Your investment update

Q1 2023

Succeeding together

7IM

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Welcome

A tough year... (to be continued)

Phew! Glad that's over. Not many people will look back on 2022 with any fondness. Certainly not consumers who've faced soaring costs on all fronts, from food to interest rates.

Not investors who've had to struggle with huge volatility in asset prices, negative returns and a world where so-called 'conservative' investments prove to be anything but. And certainly not policymakers who have been forced to deal with a set of circumstances, namely stubbornly high inflation with slowing growth, that they'd only ever encountered in history books.

The problem of course, with my opening sentiment is that the challenges outlined above will not disappear merely because the clock has ticked over to 2023. It is simply the calendar year, which is over rather than the market environment. It is distracting and frankly, not very helpful to see the new and exciting market outlooks for the New Year which dominate the airwaves, inboxes and post-boxes throughout December. That has never been our approach. Financial markets don't respect neat end of year-end. It's likely that the tough conditions of the last few months will continue for at least the next six months. That's the world we are positioned for.

2022 has delivered negative returns for clients across the board. That's always unsettling, particularly given the tumultuous domestic backdrop, which tends to loom larger in our thinking and concerns than it should. It's worth restating that we are a global investor, so portfolios are not as linked to developments in the UK as many might fear. This, combined with our cautious approach, has enabled us to avoid the worst ravages of market falls.

Our senses have been assaulted by wave after wave of negative news in 2022. We've consistently reminded our clients of the importance of staying the course, focusing on the long-term plan and avoiding emotions in investment strategy.

Combining this strategy with a conservative style, a commitment to being properly diversified and a desire to avoid fashionable 'hot' areas of investment should be a winning approach. But when? And where should we set our expectations?

You will read elsewhere in this publication about 'regime change'. We've seen the end of an era of derisory interest rates, benign inflation, stimulatory monetary policy, globalisation and a stable international order, which creates a sea change for investors. The challenge as we consider our expectations for the future is the frame of reference we use. For instance, many house buyers are speculating when mortgage rates might become more affordable and fall back to the 2 to 2.5% range that was the 'norm' a few years ago. That's likely the wrong frame to be using. Unfortunately for them, they should be looking to the pre-financial crisis period when mortgage rates averaged 5.5%, not the last ten years.

We've consistently reminded our clients of the importance of staying the course, focusing on the long-term plan and avoiding emotions in investment strategy."

Similarly, for investment markets, the temptation is to look to the 2011-2021 period for reference. This was a period of US supremacy, growth-style equity dominance, rock-bottom bond yields, and diversification just not delivering. This is not the world we expect to move back into. Rather, we expect the change in regime will be long-lasting. We should get used to higher rates, higher inflation and international disorder. We should get used to equity markets driven by specific industries and sectors rather than countries. And we should get used to proper diversification resuming its rightful role as the bedrock and key to success for any sensible long-term investment strategy.

Although the world we've moved into might not be a straightforward one, it is a world where our portfolios should do well. I am optimistic that an approach with a demonstrably successful long-term structure (the Strategic Asset Allocation) supplemented by thoughtful tilts (the Tactical Asset Allocation) will prove to be rewarding. It's an approach where long-term themes in healthcare, climate change and natural resources are complemented by meaningful allocations to alternative investments. An approach where risk management in all its guises is at the forefront of our attention. Salim Jaffar and Ahmer Tirmizi add more detail in their pieces below.

As George W Bush (of all people!) famously said "hindsight is not wisdom and second-guessing is not strategy". The same is true of investments. Nothing ever goes completely as planned. We're not looking backwards as a guide to the future and our approach leaves us prepared for whatever 2023 might bring – Ben Kumar digs into that at the end.

Enjoy reading and may I take this opportunity to wish you all the healthiest and happiest New Year.

MARTYN SURGUY

Chief Investment Officer

Strategy

It's the economic cycle, stupid!

In many end-of-year market commentaries, you'll see phrases like 'the FTSE has held up *relatively* well' or 'the S&P has *really* suffered this year'. But there's something weird about these phrases that get missed.

What they are *actually* saying is that...

- an arbitrarily chosen group of stocks...
- weighted and rebalanced idiosyncratically...
- in geographies you could slice up in any number of ways...
- over a time period determined by a rock spinning around the sun...

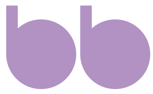
...has done x, y, or z.

Sounds like a lot of randomness when spelt out like that, right? And it tends to mean that people *reading* the commentaries focus on the wrong things:

First, the timeframe – humans obsess over calendar years. For long-term investors, the key market driver is the economic cycle.

The global economy and the slow-moving factors that impact it don't care about the Gregorian calendar. The coronavirus wasn't waiting until the earth moved around the sun to spread, and Putin didn't invade Ukraine because of his *New Year, New Me* resolutions.

Second, the actual indices. The S&P 500 didn't underperform the FTSE 100 simply because it's a collection of the 500 largest US-listed stocks. It wasn't the size of the companies or the location of their headquarters that mattered. The S&P underperformed the FTSE 100 because, on average, S&P stocks were more technology-focussed, trading at higher valuations, were more sensitive to rising rates, and didn't have the same energy exposure. Yet we insist on linking indices to countries.



The coronavirus wasn't waiting until the earth moved around the sun to spread, and Putin didn't invade Ukraine because of this New Year, New Me resolutions."

We know that the S&P *massively* underperformed the FTSE this year. But if you take the biggest ten stocks out of both indices and calculate the returns of the remaining stocks, the results are completely different:

	2022 return
S&P 500	-19.4%
S&P 500 excluding top 10	-8.8%

	2022 return
FTSE 100	0.9%
FTSE 100 excluding top 10	-9.8%

So, there really isn't a simple story for each index. Taking big tech out of the S&P, and a few hefty blue-chip energy and materials stocks from the FTSE, means the indices respond to economic conditions very differently. As forward-looking strategists, understanding the drivers of the economic cycle allows us to make more nuanced forecasts than just picking indices. >>

SALIM JAFFAR
Investment Analyst

Strategy
Continued

Why are we talking about this now?

We are heading into a new part of the economic cycle. Things will be different, and it's our job to create a picture of what we think this cycle will look like. This picture doesn't care about indices or annual timeframes. Only once we have this picture can we form our best view on which assets we want in our portfolios – Ahmer Tirmizi discusses this later.

To compare the last economic cycle with what lies ahead, let's strip down the old cycle versus the new cycle into data points that we can monitor:

Inflation

Recent high levels of inflation have really hurt, but context is always important. Since the turn of the millennium, we have got used to abnormally low inflation in the developed world. Going from below-target inflation to 40-year highs has felt extreme, but over the next cycle, we will have to get used to higher trend inflation.

Right now, shocks are still having a very real impact on the economy and inflation – things aren't *normal*. Huge Covid stimulus packages led to demand-driven inflation, and Russia's invasion of Ukraine led to volatile and uncomfortable supply-side pressures.

After 2008, the factors keeping inflation low were longer-term. Banks were made to sit on more cash so lower rates didn't kickstart inflation the way textbooks say it should, and the economic slowdown was drawn out. The factors at play now should be viewed very differently. Stimulus will pass through the economy, and the supply-side constraints will ease.

We believe inflation will settle at a level above the pre-Covid norm in the coming years.

Interest Rates

The rates story is similar to the inflation one. Since the 80s, rates have been coming down very consistently in the major economies. And since 2008, rates have been really, *really* low. Again, this is not *normal*, and it certainly isn't something companies, consumers and governments should have got so used to.

Central banks have their feet on the brakes. They are determined to kill inflation, and the data are starting to turn.

But ***central banks will be in no rush to get rates back to the historic lows of the 2010s – they'll take this opportunity to press the Reset button***. In the 2010s, central banks could not use interest rates as an expansionary policy tool once rates hit zero. By re-normalising interest rates in a 3-6% range, central banks will regain their ability to put their foot on the accelerator when the next slowdown comes by meaningfully cutting rates.

Growth

This is harder to forecast, because there isn't as much of a *return to normal* as there is with inflation and rates.

In the short term, most economic leading indicators are saying a recession is just around the corner. The yield curve has dramatically inverted, and consumer confidence has taken a knock. Perhaps more importantly, central banks are willing to embrace a recession as the lesser evil versus inflation.

But the story is not all bad. Economies work in cycles, and ***we expect growth over the next cycle to be higher than what we have seen post Global Financial Crisis***. The recession we are heading into is *not* the GFC. Systemically important companies are not on the verge of collapse, and the largest part of the average individual's wealth – property – is not in crisis.

The shorter-term factors that are causing this recession will soon go away and are not likely to cause a recession as deep or painful as the one following 2008.

The story is not all bad. Economies work in cycles, and we expect growth over the next cycle to be higher than what we have seen post the Global Financial Crisis. This is not the GFC."

Salim Jaffar, Investment Analyst

Portfolio implementation

Our portfolios are ready for a recession... and the recovery

A well-telegraphed recession

The market outlooks for 2023 are starting to come through, and they make for unhappy reading, though as Martyn said at the start, they're usually best ignored entirely. Talk of recessions are being ramped up.

The UK has just brought one onto itself, Europe has been forced into one by Russia, according to the Federal Reserve the US *needs* one, and China is torn between controlling Covid and stimulating growth. Whatever the reason, 2023 will be the year where consequences (intended and unintended) lead to a synchronised global slowdown.

Cash is a tempting mistake

When recession talk picks up, imaginations can run riot. What will happen if house prices fall? How bad will the equity market downturn be? What's the job situation going to look like? The temptation in this situation is to move to cash and 'sit it out'. But this is usually the wrong thing to do. Instead, remembering that equities recover over the long run is helpful.

It's also important to acknowledge the job of a multi-asset portfolio is to smooth returns during times of stress. Traditionally, holding bonds and foreign currency alongside equities has done the job well. But traditions evolve, and at 7IM, we try to move *ahead* of everyone else. A big part of the way we have guided portfolios through the recent downturn is to have a market-leading alternatives capability.

7IM's unashamedly conservative approach has recessions in mind

What goes on in the conventional part of the portfolio is equally important, though. Managing this part is a careful balancing-act between smoothing returns in the short-run and capturing the long-run returns on offer to meet our clients' savings goals.

Whatever the reason, 2023 will be the year where consequences (intended or unintended) lead to a synchronised slowdown."

One way to do this is to **adjust the amount of equity** we hold through the cycle – this requires full-time monitoring by a team of professional investors, a lot of quantitative and qualitative economic analysis and is certainly not something clients should consider themselves, no matter how tempting it may seem. Another is to make sure the equities we do hold are **properly diversified** across geographies and sectors – avoiding concentrated positions is key to managing recession risks.

Finally, we can look to find **equity replacements**. Equities tend to deliver the strongest returns over the long run, but at certain points in time there are other asset classes that offer similar potential.

So instead of buying shares (which offer you a slice of a company's profits), you could invest in the company's *bonds* (lending to that same company). Most of the time, shares should return more than lending, but occasionally the opposite is true.

Right now, corporate bond yields can be anywhere between 5–10%, depending on the company. That's a high hurdle rate for equity returns, which tend to need companies to predictably grow their earnings, which is difficult in a recession. By contrast, strong credit returns simply require companies to pay their debts – *much* more likely in a recession.

Another example is Put-Selling, which is akin to selling insurance on the equity market. The more nervous investors are, the more they pay for insurance; currently, equity investors pay over 3% per month to protect against market falls. Steadily receiving 'premium' payments is a moneymaker over the long term – there's a reason insurance companies are some of the oldest businesses in the world!

In most scenarios, the insurance premium is so high that equity markets would have to rally by more than 30% in a very short space of time for put-selling to underperform. Given that we're still not far from all-time equity highs and just approaching a recession, the chances of this are extremely slim. Equity-like returns when equities are struggling is exactly the kind of 'risk assets' our clients should be exposed to in a recession.

AHMER TIRMIZI

Senior Investment Strategist

Featured topic

Compelling stories aren't investment wisdom

A life of stories

Our lives are built around stories. As children, stories send us to sleep each night. As adults, they're also everywhere. On commutes and on holidays, on evenings out or nights in, we're reading, watching, and listening to stories. At birthdays, graduations, wedding days, retirement dinners and funerals, we tell stories to our friends and families.

It's been like that for thousands of years. From fireside sagas to Shakespeare to Netflix, human history *is* storytelling.

Even in our high-tech modern world, stories are incredibly powerful. Advertising *is* storytelling – and makes up almost all of Google and Facebook's revenues. Jeff Bezos founded one of the biggest companies in the world as a place to sell stories online. Hollywood is built on stories and populated by the people that tell them. We see heroes and villains all around: politicians and film stars, royals and billionaires, footballers and comedians. Stories are everywhere.

And that won't change.

Looking for patterns to learn from

Stories are wired into our biology, as part of our evolution. One of the main problems in life is that facts are boring. Memorising long lists of things is *difficult* and can feel pointless – who's to know what might be useful or not? Stories tackle both of those problems.

Human beings are *incredible* at spotting complex patterns in the world. But we're *even better* at communicating those patterns to others. The ability to tell a story allowed our ancestors to do something no other species could do – use the past to predict and prepare for the future. To learn, and then to teach in a highly effective way. >>

Stories stick in the brain better than facts

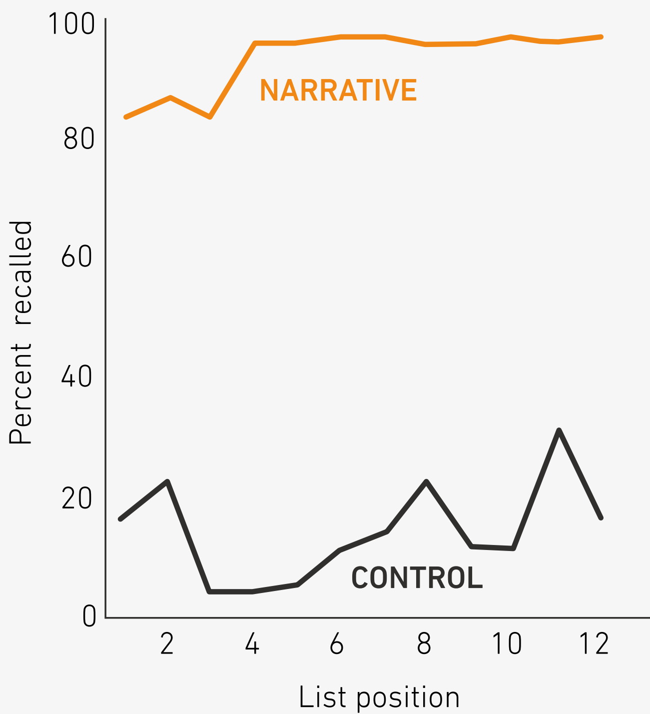


Fig. 1. Median percentages recalled over the 12 lists

A psychology experiment in the 1960s gave students twelve lists of ten random words. The control group were simply asked to remember as many as they could. The other group were told to make up stories using the words.

The storytellers remembered 93% of the words, while the list-learners could only remember 13%. Narratives are enormously powerful!

Data source: Bower, G.H., Clark, M.C. Narrative stories as mediators for serial learning. (1969).

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.

BEN KUMAR

Senior Investment Strategist

Featured topic
Continued

Learning is *much* easier with stories (see box). A story gives memorable structure to a series of facts, and – if told well – is interesting enough to be worth listening to, whether it's useful or not. Most people don't know much about the Wars of the Roses but can happily reel off exactly what happened to who in *Game of Thrones* or *Harry Potter*.

In pre-history, these stories allowed generations to pass on useful knowledge, e.g. avoiding dangerous areas through passing down stories of haunted caves and monsters, or sharing successful hunting techniques through heroic tales of victory. Think problem-solving through pattern recognition, and communication. Survival through stories.

Narrative bias

Patterns and narratives are still a key part of our lives: by some estimates, two-thirds of all conversation is storytelling[1]. Most of the time, it doesn't matter whether these stories are true or not – they're harmless and enjoyable diversions. But from time to time, our tendency to fall for a good story can get us into trouble. Our bias towards a compelling narrative stops us from thinking clearly.

This bias can be deliberately exploited. Conspiracy theorists and cults use it to recruit and indoctrinate believers. Dictators use it to gain power, while con artists use it to steal.

On other occasions, there's no malevolent force at work – it's simply that a story becomes widely accepted and leads to irrational behaviour. Take the hoarding of loo-paper at the start of lockdown – would you have thought about it if you *hadn't* heard about it? Or hour-long petrol station queues, based on rumours of shortages?

In investing, narrative bias often overwhelms common sense – arguably it's what creates the market cycle of ups and downs. During recessions, the negative story becomes so consuming that no-one wants to *buy*. But recessions end. During bull markets, the positive story becomes so overwhelming that no-one wants to *sell*. But bubbles burst eventually.

Seeing past the current compelling story isn't easy. But a long-term investor has to do just that.

[1] Dunbar, R. Gossip in evolutionary perspective (2004)

During bull markets, the positive story becomes so overwhelming that no-one wants to sell. But bubbles burst eventually. Seeing past the current compelling story isn't easy. But a long-term investor has to do just that."

Beyond the story

How can we tackle narrative bias if the love of stories is so inbuilt? On the 7IM Investment Management team, we have a few ways.

The first is simply to remember that the more layers between us and the information, the more storytelling there will be. If something has happened in the financial world, it's best to look at the original data if possible – rather than a reporter's interpretation of a press release, or an analyst's write-up of a company's results.

We also try to avoid making very specific forecasts; it's too easy to get carried away in building a story that ends up the way we want, only to be blindsided when the world changes. Instead, we use scenarios to describe more than one outcome, with as little evocative detail as possible.

Where appropriate, we rely on statistical models to help form our views. Numbers don't tell great stories, but they don't write fiction either. We have various kinds of model, built on different principles by different people, looking at problems in more than one way.

There will always be a story that *sounds* compelling. But our best chance of making sensible investment decisions is to assume it *isn't* the whole picture, and look for more detail and perspectives.

Meet the teams

Investment Management Team

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

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Hugo Brown
Investment Analyst – Alternatives

BEng, 3 years of industry experience.

Christopher Cowell
Senior Quantitative Investment Strategist

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Quantitative Investment Strategist – Multi Asset

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Salim Jaffar
Investment Analyst

BA in Economics, IMC, 2 year of industry experience.

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Senior Investment Strategist

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

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Head of Model Portfolio Management

CFA and CAIA, 21 years of industry experience.

Stephen Penfold
Senior Investment Manager

BSc in Economics & Computing, 36 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

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Loic Yegba
Investment Risk Developer

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William Wood
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Matthew Hall
Investment Risk & Performance Analyst

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