

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-awaited 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 Deloitte's 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.



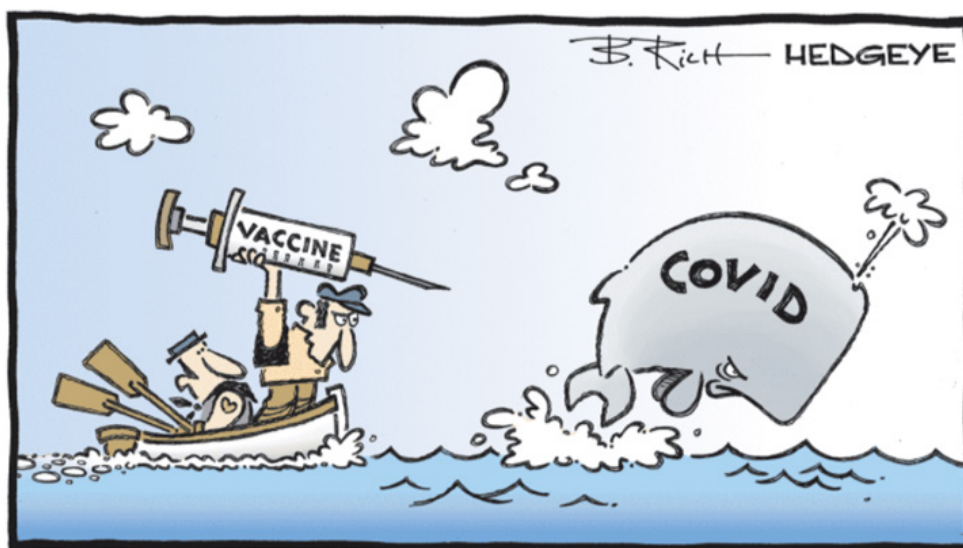
Whilst the Brexit deal helps the immediate economic outlook, it marks a step change towards a more distant, complex economic relationship with the EU. As Professor Anand Menon of King's College put it, "On the spectrum of hard to soft Brexit, this agreement is located very much at the former end". Leaving 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 November we made some changes to the portfolio. We introduced a new fund, **JOHCM Regnan Global Equity Impact Solutions**. This recently launched fund is managed by the same team who previously ran the Hermes Impact Equity Fund and produced very good performance during that time. Our relationship with JO Hambro meant we were able to access the founder share class of the fund that comes with an Annual Management Charge of only 0.25%, which is significantly lower than the standard share class.

The fund invests in companies that provide solutions that have a positive impact on people and the planet. The lead manager, Tim Crockford, and his team have developed an investment process that sets it apart from the standard ESG offerings in the marketplace. This includes conducting a detailed impact assessment of all potential investments consisting of five “tests” that must be passed. One test is that the solution provided by the company must directly drive a positive impact by contributing to a specific SDG (United Nations Sustainable Development Goals). This solution must also be central to the company’s strategy and mission, and it should be clear that the positive impact would not occur if the solution did not exist. The company’s actual and potential negative impacts are also assessed.

There are currently eight investment themes within the fund:



The new investment was funded by reducing exposure to a couple of funds in the portfolio, **Trojan Ethical Income** and **Liontrust Sustainable Future Global Growth**. The Liontrust fund has enjoyed a strong performance this year, so we decided to take some profits off the table. The Trojan fund is relatively defensive, and unlike the new Regnan fund (that holds companies that offer a solution to global problems) it simply excludes any companies that derive material revenue from fossil fuels, pornography, tobacco, alcohol, gambling, high interest rate lending and certain types of armaments. The defensive nature of the fund helped its performance to hold up well during the COVID related selloff earlier in the year, but we are now comfortable reducing exposure to make room for the new Regnan fund, which we feel to be well suited as a core position in the portfolio.

Also, during November the holding of **Baillie Gifford Positive Change** was reduced by roughly a quarter, to bring the weighting back to target, following a period of strong performance. The proceeds from the sale were used to increase exposure to Emerging Markets, via the **iShares MSCI EM ESG Enhanced UCITS ETF**. The iShares fund is a passively managed fund that holds companies that are based in countries described as “emerging”. It has a c. 80% exposure to Asia, which is a region we continue to favour due to their better handling of the COVID-19 virus, and corresponding better growth rates. The fund excludes companies that are associated with controversial and nuclear weapons, producing tobacco or civilian firearms, or deriving their revenues from the following activities (i) thermal coal (ii) tobacco related products (iii) civilian firearms or (iv) oil sand. Companies that are classified as violating United Nations Global Compact principles are also excluded from the Index.

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.