McLaren
wealth & asset management

International Perspective & Independent Advice   Since 2004

Global Market Strategy – March 2017

The Active versus Passive debate

Terry Smith is a well-known and well-followed fund manager in charge of managing Fundsmith's Equity unit trust and the Fundsmith Emerging Equity Trust (FEET:LN).

Both funds have around 30 stocks in them, offering greater potential for gain but also loss if the allocation goes awry. This year the equity unit trust is up 28%, however most of that gain was achieved in the first half, with minimal gain in the second.

In FEET, the trust has until last year always traded at a premium to net asset value (the value of its assets minus its liabilities) The premium was more than seven percent in 2015 but over the last 12 months it has fallen to negative 1.38% as the performance of the components of the fund has been negative by as much as 6% over the last five months, although over one year the fund is up 12.93%.

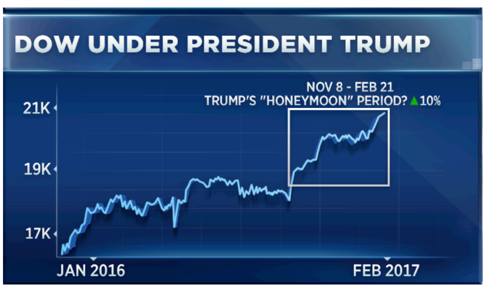
Investors holding FEET over 12 months might feel quite chuffed with a 13% gain if they are not aware that had they bought an emerging market ETF, their gain would have been more than 29%.

Obviously, EM is a tricky space to get right at the best of times, and like the US, Japan, the UK and many other major market indices, finding a fund manager who can consistently outperform a tracker fund is not easy, but the drawback of tracker funds is their inability to differentiate tracking the performance of the best companies from the worst. Clearly, the reason for being willing to pay an extra fee to a fund manager, is the expectation he or she will sort the wheat from the chaff, but if the fund is too diversified and holds too many stocks, by its very nature it becomes more of a tracker and unable to make the important differentiation. It follows then that the managers to look for, are those who can beat the index with few stocks, hence the appeal of people like Terry Smith, who has relatively few stocks in his funds. The paradox, however, is that where money flows into index funds by an increasingly independent investor, the index can be driven higher purely by weight of momentum, rather than by discerning investment choice, and under those circumstances the 'Terry Smiths' can, occasionally, be left behind during a bull market such as we have at present. Not so, generally speaking, in a more sideways or bear market however, where quality stockpicking, targeting healthy return on equity, good current and acid ratio numbers and positive cashflow figures, will generally hold up better companies over poorer, and the good fund manager will outperform an ETF which becomes at the mercy of adverse momentum.

One other point about ETFs is that their fully visible pricing and ease of trading can tempt the investor to be more trigger-happy, getting into a frequent trading mentality beyond their expertise. For better, for worse, the more obscure appearance of the Open Ended Investment Company (OEIC) or unit trust, and the more illiquid nature of it (it can take up to two weeks for some fund managers to liquidate positions and return proceeds to the investor) conveys the subliminal obligation to hold on, and not trade in haste. Passive investors, those who seek low cost, hands-off investment are notoriously bad at timing their movements in and out of their positions, precisely because they can move their money more easily and transparently - daily or even multiple times in a day if desired. As Financial Times columnist, John Authers, brilliantly put it in his column recently: "The easier it is to time the market, the more we take advantage of the opportunity to time it badly."

How much further can the **American stockmarket** rise? In the short term, not much, if a comparison with Ronald Reagan's successful tenure is anything to go by. However, following Trump's more optimistic tone, perhaps to Dow 22,000 quickly.

Like Trump, Reagan was all for uncluttered government and incentivised business. Reagan had a six month honeymoon period after his election victory in 1980, before the market fell 25% over the following 16 months because Reagan began to have trouble implementing what he wanted to achieve, but then from August 1981 there began the next secular bull market which lasted 18 years. Ralph Acampora, long-established and respected independent technical analyst, foresees the current US bull market continuing for another two months before the market begins to find some difficulty accelerating any further. Following a period of probably six months when markets will come under pressure, Acampora expects the Dow Jones to rise to 22,000 (current level is 20,800).



Although banks and financials have picked up the momentum of the current rally, Acampora says, “I don’t like to chase; instead I favour the utilities.” Energy stocks, including water, have not fully participated in the rally to the extent of other sectors.

America apart, EM is attracting the most money in 6 months, as resilience in commodity prices and signs of improvement across the world’s major economies has whet investors’ appetite for risk and opportunity away from the US. Data firm EPFR Global reported to the Financial Times that reasons for the inflows are, “moderating expectations for US rate hikes, evidence of growth in key export markets and renewed enthusiasm for BRIC”. Brazil has been the biggest beneficiary of money to the BRIC countries, recording their greatest inflow since the final quarter of 2014. The Bovespa is up 12% this year.

Europe too is on a tear, attracting more money now since a year ago, on a more positive tone for an economic recovery across the Continent. Only French stock portfolios have recorded net outflows, prompted by uncertainty over the upcoming election. Spanish equities on the other hand, have proved more appealing, with inflows climbing to a 22 month high. Spain’s IBEX is up 9.7% over the last three months, eclipsed only in Europe by the DAX, up 11.8%.

So do we keep going? All this bullishness begins to be troubling. If more than two trillion dollars is repatriated to the US as a result of tax incentives to both companies and individuals, it gives enormous scope for US investment, share buy-backs, potential wage growth - and inflation. There’s no question that value territories are more Europe, Asia, Japan, than the US, but if the US market begins to retreat and take a pause, it is likely to have a ripple effect across all equity markets. However, equities continue to represent the most attractive home for capital from both a growth and income perspective over the medium term (minimum three years). Cash offers barely any interest, bonds are selling off in anticipation of higher rates and property, at least in the UK is slowing decisively. Anyone looking to shed UK property after a wonderful run of 20 years, should consider doing it now. Interest rate rises might not happen in the UK until 2018 but Rightmove reports many sellers now are waiting months to shift their property, a fact consistent with figures showing property transactions lower by 8.5% in December on a year earlier. Property investors are learning afresh that property is high risk when the market turns because it is illiquid. As Chris Dillow of the Financial Times put it: “This makes housing a poor store of wealth. Its good returns might be only a reward for taking on cyclical risk.”

Where are we on **gold**? According to the World Gold Council, global gold demand rose 2% in 2016 to reach 4,309 tonnes (t), the highest level since 2013. This was largely driven by inflows into gold-backed ETFs of 532t, the second-highest year on record, as investors responded to concerns over future monetary policy, geopolitical uncertainty and negative interest rates. Continued global economic and political uncertainty, most notably Brexit, the US election and currency weakness in China, helped to boost overall investment demand by 70%, to a four-year high of 1,561t.

China is as concerned over the unpredictability of Trump. It should be no great surprise that China seeks an alternative store of value to its existing holdings of US treasuries which are becoming worth less with every round of QE, and it is fairly safe to assume that if Donald Trump’s infrastructure plans go ahead on the scale he announced, we can possibly expect QE4, QE5 and QE6.

Please see the attached Precious Metals Report from Sprott Asset Management which makes very interesting reading.

Favoured investment plays:

Nil risk:	USD cash (in preference to Euro cash)
Cautious risk:	AAA Corporate
Balanced risk:	Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk:	UK**,** European equity
Adventurous risk:	**Japan, Asia, Germany,** US equity, UK/European/US smaller company sector
Speculative risk:	Water, Technology, **China, India, Other EM, Natural Resources**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 20%, Global Equity 16%, US smaller cos 2%, (Other) US equity 9%, UK equity 4%, Germany 4%, (Other) European equity 9%, Japan 6%, India 4%, (Other) Asia 16%, Pharmaceuticals 7%, Natural Resources 2%, Energy 1%