Lincoln Private
Investment Office
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Investment Letter – Q3 2016

"We cannot solve our problems with the same thinking we used when we created them." Albert Einstein

For the first half of the year, we were warned early and often by authorities that a Brexit vote would be a calamity. The IMF claimed that a "Leave" result would threaten to "cause severe damage", while Standard and Poor's said that it would "paralyse" investment in the UK. But remarkably, 90 or so days after the vote, the UK was back on its feet, buoyed by a rapidly depreciating pound. Unemployment was at 11-year lows, with other economic indicators, such as the manufacturing confidence survey, stable or improving. The FTSE 100 rallied strongly, and interest rates were lowered even further by the Bank of England (BoE) after the result.

In fact, Q3 saw a raft of further rate cuts or supportive changes to monetary policy from central banks globally. The Bank of Japan (BoJ) announced a suite of new tools aimed at loosening conditions to stimulate growth, while the European Central Bank (ECB) was under pressure to support markets in the wake of post-Brexit turmoil. The Fed failed yet again to come good on claims in 2015 that it would raise rates up to 4 times this year, much to the delight of exuberant equity markets. And so the simple view that central bankers can solve all problems supported equity markets around the world for another quarter, propelling many close to their all-time highs. The mantra of 'bad things happens, and central bankers cut rates' has worked time and time again - why should this time be any different? Why, then, do we continue to be positioned cautiously?

To answer that question, let's digress for a moment and consider traditional theories of portfolio construction. Historically, balanced portfolios were constructed to contain assets which would perform well in different environments, rather than concentrating all the risk in one strategy. This idea of diversification led to balanced portfolios being split, in simple terms, between bonds and equities; the idea was the bonds would perform well when equity markets took a turn for the worse. Balanced portfolios were constructed to contain more bonds for those investors who wished to take less risk or had a shorter investment time horizon, and vice versa for equities. This theory has held during all recent crises. In 2008, for example, when equity markets fell in response to the unfolding financial crisis, safe-haven bond markets rallied strongly. And so, while investors into equities felt pain, those that had a diversified portfolio at least experienced an offsetting gain from their bond holdings.

After the crisis, central banks around the world took up supportive policy stances in an attempt to stimulate growth. Interest rates were brought down to historic lows, driving up the prices of fixed income and equities in tandem. An unprecedented amount of stimulus in the form of quantitative easing also supported asset prices. Investors' incentives were skewed by the size and force of central bank intervention. As interest rates fell further and further, they were willing to look further and further down the quality spectrum for income-yielding assets; the initial move from cash to government bonds led to an inevitable trickle down into corporate bonds, and, eventually, even the riskier high yield bond and equity markets. Fast forward to 2016, and the benefits of traditional portfolio diversification are no longer being felt. Correlation, or the extent to which different assets move in the same direction at the same time, between bonds and equities has never been higher. In a 'normal' world, bond prices and equity prices should move strongly in opposite directions, but the last few years have seen a major regime shift as the entire financial market became reliant on central bank stimulus.

Trying to implement these kind of portfolio diversification methods in today's markets is now almost impossible. Using the traditional methodology, there is nowhere to hide if something goes wrong. It is this changed relationship that is at the heart of our concern. The majority of investors seem to still subscribe to these traditional fixed income instruments and overvalued areas of equity markets, meaning that they are now receiving no diversification benefits. They are betting that both instruments will continue on up in the same direction into perpetuity. They are relying on the theory that there will always be someone more foolish than them to whom they can sell. They are essentially placing a zero probability on anything going wrong. And that is with stretched valuations in developed equity markets, lack lustre growth globally, a US election looming and USD 16trn of debt globally currently giving investors a negative yield.

Our strategy has long focused on identifying the most overvalued areas of the market, and then positioning our clients' assets in areas that are less compromised. When assets are overvalued and moving in tandem, it is vital to look for alternative sources of diversification. It is important to not pile into the same overcrowded trades as everybody else; should sentiment reverse, the rush for the door will be swift and hard. Our investment approach is unconstrained: we do not follow a benchmark. This means that we are not forced to hold instruments that we feel can only lose money for fear of performing too far away from an arbitrary index. It means that we can move away from the traditional portfolio diversification methodology when historical relationships breakdown, and seek capital gains and income from a wider variety of sources.

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And despite the areas of the market that we view as dislocated continuing to defy reason, we continue to perform well on behalf of our clients. We have long been positioned in alternative fixed income strategies, avoiding the crowded trade of conventional government and corporate bonds. Our actively diversified currency position continues to benefit us. We continue to favour emerging and Asian markets, from a fixed income and equity perspective; fundamentals are improving in these regions, and they are yet to experience the same central bank-driven bubble in their markets.

Of course, we do not have a crystal ball, and do not know what catalyst, if any, there will be for a potential sell-off in the most overvalued parts of the market. We are not suggesting that there will be an immediate fall in markets; in fact, there are several reasons that valuations of equities may indeed rise further. But the point to stress is that this trend is becoming increasingly less likely to continue, particularly in fixed income markets. We will continue to position ourselves across asset classes that offer genuine diversification benefits, while avoiding the more irrational areas of the market. We are pleased that we continue to capture upside, even when our eye is firmly focussed on capital preservation.

Fred Hervey
Chief Investment Officer