# Market Update

*23rd April 2020*

There is no doubt that the global economy is heading for a deep recession, but how quickly it recovers depends upon the speed and success of any reintegrating plans. The process is likely to be a slow evolution and setbacks are inevitable as the plans are consequently rolled out around the world at different times. Certain sectors of the market look more challenged than they once were and therefore the investable landscape is likely to have a different structure from that which we see today. The silver bullet is obviously a vaccine, however one should not count on seeing this anytime within the next few quarters. So, against this all too familiar backdrop, outlined below are three future actions that we are considering within the portfolios.

First, we are looking to create liquidity across the portfolios. We will be raising liquidity within the portfolios, looking to move holdings within the cash fund to platform cash to increase the speed at which we can trade into the market. With market volatility operating at record highs to date, it has been important to spend as much time as possible in the market in effort to reduce the risk of missing out on one of those irrational bear market upswings, of which we have seen many to date. Volatility levels are now subsiding but are still operating at elevated levels. It is therefore important to be nimble enough to move when the time is right.

Second, we are considering reshaping the underlying fund composition, given the changes in the investable landscape ahead. With this landscape looking changeable over the foreseeable future, we are not only thinking about the types of managers and styles we want to include within the portfolios, but we are also making a stronger case for active management. Specifically, we are looking for managers that seek to invest in companies with high quality balance sheets and which are more likely to withstand a protracted period of no growth. Additionally, we are looking to increase our exposure to technology-based themes, which incorporates identifying managers with a technology bias beyond just the well-known market regulars.

Finally, and arguably the most important decision, is finding the right time to re-risk across the portfolios. A key component to finding an appropriate entry point to any market is forming a relative understanding of its current valuation. There are many approaches to doing this, but a common approach is through the adoption of a discounted cashflow model where the cashflow is usually based upon estimated future dividends for equities, or the more contractually stable coupons for bonds. With the increased variability in future dividend payments, such models need closer scrutiny than usual. However, scenarios can still be applied and provide some form of objectivity within the decision-making process.

Our base case scenario is that dividends will be cut by nearly 50% across the global markets over the next 12 months and possibly cut further in 2021. We feel this is a reasonable assumption given that 35% of the dividends paid within the UK in 2019 came from the financial and oil sectors, both of which will be paying out very little in 2020 for different reasons. Within the US, stock buy-backs are also expected to halve. Factoring this information into a cashflow model makes the expected level of return one would expect based on today's market levels somewhere in the order of 5.5%. When comparing this to our long term capital market assumptions provided by our key partners, this looks light but most importantly it comes with much more risk based on present conditions.

When it comes to re-risking, one should not just consider equities. The credit, or corporate bond, market can also provide opportunities, particularly within the higher yielding part of that market. Yields have ballooned out to levels not seen since the financial crisis across all credit ratings which has signified a decrease liquidity and a higher probability of default risk. What is particularly interesting is that the Fed has begun buying bonds directly from the primary market for the first time ever, which has stabilised liquidity points somewhat. This therefore leaves default risk elevated but this is something that a skilled bond manager with an experienced credit team should be able to navigate around. Using a bond manager over an equity manager not only provides further diversification but also increases the stability of future cashflows given coupon payments are contractually binding and, in the unfortunate event of a bankruptcy, sit higher up the ladder than an equity stakeholder.

It is important to remind ourselves that we are long-term investors and severe market volatility like that which we have experienced, often only provides the perception of opportunity. We must therefore remain level-headed and try to understand the risk we are entering into to the best of our abilities, based on the information available. Anything short of this level of macro analysis could be construed as speculation.

Chris Fleming, Investment Services Director

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