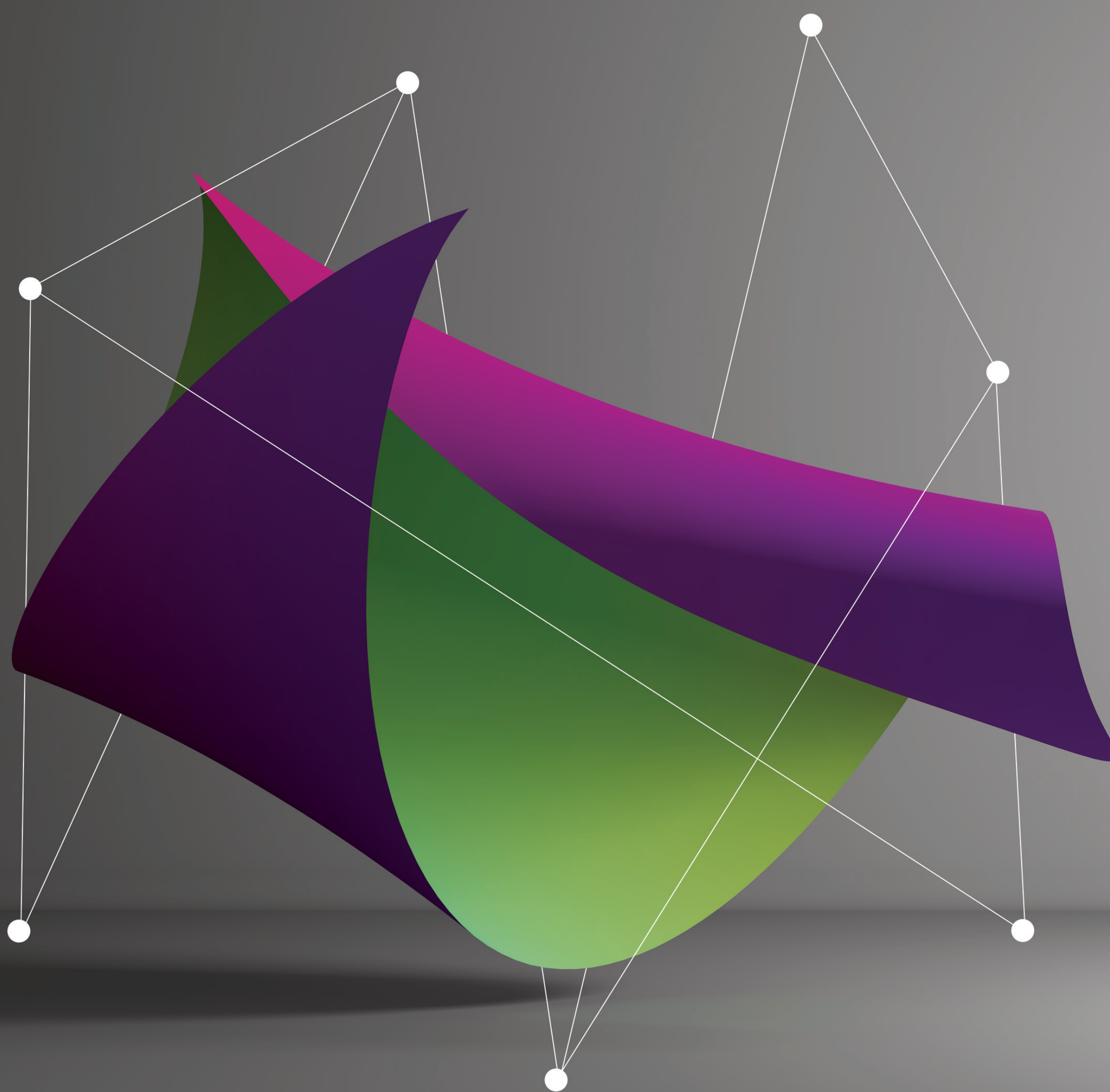
Your investment update

Q2 2022



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7IM

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Senior Investment Stratgist

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latest news and views.

Welcome

When Prime Minister Harold Macmillan described the greatest challenge facing decision makers as "events, dear boy, events", he can't have imagined that all the events would arrive at once. That certainly seems to be the case for investors at the moment, as we survey the global investment landscape. The geopolitical horror and human tragedy of the war in Ukraine has combined with soaring inflation, rising interest rates, and what we hope are the last throes of a global pandemic to challenge us in every way.

Of course, our first thoughts must be with everyone affected by the terrible events in Ukraine. It almost seems inappropriate to consider investments when confronted by the scale of human suffering we see on our television screens every day. But it's our job to steer a way through these events which have appeared all too often through time – not that you would necessarily be aware that anything untoward was going on from a brief look at stock markets, which are now above the levels they were prior to the Russian invasion. So, what is happening? How can this be?

Later in this publication, our Head of Investment Strategy and ESG, Terence Moll, considers the short and medium-term investment impacts of similar conflicts through history. He concludes that the impact is, usually, rather temporary notwithstanding the traumatic nature of the events themselves.

Energy prices, geopolitical alignments and ongoing energy security are the obvious hotspots. While not completely immune, it remains the case that the two largest economies in the world, the United States and China, are fairly well insulated from developments in Ukraine. This provides confidence for investors that we are not hurtling inevitably toward a global recession.

Moving away from the war, it's uncomfortably high inflation and rising interest rates which are much more traditional bogeymen for financial markets. Here, the news does not appear encouraging but, as always, there is nuance to it. Core inflation is undoubtedly rising (wages, key services, goods, etc.) but the reason that we are at 40-year highs is largely a function of more flexible elements such as energy, commodities and supply chain issues which do tend to be shorter-term in nature.

Regime change has arrived in interest rates too. The Federal Reserve and the Bank of England, amongst others, have now embarked on the journey to raise rates meaningfully. There is some way to go, but we should remember that interest rates have been operating at *emergency* lows since the Global Financial Crisis, which no longer seems appropriate given current conditions. Future rises seem assured but are well flagged and longer-term expectations do not appear to be untethered from current reality.

The changing environment will, once again, focus attention on being highly selective in our investment strategies. We have long argued that we are heading towards a world where a rising tide will not float all boats. We have preferred a strategy that targets specific sectors, such as healthcare or more cyclically sensitive areas which will benefit from steady growth – notably in Asia and the United States.

We have long argued that we are heading towards a world where a rising tide will not float all boats."

We have avoided mainstream bond markets which seem particularly vulnerable to the mix of inflationary pressures and rising interest rates. Instead, we have substituted alternative assets which are capable of delivering well in a much broader set of circumstances – as indeed they already have in 2022.

A sensible spread of assets is always our key to navigating challenges of the kind we face at present. That's ingrained in our identity. But so too is the absolute imperative of understanding the true characteristics of every investment in a portfolio and how they are likely to behave in moments of stress. Our Head of Portfolio Management, Uwe Ketelsen, expands on this in his piece. We know that we are as much risk managers as portfolio managers, so stress testing forms a valuable and differentiating part in the careful management of our clients' money.

Our emotions are very much to the fore as we digest the implications of the deeply troubling images we see in the media. That's highly dangerous for investors as reacting to emotional prompts is the enemy of generating long-term returns. When times become stressful, it becomes tempting to consider leaving well established strategies and plans to achieve our long-term investment goals. Our resident behavioural expert, Ben Kumar, puts this in context with a particularly appropriate historical example of panic, rather than planning.

So, there's perhaps more than usual to contend with in financial markets at present. However, in the frequently used words of President Abraham Lincoln, "this too shall pass", however unlikely that might seem today. Our strategy will always be to be sensibly diversified, highly selective, scrutinise every investment we hold and be faithful to a process which has delivered consistently well through similar episodes in the past. Enjoy reading!

MARTYN SURGUY
Chief Investment Officer

Strategy

Beating the Russian bear

For those of us who grew up during the Cold War, the year 1990 was an immense relief. The collapse of the Soviet Union meant that the threat of nuclear war had been swept away, we thought, and we could suddenly be far more optimistic about our lives and humanity.

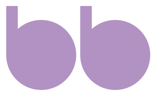
Not necessarily. Russia's invasion of Ukraine on 24 February 2022 was a reminder that Europe and the world are still riven by immense tensions and enmities. War with a rogue nuclear state is not inconceivable anymore.

All wars are human tragedies, above all. We empathise with the besieged people of Ukraine, the millions of Ukrainian refugees, and with the many Russians who do not support the war. At the time of writing, peace talks seem to be making some progress. While conflicts rarely end quickly, we hope this one is moving towards a tolerable outcome.

The surprises of war

The first surprise of the war is that Russia's military capabilities have been found wanting. In 2014, Russia swept up the Crimea without difficulty; not this time. The bear is big and bad, but not invincible, partly because many of its soldiers don't see the point.

Second, the Ukraine invasion has brought old Western allies together. Europe and the USA responded to the invasion with a barrage of sanctions and promises to hike defence spending. Even neutral Sweden and Finland have expressed interest in joining NATO, the North Atlantic Treaty Organization. Regardless of how the war turns out, formal and informal sanctions are likely to be applied to Russia for many years to come, with its people as the main victims.



If you look back after a year or two, it's often hard to see the effect of the war or geopolitical crisis, relative to the many other forces driving equity markets."

And third, the Ukrainian resistance has been remarkable. Mr Putin seems to have made the classic dictator's error of underestimating the commitment and capabilities of soldiers who are fighting for a democracy they believe in. This can be a costly mistake, as the leaders of Germany and Japan discovered during the Second World War.

Impact on financial markets

We have been following the situation in Ukraine closely, and considering what it might mean for our portfolios. While the Russian and Ukrainian economies are small, they are large producers of commodities, led by oil, natural gas and coal, iron and steel, as well as wheat and maize. To the extent that these products are taken out of world markets by sanctions and war, we can expect ongoing market bottlenecks and inflationary pressures – just when it seemed the post-COVID-19 pressures were beginning to ease.

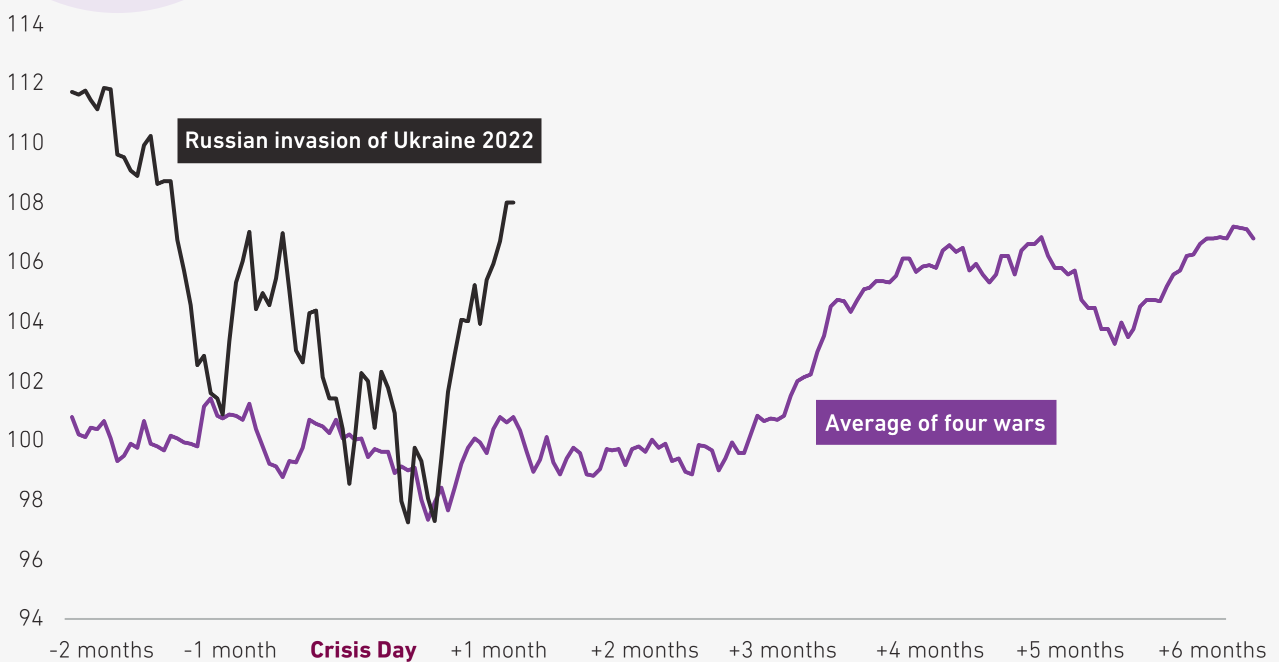
We have observed many wars and geopolitical crises over the years and found that financial markets often react in similar ways. This is illustrated in the chart, which refers to four major wars and geopolitical events since 1990, plus the Russian invasion of Ukraine. >>

TERENCE MOLL

Head of Investment Strategy and ESG

Strategy
Continued

The impact of five wars on global equities



Wars have curiously little impact on markets in the long run. This chart shows average S&P 500 returns over the two months leading up to four major wars since 1990 and the six months after. US equities fall after the crisis but recover quickly and are usually up by 3–6 months later.

The four wars are: Iraq invasion of Kuwait, 2 August 1990; 9/11; the 2003 Iraq War, beginning 20 March 2003; the Russian annexation of Crimea, beginning 27 February 2014.

Data source: Bloomberg Finance L.P.

Before the crisis, equity markets tend to do nothing much. If the crisis or war has been telegraphed beforehand, as in Russia's invasion of Ukraine, markets tend to fall.

Then the war begins. Markets usually plunge for about 5–15 trading days after that. They bottom out quite soon though, usually while the war or crisis is still on the go and do fine thereafter. If you look back after a year or two, it's often hard to see the effect of the war or geopolitical crisis, relative to the many other forces driving equity markets.

9/11 was a prime example. Two planes were flown into the World Trade Centre towers early that Tuesday morning, and markets were closed for the rest of the week. They opened the following Monday – and by Friday, the S&P 500 had lost 11.6%. Then it began bouncing and made all the money back by 11 October.

Why do equity markets work this way? The main reason is simple. In the long run, the value of a company should be determined largely by the dividends and share buybacks that it generates for many years into the future.

In practice, most geopolitical crises don't affect economic growth or company performance long term. Think of Apple, for example. Though 9/11 and the Russian annexation of Crimea in 2014 were major geopolitical events, did they affect Apple production, sales and earnings over the next decade or two? No. Apple's big markets in the USA, Europe and Greater China were largely unaffected.

Fortunately, it is rare that large economies declare war on one another. The last war that affected company sales and earnings across the world was the Second World War.

What next?

As shown in the graph, the S&P 500 reached a low 13 days after the Russian invasion and has bounced since. At the time of writing, it's about 10% above its 17 March low.

The worst might not be over. If the war continues, possibly even worsens, then Russian oil and gas might be banned from world markets, boosting energy prices and inflation. You can imagine scenarios in which oil reaches $200. Sooner or later, much of the world might plunge into recession.

Our view, though, is that firms, governments and consumers will probably be able to adapt to whatever lies ahead. 2021 was a great case study in adapting to difficult economic and financial conditions: most of the world came through pretty well. The path ahead might be rough, but we don't expect roaring inflation and growth will probably remain healthy, as we've been saying for the last year.

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Terence Moll, Head of Investment Strategy and ESG

Portfolio implementation

Managing portfolios under pressure – information and communication

Russia's invasion of the Ukraine on Thursday 24 February triggered a range of actions within the Investment Management team at 7IM. Most obviously, we had to review our existing positions. The first question we ask ourselves is whether the tactical ideas in our portfolios remained as valid after the events as they did before.

When it comes to investing for the long term, a valuable skill is the ability to *not* react; but instead to conduct a thorough assessment of where you stand. Knowing *what* you own is a vital first step. Much of what you can read in this Quarterly Investment Update reflects the next step of this process – working out what you want to do next.

We knew straight away that we did not have any material exposures at risk from the invasion. Investors rushing for the exits, were primarily focused on Russia or Central and Eastern Europe funds. However, we *were* concerned over potential 'herding' behaviour; would investors start penalising emerging market investments?

So, we have been monitoring fund flows in this space from the very beginning of the crisis. We are comforted by the fact that redemption pressures remained centred on investments with a narrow focus on Russia.

After the market impact, we had a second area of consideration – sanctions. Russia is now the 'most sanctioned' country in the world. We needed immediate knowledge of our exposures to Russian securities, their magnitude, whether these included sanctioned securities, and whether the external fund managers holding these securities had processes and systems in place to adhere to sanctions.

When it comes to investing for the long term, a valuable skill is the ability to not react; but instead to conduct a thorough assessment of where you stand."

Fortunately, we have on-desk risk and portfolio management systems at our disposal that allow us to quickly look under the bonnet of the funds we own. This is essential in times like this. Imagine the stress of having to look at their fact sheets or – worse – having to call them up. This 'look-through' enabled us to detect Russian (and Belarusian) securities in more than thirty actively and passively managed funds (including a FTSE All Share Tracker Fund) and liaise with each of those fund managers.

We were able to conclude that our fund managers had disposed of those exposures where possible, and that remaining holdings were small in size and could not be sold due to current restrictions. Perhaps more importantly, we found that our chosen external managers were able to keep up with the quickly changing sanctions landscape.

Given prevailing circumstances, Russian securities are generally un-investable at this time. Our blend of monitoring and risk management meant we were able to identify and minimise our direct and indirect exposure – and let our clients *know* what is going on in their portfolios.

UWE KETELSEN

Head of Portfolio Management

Featured topic

Don't 'Keep calm and carry on'... dig deeper, and challenge

When the world gets stressful, the way we think starts to change. Our survival systems start to swamp our analytical abilities. We oversimplify complex situations, overemphasise negative aspects and overcompensate for any risks.

And one of the (many) issues with our brains is that they're pretty bad at telling the difference between *genuinely* dangerous situations and *perceived* dangerous situations[1]. Tens of thousands of years ago, these overreactions were an evolutionary advantage; there were lots more genuinely life-threatening situations to avoid. In today's world, *most* of the time, panic is a false alarm.

That's particularly true in investing, where the number of life-threatening portfolio management decisions rounds to zero in most years. And yet the constant barrage of financial news – most with a faintly hysterical tone – prompts panic and stress, often on a weekly or daily basis.

What to do to remain level-headed?

There's a popular slogan that's trotted out again and again that I think can be helpful as a reminder. But not, perhaps, in the way you think.

[1] I've written about this lots of times before, but evolution moves slowly!

But the real *investing* lesson comes from the *history* of the slogan, not the slogan itself."

We've all seen the slogan, and another thousand different takes on it. Coffee mugs, posters, T-shirts. It's been one of the most successful memes of all time.

It's a simple message, and it sounds appropriate as investing advice. But the real *investing* lesson comes from the *history* of the slogan, not the slogan itself.

Many people think they know the history. In your mind's eye, maybe you can see the words, posted on a half-collapsed wall in 1940s London – symbolising the Blitz spirit, the stiff upper lip and the resilience of the plucky Brits.

BEN KUMAR

Senior Investment Strategist

Featured topic
Continued

But that's a completely made-up narrative. Here's what really happened[2]:

In the summer of 1939, as the potential for conflict became more and more likely, the Ministry of Information formed a small committee of civil servants, academics, and publishers to think about 'Home Publicity'. The remit was to work on a campaign to reassure the British public in the event that war (and accompanying panic) did break out.

The committee made an error. Although they were trying to *prevent* panic, they ended up panicking themselves. They started thinking about Nazi invasions of Britain – the worst-case scenario, given that war hadn't even been declared! They built a campaign for a problem that didn't exist; at the time, the general British population were quite relaxed about the day-to-day impact of a possible war. **Keep Calm and Carry On.**

If you're anything like me, you've experienced how irritating it is being told to stay calm when you're already feeling relaxed. It tends to irritate me – and the same thing became apparent when a few test versions were shown to a public who were calm and carrying on already. The civil servant in charge of the Ministry of Information, A.P. Waterfield, suggested that the poster would "annoy people that we should be seen to doubt the steadiness of their nerves"[3], while *The Times* called the posters "insipid and patronising invocations"[4].

The poster *never* made it into the public eye during the war[5]. Although two million copies were actually printed, these spent the first part of the war collecting dust on shelves in the Ministry of Information, before being pulped in April 1940 to tackle a paper shortage[6].

The *story* of Keep Calm and Carry On has a few lessons for investors looking to remain level-headed.

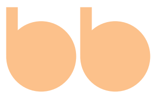
[2] Lewis, B. (2017) Keep Calm and Carry On: The Truth Behind the Poster. London. Imperial War Museum

[3] https://history.blog.gov.uk/2014/06/27/keep-calm-and-carry-on-the-compromise-behind-the-slogan/

[4] https://web.archive.org/web/20150402071239/http://ww2poster.co.uk/2009/04/1939-3-posters/

[5] In 2000, a bookshop owner in Northumberland found an original copy of the poster in an old box of books, and started selling copies of it – breathing new life into an old and never-used slogan which is still being used two decades on.

[6] https://history.blog.gov.uk/2014/06/27/keep-calm-and-carry-on-the-compromise-behind-the-slogan/



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1

The first is the reminder that the big picture is crucial. We often use scenario analysis to think about best or worst cases. But spending too long on just one scenario (i.e. Nazi invasion) can give us tunnel vision – and we end up overemphasising that outcome, no matter how unlikely. Thinking about the other ways things could turn out is vital.

2

The second is to be aware (and wary) of groupthink. It's often assumed that a group is a good way to moderate individual irrationality. But a group of panicked people can be even *more* irrational than a single person. Stress can spread through a group – like it did to the committee – creating tunnel vision, and poor decisions. Just because a decision has more than one person supporting it, doesn't mean it's any more rational.

3

The third takeaway is that having the right checks in place can stop you from making a mistake. Despite the tunnel vision, and despite the groupthink, the posters *weren't* printed. Breaking the echo chamber by testing the idea with members of the public, with journalists, and other outside sources brought different opinions – and got the right result.

4

And the final investment lesson is to make sure you dig deep into any potential investment – even if it seems sensible! Don't just take something at face value, but work out where the information came from, why it was produced, who produced it, and in what circumstances. Looking beyond the obvious narrative can open your eyes to possible risks, potential opportunities, or just make you ever so slightly better-informed.

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

BEng, 3 years of industry experience.

Risk Team

Joe Cooper
Head of Risk and Portfolio Analytics

CFA / MSc in Applied Economics, 10 years of industry experience.

Alex Mitsialis
Senior Performance and Risk Analyst

MSc / CFA, 5 years of industry experience.

Haris Slamnik
Investment Risk Analyst

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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