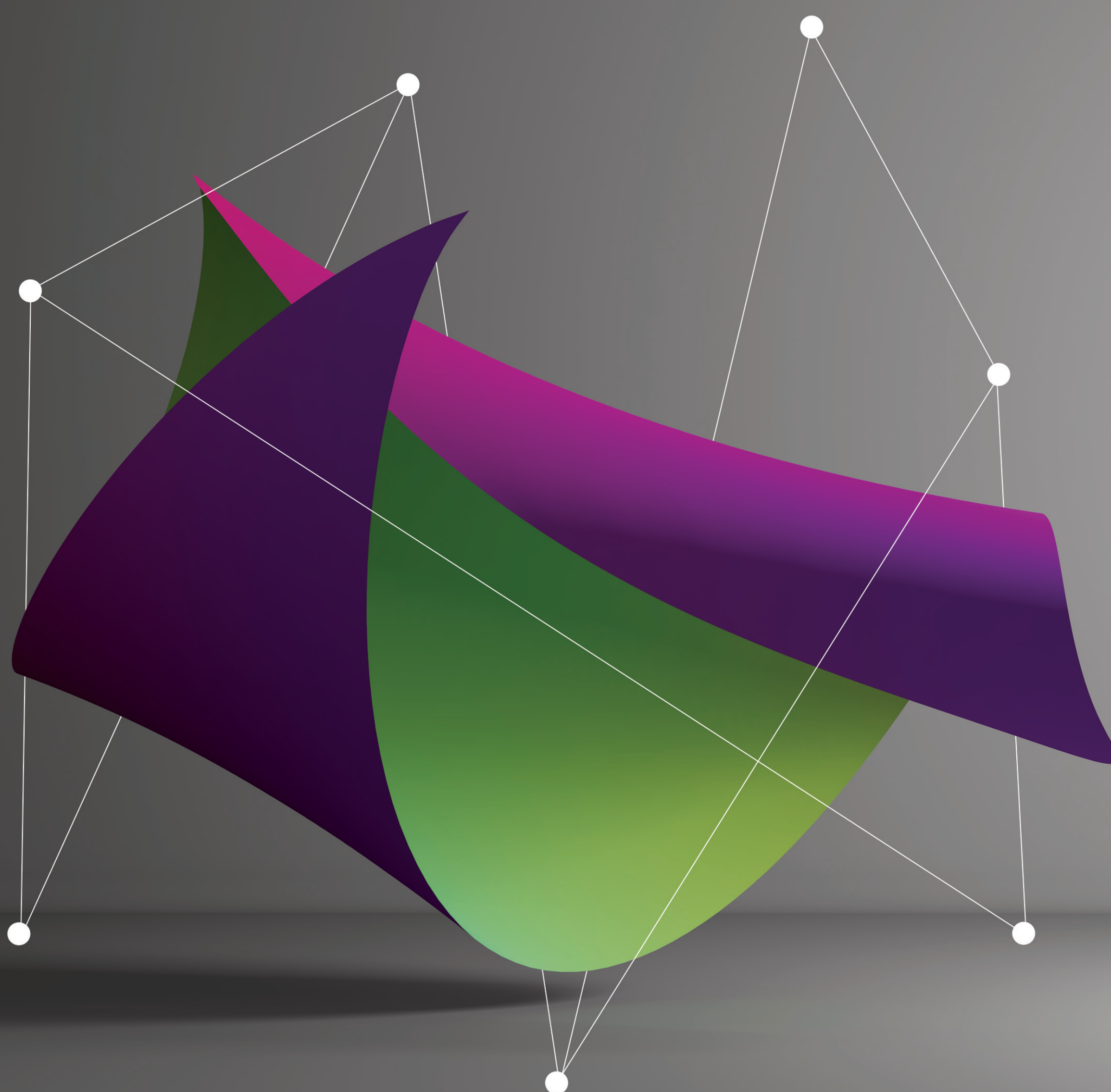
Your investment update

Q4 2022



Succeeding together

7IM

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Welcome

If you can keep your head while all around you...

It was my fervent hope that one of these days, I would be able to use this column to refer to the benign economic backdrop and the period of relative calm in markets it had given us. Today is not that day!

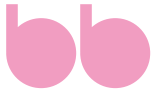
Once again, we seem to be cursed to live in 'interesting times' as we lurch from one crisis to another. The roll call of concerns seems to grow ever longer and more serious. Leading economies are sliding closer to recession. Interest rates continue to ratchet up to combat stubborn inflation. Stock and bond markets continue to fall in lockstep. And closer to home, sterling recently hit an 'all-time low', while longer bond yields have experienced their largest spike in history. Interesting times, indeed.

Notwithstanding the assault on our emotions from the above, our overall advice in times of calm or stress is essentially the same. It's just that the merits of that approach are much more visible when markets are at their most challenging. Remind yourself of your long-term investment goals, have a plan that you can be confident of sticking to and, above all, don't listen to your emotions. Of course, there is nuance to that.

We have progressively tilted those long-term plans in a more cautious direction for about a year now as the storm clouds began to roll in, but the plan remains the same. As Chinese General Sun Tzu reminds us, "strategy without tactics is the slowest route to victory, but tactics without strategy is the noise before defeat".

These times of heightened uncertainty and nervousness provide investment managers with the opportunity to demonstrate the real value they can deliver to investors. The best way to test how sturdy your investment vessel is and how skilled your crew is, is not on a mill pond but in a storm. Or in the typically pithy words of Warren Buffett "... it's only when the tide goes out do you discover who's been swimming naked".

Readers will be relieved to learn on a variety of fronts that the 7IM Investment Management team are very much swimming with costumes on! A key part of our long-term success has been an ability to cope well with crises – think of the Great Financial Crisis of 2008 or the Brexit vote of 2016 or the COVID pandemic. 2022 is currently shaping up as another example of a challenging year where our portfolios are weathering the storm. Certainly, portfolios have not been able to avoid the downdraughts completely, but they have been controlled and are in good shape to recover strongly when better conditions appear, as they inevitably will.



Much of the confidence we have in our approach is derived from our investment identity. Our identity is our anchor and won't ever change."

Much of the confidence we have in our approach is derived from our investment identity. Our identity is our anchor and won't ever change. We pride ourselves on being unashamedly conservative – the team-based approach and our commitment to risk management are paramount. We continue to – and will always – build properly diversified portfolios which balance asset classes, sectors and currencies across a whole variety of regions. We refuse to follow investment fashions and instead, we remain focused on our clients' goals and the soundness of our long-term plans.

Turning to this publication, Ahmer Tirmizi has the enormously difficult task of making sense of the current environment, while Jack Turner turns his expert eye towards the future for sustainable investing. And finally, Ben Kumar reminds us that even during a recession, history tells us to remain invested.

Enjoy reading and please be assured that however challenging market conditions may be, we will be faithful to the identity that has seen us successfully navigate similar episodes in the past.

MARTYN SURGUY

Chief Investment Officer

Strategy

How many corners can your portfolio look around?

There are too many corners!

Investors often think markets are efficient, forward-looking, discounting mechanisms. This is a fancy way of saying; they adjust quickly for the future. Not only can they look around the next corner, but they can navigate the next several ones too. This is only partially true.

If there is just one problem to focus on, markets aren't so bad at figuring it out. But the more things that are going on, the more corners there are to look around, and the more confused they become. And right now, there seems to be a lot going on. Where will inflation peak? And what will happen to growth? And Ukraine? And Europe's winter? And Taiwan? And the US mid-terms? And the 'fiscal event'? There are a lot of corners.

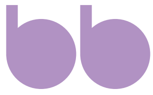
Two things happen in these situations. First, stuff that shouldn't matter, starts mattering. Why exactly did European and US bond yields rise on the back of the UK's unrelated budget? Second, markets find one thing, the thing they think is around the corner, and obsesses over it more than any other. This is a problem because those other things haven't stopped happening!

Markets are only looking around the first corner: Inflation

It's not often that 'Wall Street' (the markets) cares about what 'main street' (ordinary people) is thinking. But right now, they do care. Because main street is focusing on inflation. How long will it stay high? When will it come down? And where will it fall to? These questions are crucial.

Inflation is created by human psychology. If we all start thinking that inflation will be high for a long time, we start factoring that into our wage demands more permanently. Which then does keep inflation high. Or if we think that goods today will definitely be more expensive tomorrow, we might buy more of them today before those prices go up. This rush to buy also pushes inflation up. It can be a self-fulfilling prophecy.

Central banks, led by the US Federal Reserve, are obsessed with this question of people's 'inflation expectation'. Remember that their main purpose is to keep inflation under control. To do this, they need the rest of us to believe they will keep inflation under control. This explains why interest rates have surged this year and may remain there for a while. Crush inflation at all costs – in the minds of the general population – and, eventually, it will come down.



Inflation is created by human psychology. If we all start thinking that inflation will be high for a long time, we start factoring that into our wage demands more permanently."

As a result, Wall Street currently has tunnel vision about inflation. It's the only thing to care about. The next corner doesn't matter. Every inflation-related data, commodity price move, and central banker statement has been followed by extreme market reactions. The market returns are a testament to this. 2022 has seen the worst returns for bonds since the infamous 1970s. Equity markets don't take kindly to this inflation and interest rate uncertainty either – as we've seen this year.

Don't ignore the costs of crushing inflation

One of the major sources of angst over the last year has been 'supply-chain' problems. Stuck at home, we bought too much stuff, clogging up the global freight industry. Too many goods, not enough space. This caused a huge backlog in ships waiting to dock (most notable on the US west coast) and a surge in shipping costs. This was arguably the canary in the inflation coalmine. As of end-August, though, the number of ships queuing to get into those same west coast ports has fallen to close to zero, with global shipping costs down by almost half and heading to pre-COVID levels fast. This could well be a new canary, signalling the peaking of inflation. »

AHMER TIRMIZI

Senior Investment Strategist

Strategy
Continued

In addition, the pace and extent of central bank rate hiking has made sure that, while timing is uncertain, the job of crushing inflation will happen – regardless of what's going on in supply chains. But something important is going unsaid and being ignored. To bring inflation down, policymakers need to bring growth down. Raising interest rates makes consumers think twice about that next purchase, while businesses shelve investment plans. Slowing growth isn't a by-product of reducing inflation. It's the essential ingredient. And to bring inflation down to comfortable levels, you need to bring down growth to uncomfortable levels. Perhaps recession levels.

The Bank of England has literally said so. The US Federal Reserve, the most important central bank, on the other hand, is not saying a recession is required. And investors, so focused on the inflation topic, are not questioning this. But we are. As inflation comes down over the next year, we believe we need to focus on the next corner – the potential for US recession. That shift in focus could prompt further trouble in markets.

Portfolio diversification helps deal with whatever's around the corner

Historically, US recessions have coincided with equity market falls of over 20%. So, looking at equity returns this year, it would be easy to conclude lower growth in the US is priced in. However, we believe that the fall we've seen so far is simply because interest rates and inflation have gone up.

If rates go up, investors want a higher future return from equities (and thus want to pay a lower price). But it's not clear that they are factoring in the hit to growth. Market earnings expectations are still predicting growth of over 10% per year, for the next few years. We think this is unrealistic, if a recession begins. Remember, slower growth is essential to bringing inflation down.

The natural instinct on hearing about a recession is to raise cash and run for the hills. When investors panic, they struggle to look beyond the first corner and so, only focus on the 'solution' to what they think lurks there. But where we face multiple challenges, investors should look for multiple solutions.

They should allow their portfolio diversification to help them deal with whatever is around the corner – and the next few after that. Every 7IM portfolio starts with a Strategic Asset Allocation (SAA), built to grow over the long-run, while acknowledging that the long-run is a series of short-runs where anything can happen.

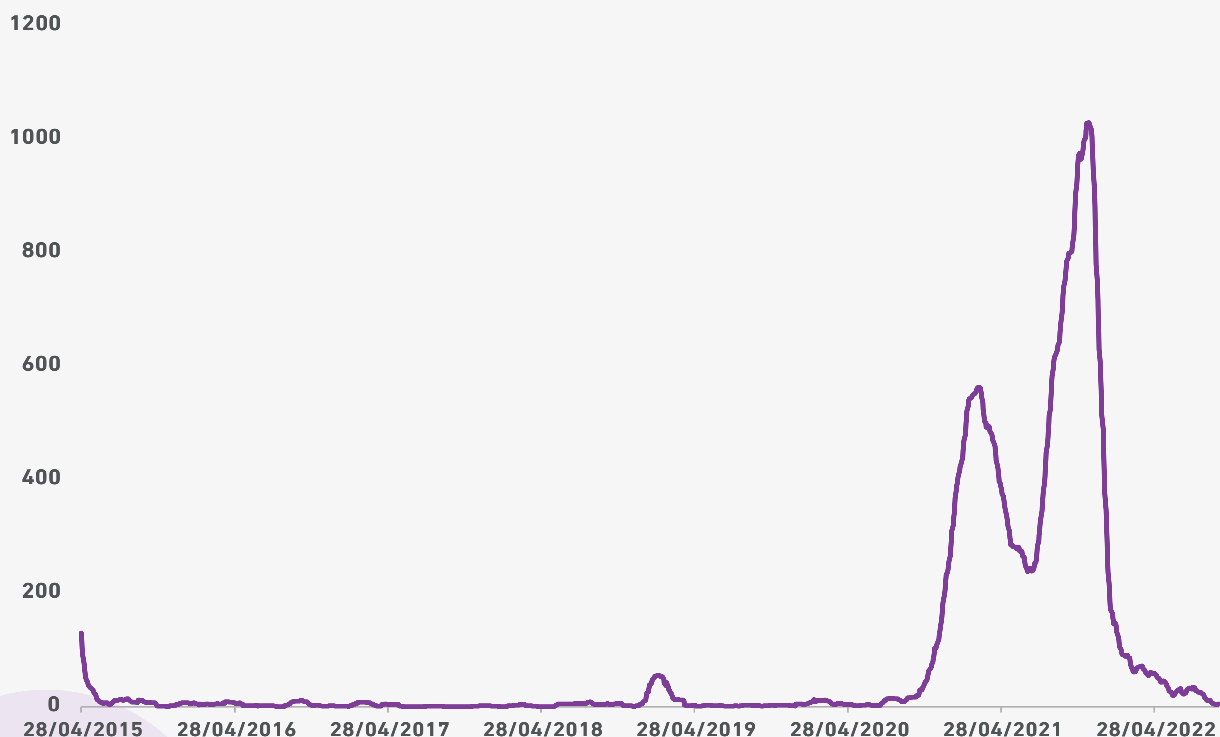
It deals with this by:

- **Diversified equities exposure (not relying on US equities for returns)** – When things become uncertain, it pays to reduce concentration rather than increase it.
- **Diversified returns (credit can generate equity-like returns)** – Right now, high-yield bonds are offering yields of almost 10%+. Equities will need to work extra hard to deliver that!
- **Diversified defensive assets (alternatives)** – the last couple of years have demonstrated why bonds should play less of a role in portfolios. The 7IM alternatives basket adds the protection investors are looking for.

But we also have taken a step back and adjusted the long-term SAA for the world we see coming. We call this the Tactical Asset Allocation – choosing which of the many tools to use at a given time:

- Underweight equity risk – we think limiting equity exposure in favour of other assets makes sense.
- Global healthcare tends to be defensive – healthcare profits will stay stable as the US recession hits.
- Climate change solutions are not linked to the economic cycle – there will be no let-up towards the climate transition even as the economy slows.
- Selling market insurance during bouts of fear is profitable – as fear picks up, so does the premium to insure against it. Equity-like returns, with lower downside, are available for those that can do it.

Vessels at LA port, number waiting to dock has collapsed back to zero



Data source: Bloomburg

The canary in the inflation coalmine was global shipping costs. As we were stuck at home, mostly buying goods, the cost of transporting those goods surged, a big driver of the inflation we are seeing. As we switch to spending on services from goods, those shipping costs have started to come down. Eventually, this will feed through into falling inflation. Sometime next year, the focus will shift from falling inflation to its cause, falling growth.

Every 7IM portfolio starts with a Strategic Asset Allocation (SAA), built to grow over the long-run, while acknowledging that the long-run is a series of short-runs where anything can happen."

Ahmer Tirmizi, Senior Investment Strategist

Portfolio implementation

A window into a changing world

One of the great aspects of managing sustainable portfolios, is that it gives you a fantastic insight into how quickly technology is adapting to fix the world's problems. These new technologies are far-ranging and hit every part of our daily lives. This isn't just about electric vehicles; take the food you're eating, for example.

We've all heard of Beyond Meat, but strangely enough, the more interesting firms are now involved in how we feed the food we eat. DSM is a company revolutionising the agriculture world by making more sustainable livestock feed. This is becoming increasingly important as the input demands for rearing your favourite foods are huge. It takes 25kgs of feed to produce 1kg of beef, and 15kgs to produce the lamb needed for a standard family roast. More of a pescatarian? Well now there are companies specialising in developing algae-based omega 3 substitutes that can be used in fish feed, instead of actual fish! Both food substitutes mean more guilt-free meals coming your way.

Some of the most impactful technologies are in the industrial sector, new ideas that are making dirty industries fit for a low-carbon world. Befesa is that type of company. It helps make the production of steel more efficient, a metal that is frighteningly polluting to produce. Befesa's best-in-class recycling technology offers an alternative to landfills and its technology can extract and re-use the valuable metals contained within hazardous waste created in the production process.

Some of the most impactful technologies are in the industrial sector, new ideas that are making dirty industries fit for a low-carbon world."

Hoffman Green Cement specialises in a more sustainable method of producing cement. Cement is the source of 8% of greenhouse gas emissions globally – just look at all the buildings and roads that you can see from your window. Currently, there are few decarbonisation options, meaning that the sector is coming under increased pressure to innovate. Hoffmann Green cement has developed one of the few scalable low-carbon solutions, that significantly reduces emissions whilst providing superior technical performance.

But not all technologies are destined for glory. Hydrogen has been dubbed as the answer for virtually everything for the last 30 years, but it is becoming increasingly uncompetitive for use in passenger cars, lorries and heating homes. Its real potential might still be realised in energy-intensive industries like aluminium production, but don't expect to see it when you next fill up at the petrol station.

There is strong evidence that suggests when oil prices are high, patents for new technologies increase as entrepreneurs look for alternatives. This occurred in the 1970s and early 2010s, and with the oil price back near the sweet spot, there should be even more interesting companies to invest in, in the future.

JACK TURNER

Investment Manager

Featured topic

Investing through a recession

If you've read the financial headlines recently, you're probably a little nervous about a recession. And as Ahmer noted earlier, we share some of those concerns. At some point, a recession will happen – it's part of the way the world works. And making sensible investment decisions during that recession is essential. That's quite literally our job.

But it's important to be clear on what we believe that job entails. Because when recession hits, it can be easy to think that the sensible investment decision is to be nowhere near the market. To move to cash. To avoid losing any money.

That's not the case.

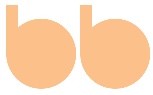
Our job is to make sure that the majority of our clients' money is working over the long term – we are not 'Dis-Investment Managers'. To understand that, it's helpful to understand our mindset, and what 'success' means for our clients.

When 'winning' matters...

In competitive sports, winning is everything. Your number of wins dictates your level of success. If you're a football or rugby or cricket team, the ideal season would be one where you win every game and lose none.

Or look at a period in the career of recently retired tennis player Roger Federer. Between 2003 and 2008, Federer was unbeaten for 65 matches on grass, resulting in five successive Wimbledon titles. One loss, at any point, would have cost him one of those titles.

Whether it's beach volleyball or boxing, chess or croquet, the optimal strategy is identical for every competitor. Maximise wins. Beat everyone else. If you win the most, you'll be the most successful.



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...and when it doesn't

People talk about investing in the wrong way. There are 'good' investments and 'failing' investments. We hear about superstar stock pickers, league tables of their funds, and quarterly or weekly (or daily) 'results'. Pundits appear on financial shows and in newspapers, talking excitedly about possible 'winning strategies'. TV shows like *Billions* push the competitive narrative even further. Investing ends up being portrayed as a tournament.

It isn't.

Investing isn't a head-to-head competition. And if people get suckered into thinking about it competitively, they end up approaching investing in completely the wrong way – thinking about short-term results, instead of long-term outcomes. They get twitchy, and start equating portfolio declines with 'losing', and 'losing' with 'failing'.

But there's no match or race to win when it comes to investing. No grand prix, no world cup, no Olympic final, no trophy. More importantly, no one-off event to 'lose'.

Instead, the right mindset for investing is to approach it as you approach having a healthy lifestyle; as a long-term way of behaving, which acknowledges that there's no finish line or final whistle. You don't 'win' or 'lose' a diet or an exercise regime – you just try to do the right things over time. If occasionally you drink and eat a little too much, or skip a workout, it doesn't mean you've lost. You don't abandon everything, and then wait for next season.

It's a process, rather than a match. Fluctuations in markets happen. They're an integral part of the experience of investing. Treating them like losses to be avoided is the wrong approach.

If you broadly stick to your process, over time, you'll see the benefits – whether physical or financial. »

BEN KUMAR

Senior Investment Strategist

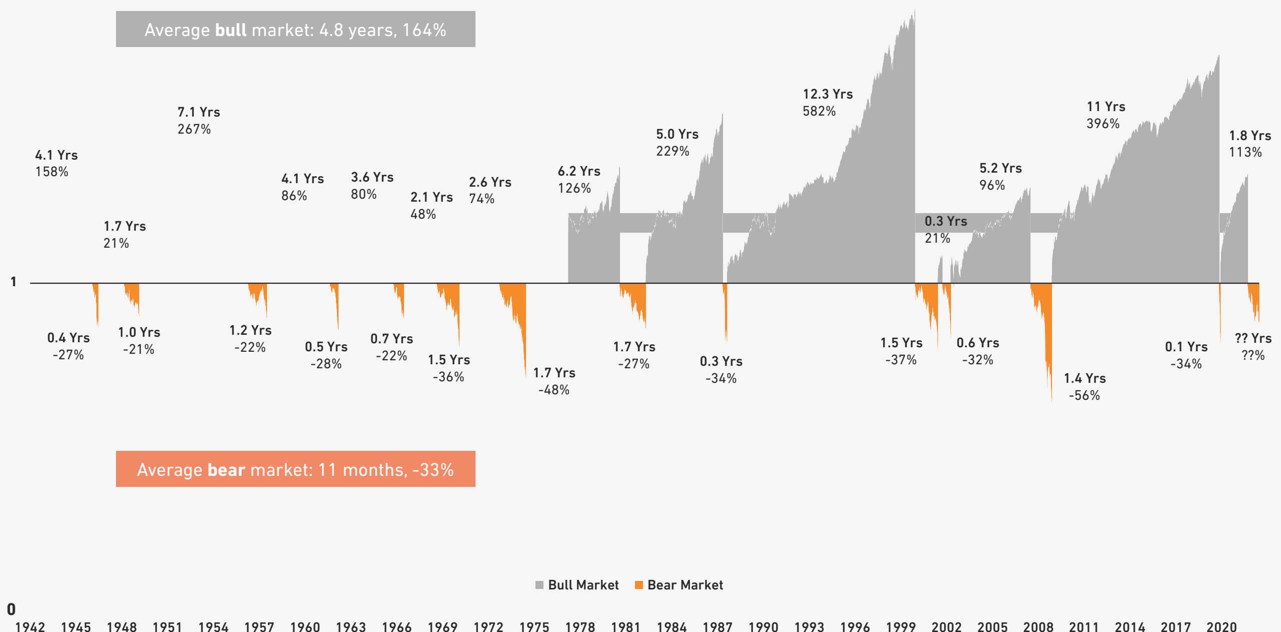
Featured topic
Continued

The secret to successful investing? Don't worry about 'winning' or 'losing'

Adopting this process-driven way of thinking is especially important during recessionary periods, when the temptation is to make extreme portfolio decisions to try and avoid any pain. But much like going on a crash-diet causes backsliding, or trying to get fit quickly causes injuries, this is often counter-productive.

Investors who are trying to time the market over the course of an investment cycle often suffer whiplash. It won't be until a recession is underway before they feel like they're losing the match. They move to cash to try and avoid 'losing'. Then the market bounces, but they buy back in too late to give themselves a chance to 'win'.

Looking at financial history helps us understand why timing the market – abandoning the process – is rarely a good idea. The chart shows bull and bear markets going back to the Second World War (using US equity markets where there's lots of data).



Data source: 7IM, Bloomberg Finance L.P

Past performance is not a guide to future returns, chart(s)/data for illustration purposes and are not for further distribution. Returns and analysis is based on daily total returns. The chart is for illustrative purposes only.

On average, half of the total bull market returns occur in the first year following a bear market."

Although the world has changed a lot in the last 80 years, the investment cycle has maintained a familiar shape. The heartbeat of market forces looks pretty similar through the decades. Neither good times nor bad times last forever.

The good times tend to be better than the bad. Bear markets see average declines of 33%. Bull markets see average gains of 164%. And the good times tend to be longer than the bad. Bear markets last an average of 11 months, while bull markets last an average of nearly five years.

But there's another important statistic hidden away in the data – which explains the whiplash mentioned earlier. On average, half of the total bull market returns occur in the first year following a bear market. That bounce back from recessionary lows to starting a new cycle happens violently and quickly – we saw that most recently during COVID-19.

Missing out on that first period of gains is catastrophic for returns.

So, our process is designed to avoid that mistake. We want to make sure we're invested for the ups, which means accepting that we'll be invested for the downs.

Of course, there are things you can do to soften the blow of those downs. We can reduce equities a little and have had some success over the last few years doing this. But this is a full-time decision not to be taken lightly – something we strongly advise our clients against trying. And even though we have had success, when we do reduce equities, we make sure that our clients still have enough equities for their long-term goals.

Other things you can do involve holding diversifying positions. Traditionally this would be bonds, that tend to make money (not this year!) when equities don't. The trick here is to find diversifying assets that help you in the bad times, but don't offset equities in the good times. Easier said than done. Our custom alternatives basket has played that role in the last few years.

The upshot is that we'll try and mitigate the impact of the down periods on our clients' portfolios, but we'll never avoid them entirely. Doing that all but guarantees a lower return in the longer term.

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, 25 years of industry experience.

Hugo Brown
Investment Analyst – Alternatives

BEng, 3 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, 7 years of industry experience.

Tiziano Hu
Junior Quantitative Strategist

MSc in Financial Technology, 1 year of industry experience.

Salim Jaffar
Investment Analyst

BA in Economics, IMC, 2 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, 13 years of industry experience.

Risk Team

Joe Cooper
Head of Risk and Portfolio Analytics

CFA / MSc in Applied Economics, 11 years of industry experience.

Alex Mitsialis
Senior Performance and Risk Analyst

MSc / CFA, 6 years of industry experience.

Loic Yegba
Investment Risk Developer

MSc Mechanical Engineering, CFA level 3 candidate

William Wood
Investment Risk and Performance Analyst

BSc in Physics, 4 years of industry experience.

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