Market Update: "State of the Union" commentary

24 October 2018

Marlborough International

This information is for Financial Advisers only and should not be relied upon by Retail Investors.

Investing, unlike gambling, is a long-term activity. Betting on horses or football matches provides speedy gratification or disappointment. Investment does not, unless you're betting on daily, monthly or quarterly share price movements. Most retail investors don't 'bet', of course, so considering a 10 year investment has 2,600 trading days, it does seem a little odd to find significance in a few days' price movements.

Since 1964, the FTSE All-Share Index has gone up on 57% of days, and down on 43%*. Marathons would be easier if they were run downhill, but experience tells us ups and downs are par for the course. Volatility is the normal state of stock markets, and so the best investment portfolios are built to weather storms. As US Admiral Grace Hopper said, "A ship in a harbour is safe, but that's not what ships are built for". Ships are built to carry passengers or cargo to a destination - staying in harbour is pointless. Mariners expect variable weather conditions on their journeys, consequently ships are built to withstand bouts of very rough weather on the journey, while being able to travel at speed in calmer waters. Asset class and style diversification allows investment portfolios to weather equity or debt market storms as these very rarely occur together; not having all your eggs in one basket means that even if all assets do fall, since each asset will be affected to varying degrees, the 'worst case' scenario can be avoided.

Company shares on stock markets can rise or fall in unison, due to events that impact them all (e.g. positively, like the US reducing company tax levels, or negatively, e.g. if interest rates rise more quickly than expected). This is known as 'systematic risk'. This can sometimes drown out individual companies' successes, where their shares normally respond to news about their profits, or sales etc. This latter effect is described as 'idiosyncratic risk'. But a company's share price can also rise and fall because of sentiment - sometimes investors get carried away with over or under-optimistic expectations, or rumours. As Benjamin Graham famously said "in the short run, the market is like a voting machine--tallying up which firms are popular and unpopular. But in the long run, the market is like a weighing machine--assessing the substance of a company".

During 2018, systematic risk has been at the forefront of investors' minds. The US equity market has accelerated due to President Trump's cuts in Federal corporate taxes from 35% to 21%. Bank of America saw its tax bill fall by over $700 million in the first quarter of this year, so it was no surprise when it declared record profits, up 30% on the same period in 2017. Google's parent Alphabet saw its tax bill drop by over a billion dollars. The cut was introduced to persuade companies to spend more on new equipment etc (Google is using theirs to increase research on artificial intelligence), but it seems many companies are using the windfall to buy back their shares. Reducing the number of shares in issue increases the price (the companies' assets stay the same but divided by fewer shares). This looks like the company is growing, but it's an accounting ruse. Executives whose pay is tied to the share price are effectively giving themselves a bigger bonus.

Meanwhile, technology stocks make up 26% of the S&P 500 Index, but those companies contributed 98% of the index growth in first half of 2018. Facebook, Apple, Amazon, Netflix and Google (FAANG) alone contributed nearly 4% of the index Growth. Since the index was up less than 3%, excluding FAANG the index would have been down almost 1%**.

The strong dollar has boosted US equity returns further, as non-dollar investors receive more and more local currency for every dollar of investment they own. However, dollar-based investors in global ex-US assets (e.g. dollar share classes investing in funds with underlying GBP constituents) see precisely the opposite effect - your pounds can buy fewer and fewer dollars. Emerging markets and other developing countries, who borrowed dollars heavily to invest in their infrastructure at historically low interest rates, are suffering as their cost of servicing the debt goes up. Rising interest rates, and having to spend more of their local currency to pay a dollar back, has been a headwind for companies in those regions.

If that were not enough, President Trump's 'unpresidential' behaviour creates nervousness as investors expect more 'unknown unknowns'. The escalating trade 'war' with China has seen that country's market fall by over 14% this year, while his withdrawal from previously sacrosanct agreements like climate change accords, along with nuclear weapons treaties with Russia and Iran, increases tensions. A strong anti-Trump vote in the November US mid-term elections could change the shape of the US Congress, currently controlled in both Houses by Republicans; mid-term elections usually see the president's party lose seats in Congress, and also frequently see the president's intraparty opponents gain power. With a concerted campaign by the Democrats to get young voters to take part, the result could significantly impact the President's ability to advance his agenda.

Elsewhere, Brexit uncertainty prevails as the terms of the UK's withdrawal remain unsettled. Although only the Irish border question remains, the solutions proposed satisfy neither Brexiteers or Remainers. The fear now is that Theresa May's future as Prime Minister is in doubt, with rumours of a vote of no confidence being triggered by renegade Tory MPs.

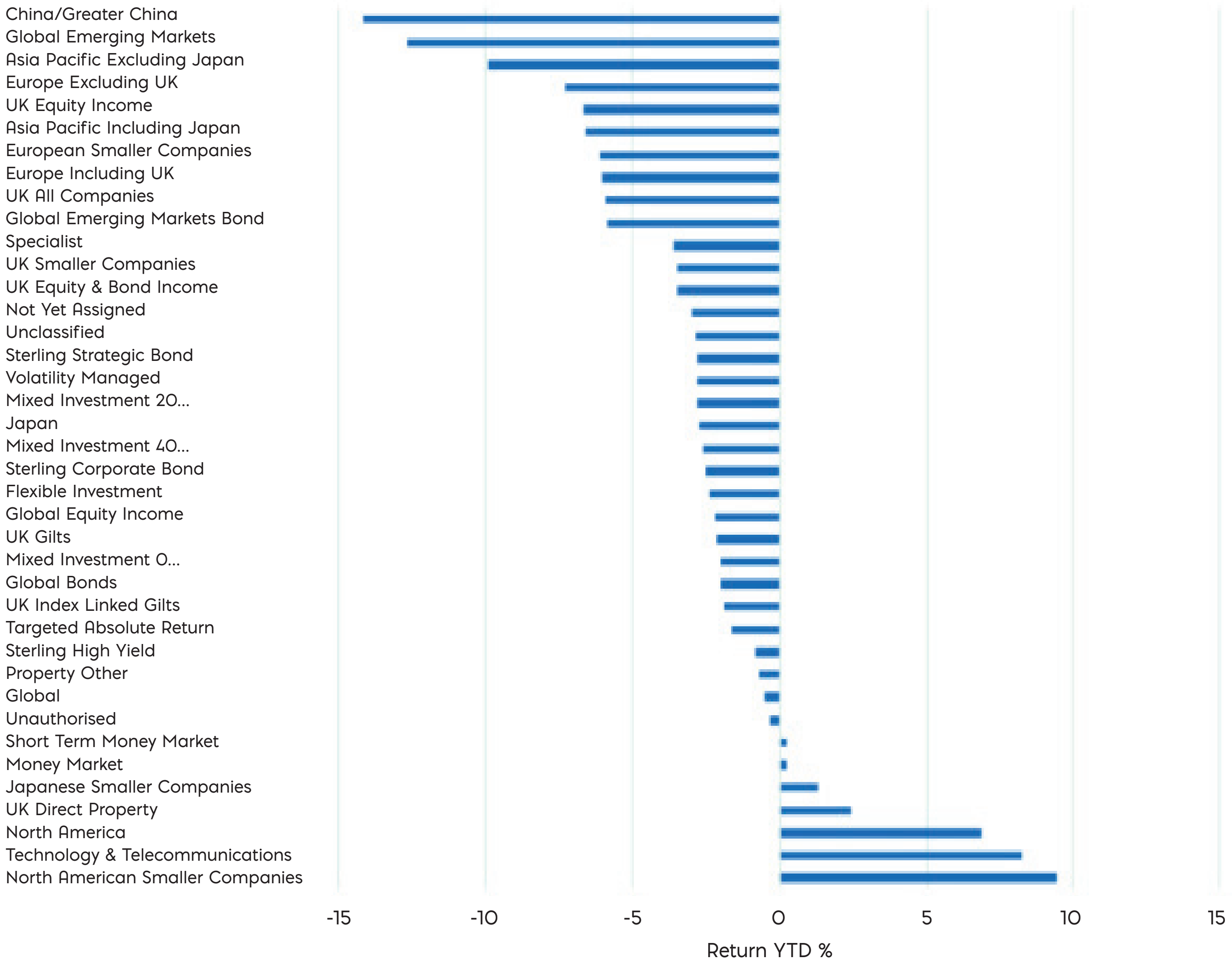
Meanwhile, the EU has problems with Italy's new government to contend with, At the end of September 2018, the ruling coalition comprising the Five Star Movement and the Lega Nord announced their 2019 budget, which increases deficit spending. The move has upset Italy's euro zone partners, who had been pressuring Italy to decrease its debt, currently over €2 trillion - one of the largest in the world. Elections due in early 2019 may strengthen the hand of anti-EU groups, adding further pressure on the European 'project', and indeed the Euro itself.

Against all these headwinds, it is remarkable how resilient Marlborough's Funds of Funds, and the underlying single strategy flagship funds have performed. Of the Investment Association's 29 sectors, only 5 non-Cash sectors have produced positive returns year to date in 2018 - Direct Property, North America, North American Smaller Companies, Technology, and Japan Smaller Companies. In the UK, all three equity sectors saw average losses of up to 6.5%. Similarly, all multi-asset sectors were negative (see Figure 1).

Marlborough's UK funds have been resilient through 2018, with Nano-Cap Growth showing almost a 9% gain for the year despite the October correction.

The Marlborough International Funds of Funds (FoFs) caught the ebb tide along with everyone else as corporate fundamentals were ignored, but the alpha skills have still shown through with the funds being ahead of their benchmarks. History has shown time and time again that sticking to the long term story pays (literally) dividends, as company fundamentals regain investors' attention versus the herd of market sentiment. In every year since its inception, the UK's FTSE All-Share Index has over the calendar year produced a higher return than its worst fall in that year. Even in 1987, when the Crash saw a 37% fall, long-term investors who stuck to their plan saw a positive return of 4% over the full year. Despite average intra-year drops of almost 15%, annual returns were positive in 34 of the 41 years since 1976 (see Figure 2).

Figure 1: Investment Association Sector Average performance YTD 2018



IA Sector averages 29/12/2017 to 19/10/2018, Source FE Analytics

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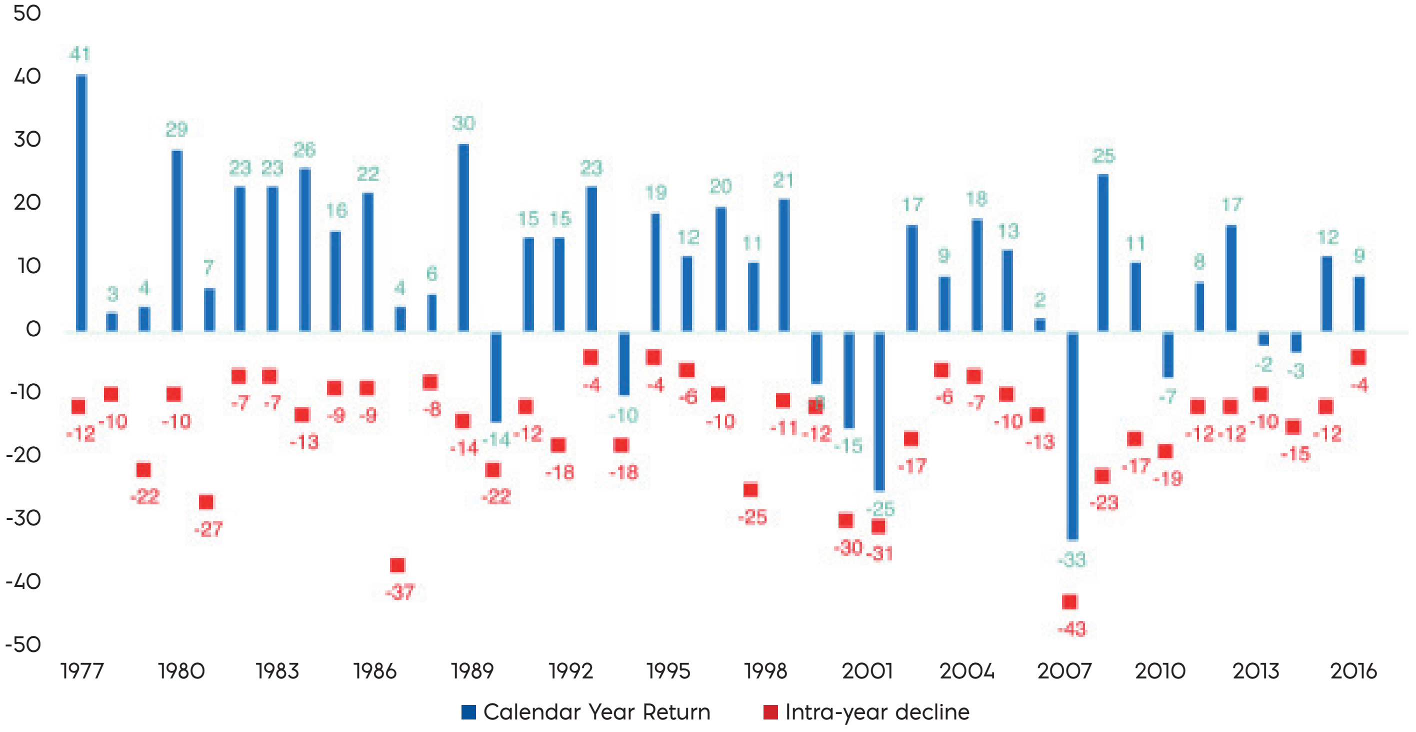
Figure 2: FTSE All-Share capital returns and intra-year maximum drawdowns calendar years 1977-2018



Average return is 9.6%, average drawdown is 14.8%.

Wise investors recognise that market falls can affect both good and bad companies indiscriminately. Consequently stock-pickers like Marlborough's team of managers see opportunities to buy shares in great companies at bargain prices.

As the current economic and political issues resolve themselves over the coming months, company fundamentals will regain the ascendancy, and over-reactive price falls should correct on the upside. While temporary falls in investors' valuations may be uncomfortable, the regret at permanently missing out on subsequent recovery can be even more painful.

Graham Bentley -24/10/2018

**Source: gbi2 Research   ** Source: S&P, gbi2 Research*

All IA fund and sector performances sourced from FE Analytics, 29/12/2017 to 19/10/2018

Regulatory Information

Marlborough International provides access via offshore cells, which act as feeder funds into the award-winning Marlborough fund range.

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