Courtville Partners Investment Outlook – September 2016

"What a strange world we live in," said Alice to the Queen of Hearts.

For most of the last 100 years bonds (both government and corporate) have yielded more than equities - sometimes much more – in response to the belief that investors should accept a lower yield from equities in return for the prospect of capital growth. Today that yield relationship has mostly been turned on its head: equities in many countries yield substantially more than local government bonds.

Bond yields have fallen to unprecedented low levels. The yield on benchmark 10-year UK gilts fell below 0.6% recently, down from 2% ten months ago and having been in a 5-10% range for most of the last 25 years. More startling still is that the total global volume of sovereign and corporate bonds with *negative* nominal yields is now above $12tn, according to the Financial Times. That represents almost half of all the western world's debt. By historical standards this is truly extraordinary. It certainly feels like an Alice in Wonderland world when companies and households are paid to borrow and charged if they save.

Bill Gross (the high-profile investment manager at Janus Capital) wrote recently that "capitalism, almost commonsensically, cannot function well at the zero bound or with a minus sign as a yield. Central Banks' monetary policy over the last decade has deferred long-term pain for the benefit of short-term gain and the hopes that the economy normalises over the next few years. If this doesn't happen, investors are treading on pretty thin ice. Continued high global debt and out-of-date monetary/fiscal policies, that hurt rather than heal real economies, are likely to give markets a nasty shock at some point in the next few years." We agree. It is possible that a significant correction has already started; the yield on 10-year UK gilts has risen from 0.52% to 0.9% in the last month. At some point we believe the bubble will burst with a very loud bang.

Quantitative easing programmes have changed the role of government bonds in financial markets. Simply put, the risk-free rate of return is one with no risk of financial loss; and this rate (whatever it may be at any given moment) has long played a central role in financial markets – in both theory and in practice. But, thanks to central bank money-printing, the proxy of government bond yields for the "risk-free" rate of return has now become an imperfect substitute – and one that brings potentially dangerous consequences. Thanks to rock-bottom interest rates and biblical quantities of money-creation by central banks, no one knows what the price of money is (or ought to be). And as the risk-free rate is the anchor for valuing all risky assets, asset price bubbles have been the inevitable result. This makes us nervous because a significant market correction becomes almost inevitable at some point. That said, even though the bull market in equities has already lasted eight years (which is longer than most bull markets), such a correction may not necessarily be imminent.

The loose monetary policy of the last decade has massively distorted market returns. Investors, however, are by no means oblivious. Many measures of anxiety and risk-aversion show that investors are deeply alarmed, or even already braced for a crisis: the price of gold is up 25% since December last year and stands at its highest level since August 2014; the yen (a currency to which investors traditionally rush at times of stress) is at its strongest level since August 2014, despite attempts by the Bank of Japan to weaken it; and the US dollar has fallen by 17 per cent against the yen since last summer.

The Barclays Bond Composite Global Index has risen 16.5% year-to-date for sterling-based investors (although by only 7.5% in US dollar terms); and corporate bonds have done even better. Equity market returns have also been pretty good in 2016 after a weak start to the year. In 2016 so far the FTSE

Index has gained 8%; and the MSCI World Total Return Index is up 15% in sterling terms. The MSCI World Total Return Index (priced in US dollars), however, is still 3% below its April 2015 high, though up 15% in when priced sterling. In sum, equities are worth broadly the same as they were a year ago, but the pound is not. In other words, for sterling-based investors the rising value of equities has been to some extent an illusion, generated mostly by the pound's weakness. Meanwhile bond market valuations look more stretched than equities.

If the price of bonds is being set within a bubble created by central banks and equities are not particularly cheap, what do you do with your money as a long-term investor? Despite the many reasons for caution there can be as much risk from being out of the market as in it. Portfolio gains (and losses) tend to come in a rush — as happened in the spring of 2009. For sure, the long-term journey for investors who stay invested may be bumpier (or "more volatile", to use investment jargon) than if their capital was invested, say, in zero-yielding cash and/or inflation-linked bonds. For example, during the 2008/9 financial crisis the value of a typical sterling-based balanced diversified global portfolio fell by about 30% from peak to trough within the space of 10 months – but that same portfolio today would nevertheless have grown in value by about 70% over the nine years since 2007, equivalent to a compound growth rate of 6% p.a. In other words, even a significant crash can look like a blip if one takes a long enough view.

We set out below our recommendations for a core asset allocation. In this exercise we are guided by two overriding principles: the desire to preserve the value of capital and an ambition to generate real (i.e. inflation-adjusted) returns over time. We also recognise that so-called "market-timing" is a skill that eludes almost everyone.

- Cash
  We advocate keeping higher levels of cash than most mainstream asset allocation models would normally recommend. This is for two reasons: first, cash provides higher portfolio resilience and, second, we want to have the wherewithal to exploit a possible market crash. As Merryn Somerset Webb wrote in a recent article in the FT: "While cash shouldn't be the only thing you have, or the thing you have for the very long term, there is no shame in holding quite a lot of it. The global financial system is very unstable (as are global politics) and a proper crash is very possible, at which point everyone who doesn't have cash will really wish they did."

- Fixed Income
  We advise a relatively low exposure to fixed income. Government bond markets are firmly in bubble territory, in our opinion. The great boom in government bonds prices that we have seen over the past 30 years cannot continue – not at the same rate, anyway. Again, to quote Bill Gross: "The [US government] bond market's 7.5% 40-year historical return is just that – history. In order to duplicate that number, yields would have to drop to –17%! Tickets to Mars, anyone?" We prefer our (low) fixed income exposure in the form of corporate bonds. These have also performed well, but may still offer scope for further yield compression (i.e. a narrowing of the yield differential versus government bonds).

- Equities
  The huge distortions brought about by quantitative easing mean that equities remain our investment-of-choice, but in some cases only by default. Our overall weighting in equities is in line with the WMA benchmark. The strong performance of US equities since early 2009 may induce some nostril-pinching by investors. But we still see reasons to be relatively enthusiastic. Equity valuations are not extreme, even in the US. Previous over-valuation episodes saw equity prices outstrip earnings growth more aggressively. Indeed, the number of markets more than 40% above their three year troughs remains low. Bonds, not equities, are

the overvalued asset class. In sum, we think that the US economic & profit cycles have further to run and that the risk of a global recession remains quite low, for now. The Eurozone, by contrast, faces deep structural problems; and growth here has continued to lag. There are, however, some signs of recovery; and equity valuations in this part of the world now look more attractive.

- UK
  UK economic growth has not collapsed in the wake of the EU referendum vote – not yet, anyway. UK equities have rallied after the initial sell-off; but the pound remains weak, which is good news for UK exporters and owners of foreign-currency investments. These are still early days in the Brexit process, however. Uncertainty about the economic and financial consequences of Brexit is likely to hang over UK markets for the next couple of years. Equities in any market rarely do well when the macro-economic picture is so cloudy. Those who predicted immediate disaster (or at least recession) in the event of an "Out" vote (including legions of economists) may have egg on their faces. Nevertheless, we struggle to believe that the UK economy will escape unscathed by the dislocation of Brexit for long. In any case the UK's current account deficit remains of such a size that further sterling weakness seems to us likely.

- Emerging Markets
  Further afield, we find it hard to be enthusiastic about emerging markets. (Mind you, "emerging markets" is not a term that we find very helpful since it covers such a mish-mash of different markets.) Judged by book value multiples, the emerging world is cheap (on a multiple of 1.5x, compared to 2.2x for developed markets); but the best value is only available where there is most risk (e.g. Russia and Brazil). In the short term emerging markets generally remain vulnerable both to a rise in bond yields and to a rise in perceived geopolitical risk, both of which are clear and present dangers. Sentiment towards emerging markets tends to move in long waves; and there are signs that sentiment is beginning to shift. At some point, possibly quite soon, it will be right to have a higher allocation to emerging markets.

- Property
  We still like commercial property as an asset class - mostly in parts of the Eurozone and Asia. Lower yields (the flip side of higher prices) are another effect of the central bankers' money-printing binge. But in absolute terms it is still possible to find reasonable incomes streams from property.

- Gold
  Many investors scoff at gold, but not us. The tsunami of quantitative easing has ensured that *fiat* currencies inspire less confidence than they once did. Gold may not yield anything, but it has the overwhelming merit of being immune to the central bankers' urge to debase. Every portfolio should have at least some gold, we think.

We have an overwhelming preference for low-cost investment vehicles – and for ETFs in particular. None of us can predict, let alone control, future investment performance; but most of us can control (and reduce) the costs of our investments. Happily, there is a vast weight of evidence to show that controlling costs is the single biggest factor in the long-term performance of most portfolios.

Asset Classes	FTSE WMA Balanced Index (%)	Courtville Partners Asset Allocation (%)
UK Equities	35	20
International Equities	30	45
Fixed Income	17.5	10
Alternatives (Gold)	7.5	5
Commercial Property	5	5
Cash	5	15
Total	**100**	**100**

Courtville Partners Model Portfolio	Weight (%)	ETF	Total Expense Ratio (%)
UK Equities	**20**		
	9	VUKE LN	0.09
	11	VMID LN	0.10
International Equities	**45**		
US	20	VUSA LN	0.07
Euro	14	VERX LN	0.12
Japan	6	VJPN LN	0.19
Other EM	5	VFEM LN	0.25
Fixed Income	**10**		
Government Bonds			
US	1	BND US	0.08
Int'l	1	BNDX US	0.19
UK	2	VGOV LN	0.12
	1	INXG LN	0.25
Corporate Bonds			
US	5	VCLT US	0.12
Alternatives	**5**		
Gold	5	IAU US	0.25
Commercial Property	**5**		
US	1	VNQ US	0.10
Europe	2	IPRP LN	0.40
Asia	2	IFAS US	0.48
Cash	**15**	GBP	
Total	**100**		**(Weighted TER) 0.13**

Courtville Partners	Model Portfolio	WMA Balanced Index	Relative performance
YTD	14.23%	11.50%	2.73%
Since inception (1st Jan 2015)	15.58%	14.52%	1.06%