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Courtville Partners Investment Outlook – July 2017

"It's the economy, stupid!" (James Carville – campaign manager for Bill Clinton in 1992)

The apparently inexorable rise of global equity markets so far this year is almost shocking. In our April Investment Outlook we noted that worldwide equities had risen 6% (in US$ terms) during 1Q17; and by now they have risen 11%. Given how crowded the news agenda seems to be almost everywhere, isn't the remorseless advance of stock markets remarkable? As always, those global returns can be broken down into their myriad components, among which the performance of Emerging Markets (+12% in 1Q17, +17% by mid-year) stands out for us as evidence of investors' continuing appetite for risk. To continue with our April metaphor, the volcano-based danceathon continues. Why so? How so?

There are still two main influences at work on both stock and bond markets, as far as we can tell: ultra-loose monetary policy and respectable economic growth. (The architects of the former would argue that it has generated the latter, though we are less convinced.) Quantitative easing has continued so far in 2017 to the tune of $1.1trn (i.e. another too-large-to-comprehend number). This takes to $14trn the value of financial assets held by the world's major central banks. By suppressing interest rates for nine years (and counting), this policy has helped to prop up stock market valuations (by keeping artificially low the rates at which companies' earnings and dividends are discounted).

How long can this go on? No one knows. But *can* it go on? Yes - at least in some parts of the world. For sure, the US interest rate cycle has already turned. And in the UK there are now straws in the wind suggesting that the Bank of England's hand may be forced. Mind you, Governor Carney's guidance has shape-shifted so often that his prognostications are no longer taken at face value by investors. Even the European Central Bank's Mr Draghi is struggling to get his messages across as clearly as he once did. It is possible that this will be the catalyst for a re-run of the 2013 taper tantrum.

Meanwhile in the real world the global economy is still expanding at a modest 3% p.a. or so; and there are no obvious warnings signs of imminent recession. Indeed, growth in some parts of the world – e.g. the Eurozone, Asia and some emerging markets – seems even to be accelerating.

The Eurozone, in particular, has seen its prospects brighten materially in recent months. Macron's defeat of Le Pen has calmed investors' fears of runaway populism, while Merkel looks set to be re-elected in the Autumn. Continental stock markets have also been cheered up by strong corporate results, which in turn have bolstered an already encouraging outlook for profits (+8% this year, reckons UBS). Even better, equity valuations in Europe are near to long-term averages (in contrast to the US). For sure, the huge fiscal strains within the Eurozone have not gone away, but do seem to be lying dormant for now. At the very least, from a UK investor's perspective Eurozone equities look more attractive than they have done for a while.

At a global level, however, it is hard not to worry that there is just too much cash chasing too few investment opportunities. The worldwide cash glut owes to several factors, including corporate profits accounting for a record share of GDP and the tendency of ultra-low interest rates to benefit the wealthy (whose marginal propensity to consume is often low). Whatever the reasons, the excess of cash has brought serious distortions. Asset prices ultimately depend on the real economy (not the financial economy); and there is plenty of evidence that the real economy's growth prospects – and, above all, productivity – are being stunted by various factors, including sky-high levels of debt, ageing populations and the replacement of labour by technology. Faced with fewer decent investment opportunities in the real economy, yield- and return-hungry investors have been rescued by central banks' ultra-low interest rate policies, which have inflated asset values. But right-thinking investors are bound to feel uneasy at the sight of finance-based capitalism eroding the real economy of companies big and small.

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As investment advisors, we admit to having an in-built bias towards equities over bonds (leaving aside the valuations of either asset class at any given moment). At the most fundamental level our bias is rooted in the knowledge that *over the long term* equities offer a way of investing in the *real* growth of businesses and economies. Almost without exception, bonds do not – and cannot – offer this exposure to growth. None of this is terribly controversial. We were, however, struck by both the force and the simplicity of the arguments in a recent FT article by Terry Smith (one of the few "active" fund managers that we tend to include in portfolios). In the space of a few paragraphs, Mr Smith nails the main advantage to investors of equities over bonds – namely, the reinvestment and subsequent compounding of profits. On average the companies making up the FTSE 100 or the S&P 500 pay out about half their profits as dividends. But the other half is automatically reinvested in the companies' operations. This feature is unique to equities. Both bonds and property will pay you interest and rental income, respectively; but none of these cash flows will be reinvested in more bonds or more property on your behalf. Crucially, equity profits are reinvested – and then *compounded* – at the company's rate of return on equity capital, which for the average S&P 500 company last year was 13%. But it is even better than this for equity investors. Whereas the cash yielded by dividends *can* be reinvested in shares, this has to be done at the market price of a company's shares – which on average for S&P 500 companies is about three times book (or net asset) value. By contrast the retained half of a company's profits is automatically reinvested at *book* value, not at market value. In sum, it is the reinvestment of retained profits, allied to the power of compounding, that accounts for most of the growth in the value of equities – and not dividends (whether reinvested or not).

There are many sensible *caveats* to Mr Smith's argument. For example, a company must continue to have the opportunity to reinvest at the same rate of return on capital. In practice, superior rates of return tend to attract competition, which then drives down those rates of return. But this is not always or inevitably the case. In addition, an investor (or a fund manager on the investor's behalf) must have the skill to be able to identify those companies with defensibly above-average returns. Nevertheless, both his basic proposition and his emphasis on the power of compounding accord with Courtville's philosophy.

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Cash

We continue to overweight cash in the expectation that after nine years of gains stock markets will hit turbulence sooner rather than later, whether this is triggered by the reversal of ultra-loose monetary policy or by something else. Relatively high levels of cash should give us the flexibility to exploit any such developments.

Fixed income

Benchmark government bond prices have edged up over the last quarter – which only serves to make us more nervous about their valuations. Within the asset class, we keep our bias towards emerging market and index-linked bonds.

Equities

Within an overweight allocation to equities, we prefer the Eurozone and emerging markets, are neutral on Asia and Japan and are decidedly underweight on the UK (where economic and political risks keep piling up). We have increased our weighting to Europe, reduced the US and increased Asia ex-Japan.

Alternative assets

Gold has been a friend to our portfolio so far this year (up 11% in US$ terms) as inflationary pressures mount and in response to rising geopolitical risks.

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. We have increased the weighting to US

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real estate which looks good value, particularly in relation to US equities. EM property has a lower yield but offers good dividend growth over the short and medium term.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	18	32.5
International Equities	45	30
Fixed Income	12	17.5
Alternatives	5	10
Commercial Property	5	5
Cash	15	5
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Total Expense Ratio (%)
UK Equities		**18**	**0**	
UK	VUKE LN	10	0	0.09
UK	VMID LN	8	0	0.10
International Equities		**45**	**0**	
US	VUSA LN	8	-1	0.07
	XDPG LN	7	-2	0.30
Euro	VERX LN	15	+3	0.12
Japan	VJPN LN	6	0	0.19
Asia	VAPX LN	2	+2	0.22
Emerging Markets	VFEM LN	7	-2	0.25
Fixed Income		**12**	**0**	
Government Bonds				
US	BND US	1	0	0.08
UK	VGOV LN	1	0	0.12
Index Linked Gilts	INXG LN	4	0	0.25
EM	EMB US	4	0	0.40
Corporate Bonds				
US	VCLT US	2	0	0.12
Alternatives		**5**	**0**	
Gold	IAU US	5	0	0.25
Commercial Property		**5**	**0**	
US	VNQ US	2	+1	0.10
Europe	IPRP LN	1	-1	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
YTD 30/6/2017	+6.14%	+4.19%	+1.95%
Since inception (1/1/2015)	+29.01%	+25.35%	+3.66%