Introduction and Market Overview

US Elections, COVID-19, Brexit!

All eyes turned to the US in the 4th quarter to see if President Trump could see off Joe Biden's challenge. Although the method of counting postal votes after polling stations gave us some excitement, ultimately Trump was beaten. We expect him to stand aside and for Joe Biden to be sworn in on the 20th January as President Trump's legal effort to overturn the US election result failed. Joe Biden's campaign and nominations for key posts give us a clear idea of the direction he expects to take. One appointment worth highlighting is Biden's nomination for Treasury Secretary, former chair of the Federal Reserve (FED) Janet Yellen. Yellen will no doubt want to give the FED as many tools as possible, enabling it to provide continued support to the US economy as it recovers from the pandemic. Some of Biden's early initiatives will likely include re-joining the World Health Organisation and the Paris Accord on climate change, as well as increased spending on environmental projects. Should the Democrats fail to gain control of the Senate, Biden's spending plans and proposed tax rises may be diluted. However, a more measured approach to diplomacy should still be welcomed by markets that dislike uncertainty.

COVID-19 once again gained momentum towards the end of the year, although the more vulnerable members of society and health workers had already started receiving vaccinations. However, manufacturing and distribution of the vaccines at scale will take some time, and it may not be before mid-2021 when other vaccines become widely available, to help ease supply. This is more likely the case now that second doses of the Pfizer vaccine have been put back to a 12 week wait to ensure that more people can be given the first dose, which apparently has an efficacy rate of 70% and should reduce symptoms if you were unlucky enough to catch COVID after the first vaccination. There is some much-needed light at the end of the tunnel, and in the meantime, we continue to watch the virus wax and wane and measures to counter the pandemic may be in place in one form or another for most of the year. As a result, it is still too early to be tightening financial conditions, and a continuation of the coordinated support, from both fiscal and monetary authorities, is still needed to prevent long-lasting economic damage.

The main fillip to UK markets in the 4th quarter was the final agreement, albeit at the very last minute, of a trade deal with Europe. The outcome was admirable under the circumstances, as negotiations were conducted during a pandemic, to a tight timetable and with, at times, what seemed to be irreconcilable differences. The deal is broadly in line with precedent but, crucially, by providing for zero tariffs and zero quotas, goes further than other free trade agreements. The fact that the two sides reached an agreement provides a basis for more positive future cooperation than a possibly acrimonious no-deal outcome.

There is little doubt that a deal should be good news for the UK economy. It brings long-waited clarity for business and is a better outcome for the economy than the alternative of operating under the rules of the World Trade Organisation. Trade tariffs and quotas would have added immediate and unanticipated additional costs to trade. Without a deal, Sterling would have almost certainly have fallen and inflation risen. As it turned out, Sterling rallied into the end of the year and the chairman of Tesco, John Allan, said that the effect of the deal would, "hardly be felt in terms of the prices that consumers are paying".

The consensus view was that the failure to reach agreement would have significantly dented the expected rebound in growth this year. A 'no deal' forecast for 2021 UK GDP was 1.3% lower than the current 4.4% forecast from Deloittes predicated on a deal. A deal substantially reduces Brexit-related uncertainties which have weighed on business investment and risk appetite since 2016. The deal may also offer some support to consumer sentiment too. This was certainly the case when a deal started to look more likely as we moved through the fourth quarter and the UK market drove portfolio returns higher in October, whilst investors in US equities worried about the election. It was a very strong rally, albeit from a low base, and it was good to see a "Santa" rally in one of the hardest hit areas of the markets in 2020.

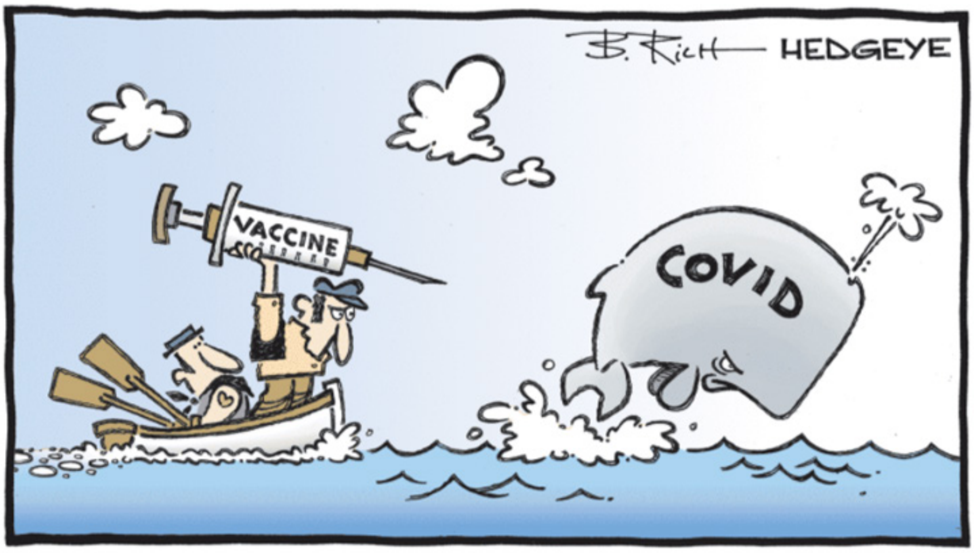
Whilst the Brexit deal helps the immediate economic outlook, it marks a step change towards a more distant, complex economic relationship with the EU. As Professor Anand Menon of King's College put it, "On the spectrum of hard to soft Brexit, this agreement is located very much at the former end". Leaving the Single Market and Customs Union and ending free movement introduces new frictions and costs in economic relations with the EU.

This has been inevitable since the Conservative victory in the 2019 General Election and is not news, but it is highly material for long-term growth. Extra paperwork and bureaucracy will mean more costs. HMRC, for instance, estimates that 215m new customs declarations will be required every year at an annual cost of £7bn. Lower migration from the EU directly would reduce headline GDP growth, though its impact on per capita GDP growth, a more important indicator of prosperity, is less clear cut. (High earning migrants contribute more to GDP per capita than those on lower pay.)

Most economic models assume that a more distant economic relationship with the EU will mean lower levels of inward investment and competition and reduced specialisation, and, therefore, lower long-term growth. Thirteen separate economic assessments of the impact on UK growth of operating under a free trade agreement showed an average reduction in the long-term level of GDP of 4.0%. The fact that some, much shorter-term Brexit risks, have failed to materialise, such as the Treasury forecast that a vote to leave the EU would trigger a recession or estimates of large job losses in finance, underscores the speculative nature of even longer-term forecasts.

The UK-EU deal is not the end of the Brexit story. Under the deal the UK will need to establish a new regime for monitoring subsidies and environmental enforcement. Both sides have the right to challenge the other on state aids and other 'level playing field' issues. Fishing will be back in the headlines in 2026 when the first annual UK-EU talks on quotas take place. Meanwhile May's elections to the Scottish Parliament will be a test of the SNP's dual commitment to an independence referendum and re-joining the EU. The pandemic and Brexit seem to have sharpened the Government's appetite for reform. The challenges are formidable – recovering activity lost in the pandemic, rebooting productivity, spreading prosperity across the UK and delivering a vast energy transition.

It is a well recited statement that markets like to climb a wall of worry, and there is certainly much to occupy us over 2021. Infection rates are picking up and the advent of colder weather and a release from the November lockdown has triggered a more meaningful second wave. Markets seem to be taking much of this news in their stride and barring a spate of disappointing news on the actual distribution and efficacy of the various vaccines, we enter 2021 with high hopes of a better year for markets and maybe, just maybe, the UK market can be at the forefront.

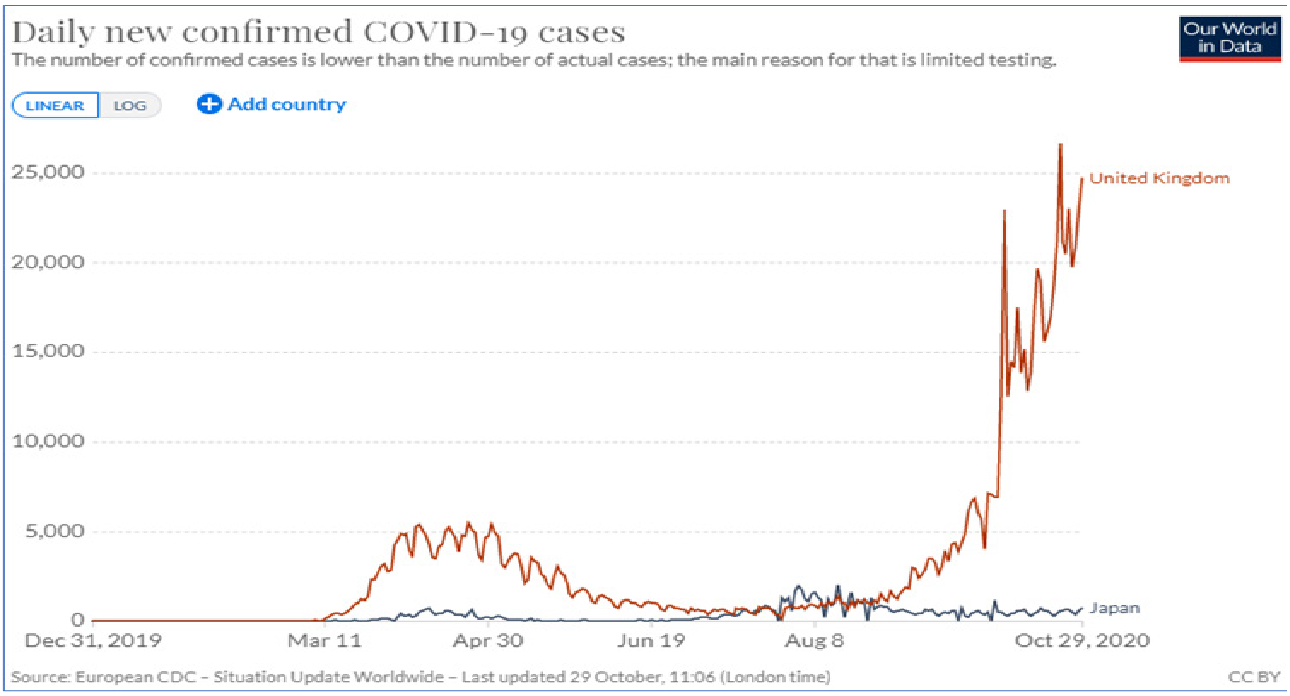


Portfolio Changes Over the Quarter

During October we made a defensive change to the portfolio. Equity markets had been exhibiting a higher level of volatility than usual on fears that worsening COVID-19 case numbers may make stricter lockdown measures unavoidable. Also, uncertainty over the outcome of the upcoming US presidential election (including the potential for a contested result), and how this will impact the expected £2trn US COVID relief plan, were also weighing on markets.

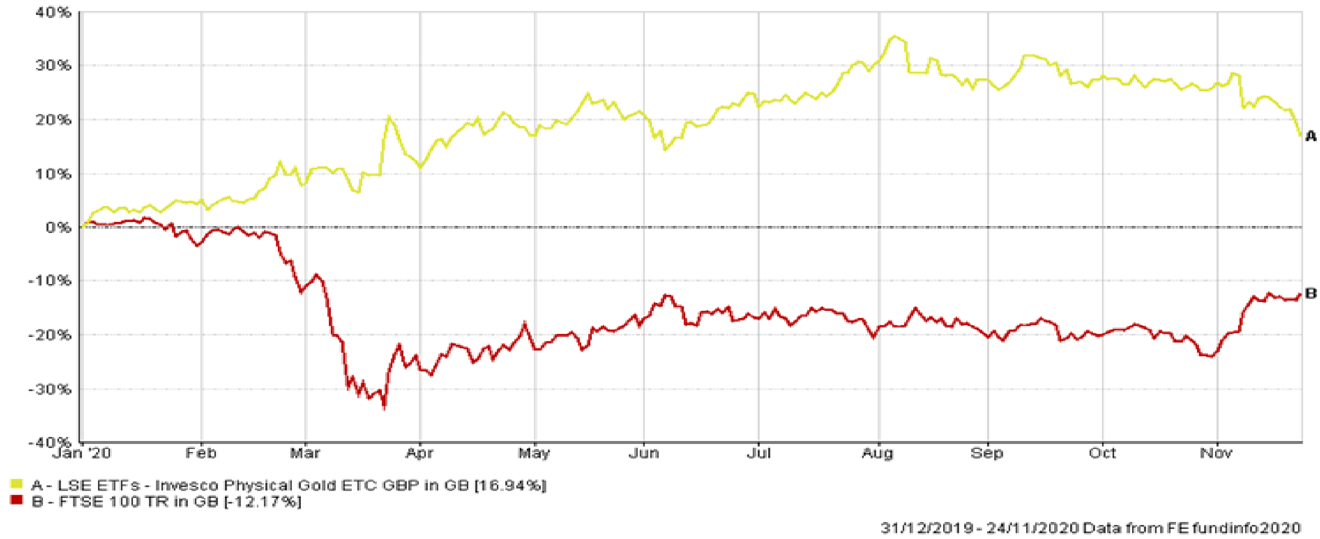
We expected this volatility to continue into the following week around the election, so we felt it prudent to take a little risk off the table. We reduced the exposure to UK equities, via the **Fidelity Index UK Fund** and increased exposure to Japanese equities by adding an exposure to the **Vanguard FTSE Japan ETF**. Japanese equities are usually more defensive than US and UK equities and this had certainly been the case over the preceding few weeks. Part of the defensiveness stems from the fact that the shares are priced in Yen, which is generally viewed as a safe-haven currency (which causes its value to rise) in risk-off periods. The Vanguard fund is a low-cost passive that aims to track the FTSE Japan Index.

A further reason for the strong relative performance of Japanese equities may be due to the country appearing to be doing a good job of containing new COVID-19 cases. The number of new daily COVID cases had stayed quite low and stable in Japan over the previous few months in contrast to much of the rest of the world.



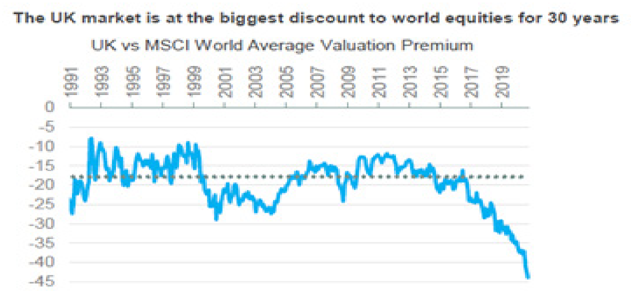
In early November we made a further change. We introduced a new fund into the portfolio, the **Invesco NasdaQ 100 ETF**. The Invesco fund offers exposure to the 100 largest non-financial companies listed on the NasdaQ Stock Exchange, which is heavily weighted towards technology companies. The fund counts Apple, Microsoft, and Amazon amongst its largest holdings. Technology stocks reacted positively as it looked more likely that Joe Biden would win the US Presidential election, but that Republicans would retain a Senate majority. The absence of a 'blue wave', with both chambers in Congress controlled by the Democrats, was perceived to reduce the ability for Biden to push through tax hikes and crack down on 'big tech'. We therefore responded by increasing exposure to US technology stocks.

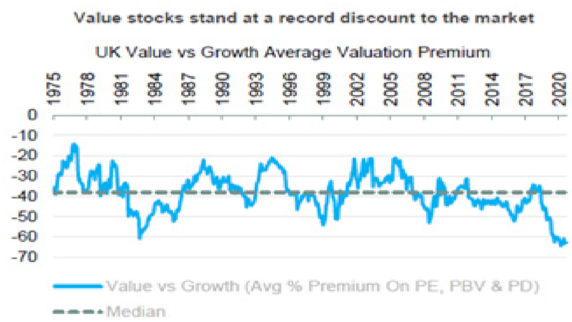
The purchase was funded by the sale of the **Invesco Physical Gold Fund**. We felt the diversification benefits from holding the gold fund in the portfolio outweighed the fact that it does not pay an income, but the backdrop had changed. Bond yields look to be heading higher (which makes gold less attractive as a non-income producing asset) and equity markets looked to be entering a more risk-on period, which will likely reduce the demand for gold as a traditional safe haven asset. We also noted at the time that gold funds had started to suffer significant outflows. The gold price has enjoyed a strong performance over the past couple of years and performed particularly strongly during the COVID-related equity selloff in March (see chart below), but its performance had stalled to some extent since the end of summer, so we took the decision to liquidate the holding.



In the second half of November, we decided to rebalance the portfolio, to bring each position back to its target weighting, and we took the opportunity to make some further changes. With equity markets looking to be in a strong uptrend, helped by a string of positive vaccine news, and looking ahead to a strong economic recovery next year, we increased equity exposure. We did so in a selective way by focussing on UK equities that are classed as showing 'value'. There are many different definitions of what represents value but generally it is interpreted as shares whose price is relatively low versus their fundamentals (e.g earnings and book value). This contrasts with 'growth' stocks, which generally have higher growth in their earnings, but whose prices are typically much higher in relation to their fundamentals.

Over the very long term, value stocks have outperformed growth stocks, but the opposite has occurred over the past decade or so, which in the UK has pushed value stocks to stand at a record discount to the market on some measures. On top of this the UK equity market is still very unloved as international investors shun the market, most likely due to uncertainty surrounding the outcome of Brexit, which should make the current price levels attractive.





Source: RWC 31.8.2020

There are some signs that the recent trend of growth outperformance may be reversing, partly because value stocks offer exposure to sectors and industries that were hit hardest by the economic downturn caused by COVID-19, such as energy and banking. These are the areas of the market that are bouncing back the strongest following the positive vaccine news, but whose year-to-date performance still stands at a significant discount to sectors such as technology that have done the best.

Exposure to UK value stocks has been achieved via the purchase of two new funds: **Man GLG Income Fund** and **JOHCM UK Dynamic**. Both funds are actively managed, which we feel to be important for this type of exposure. They are also both run by a strong and experienced team, but with very different investment approaches, and we feel they complement each other well.

The new purchases have been funded by reducing exposure to the **Fidelity Global Enhanced Income** and completely selling the **Royal London Short Duration High Yield Bond Fund**. The credit spread on high yield bonds, which measures the extra yield available in comparison to government bonds of the same maturity, have reduced considerably since the spreads widened in March due to the COVID-related crisis, meaning future returns will likely be lower. The spreads now stand close to the average over the past five years, so we feel now is a good time to reduce exposure to the Royal London fund. The Fidelity fund invests in global equities paying a high dividend and has a quality bias, rather than value, so reducing it allows us to increase exposure to UK equities and the value factor.

The holding of **Ninety One UK Equity Income Fund** was also trimmed. It offers exposure to UK equities but with more of a focus around quality rather than value. This bias towards quality shares has helped the fund this year, particularly in March when equity markets sold off as the scale of the COVID-19 crisis became clear. It had outperformed the FTSE 100 by over 5% in 2020 at the time of sale, but we felt it was a good point to switch part of the exposure into the above-mentioned value focussed funds.

In December we introduced a new fund into the portfolio, the **Schroder Equity Income Maximizer Fund**. This recently launched fund has a very similar setup to the Schroder US Equity Income Maximizer Fund that we already hold in the portfolio, in that it invests in a basket of shares that aims to track an equity index, but it boosts the dividend income from these shares by also selling call options on the shares it holds. The only difference is that the shares held in the UK fund tracks the FTSE 100 Index, whereas the US version tracks the S&P 500 Index.

Schroder have been running their maximizer range for a number of years and are very experienced at trading in call options and have built strong relationships with the counterparties they deal with when trading these options. These relationships, together with their size, means they can obtain preferential terms on their call option trades.

If you are not familiar with how call options work, you are simply giving up part of your upside from holding a stock to receive a premium income to boost the yield on your fund. It is therefore important that we leave this in the hands of experts to ensure the right stocks are being covered. The option-selling overlay makes the fund more defensive than a similar strategy that does not sell any call options, as although the upside can be partially capped, the fund will outperform if equity markets are weak, because it generates extra income from the selling of option. I should also add that the majority of the portfolio's exposure to UK equities does not employ call option selling, so you will still benefit if the recent recovery for UK equities continues.

The fund aims to generate an annual income return of 7%, with roughly half of this being generated from the dividends on the shares it owns, and the rest from the premium it receives from selling the call options. If the dividend yield on the FTSE 100 should fall, the fund will top this up be selling further call options. This high income is particularly valuable in the current climate, with bond and cash yields currently very low, and many companies around the world being forced to reduce their dividend pay-out in response to the drop in their profits as a result of the Covid-19 pandemic. The high yield on this new fund means we are not forced to take additional risks in the portfolio to keep the income yield high by concentrating risk in the shares that still do pay a high dividend, and also by taking more risk in the bonds we hold (as riskier bonds tend to pay a higher yield to compensate for their risk).

We purchased the fund a few days after its launch and due to our relationship with Schroder we were able to access a restricted share class of the fund, which comes with a low annual management fee of 0.20%.

The new purchase was funded by selling the remaining holding in the **NinetyOne UK Equity Income Fund** and trimming the **Fidelity Index UK Fund**, so the overall exposure to UK equities was not increased as a result of the switches. The Fidelity Fund is a passive fund that aims to track the FTSE All Share Index, which has a roughly 90% overlap with the FTSE 100 Index. We feel it a good time to switch this exposure to a fund that employs call-selling, which will boost the overall income of the portfolio, and will also introduce a more defensive exposure to UK equities to complement the new UK equity funds that have been added during the quarter.

In summary it has been a challenging quarter with lots to contend with, including a second wave of COVID, the US Presidential Election, as well as continued uncertainty around the outcome of Brexit, however the changes we have made have helped the portfolio enjoy strong performance over the quarter.