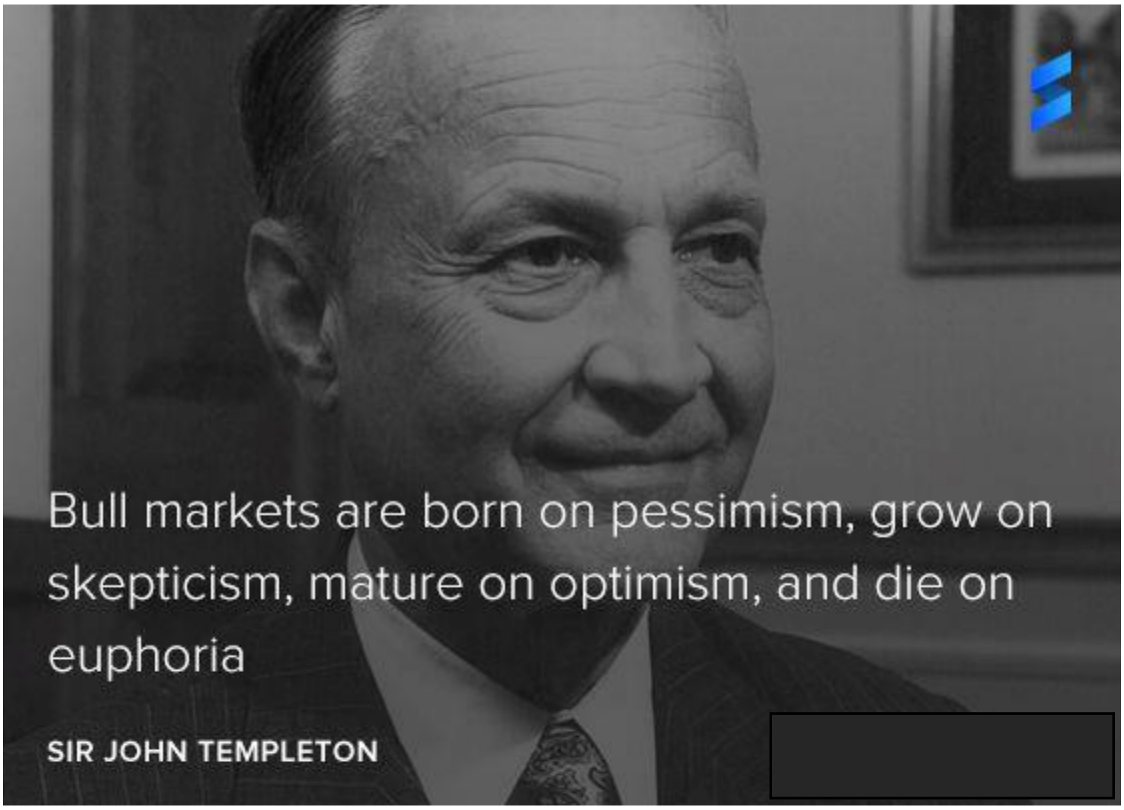
Investment Report 2017

‘Future Shock’



11th January 2017 – “FTSE 100 records its longest winning streak since 1984” (Daily Telegraph)

Roger
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2016 - How could we have been so wrong?

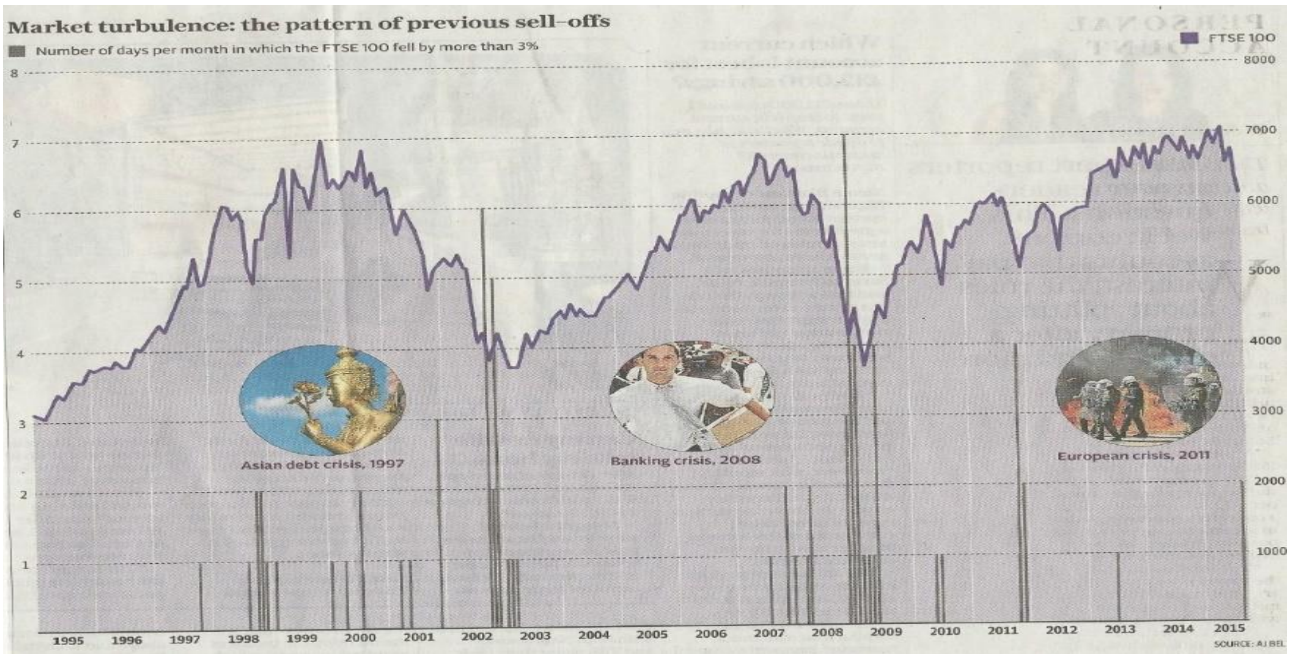
Looking back over 2016 we can see now just how misguided we all were about anticipating global trends. The politicians didn't see Brexit, Trump, or Italy. The economists were entirely mistaken on their Brexit predictions, including the IMF, OECD, Bank of England. Most of corporate Europe and America continued their long sleep while digital natives such as Amazon, Facebook, Netflix and Google disrupted global sectors. The reality is that for incumbents, the future is just a linear extrapolation of the past. But in a disruptive world, this is the inverse of the truth! The mass populous were far smarter – they voted against such endemic incompetence.

Welcome to the VULCA world of volatility, uncertainty, complexity, and ambiguity. It is time for the contrarians to have their say. My university research in 2015 (A State of Digital Disruption) revealed that almost all sectors are being disrupted by digital, but most corporate Boards persist in a state of near denial. Fortunately, the investment strategy outlined in my 2016 Investment Report, Cup Half-Full, delivered strong returns of 12% whilst minimizing risk – with nearly 50% of assets in cash by year end. However, set against Sterling devaluation of 15% against a basket of currencies, this was a near home-goal!

What really happened in 2016?

As per the 'three peaks' theory, 2016 was forecast to be the end of the bull market, starting after the 2008 crisis. We anticipated a major crash of the same level of 2003 and 2009 when markets nearly halved. What happened was a short crash, taking only a few months to recover.

Figure 1 – the three peaks theory



The first quarter was one of the worst since the great depression. Stock markets across the world fell into bear territory, down as much as 20%. Oil reached rock bottom at $25 a barrel, China was on the brink of YUAN devaluation, commodities fell off a cliff, and dividend cover looked dangerously thin due to stagnant corporate profits. Stock market swings during the year averaged around 25-30%. However, despite the many bumps in the road, global equities rallied strongly by year end with the FTSE100 up 14%, the S&P up 9.5% and DAX up 8%. Asian markets fared less well with Shanghai SSE down 6% and Nikkei up just 3%.

Figure 2 – Changes in the 2016 market indices

Market Index	***Change in 2015 (Jan-Dec)***	***Change in 2016 (Jan-Dec)***	***Range in 2016***	***Peak 2000***	***Peak 2008***	***Peak 2016***	***Final level in 2016***
FTSE 100	-5%	+14%	29%	6,950	6,750	7,146	7,146
FTSE 250	+9%	+4%	22%	7,000	12,000	18,000	18,342
AIM	+5%	+14%	25%	2,750	1,200	844	844
S&P 500	-1.0%	+9.5%	23%	1,500	1,500	2,250	2,250
NASDAQ	+9.5%	+12%	26%	4,400	2,200	5,482	5,470
DAX	+9.5%	+8%	32%	8,000	8,000	11,580	11,580
CAC	+8.5%	+6%	28%	6,500	6,000	4,885	4,750
SSE	+10%	-6%	26%	2,200	6,000	3,350	3,165
Nikkei	+9%	+3%	30%	20,000	18,000	19,615	19,600

The big realization for 2016 was that globalization was not all that it was cracked up to be. The rush to off-shore manufacturing and services has brought a decline in living standards to the lower and middle classes in the UK, USA, and other developed economies. The spiraling debt amongst the emerging nations such as China (at $25TR) continued to cause global concern, especially as the dollar strengthened. Capitalism was in the balance as global growth slowed to unprecedented levels, inflation remained below 1% and interest rates were barely above zero. We remained in an era of secular stagnation and no end of QE funding could resuscitate the 'walking dead' such as Japan and much of the EU (Italy, Greece, etc).

Making the most of a torrid year

The most constructive investment strategy (as laid out in the 2016 Investment Report – Cup Half Full) proved to be about ***smart timing*** as much as asset class or stock pick. It was more about "picking the race than picking the winning horse". Here are some of the positive aspects of my portfolio during the year:

- Being weighted towards US stocks (25% of the portfolio) yielded an immediate 14% return for Sterling holders, as did much of the FTSE100 which earns 70% of its income overseas (mostly in dollars)
- Focus on Digital native stocks – Facebook, Amazon, Netflix, and Google (FANG) also yielded substantial upside during 2016. NVIDIA trebled its value during 2016.

- Maintaining a presence in emerging markets through global and Asian funds provided some recovery from a depressed 2015 position
- Regular trading that exploited the 20-30% swing in most stock markets also helped the portfolio, although some early sell-offs proved to be detrimental, especially US banking stocks
- De-risking the portfolio with a move away from equities into short term bonds (especially for ISAs):

Figure 3 – 2016 asset allocation

Asset Class (SIPPs and ISAs)	H1 2016 allocation	H2 2016 allocation
Cash/Short dated bonds	25%	40%
US Equities	25%	20%
European Equities	10%	10%
UK Equities	20%	10%
Global Equities	15%	15%
Other (property)	5%	5%

Higher value London properties took a beating during the latter part of the year (5-10% decline), due partly to 12% stamp duty, and Brexit concerns. Despite this, some six homes were sold in our road at above market prices by mid-2016. Location continues to be a key factor in maintaining value in London and elsewhere.

Global outlook for 2017

Capitalism remains in the balance as growth, inflation, interest rates remain at all-time lows. In contrast, global debt levels remain at all-time highs, around $217TR, with the USA having doubled its debt under Obama from $10 to 20TR, and China standing now at $25TR. Few in the West have seen any improvement in their standard of living since 2008, whereas the big owners of capital are enjoying returns well above inflation. 56 Billionaires have wealth equivalent now to 50% of the world's population. Polarization of wealthy people and cities such as London are becoming increasingly evident. Trickle down is under question.

All regions of the world look increasingly problematic. The EU is in danger of disintegration, as its bloated bureaucrats take up residence in their lavishly refurbished Brussels HQ. Elections in France, Holland and Germany might just produce some big surprises given the growing level of dissatisfaction with the 'old guard'. Time for unelected leaders such as Junker and Schultz to move aside in favour of national elected representatives. Russia is expanding its borders to take in parts of the former USSR such as Crimea and Ukraine. Putin has high ambitions and there seems to be no barriers in his way.

The Middle East has reached ever greater levels of instability with Iran being gifted billions of dollars by the USA and EU to pursue its terrorist agenda. This may be regarded as Obama's most hideous legacy, and the one that could reach danger point in 2017 and beyond. Russia and Iran now dominate the region and will be the deciding factor on how borders are redrawn. We can expect further bloodshed and instability in 2017 as Turkey becomes further embroiled in terrorist attacks. ISIL confirms that we are entering a global 'cultural' war.

Trump may start to rectify regional and global issues by forming a triumvirate with China and Russia. This could help combat terrorism, marginalize Iran, and encourage the break-up of the Europe 'state'. Given the disruptive nature of politics and economics in this early stage of the millennium, almost anything would be better than the status-quo. My bet is that despite the man, Trump's policies are right for the time – especially his approach to attracting capital and labour inflows to the USA (with reduction in 35% corporate tax, and high penalties on off-shoring of jobs). Recent GM and Ford cases illustrate that he is serious.

And finally, in the case of Brexit, a 'clean' exit would help to regain confidence and stop wasting time on unproductive negotiations. Junker has already threatened the UK with major leave-penalties. This is hardly a positive reason for others to stay within the EU. Best to give him what he wants and ditch the sinking ship. After all, we have a £60B trade deficit with the EU as against a £30B trade surplus elsewhere. Let's adopt WTO trading and cast ourselves loose. We can negotiate deals with rest of world in record time compared to EU.

Risks and opportunities for 2017

Some but not all the factors that caused a near stock market collapse in early 2016 continue to haunt 2017, such as Chinese and Global debt, Brexit negotiations, Trump's presidency, secular stagnation, Middle East war and terrorism (especially Iran). An incremental approach to such endemic problems will not work, as we have seen in 2016. The World is entering a highly disruptive period that spans politics, economics, social agendas, and technology (the PEST framework). When all these factors start to change dramatically, entirely new answers need to be found.

A personal view on 2017 is:

- Regarding Brexit, May could underwhelm us with her compromising strategies and negotiating tactics. We need an iron hand to deal with the EU bureaucrats who are seeking revenge on our decision to leave. A 'clean' or 'hard' Brexit is the only real choice. The UK needs to take a global stance and exploit its enormous capabilities, especially in Technology. We should aim to be the Singapore of the West
- A collapsing EU. Whether the current elections produce a shock result such as Le Penn in France gaining presidency, or a more gradual change in the political order, the EU must recognise that the current political and economic frameworks are not sustainable. Youth unemployment remains at 50% in the southern countries. Growth

is below 1%. Only Germany gains from a single Euro currency, with its weakness against the dollar. Time for a radical rethink.

- Trump's presidency. So far, all the signs look promising with some impressive hires within the new administration. Trump's policies are radical and respond to a world in crisis. However, the man himself has a deeply flawed history so his ability to gain respect and implement change must remain under question. My hope is that he will prove his detractors wrong and deliver on his radical agenda.
- Syria and ISIL. The combination of Russia and Iran as the 'peace' negotiators for the current war in Syria is a worrying scenario, to say the least! We all recognise that the Middle East countries are unstable and need tyrannical dictators or military juntas to maintain order, as per Egypt. Assad may be a temporary solution for Syria, but he needs careful handling. After all, it was his father who instigated suicide bombing as a tool of war.
- Asian issues such as China and Japan. Abe's policies have begun to stimulate the world's third largest economy, but at great cost, with QE measures heaping on debt to a fragile economy. China is also reaching a critical stage with excessive debt and pressure to devalue the YUAN. Higher US interest rates may backfire on this precarious part of the global economy.

2017 might be the start of a new era if these pieces fall into place. However, we can expect many bumps in the road and false hopes leading to high levels of economic volatility.

Investment strategy for 2017

Recognising the above risks and opportunities, a wait-and-see investment strategy makes sense for 2017. It is clearly too early to make accurate predictions on any of the above events. It is safe to say that there will be mixed outcomes, with inherent downsides. The only light at the end of the tunnel is the prospect of higher oil and commodity prices that will help maintain dividends from energy majors such as Exxon, Shell, and BP. At $60 a barrel, the US becomes relatively self-sufficient, relying on shale and fracking as well as domestic wells. This will give Trump further leverage in dealing with disruptive ME players such as Saudi and Iran.

One possible view is a strong first quarter based in Trump optimism and possible tax cuts (with cash repatriation), followed by a sharp downturn on global stock exchanges. One factor promoting this view is that investor cash reserves are below 4% as the rally powers along. They will look to deleverage as soon as any cracks appear in the current bull run. Global debt at 325% of GDP remains an overhang with little sign of government deleveraging. Any tightening of US interest rates could hurt Asian borrowers as the dollar strengthens.

Essentially, we are walking a tight rope between stimulus, debt, and interest rate hikes.

An associated investment strategy for this coming year would comprise the following elements:

- Buy on the troughs and sell on the peaks. We can expect further market volatility of perhaps 20-25% during the year. Trackers are low cost instruments to exploit this condition, for example, in the FTSE100 and S&P500.
- Maintain USA exposure despite relatively high market valuations. The prospect of further interest hikes after December 2016 should maintain a strong dollar against sterling. Trump-economics could boost the domestic economy and US stock market, at least for the short term
- Monitor movements in European and Asian markets where conditions remain weak, as per China SSE and Nikkei. There may be value opportunities here that well managed global funds can exploit.
- Look at unloved UK assets such as the FTSE250 that declined by 20% relative to a basket of currencies in 2016.
- Keep a strong cash reserve to dampen the impact of market volatility and be ready for strong buying opportunities. It is still possible that our third peak/trough may appear in 2017, with possibilities of a 30-40% decline in stock market values

These elements suggest a diverse portfolio, covering a wide range of currencies and assets. It also promotes a longer-term strategy based on strong dividend flows (5-6%) rather than pure capital growth. With the return of $60 oil, energy stocks look attractive in this respect. Higher interest rates support the banking sector. A rebalancing of the current portfolio may look like:

Figure 4 – asset allocation for 2017

Asset Class (SIPPs and ISAs)	Recent allocation H2, 2016	2017 allocation	Rational
Cash/Short dated bonds	40%	25%	Cash reserves for buying opportunities
US Equities	20%	25%	Strong dollar, growth potential post Obama
European Equities	10%	10%	Value opportunities, surprise outcomes
UK Equities	10%	15%	Healthy dividends, global exposure, unloved assets
Global/Asian Equities	15%	20%	Balanced portfolio of risk and opportunity (Asia)
Other (property)	5%	5%	Hold positions post Brexit

Currently, cash in the SIPP and ISAs is held in short dated strategic bonds to gain some improvement over cash on deposit (now at 0% interest rates). Buffet's view that 10% of a portfolio should be held in cash to cover near term market down turns would appear to make sense. However, buying opportunities in this volatile world might encourage a higher proportion of the portfolio to remain in cash ready for a steep downturn (say 25%).

The old tenant that investing in stocks and shares could produce a 4% return over time is largely discredited today. Although this held true during the eighties and nineties, recent market dislocations have challenged this long-standing assumption. More realistically, a static approach to investment is likely to yield just 2-3%, even when dividends are reinvested. Active management is needed to address this shortfall, especially given current levels of volatility.

Time for a more active approach to wealth management.

Appendix: Key asset classes

Over a century equities have delivered exceptional gains of 100 times in real value, compared to three times for cash and five times for bonds. However, timing is everything. Between 1999 and 2015 the UK FTSE100 index has been flat, with only modest income (via dividends) of around 2.5% per annum. This corresponds to similar periods of flat performance between 1971 and 1982, and 1936 to 1950.

Other periods have enjoyed much stronger performance such as the eighties and nineties, where stocks rose on average at 8% plus per annum excluding dividends. In the last sixteen years, the FTSE has fluctuated between 5,500 and 7,300, with no overall advances. In contrast, the S&P, NASDAQ and FTSE250 have all delivered substantial gains. The outlook for UK FTSE100 remains cautious for 2017 with most predictions lying between 6,900 and 7,200.

Global equities

With global debt of $152 representing 225% of global GDP, and accompanying growth of sub 3%, prospects for 2017 do not look positive. There has been no deleveraging of debt since the crash of 2008/9. The MSCI World index did advance in 2016 by 5%, but has not made any progress since 2014 (having advanced considerably post 2008 crash). The best policy at a global level is to back income and growth funds that exploit regional differences and value opportunities. Recommendations include:

- Lindsell Train global equity and global opportunities; Rathbone global opportunities;
- Artemis global growth; Fundsmith Equity
- Newton global income; M&G global dividend; Trojan global income
- Baillie Gifford Global discovery

USA equities

The US economy remains weak after a decade of Obama mismanagement. Growth has dropped from 2.7% down to below 1%. Stalling house prices and flat line car sales illustrate the level of current weakness. The FED has missed 3 out of 4 rate rises this year. However, it is fair to say that Obama was inaugurated during the height of the 2007/8 crash, giving him a tough start to his presidency.

Trump could take advantage of current weaknesses by attracting capital back to the US (e.g. Apple's $150B), as well as jobs. Spending on defense and infrastructure might also stimulate the S&P500. USA share dividends have dropped to 2% against a long-term average of 3.5% after inflation. Yields for the decade will be around 2.5% compared to a historic average of 4%.

Despite economic weaknesses, the USA remains an expensive stock market and is likely to yield 4% growth in the future against 7-8% elsewhere. Factoring in a strong dollar based on likely rate hikes, this remains an attractive haven for UK investors, with 10-15% upside for 2017.

Funds to back include major industrial stocks and small companies:

- Major corporates such as GE, J&J, P&G, EXXON; Coca Cola via trackers and managed funds, e.g. Old Mutual North America
- Banks such as JP Morgan, Citi and Bank of America as interest rates continue to rise
- Small company funds such as Threadneedle Small American companies

UK equities

The FTSE 100 rose by 14% in 2016, with much smaller gains in the FTSE250. The equity market is expensive, as with the USA, with P/E ratios of around 20 against a historic average of 14. CAPE measure is more favourable standing at 15 compared to a historic value of 19. There remains room for annual growth of 7-8% over the next decade.

Much of the FTSE100 movement in 2016 was due to a recovery in energy and mining stocks; and Sterling devaluation (improving the earnings prospects for many of the major companies – with majority of income from overseas).

Post Brexit, the UK has every opportunity to exploit international markets such as USA, India, and China. Its leadership in financial innovation could supersede worries about Passporting. New technologies for trading such as Block Chain could transform the position of UK banks, just as Euro-bonds and Big Bang did back in the seventies and eighties.

High Internet usage in the UK of 12% of GDP compared with 8% in South Korea and 4% in Germany makes this country attractive for digital natives. Snapchat, Google, Amazon, and Facebook have all backed London as the European HQ post the Brexit decision.

Our national debt and balance of payment deficit continue to haunt successive governments. Spending on government departments, civil service pensions and the NHS remains out of control. Radical and drastic measures will be needed to address this issue. Meanwhile, Labour is in disarray, with Jeremy Corbyn determined to take the party back to a by-gone socialist era. This can only be good news for the Conservatives, although it might soften their approach where more aggressive actions are merited, e.g. Brexit and NHS.

Funds to follow include strong dividend performers and value opportunities:

- Vanguard FTSE UK equity tracker and Lifestyle*;
- Discounted trusts that offer strong dividend yields such as City of London
- Small company funds such as Marlborough special situations
- Woodford Equities*; Old Mutual UK Alpha*; MFM Slater Walker Growth*; Lindsell Train UK equity; Unicorn UK Income; Old Mutual Equity1; Invesco Perpetual High Income
- Lions Trust special situations; Milton UK Value Opportunities*; Fidelity special values*; Jupiter UK Growth; JO Hambro UK Dynamic
- Individual stocks from Energy (Shell and BP); consumer goods (Unilever, Diageo, RB, BAT) and Banking (Lloyds, HSBC, Barclays); construction (Taylor Wimpey)

China

The SSE declined by 6% in 2016 with high levels of volatility. Hong Kong exchange managed a small gain of 1%. Continuing danger of a hard landing in 2017, with $28TR of debt overhang. Credit growth has fueled the economy, via corporate and consumer, as well as government spending on new towns and transport infrastructure. The credit to GDP gap has reached 30, which is well beyond the critical 10 danger level. Overall credit is now 225% of GDP, with corporate around 170%.

Growth continues to slow, down from 10% to 6.7% in 2016. China remains the world's manufacturing platform, but Trump may encourage companies to return jobs to the USA. Time for the domestic market to take up the slack and increase its share of manufacturing output.

China is best accessed through Asian funds such as:

- Stewart Investors Asia Pacific Leaders
- JP Morgan global emerging markets
- First State Greater China Growth

Japan

The Nikkei gained 3% during the year. However, Abe-economics is failing to deliver growth. Wealth from an entire generation has been wiped out due to the collapse of land and security values over the last thirty years. National demographics are also not positive, with low levels of immigration and an ageing population. Debt has reached 2.5 times GDP with little scope for further stimulus. The Yen has strengthened due to expansionist monetary policies (QE and BofJ support), further restricting corporate growth. A recent report by Omfif positions Japan 'at the edge of shock'.

Funds have delivered well despite the economic situation,

- Neptune Japan opportunities
- Invesco Perpetual Asian
- MAN GLG Japan Core Alpha

Europe

As mentioned, a mixed scene with countries such as Italy and Greece running close to bankruptcy. The recent collapse of Italian banks illustrates the fragility of this region. Only Germany has benefited from a single currency. Growth in GDP across the union remains stagnant with creeping protectionism and an inability of the EU to strike deals – as witnessed with the Transatlantic Treaty (TTIP). There is rising anti-global sentiment as with the USA.

The MSCI index for Europe peaked in 2014 at 1,820 and declined to 1,465 recently. Despite this poor performance, there are value opportunities, especially with smaller companies. Funds to back include:

- CRUX European special situations (the 'Woodford of Europe')*
- Blackrock European Dynamic
- Invesco Perpetual European equities
- Artemis European opportunities
- Invesco Perpetual European small companies
- Jupiter Europe

Bonds

Government bonds have been falling for nearly thirty years as interest rates and inflation narrow to around 2%. QE and broader government support has created a golden age for bond holders as capital value spirals. However, there is little sign that this golden age is over yet. Caution is needed however as interest rates begin to rise in the USA and possibly the UK.

Short dates strategic bonds offer lowest risk:

- TwentyFour dynamic bonds
- Henderson Strategic bonds (high quality corporates);
- Jupiter Strategic bonds

Technology

Tech stocks remain massively over valued with P/E ratios of 50 to 150. Amazon has recently doubled its value from $470 to $840. NVidia tripled its value in 2016. They are likely to continue their strength well into the next decade given potential for disruption.

Funds and stocks to invest in for 2017 include

- FANG – Facebook, Amazon, Netflix and Google. Possible addition of Apple as it exploits its 1B customers for software services
- Scottish Mortgage that focuses on Tech across the Globe
- Baillie Gifford Pacific Funds that pick up on STATS – Tencent, Alibaba, Samsung and Twain Semiconductor

Gold and Commodities

Gold stood up well in early 2016 but has stabilized since then, ending the year at around $1,150 compared to $1,300 mid-year. Overall, Gold has declined steadily from its peak of $1,950.

Commodities have had a turbulent year, but ended on a high with oil up 80%, silver up 20%, Iron up 87% and copper up 30%. Overall this reflects confidence in manufacturing. Mining companies had an exceptional upswing, with gains of 100% across the sector. Overall this is not a preferred area for personal investment, although gold provides a longer term hedge against volatility. I would prefer cash as a more liquid hedge.

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