# Watson Moore's Monthly Investment Update

## October 2018

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## PERFORMANCE UPDATE

- **Over the last quarter the FTSE 100 has fallen 0.66%, so we are pleased that the portfolios have grown by between 0.43% and 7.22%.**
- The summer months are now behind us and whilst returns have been low they have historically been better than other summer periods.
- US stock markets continue to be the clear leaders and "Trumpenomics" appears to be working, with tax cuts and the rolling back of red tape the main catalysts. US consumer confidence hit an 18-year high, adding to a string of recent US data that pointed to strong US economic momentum.
- Whilst the US has been the leader, China and Europe continue to lag, mainly due to the "Trump Trade Wars".
- September saw interest rates rise in the US to 2.25% and this led to bonds falling. UK Gilts fell 1.20% and UK inflation linked bonds are now down 1.91% over the last 6 months, despite fears of inflation returning.
- The performance of the portfolios over the last month and year is shown below:

| Portfolio | Performance % 1 month | Performance % 1 year |
|---|---|---|
| Foundation | -0.77 | 2.16 |
| Cautious | -0.81 | 0.74 |
| Balanced | -0.68 | 3.48 |
| Adventurous | -0.67 | 7.35 |
| Dynamic Equity | -0.66 | 14.17 |
| Income Generating | -0.10 | 2.29 |
| Third Industrial Revolution | -1.23 | 22.89 |
| Retirement Investment Solution 1 | -0.73 | 2.70 |
| Retirement Investment Solution 2 | -0.73 | 4.15 |
| Retirement Investment Solution 3 | -0.72 | 6.76 |

Please note that these figures do not include the Standard Life platform or Watson Moore's fees.

### Trend Following Signals

The table below shows whether the asset class is either in a positive trend (✓) or a negative trend (✗). The portfolios will have more exposure to those asset classes in a positive trend and less (if any) to those in a negative trend. These are the main asset classes we monitor:

| Asset Class | Trend Signal | Asset Class | Trend Signal |
|---|---|---|---|
| **Global Equity** | ✓ | **Emerging Market Equity** | ✗ |
| **UK Equity** | ✓ | **Commodities** | ✓ |
| **Europe ex UK Equity** | ✓ | **UK Corporate Bonds** | ✗ |
| **US Equity** | ✓ | **UK Corporate Bonds (Short dated)** | ✗ |
| **Japan Equity** | ✓ | **UK Index Linked Bonds** | ✗ |
| **Pacific Equity** | ✗ | **Global Bonds** | ✗ |
| **Gold** | ✗ | **UK Gilts** | ✗ |
| **Global Property** | ✓ | **Emerging Market Bonds** | ✓ |
| | | **Overseas Corporate Bonds** | ✓ |

### Summary of Portfolios

The summer has produced better returns for our portfolios than normal despite September's negative impact. The "sell in May and come back St Ledgers Day" adage has historically meant that the winter months have produced significantly better returns than the summer months. This anomaly can be seen across nearly every stock market globally and whilst there are many explanations no one really understands why.

Going forward, October has a history of volatility and on average has delivered positive returns of about 0.4% since 1970. October does have a bad reputation from the fact that falls, when they occurred, were quite large. Since 1984, seven of the ten largest falls in markets have been in October. The large falls in 1987 and 2008 occurred in October and in 1929 too. The recent record is somewhat different however. Since the year 2000, October has given good returns, placing it among one of the top performing months of the year.

We continue to have clear leaders and losers in equity markets, with the US being the leader and China being the loser. The portfolios continue to be overweight US equities as our investment philosophy attempts to invest more in those markets that are high up on the momentum scale i.e. the ones that have performed the best over the last year.

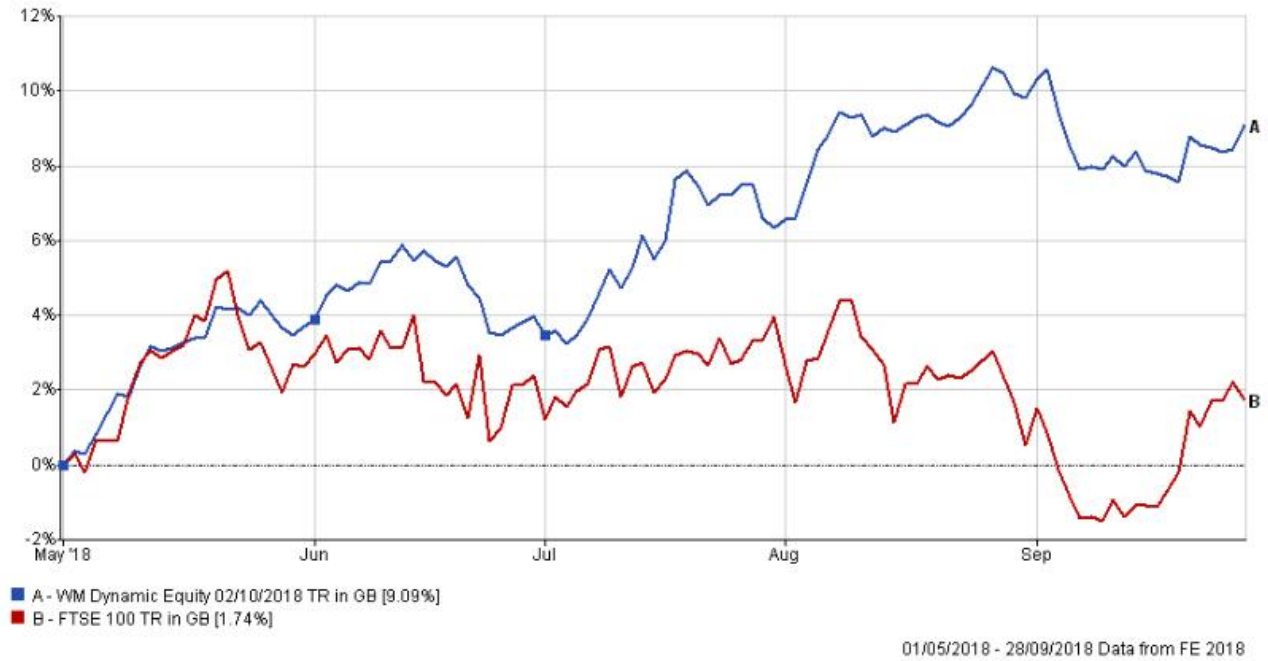
### Cautious, Balanced and Adventurous portfolios

The Cautious portfolio significantly reduced its exposure to Bonds as the trend from four Bond asset classes turned negative over the month. The exception was Emerging Market bonds which went back above trend and therefore exposure was increased. We are expecting Bonds to be extremely volatile as interest rates rise. On the equity side Pacific equities went below trend but UK equities went back above trend. For the Adventurous portfolio the momentum has shifted from European Smaller Companies to Health & Pharmaceuticals:

| Fund | Cautious | Balanced | Adventurous |
|---|---|---|---|
| L&G Emerging Markets Bond | +2.5% | | |
| Fidelity Index UK | +2.0% | +2.0% | |
| iShares Corporate Bonds 1-10 Years | -2.5% | | |
| iShares Corporate Bonds | -2.5% | | |
| iShares UK Gilts | -2.5% | | |
| Fidelity Index Pacific | -2.0% | -2.0% | |
| iShares Index Linked Government Bonds | -2.5% | | |
| Lazard European Smaller Companies | | | -5.0% |
| L&G Global Health & Pharmaceutical Index | | | +5.0% |

## Dynamic Equity portfolio

The momentum philosophy that forms the core of this portfolio attempts to invest more money in those markets that are experiencing the strongest growth. For the first time for several months, we experienced a change in momentum and the Lazard European Smaller Companies fund was sold and replaced with the L&G Global Health & Pharmaceutical Index fund. A lot of investors just invest in the FTSE 100 and recently the performance of the Dynamic Equity portfolio compared to the FTSE 100 has been significantly higher. This shows the benefits of diversification and being able to move money into the best performing regions:




## Foundation portfolio

The Foundation portfolio decreased its exposure to Pacific equities, UK gilts, Inflation Linked bonds and Corporate Bonds as they broke below trend. Exposure was increased to UK equities, Emerging Market bonds and the market neutral funds.

## Income Generating portfolio

The Schroder Income fund which we switched into at the end of August had a great month as it grew by 1.16%. This helped the Income Generating portfolio to be our best performing portfolio over the month albeit it fell by 0.10%. The current level of income is now 3.37% per annum.

## Third Industrial Revolution portfolio

The Healthcare Innovation fund was the only fund that grew within the portfolio over the month. The portfolio was our worst performing one falling by 1.23%. It is still up 22.89% over the last year though.

## Retirement Investment Solution portfolios

The trend following part of these portfolios decreased its exposure to Pacific equities, UK gilts, Inflation Linked bonds and Corporate Bonds as they broke below trend. Exposure was increased to UK Equities and Emerging Market Bonds as well as cash. The Retirement Investment Solution portfolios are invested in not only a trend following portfolio, but the Foundation and Dynamic Equity portfolios as well.

## Summary

Most bond markets are below trend and we therefore have very little exposure to them. If interest rates rise significantly from here and Bond prices fall then our portfolios should be somewhat immune from this.

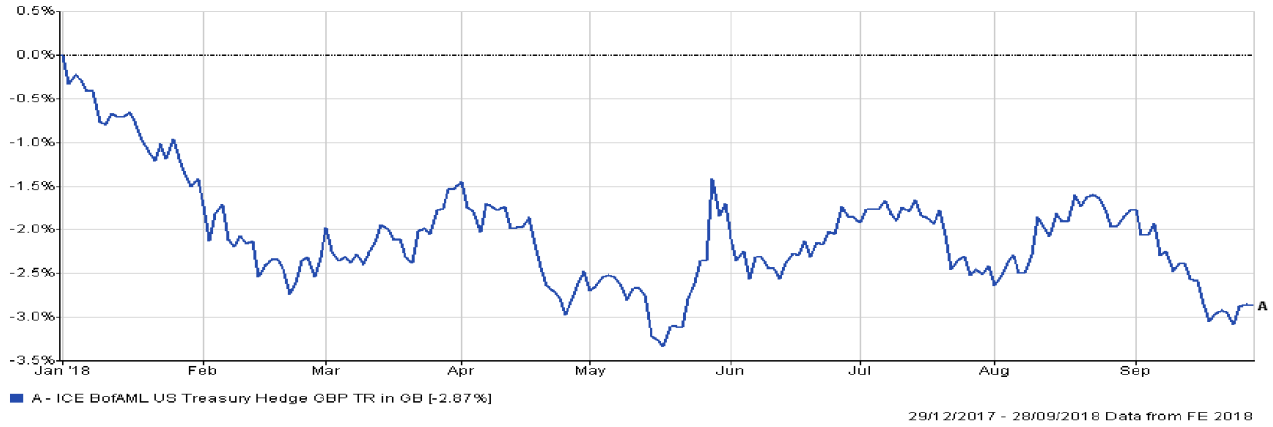
On the equity side we still have clear winners and losers with most developed markets above trend and most emerging markets below trend.

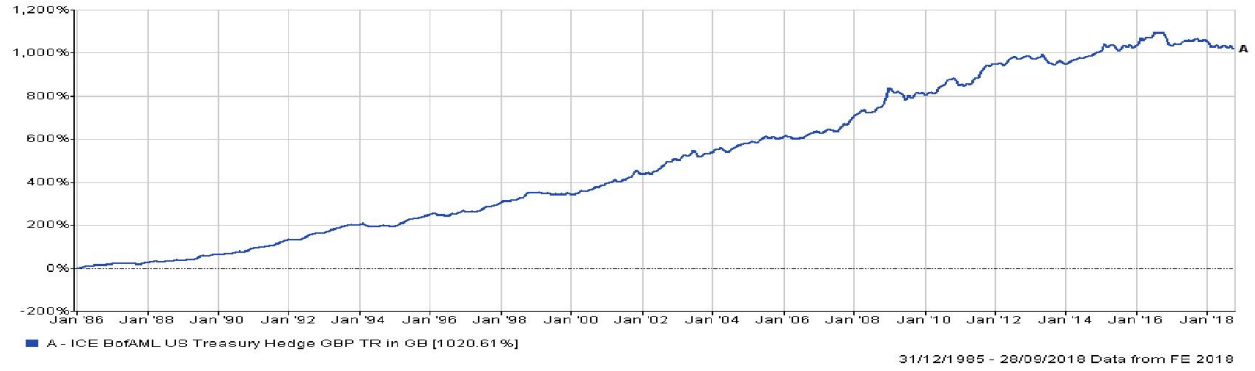
# ASSET CLASS REVIEW

This section will give you an insight into our current thinking, as we have attached some charts that look interesting. This month we focus on how rising interest rates has been affecting lower risk asset classes.

## The safest asset class in the world has been falling

US Treasury bonds are issued by the US Government and are equivalent to gilts in the UK. As US interest rates have been rising (they rose to 2.25% on September 26th), US Treasuries have been falling. Whilst a loss this year of 2.87% is not huge, it is when we consider that they have risen in value for over 30 years. The first chart shows the recent losses and the second chart shows the long-term picture:

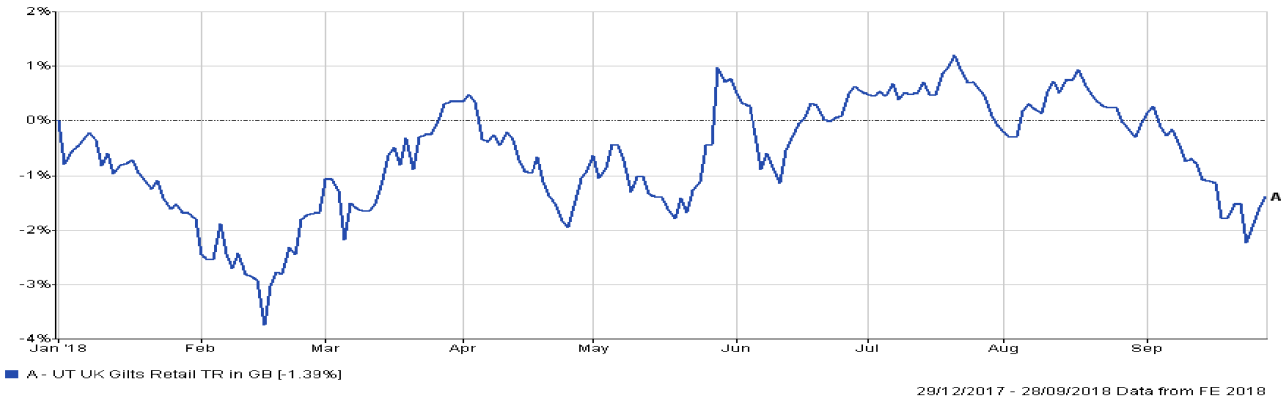



Losing money in an asset class that has been considered a great investment over the last 30 years could psychologically change investors' perception of what a safe asset class is. They may start to sell their Treasuries and reinvest in cash or stock markets. If we see large flows from Treasuries into stock markets, then we will almost certainly experience another stock market boom.

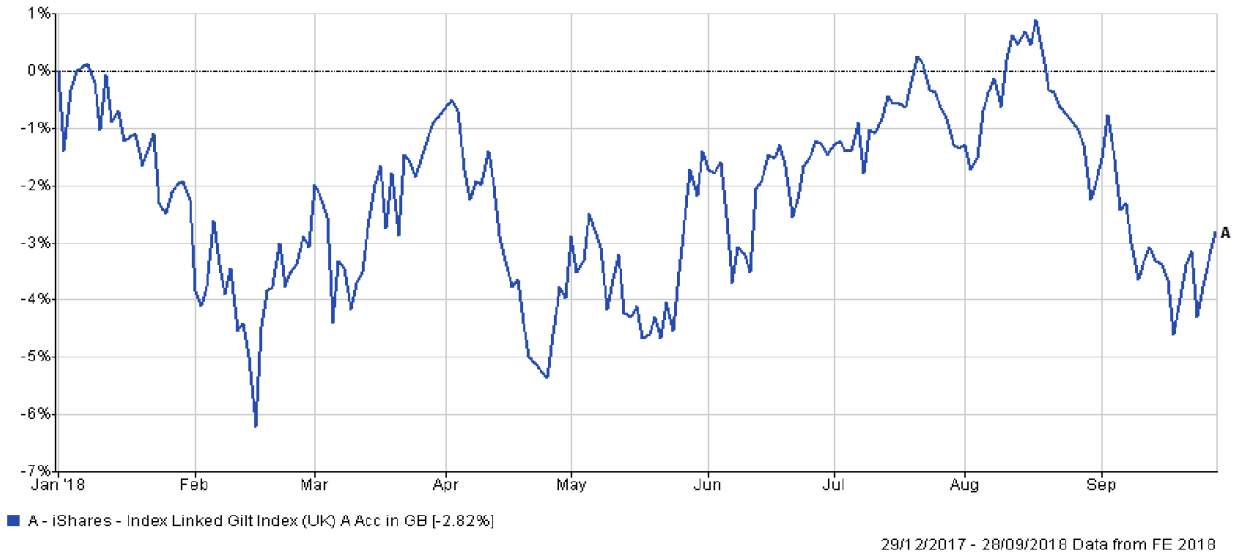
## UK gilts have also fallen

UK Government bonds (gilts) have fallen below trend and have been removed from the trend following portfolios. They have been more volatile than normal:



## Not even Inflation Linked bonds have performed well

Normally a global economic recovery leads to higher inflation or the fear that inflation will rise in the future. However, this recovery has seen Inflation Linked bonds not rise and act in a volatile way:




## Gold

Gold also acts as a safe haven in times of stress. With Trump causing global trade problems and with the risk that Brexit could cause the UK and Europe to suffer, normally we would expect gold to be performing well. However, it has also fallen and is below trend:


## In Summary

Lower risk investments have not been performing well recently and have been much more volatile than normal due to rising interest rates. If we see money flowing out of bonds into equities, this could cause the stock markets to move higher.

# FINANCIAL TIMES AND MOMENTUM

The Financial Times wrote an article on the 21st September which was titled, *"Long-term investing is simple - no matter what the 'experts' say".*

The article went on to confirm that our investment philosophy of "momentum" was a great way to outperform over the long term. The article states that *"Look at the past and you will see that the best-performing strategies over almost any longish period of time are value, **momentum** and small caps."* The article describes momentum investing as "*basically buying whatever's going up and sticking with it until it stops going up"*.

Research from the Cass Business School shows that you can outperform by at least 2% per annum by simply buying the winners. Our momentum investment strategy ranks different asset classes in terms of their historic returns and tries to invest more money in those asset classes that have the best recent returns or momentum.

The article then asks a very good question, *"So why doesn't everyone do it (momentum investing) for retail investors?".* The answer they give is as follows:

*"In the case of momentum investing, the explanation might be even more simple. Fund management companies are mostly paid a percentage of the assets they have under management. In the main it is easier to get in new assets by getting a good marketing manager to tell an interesting stock market story to investors than it is to grow by performing well. But what kind of a marketing story would include the words "we just buy stuff that is already going up" or would admit that once you'd figured out how to calculate a moving average you were kinda done? Quite".*

Momentum investing might be quite straightforward but few in the industry practise it and benefit from the excess returns it produces. The article also touches on trend following which is the other major investment philosophy that we use. It simply states that you can overlay momentum with trend following, which means selling out when the trend turns and trying to protect portfolios from significant losses when momentum turns downwards.

**How do we invest in "Momentum"?**

iShares are the largest Exchange Traded Fund (ETF) provider in the world and launched a global equity momentum ETF in October 2014. Since then it has outperformed the non-momentum equivalent by nearly 25%:


This ETF is included in all of our portfolios except for the Income Generating and Third Industrial Revolution portfolio. In addition, the portfolios will invest more money in funds that are displaying stronger momentum. For example, the L&G Global Technology fund is in our Balanced, Adventurous and Dynamic portfolios and we are overweight US equities across all of our portfolios.

**Where can I find out more about Momentum investing?**

Professors Clare and Thomas of the CASS Business School are two of the world's leading academics who have studied the effects of momentum investing. A simple blog on the subject can be found here:

https://blogs.city.ac.uk/cassfinance/2013/12/02/momentum-investing-and-asset-allocation/

**Summary**

For investors with a long-term investment horizon who are seeking to improve the returns from their investments, momentum-based investing offers a potential way of achieving this aim.

## FINAL COMMENT

Lower risk asset classes have not been performing well during a politically unstable period. This has resulted in many of these asset classes falling below trend and our investment philosophy automatically reduces exposure to them. This can help protect portfolios from significant losses if they do indeed continue to fall.

In addition to “Trend Following” we use “Momentum” to outperform and whilst this is a simple concept that has historically led to outperformance, it is not widely promoted in the fund management industry. The Financial Times have given a reason why this may be, but we also believe it is due to the fact that you have to be very active when managing portfolios and this involves a lot of hard work and research. We are prepared to do this for our clients!

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