Lincoln Private
Investment Office
London

30 June 2019

Investment Letter – Q2 2019

"My chances of being PM are about as good as the chances of finding Elvis on Mars, or my being reincarnated as an olive."
Boris Johnson, 2004

From time to time, we think it is important to take a step back and look at the key themes of our investment strategy. This quarter has seen contrasting narratives from one month to the next, driving markets to rally materially in April, to reverse substantially in May, and then bounce back again in June. It is clear that during the quarter, markets were driven by short-term sentiment and news flow around Trump's tariffs, central bank commentary and UK politics. However, with our long-term focus in mind, we instead wanted to take this opportunity to return to the core investment views running through our portfolios and why we are positioned the way we are.

The convention in wealth management has long been that the starting point for a client's asset allocation is a portfolio invested c.60% in equities and c.40% in fixed income. The rationale is that equities will provide the higher returns, whilst fixed income will protect the portfolio during periods of volatility and deliver a valuable income stream. We continue to argue that this convention is outdated for the unusual times we find ourselves in. Today, traditional fixed income instruments no longer offer the promised risk-free return, but instead carry risk, free of any material income return.

After the global financial crisis, developed market central banks stepped in to revive their respective economies. The solution was twofold; lowering interest rates below 1% and pumping new money into the financial system via quantitative easing. The latter involved creating cash to purchase fixed income instruments, primarily government and corporate bonds, pushing up prices and thereby reducing the available yields. Unorthodox central bank intervention is far from a thing of the past. The ECB President recently signalled that more monetary easing is on the horizon. This resulted in the universe of global bonds with a negative yield expanding to a staggering $13 trillion for the first time, including German, Swedish, Dutch and Swiss 10 Year government debt. In June, Austria launched a new issuance of 100 year bonds with a yield of just 1.2%. When considering the number of events that can occur over a 100 year period, it is incredible to think c.1% is a reasonable annualised return to justify the risks.

The implications for fixed income investors are significant, as most bonds are currently trading above their maturity price so will decline in value over time. Furthermore, bond prices are elevated to such an extent that risks to capital are materially skewed to the downside, because when interest rates rise the value of these bonds will fall sharply. In this challenging environment, we prefer to manage risk by avoiding conventional fixed income in the Government Bond and Corporate Bond asset classes. We instead select managers that aim to generate returns that are uncorrelated with the wider sector, have the same volatility profile that fixed income has traditionally offered, but can continue to perform regardless of the direction of interest rates.

In the High Yield Bond asset class, we remain concerned about the health of the underlying corporate balance sheets as companies have taken on more and more debt in this low interest rate environment. We instead continue to see opportunities in the CoCo (subordinated bank debt) market, which does not feature in major fixed income indices, and where the yields look attractive. We also see inefficiencies in other parts of the bond market where some of our alternative managers can take advantage of mispriced assets. Our allocation to Emerging Market Bonds is through more conventional instruments where the reward profile is attractive enough to justify the risk. Emerging Market Bonds carry the opportunity for upside appreciation, as well as offering attractive returns from their yields alone.

Turning to our equity positions; in developed markets we prefer value managers who are focused on finding overlooked companies with sound fundamentals. The disparity between the prices of growth and value stocks has now overtaken the extremes seen during the dot-com bubble at the turn of the millennium. As was the case then, investors are currently willing to pay an extremely high price for projected earnings growth. We perceive value investing to be safer in this environment. Reflecting on the chart below, which shows the extent of the divergence between the two styles across global equities, we argue that a degree of mean reversion is due.

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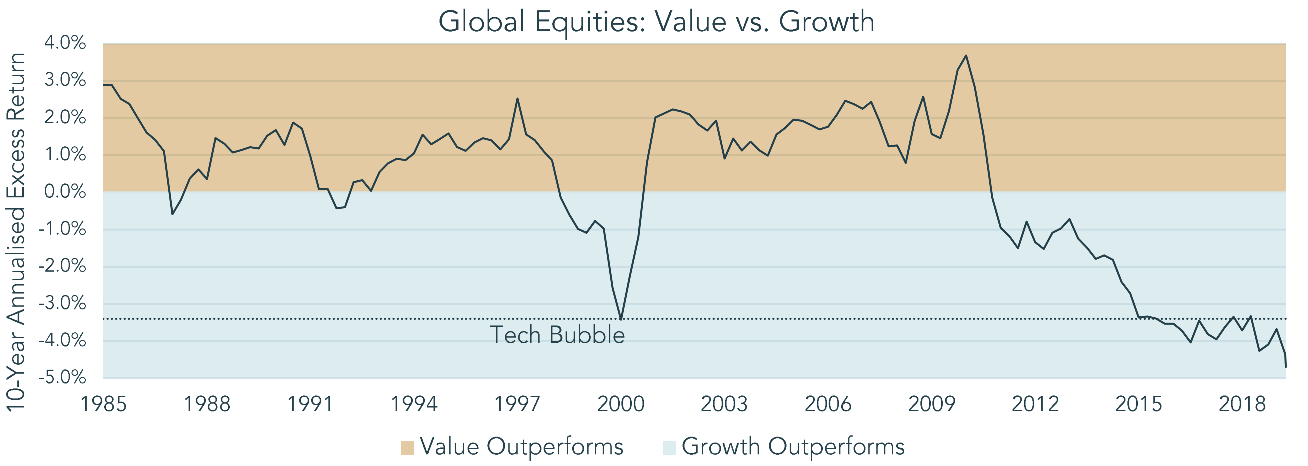
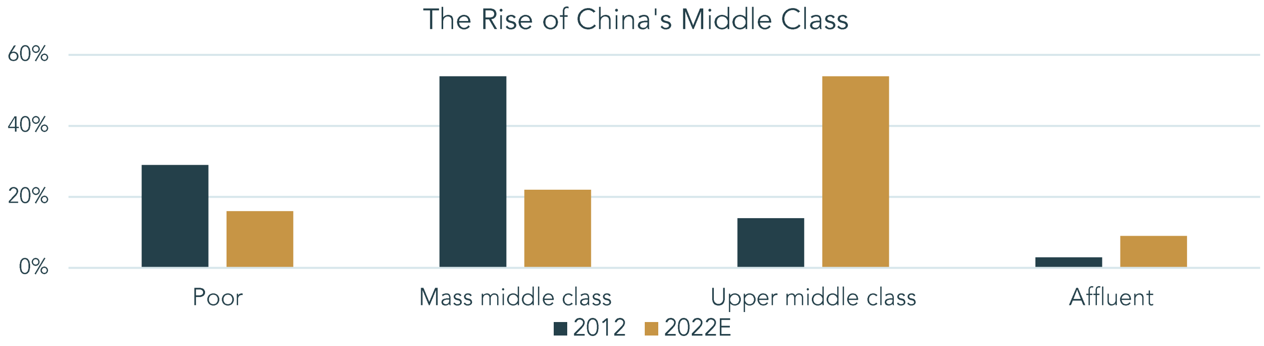


Source: MSCI World Data, 2019

We also maintain our preference for Asia and Emerging Market equities. It is impossible to predict the daily changes in trade war risk, or lack thereof. We instead look at the fundamentals and remain attracted by what we see in these regions. GDP growth remains strong, valuations are reasonable and the population's disposable income is growing at a substantial rate. The chart below highlights how significant this trend is forecast to be in China, with upper middle class consumers (those with disposable income equivalent to $16,000 - $34,000) expected to grow from 22% of the population to 54% in the 10 years from 2012 to 2022. The daily headlines also miss the opportunity created by China's gradual shift away from a manufacturing economy to one that is increasingly consumer led.



Source: McKinsey, 2018

With China gradually transforming its economy, the opportunities in Frontier Market Equities are abundant. Vietnam, for example, has seen a surge of export demand as supply chains move there from China, with recent data showing US imports from Vietnam increasing by 40% year-on-year. Frontier Markets do not have the market sensitivity that Emerging Markets have. Instead, their returns are country specific, and our manager has the flexibility to move in and out of countries depending on their fundamentals. If markets are rallying in Argentina, it will have no impact on Bangladesh. This lack of correlation means that our Frontier fund's volatility is much lower than many people would assume. Based on weekly returns since December 2010, volatility was 16% lower than the S&P 500, 27% lower than the FTSE All Share and 33% lower than the MSCI Emerging Markets index. Adding to this attractive risk-adjusted return profile, Frontier Market Equities currently have a yield of 4.3%.

Given the previously outlined risks associated with conventional portfolio construction, we maintain a high level of conviction in the approach we have taken in our portfolios. We prefer to avoid investing in overvalued equities and government bonds with artificially low yields. We are confident that our core investment views will provide the right level of protection along with the opportunity for outperformance.

Finally, with the impending Conservative leadership contest, perhaps the probability of finding Elvis on Mars has increased.

Fred Hervey
Chief Investment Officer