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Courtville Partners Investment Outlook – January 2018

"I'm not a pessimist, even though I do think awful things are going to happen" (James Lovelock – scientist, author of the Gaia hypothesis)

How are you feeling? Does the advent of a new year fill you with hope for the future? More specifically, are you optimistic for financial markets in 2018? If you aren't, that puts you in the minority – as far as we can tell, anyway. A year ago investors in aggregate were fretting about what 2017 might bring. Now, by contrast, much of the talk is of global growth that is both synchronised and accelerating (to 4.0% this coming year, reckons Goldman Sachs). Meanwhile inflation remains subdued in most places. This is what a Wall Street wag once termed "Goldilocks macroeconomics" – that is, neither too hot nor too cold. In the wake of another year of excellent returns for investors (especially from stock markets and especially in US dollars), does the current consensus seem rather complacent?

At the risk of repeating ourselves, there is no shortage of things for investors to worry about: stretched valuations, ballooning government debt, spookily low volatility, potentially unstable geopolitics, rising interest rates – and so on. Of all these risks, it is the end of quantitative easing (or "QE") that preoccupies us most. By the end of 2018, QE is likely to be over. History offers no precedent for either the scale or duration of the unconventional monetary policy that central banks have been pursuing for the last 10 years. Never mind that QE has widened the wealth gap between rich and poor, old and young; or that it has cut government's interest bills, allowing them to make deceitful claims of fiscal prudence; or that it has kept alive companies that ought to have gone bust; or that it has shattered the UK's defined benefit pension system that once upon a time really was the envy of the world. Never mind all of this. No, what concerns us most at this point is the extent to which ultra-low interest rates have propped up asset values (or, rather, distorted them) over such a long period. It now requires a huge leap of faith not to fear a substantial setback in financial markets.

The central bankers know this, of course, and are proceeding as carefully as they can. But an unemployment rate of just 4% in the US does not leave much margin for error in the event that the Phillips Curve (i.e. the positive correlation between employment and inflation) begins to reassert itself. It is quite easy to imagine a scenario in which central banks, starting with the US Federal Reserve, are forced to raise interest rates much faster and further than investors currently expect. Strong and broadly based economic growth has been good for both companies' earnings and for stock markets, as 2017 has reminded us. But the consequences of rising inflation and (therefore) interest rates would certainly be bad for bond markets and not exactly great for stock markets. We think that investors should consider more urgently than ever protecting themselves against such a scenario by holding higher-than-usual amounts of cash and inflation hedges.

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If prospective investment returns are likely to be lower after a nine-year bull market in equities (and arguably a 35-year upswing in bond markets), investors should pay greater attention than ever to the amount they pay in fees to their advisors and managers. The European Securities & Markets Authority (ESMA) has published a study of the impact that fees and charges have had on investor returns from 40,000 mutual funds across Europe. What's the bottom line? Between 2013 and 2015 annual returns were reduced by very nearly 20% as the result of fees and one-off charges. Put another way, investors' annual returns were on average 1.7% lower thanks to fees and charges. Even then, this analysis understates the extent of the "fee drag" – because ESMA's analysis did not include various types of cost that investors routinely incur (e.g. brokerage commissions, bid/offer spreads, account costs, etc.). We may assume that ESMA overlooked such costs because – funnily enough – they are almost impossible to identify accurately.

When looking at equity funds in particular, ESMA's data show that during the period the average actively managed fund generated *gross* returns of 15.5% p.a. compared with just 14.8% p.a. for the average passive (or indexed) fund. Once fees are netted off, however, passive funds produced materially better returns (14.1% p.a.) than active funds (13.0% p.a.). We are *not* evangelists for so-called passive investing (not least because there is no such thing – asset allocation is unavoidable). Nevertheless, as we never tire of saying, the one investment variable that all of us *can* control is the level of fees we pay. A lower annual cost, once hitched to the magical mathematical juggernaut of compounding, is the most reliable ally that an investor can have in an otherwise treacherous investment landscape.

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Did 2017 turn out as we expected? A 24% rise in global equities, as measured by the MSCI World Index, represents a bumper return in anyone's terms. Unfortunately for sterling-based investors, the return shrinks to 13% - thanks mainly to the pound's appreciation against the dollar, which we failed to foresee. On the other hand, our consistent preference for equities over bonds was vindicated: global bonds rose just 5% last year in dollars – and actually fell 3% in sterling terms. Within equities, we were right to favour non-UK stocks: the FT All Share's return of 10% was eclipsed by the performance of all other major geographies (US, Europe, Japan and Emerging Markets), even in sterling terms. In sum, good asset allocation meant that our model portfolio generated a 10% total return over 2017 in sterling terms, outperforming its benchmark even though we got the currency wrong and stuck with an allocation to zero-yielding cash.

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In view of the outlook from here, how might investors best allocate their assets?

Cash

It requires a huge leap of faith not to fear a substantial setback in financial markets at some point. This is why we continue to advocate a 15% allocation to cash in our model portfolio. Holding a relatively high proportion of cash provides a degree of insurance against any setback, lowers a portfolio's volatility and will allow investors to profit from lower prices as and when they come.

Equities

The prospect of synchronized and accelerating economic growth in 2018 suggests that equities may continue to generate relatively attractive returns in 2018, albeit not on the scale seen in 2017. We favour Europe, Japan and Asian emerging markets, where economic growth looks strongest and where valuations are less stretched than in the US. We have recently become more positive on Japan. The earnings outlook is robust relative to other regions and following its further de-rating in 2017 the argument for Japan on relative valuation grounds looks more persuasive. The trailing P/E for the Japanese market is currently 16x, i.e. well below Europe on 19x and the US on 24x. We are also underweight the UK. Brexit uncertainties and rising inflation are likely to dampen corporate and consumer spending, respectively, which is likely to result in lower economic growth lower than in most other economies. (We acknowledge that our view of the UK economy's near-term prospects tallies with the strong consensus.)

Fixed income

Ten years of QE have distorted the valuation of fixed income securities more than any other asset class. The prospect of the end of QE, stronger global inflation and rising interest rates all have negative implications for fixed income. In fact, you have to embrace the macroeconomic equivalent of doomsday (i.e. depression, not merely recession) in order to see value in bonds. We advocate a heavily underweight position in fixed income. Our limited exposure to fixed income is concentrated in emerging market and inflation-linked bonds.

Alternative assets

Gold has traditionally proved to be a reliable friend during periods of gradual interest rate rises and rising inflation. If we are at the beginning of an extended period of interest rate hikes by central banks, history suggests that gold may do well.

Commercial property

We continue to like the commercial property sector. It offers a decent yield, dividend growth and historically has been an asset that can protect against inflation. Emerging market property has a lower yield, but offers good dividend growth over the short- and medium-term.

Currency

We are long-term bears of sterling, even after being blindsided by its relative strength against the dollar in 2017. The UK's yawning twin deficits – on the current account and in government spending – would be enough to encourage a high exposure to non-sterling securities. The threat of a self-proclaimed Marxist in 11 Downing Street before too long provides an extra incentive.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE Russell PI Balanced Index (%)
UK Equities	18	32.5
International Equities	49	30
Fixed Income	9	17.5
Alternatives	5	10
Commercial Property	4	5
Cash	15	5
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Total Expense Ratio (%)
UK Equities		**18**	**-2**	
UK	VUKE LN	10	-2	0.09
UK	VMID LN	8	0	0.10
International Equities		**49**	**+4**	
US	VUSA LN	6	-1	0.07
	XDPG LN	6	0	0.30
Euro	VERX LN	15	0	0.12
Japan	VJPN LN	8	+3	0.19
Asia	VAPX LN	6	+2	0.22
Emerging Markets	VFEM LN	8	0	0.25
Fixed Income		**9**	**-2**	
Government Bonds				
UK	VGOV LN	1	0	0.12
Index Linked Gilts	INXG LN	3	-1	0.25
EM	EMB US	3	0	0.40
Corporate Bonds				
US	VCLT US	2	0	0.12
Alternatives		**5**	**0**	
Gold	IAU US	5	0	0.25
Commercial Property		**4**	**0**	
US	VNQ US	1	0	0.10
Europe	IPRP LN	1	0	0.40
Asia	IFAS US	2	0	0.48
Cash	GBP	**15**		
Total		**100**		**(Weighted TER) 0.15**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative Performance
2017	+10.1%	+9.6%	+0.5%
Since inception (1/1/2015)	+35.1%	+31.9%	+3.2%
3 year compound annual return	+10.6%		