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Courtville Partners Investment Outlook – October 2017

"Death is certain, but when it will arrive is not" (Khunu Rinpoche – Tibetan Buddhist)

Over the three months since our last Investment Outlook, investors have continued to propel world stockmarkets to new heights. Global equities have now risen 17% so far this year, having been up "only" 11% at the halfway stage. But there is an immediate *caveat*: those percentages are for returns in US dollars. And perhaps the most remarkable feature of markets in general so far this year has been the extent to which major currencies have diverged from each other. In short, the euro has reigned supreme and has strengthened a whopping 12% against the dollar. The dollar itself has tumbled against most other currencies; and sterling's performance has fallen somewhere in the middle, i.e. stronger against the dollar, weaker against the euro. Such currency gyrations mean that how well an international investor has done so far in 2017 depends to a large degree on the currency in which their returns are denominated. Closer to our UK home, the benchmark FTSE Russell Private Investor Balanced Index year-to-date return of 5% has an air of classic British compromise about it – with sluggish performances from bonds and US$-denominated securities offsetting solid gains from domestic & European equities.

As has been the case for a long time now, the list of worries for any investor is quite long. In no particular order we would cite: the sheer length of this stockmarket rally (verging on nine years); stretched valuations in many stockmarkets; the unprecedented bubble in bond markets; signs of incipient inflation; and much geopolitical angst. Among all the risks facing investors at the moment, the over-valuation of government bonds is the one that continues to make us most nervous. Just because it is not a new risk (bonds have been expensive for years) is hardly a reason to worry any less. Indeed, the stage is being set for "Quantitative Easing – The Sequel" as central banks (including the Federal Reserve and the Bank of England) gear up to unload the trillions of dollars' worth of government bonds that they have accumulated in recent years. There is no precedent for this – just as there was no precedent for the unimagined scale of bond-buying by the same central banks. No one knows what the effects might be on markets, interest rates, government funding programmes or investor sentiment. That is why the risk of central banks getting it wrong seems to us to be the biggest single risk facing investors for now.

While we're at it, we must also mention the left-field danger of renewed inflation. Many different reasons have been put forward to explain the stubborn refusal of inflation to rear its textbook head since money-printing started in the wake of the 2008 crash. If we don't understand why inflation has not yet taken off, we can be less confident that it won't come roaring back after all. We would simply observe that headline inflation rates have been ticking up in many countries (including the UK & the US). For what it's worth, the maverick fund manager Hugh Hendry chose the occasion of his retirement to warn that our current macroeconomic circumstances may bear an uncomfortable resemblance to the mid-1960s. In 1964 core inflation was just 1.7% - and fell further to 1.2% in 1965. Yet by 1966 the dogs of inflation had slipped their leashes. From there, it took another 30 years before inflation was back under control (i.e. below 2%).

On the other hand, the list of things that are *not* worrying – indeed, are encouraging – remains healthy enough. Above all, economic growth around the world remains both decent and synchronized (historically quite a rare coincidence). And some of the factors that gloomsters cite in support of their bearishness can just as well be used by those who are more sanguine. Relatively high levels of cash among institutions, for example, may be a sign that investors in aggregate are taking evasive action – but may also be seen as evidence that we are some way from the final capitulation of the optimists.

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Even the reversal of quantitative easing and a concomitant rise in interest rates can be cast as a "problem of success" (as we ourselves have often argued). For if the world's economies were still so weak, why would central bankers even be contemplating an about-turn in their monetary policies?

In sum, we have not changed our overarching view of markets – and equity markets in particular. We still expect to see a substantial correction at some stage – and advise investors to arrange their portfolios so as to be able to profit from lower prices as and when they come. But we have no idea *when* a pullback – and with it the opportunity to buy the same shares for less money – could materialize. As we never tire of admitting, we cannot time markets – and very much doubt that anyone else can either. Does this matter? It often *feels* to investors that market-timing *does* matter. But does history support this hunch? We recently came across an interesting analysis (by Elm Partners) of the extent to which it has ever paid (or not paid) to wait for a correction in the US stockmarket. The gist is that from any given "expensive" starting point there was a 56% probability of a 10% market correction within three years, waiting for which would result in a return benefit of about 10% (versus having invested straightaway). In the 44% of cases where such a correction did not happen within three years, the average opportunity cost (that is, returns foregone) amounted to about 30%, i.e. approximately three times the average benefit of waiting. Taken together, these observations suggest that the mean expected cost of waiting for a stockmarket correction is roughly 8% compared with investing immediately.

Elm Partners go on to examine the relative merits of different ways of putting money to work in stockmarkets. Is it better to invest all in one go – or to average-in over time – or to wait for that market correction? Like us, they argue that trying to time markets in the short term is a fool's errand. Beyond this, they conclude that the optimal approach begins with deciding on a long-term target allocation to the stockmarket. Once this is done, the only benefit of "averaging in" is psychological – because it allows glass-half-full investors (i.e. most of us) to tell themselves that, if markets rise, at least some part of their savings has been put to work. But if markets fall, the same investors are relieved that they didn't invest fully from the start. From a purely financial perspective, however, investment in incremental stages over, say, a year is a sub-optimal approach. A more efficient strategy is to invest half the total amount straightaway, followed by the other half over the course of a year – which, as it happens, is our preferred approach at Courtville Partners. Besides, once a portfolio has been invested for a while, investor typically fall prey to another powerful human trait, namely forgetfulness – and soon struggle to remember why they spent as much time as they did worrying about taking the plunge.

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Cash

As explained above we still expect to see a substantial correction at some stage – and advise investors to arrange their portfolios so as to be able to profit from lower prices as and when they come. The 15% cash allocation in our model portfolio is significantly higher than the 5% benchmark allocation and is a tactical holding to take advantage of this eventuality.

Fixed income

Among all the risks facing investors at the moment, the over-valuation of government bonds is the one that continues to make us most nervous. We are also nervous of inflation. For both these reasons our model portfolio remains significantly underweight bonds.

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Equities
Economic growth around the world remains both decent and synchronized (historically quite a rare coincidence). This makes equities a relatively attractive asset class, despite the longevity of the current bull market. We are wary of both the US and UK stock markets owing to high valuations and Brexit/political risks. We prefer exposure to equities in European, Asian and Emerging markets, where valuations are (relatively) cheaper and growth is still accelerating.

Alternative assets
Geopolitical and inflation risks are both good reasons to hold gold. The gold price is up 11% year-to-date but because gold is priced in weak dollars the return to sterling based investors has been just 2.5%.

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. EM property has a lower yield but offers good dividend growth over the short and medium term.

Currency
We are long-term bears of sterling. The big twin deficits in the UK, current account and budget, plus the increasingly real threat of a Corbyn led government, lead us to maintain a high exposure to non-sterling securities.

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