FINANCIAL PARTNERS

Getting what you want

Weekly Digest

26 March 2018

– *Richard Stutley (CFA)*

Investing is first and foremost about net returns. Our key value-add is being able to design better portfolios than a formulaic split between bonds and equities based on a client's risk profile. I wanted to bring some of this work to light. It's not rocket science, but it can get technical. Bear with me (or else use this to put the kids to sleep…).

We all have things we want, be it a new car, a house, to retire and pursue that interest you always wanted to do. Given our current savings, plus new savings from annual income, we need to solve for these future spending goals. A fairly granular analysis of one's spending goals and savings can give you a clear understanding of the range of returns you need in order to get what you want.

How will you go about achieving this return? In the past the investment industry has tended to risk-rate clients and assign them an increasing proportion of equities over bonds in a fairly simple, mechanical fashion. This is not a bad solution. But can we do better?

Given two portfolios that are both expected to deliver 5%, wouldn't it be better if one was only expected to underperform the target by a little bit given some adverse shock? And what about the short term? Do I trust a portfolio that has lost 20% in year 1 to deliver a decent return over years 2 and 3? It is reasonable, given poor initial returns, for investors to lose faith and divest at the wrong times. Hence we also pay attention to the short term.

We look at the probability of achieving the return target over the investor's time horizon, but also the extent of any shortfall versus this target in the majority of adverse scenarios. We then look at the likely range of returns over shorter time periods, such as 12 months.

Hence it is not just what we expect each asset class to return, but how it generates this return and what other asset classes are likely to be doing at the same time. We have data on each of these asset classes which informs our understanding of their behaviour, but it can be fairly limited, sometimes as little as a decade of observations. Hence we use sampling, plus our judgement, to derive a much longer history. Once we have this data we start to think about the different portfolio combinations we could hold by increasing the weight of one asset class over another. Unfortunately there is no parsimonious equation we can solve to tell us which portfolio best delivers on our key risk metrics, so instead we look at thousands, sometimes millions of possible combinations.

Rather than a simple split between equities and bonds depending on a client's classification as low, medium or high risk, the output of this work is a strategic asset allocation policy that is specifically designed to meet their future return target over their investment horizon, while also taking into account the path by which we get there. This is only the starting point – after that we look at economic variables, corporate health, risk events, trends… the list goes on – however, getting this starting point right is the first step towards getting what you want.

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The **Marketplace**

- Brent crude rose 6.4% last week to $70.4 a barrel
- Gold rose 2.5% to 1,347.4 an ounce
- Global equity indices see their biggest slump in 5 weeks
- Safe haven assets gain

Market **Focus**

US

- The Dow Jones fell 5.7% finishing the week at 23,533
- The Fed raised rates by 0.25% on Wednesday. They're expected to rise a further three times this year
- Uber may have to rethink the amount invested into driverless technology after a pedestrian was killed in Arizona during vehicle testing. The company has also decided to pull out of South-East Asia by selling its operations in the region to rival Grab
- Manufacturing PMI rose 0.4 points but services fell a hefty 1.8 points to give a composite PMI of 54.3, down 1.4 points
- The VIX volatility index rose 5.5% to above 23 in response to market jitters
- The S&P index fell 6% to 2,588.

UK

- Upward pressure on wage growth continues. Unemployment stood at 4.3% in the three months to January, down from 4.7% a year earlier
- 'Improved equivalence' for financial services a possibility post-brexit: Luxembourg are keen proponents. However, France opposed the proposal
- The Bank of England voted to keep interest rates on hold
- The FTSE 100 fell 3.4% to 6,922
- Sterling rallied 1% after the announcement that a transition deal around Brexit had been reached.

Europe

- One in seven European companies with UK suppliers have moved part or all of their business out of Britain and relocated operations to the continent
- Manufacturing PMI for the euro area fell 2 points to 56.6, expectations were for a ½ point drop. Service PMI also fell by 1.2 points to 55 giving a composite reading of 55.3 - the lowest level since January 2017
- The Euro Stoxx 50 index fell 4% to 3298.

Asia

- China set to hit back over US trade policy with $3 billion in tariffs on a wide range of products. There is hope that an agreement based around deficit reduction on US exports can avert the looming trade war
- The Hang Seng fell 3.8% to 30,309
- The Nikkei 225 rose 0.7% to 20,766
- Japan's manufacturing PMI declined by 0.9% to 53.2.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

Asset Class/Region	Currency	Currency returns			
		Week ending 23 March 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-5.9%	-4.5%	-2.9%	11.9%
United Kingdom	GBP	-3.2%	-4.0%	-9.1%	-2.4%
Continental Europe	EUR	-3.4%	-3.7%	-4.9%	0.5%
Japan	JPY	-4.1%	-5.8%	-8.4%	11.1%
Asia Pacific (ex Japan)	USD	-3.7%	-2.1%	-0.5%	21.1%
Australia	AUD	-2.1%	-2.8%	-2.9%	6.5%
Global	USD	-4.5%	-3.7%	-2.8%	12.5%
Emerging markets equities					
Emerging Europe	USD	-0.3%	-3.4%	3.5%	21.6%
Emerging Asia	USD	-4.3%	-1.7%	0.5%	26.0%
Emerging Latin America	USD	-1.1%	-2.0%	6.9%	19.0%
BRICs	USD	-4.2%	-2.8%	2.6%	30.0%
MENA countries	USD	0.5%	3.5%	6.7%	7.8%
South Africa	USD	-1.3%	-2.9%	-0.4%	19.1%
India	USD	-1.7%	-4.3%	-6.4%	12.3%
Global emerging markets	USD	-3.4%	-1.8%	1.4%	23.8%
Bonds					
US Treasuries	USD	0.2%	0.5%	-1.8%	0.1%
US Treasuries (inflation protected)	USD	0.2%	0.5%	-1.5%	0.8%
US Corporate (investment grade)	USD	-0.3%	-0.5%	-3.0%	2.1%
US High Yield	USD	-0.4%	-0.7%	-1.0%	4.7%
UK Gilts	GBP	0.3%	1.4%	-0.4%	0.9%
UK Corporate (investment grade)	GBP	-0.4%	-0.1%	-2.1%	1.4%
Euro Government Bonds	EUR	0.5%	1.2%	1.0%	3.3%
Euro Corporate (investment grade)	EUR	-0.2%	-0.3%	-0.5%	2.0%
Euro High Yield	EUR	-0.4%	-0.3%	-0.6%	4.5%
Japanese Government	JPY	0.2%	0.3%	0.6%	1.2%
Australian Government	AUD	0.2%	1.0%	0.8%	3.5%
Global Government Bonds	USD	0.9%	1.7%	2.3%	7.7%
Global Bonds	USD	0.6%	1.2%	1.2%	7.3%
Global Convertible Bonds	USD	-0.7%	0.4%	2.7%	9.2%
Emerging Market Bonds	USD	-0.4%	-0.2%	-2.9%	1.2%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 23 March 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	-4.4%	-0.3%	-11.9%	-8.6%
Australian Property Securities	AUD	-2.1%	-0.4%	-7.7%	-3.7%
Asia Property Securities	USD	-2.5%	-0.7%	-0.4%	14.5%
Global Property Securities	USD	-2.7%	0.1%	-5.6%	5.8%
Currencies					
Euro	USD	0.6%	1.3%	2.8%	14.7%
UK Pound Sterling	USD	1.5%	2.7%	4.6%	13.1%
Japanese Yen	USD	1.0%	1.6%	7.2%	5.7%
Australian Dollar	USD	0.2%	-0.8%	-1.0%	1.3%
South African Rand	USD	2.4%	1.0%	6.1%	6.6%
Swiss Franc	USD	0.6%	-0.3%	2.8%	4.8%
Chinese Yuan	USD	0.3%	0.2%	3.1%	9.0%
Commodities & Alternatives					
Commodities	USD	1.0%	0.7%	2.2%	10.9%
Agricultural Commodities	USD	-1.8%	-2.9%	2.5%	-3.1%
Oil	USD	6.4%	7.1%	5.4%	39.3%
Gold	USD	2.5%	2.1%	3.2%	8.1%
Hedge funds	USD	-0.5%	-0.3%	-0.4%	4.2%

Source: Bloomberg. Past performance is not indicative of future returns

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