Lincoln Private
Investment Office

London

30 September 2017

Investment Letter – Q3 2017

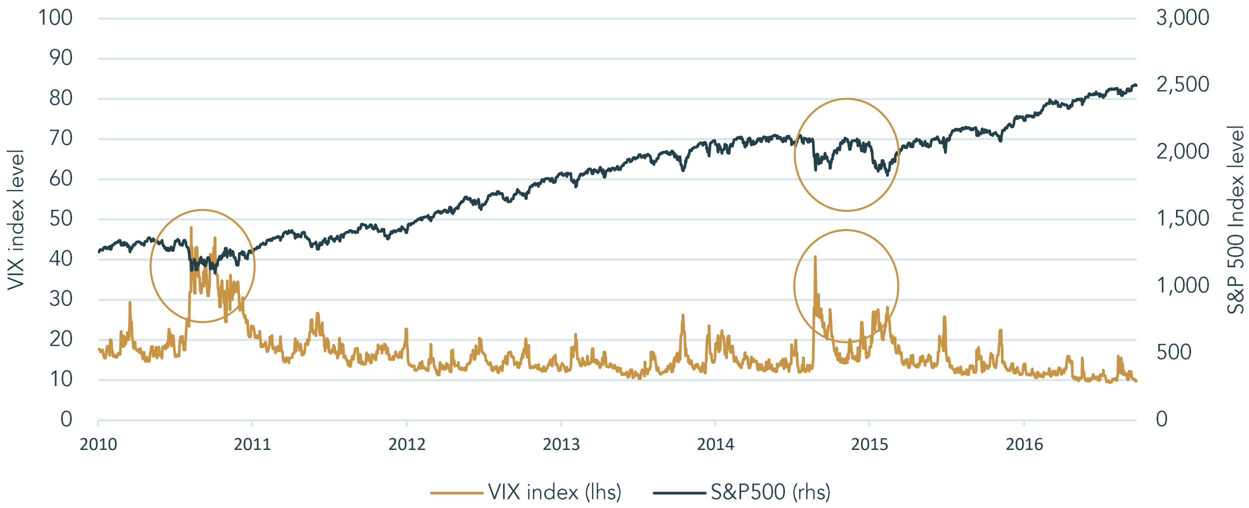
"Make hay while the sun shines….but carry a large umbrella." Francis J. Greenburger

In a quarter where there has been a high level of global uncertainty, we have continued to add value in portfolios. We remain surprised by the relative composure of markets in the face of heightened geo-political tensions between North Korea and the US, the lack of progress in Brexit negotiations, and the divisive nature of European politics. Despite all of this, international markets continued to move to higher levels. Our view is that it is only a matter of time before the blinkers come off and the reality of excessive debt levels, high valuations and political uncertainty are more realistically priced into the market.

In our last letter we wrote about France bucking the growing populist trend with Macron's election, and similarly at the end of September, we saw Merkel succeed in securing a fourth term. However, this success was somewhat tainted by a 9% fall in her votes, compared to 4 years ago, with the far-right being the major beneficiary. In the German government six parties now have seats, meaning an increase in uncertainty and a decrease in stability. Brexit negotiations are ongoing, but with the current lack of cohesion any substantive progress in the near term appears unlikely. This continues to be a headwind for the UK, and sterling in particular. These issues, combined with expensive valuations in US equities, make us prefer opportunities outside of developed markets.

There is a risk that when the market recognises the challenges that are being faced globally, investors will then begin to price assets accordingly. As UK, US and European central bankers move towards tightening monetary policy, the end of the 30 year bond bull market appears to be imminent. With 19 European countries continuing to trade with negative real yields, the opportunity for meaningful losses in conventional bonds remains high. We therefore maintain an unconventional approach in fixed income, seeking returns uncorrelated to traditional bond markets.

As quoted above, whilst we continue to make hay while the sun shines on equity markets, volatility will increase and we have our umbrellas ready. The most watched index of risk is called the VIX index which is a measure of market implied volatility. The following chart shows the US equity market (S&P 500 index) versus the VIX index. Two things are clear from this chart; firstly, we are in a period of unprecedented low volatility. Secondly, when volatility spikes higher, markets have been falling.



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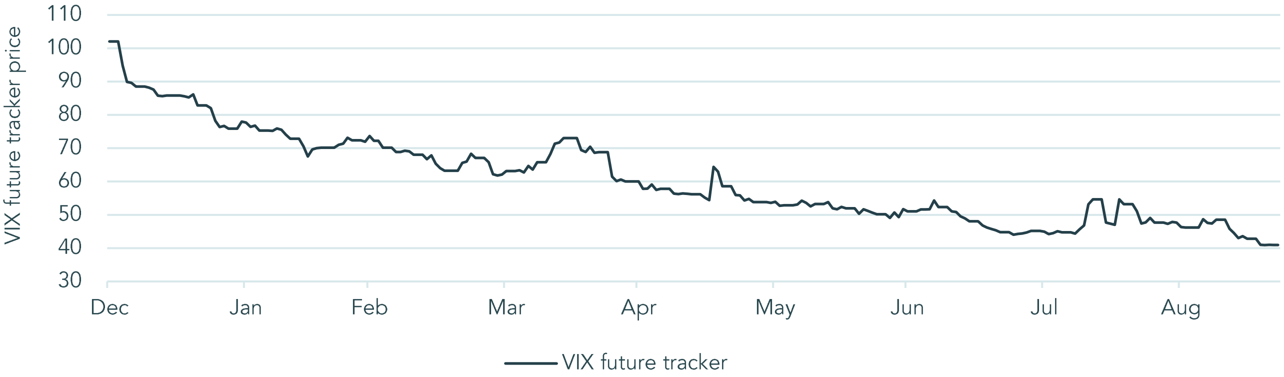
We have been looking at possible strategies to position ourselves to benefit from a sudden spike in volatility – either explicitly or to protect the portfolio against any shocks. A popular method is to use derivatives to hedge portfolios, but one of the downsides of this is the difficulty in market timing. Take for instance the strategy of investing into the future value of the VIX. If we look at a popular tracker of this market in the chart below, we can see that the cost impact of holding the position year–to-date would have been 60% of invested capital. Using the tracker for hedging purposes would have resulted in the losses being significantly greater, because of the necessity to continually buy more as the value fell. If it were possible to time the entry well, it would then also be necessary to close out the investment at the right time, to ensure a profit was taken.



Another strategy often used to protect portfolios is to buy the 'right to sell' an equity market at a particular level (a put option). If, however, the market doesn't move towards the chosen level in the agreed time frame then the put option will expire worthless. The reality is that buying options is like buying insurance; it can be expensive and may never in fact be utilised. These constraints on the cost and profitability of these strategies, leave us to consider other alternatives to protect the portfolio.

We believe that the best way to hedge against volatility, and the associated equity market weakness that would likely accompany it, is to ensure the portfolio has three things; a cash allocation that can be utilised to take advantage of any market pull-back; strong diversification both at the international and sector levels, and finally an allocation to alternative strategies that are negatively correlated to equities.

Our concerns over volatility are heightened due to some equity market valuations being stretched, most notably technology. To put this in perspective, Google and Apple have a combined market capitalisation that is greater than that of the MSCI China Index, and Facebook's market capitalisation is larger than India's. Surely unjustifiable. It is not just American tech that is expensive; the year to date increase in market cap of the five largest tech stocks in developing nations (Tencent, Alibaba, et al), is equivalent to the entire value of the Russian stock market. It looks very likely that valuations have got ahead of themselves and investors need to tread carefully.

So where do we see opportunities? One of our favoured asset classes has been, and continues to be, Emerging Market Equities. This is an asset class that is benefitting from strong investor flows, which show little sign of tailing off, plus strong and improving underlying economic fundamentals. Of particular note is the increase in intra-emerging market trade which should allow the region to become less sensitive to any dollar strength and developed market shocks. Emerging markets have large, growing and young populations, with an average age of 26, which gives an indication of the potential growth opportunity in these countries. Emerging markets are also much more attractive in terms of their balance sheets. Currency adjusted debt as a percentage of GDP for emerging markets is 72% compared to an excessive 275% for developed markets.

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The following chart shows the relative return of Emerging Market Equities versus the MSCI World market, and demonstrates that despite the recent recovery, there is considerable room for the current upward trend to continue, and a long way to go to unwind the substantial underperformance since 2010.

As a private investment office that focuses on high conviction strategies and absolute performance, we are not constrained to a benchmark and are not obliged to hold an asset class if we have no confidence in it. We also place larger positions in those areas in which we have strong belief. This means we have the conviction to take an active decision to hold cash, when we feel it is right to do so. Currently, in the more cautious areas of the portfolio, we hold cash and absolute return funds to protect capital should markets begin to face downward pressure. We look forward to being able to deploy cash, and in the meantime we invest where value does exist and are encouraged about opportunities in some areas of the market.

Fred Hervey
Chief Investment Officer