Watson Moore
INDEPENDENT FINANCIAL ADVISERS LIMITED

Monthly Investment Update
August 2021

Contents:

Performance Update

The portfolios had a good month, rising between 0.05% and 1.52%. The FTSE 100 and MSCI World rose 0.07% and 1.16% respectively.

The Delta variant is spreading rapidly, especially in Asia, with a leaked report saying that it is as contagious as chicken pox. This has caused the stock markets of those countries with lower vaccination rates or less people initially exposed to the virus, to underperform. Russia, Japan, Australia, Brazil and China all saw a fall in their stock markets last month, whereas the UK, US and Europe experienced gains.

China initiated a series of policies that were not 'business friendly', and this caused the MSCI China index to fall -14.36%. Investing in China has significant political risks.

The 'Delta' variant is, bizarrely, proving good for our wealth. It's serious enough to cause concern, but not serious enough to lockdown. This should ensure Governments and Central Banks remain cautious about increasing interest rates and will continue to pump money into the economy, thereby helping all markets, bonds and equities. As a consequence, our portfolios should benefit.

Our biggest concern has been that the price of bonds could fall significantly if we experience strong economic growth and inflation increases dramatically. This will almost certainly lead to interest rates rising to combat it and bond prices falling. The Delta variant has lowered the expectation of a rise in interest rates and increased the value of bonds last month which was good news for our lower risk portfolios, such as the Foundation portfolio, which experienced strong returns.

Companies are continuing to reinstate their dividends and while we are not back to the pre-pandemic levels, we are expecting continued dividend increases over the next year. This has led to strong returns for our Income Generating portfolio.

The performance of the portfolios over the last month, 6 months and 1 year is shown below:

Portfolio	Performance % 1 month	Performance % 6 months	Performance % 1 year
Foundation	1.32	5.66	9.33
Cautious	0.90	6.83	11.99
Balanced	0.48	7.56	14.54
Adventurous	0.90	8.88	15.61
Dynamic Equity	1.52	9.80	18.71
Income Generating	1.21	8.92	18.59
Fourth Industrial Revolution	0.05	4.52	25.99
Retirement Investment Solution 1	0.78	7.34	13.28
Retirement Investment Solution 2	0.87	7.71	14.11
Retirement Investment Solution 3	0.95	8.06	14.87

Please note that these figures do not include the platform or Watson Moore's fees.*All figures are sourced from Financial Express to 31.07.2021.

Trend Following Signals

The table below shows whether the asset class is in a positive trend (✓) or a negative trend (x). 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		Trend Signal
Global Equity	✓	Emerging Market Equity	x
UK Equity	✓	Commodities	✓
Europe ex UK Equity	✓	UK Corporate Bonds	✓
US Equity	✓	UK Corporate Bonds (Short dated)	✓
Japan Equity	x	UK Index-Linked Bonds	✓
Pacific Equity	✓	Global Bonds	✓
Gold	x	UK Gilts	✓
Global Property	✓	Emerging Market Bonds	x
Global Infrastructure	✓	Overseas Corporate Bonds	x

July saw Japanese and emerging market equities move below trend, and UK and overseas government bonds move above trend.

Cautious, Balanced and Adventurous portfolios

Equity exposure was reduced in both the Balanced and Cautious portfolios as Japanese and emerging market equities moved below trend. The Adventurous portfolio maintained its exposure to equities due to its lack of exposure to Japan or the emerging markets. This is because it takes a greater risk by investing larger amounts in less markets. The Cautious portfolio added exposure to UK and overseas government bonds as they began to trend higher. The Adventurous and Balanced portfolios shifted exposure out of corporate bonds (short-dated) and into inflation-linked bonds. Inflation-linked bonds have been very volatile, but rose 6.85% last month. It was good to see another month in which all three portfolios produced a positive return.

Dynamic Equity portfolio

The momentum philosophy core to this portfolio, aims to invest more money in those stock markets that are experiencing the strongest growth (or the lowest losses). There were no changes this month but the previous month, we saw emerging markets replaced by UK smaller companies. Emerging markets fell by 7.14% in July and UK smaller companies grew by 2.38%, demonstrating why following a momentum investment philosophy can lead to better longer-term returns.

Foundation portfolio

The portfolio benefitted significantly by having a higher exposure to bonds as they performed extremely well. Bonds do not like the global economy to grow too quickly as this can lead to interest rates going up and therefore the price of bonds falls. Therefore, the news that the Delta variant is extremely contagious and is increasing infection rates, is actually very good for both bonds and equities. This is because economic growth rates may not be as strong as previously expected (although still good), which should mean continued 'money printing' by governments, as well as the fact that interest rates won't have to rise as quickly – the Goldilocks scenario.

Income Generating portfolio

The portfolio is benefitting from UK companies reinstating those dividends that were cancelled last March. In the second quarter of this year, dividend pay-outs increased by an incredible 51% compared to the pandemic-hit second quarter of 2020. Dividends are still below the pre-pandemic levels, but we are expecting further growth over the next year. The FTSE 100 is now yielding 3.5% which compares favourably to interest rates being at 0.1%. We expect the income that the portfolio generates to continue to rise over the next 12 months.

Fourth Industrial Revolution portfolio

After a very strong month in June, July saw the portfolio pause for breath. Clean energy was the biggest faller (-3.65%), but the Herald Investment Trust which invests in smaller UK technology companies rose by 6.42%. It is important to keep this portfolio very diverse and at the last count it invests in 1365 companies across many different sectors such as cyber security, battery technology and biotech as well as the big technology names that we are familiar with.

Retirement Investment Solutions

Exposure to UK and overseas Government bonds was increased for the Solutions, but was reduced for Japanese and emerging market equities. The Solutions had another solid month, benefitting from the rise in developed equities as well as most bond sectors.

Summary of Portfolios

The Centers for Disease Control and Prevention (CDC) are saying there is a strong possibility that we are already in a fourth wave of COVID-19. This one is being driven by the much publicised Delta variant. We also heard that President Biden's objective to get 70% of the population vaccinated, has been reached. That puts the USA among a handful of countries (including the UK) that have vaccinated the majority of the population.

With the fear of breakthrough infections and a so-called 'pandemic of the unvaccinated', it is reasonable to consider whether more stringent social distancing guidelines will be reintroduced. If we dig a little deeper into the COVID statistics, the vast majority of vaccinated individuals are well protected. Even those who do develop breakthrough infections, don't tend to end up in hospital. The US government's answer is clear here. Get as many people vaccinated as possible and carry on as normal. The UK is following the same strategy.

That means we are moving into a new phase of the recovery. Public officials are no longer jumping at shadows. We are just going to have to live with the virus and any future mutations will be dealt with on an individual basis. That's why the virus now has less power to influence stock markets and so we should experience a bit more stability going forward.

Coronaviruses like the common cold, flu and COVID-19, mutate all the time. That greatly increases the potential we are going to be getting annual booster shots. News from Israel tells us that Pfizer's vaccine loses its efficacy after about six months. That's great news for the biotech industry as it ensures that money will flow into the sector and thus will help our Fourth Industrial Revolution portfolio in particular.

That's why the Delta variant might be the goldilocks 'opportunity' for markets. It's serious enough to cause concern but not serious enough to lockdown. That should ensure Governments and Central Banks remain cautious about increasing interest rates and will continue to pump money into the economy. This will help all markets, bonds and equities, and our portfolios should benefit.

Asset Class Review

This section will give you an insight into our current thinking and we have included some charts that we believe look interesting.

The FTSE-250 hits a new all-time high

The FTSE-250 is a good indication of how the UK economy is doing. Data on infections and the death rate has been extremely positive in the UK and this has helped push up the value of UK companies due to the likelihood of less disruption going forward. Having a delay of up to 12 weeks between vaccinations is proving to be an extremely effective strategy compared to the 3-week delay employed by Israel and the US. Israel is now having to implement booster jabs as the protection from infection for those vaccinated has dropped considerably, whereas in the UK, there are significantly less double-jabbed getting ill. This has helped to boost the FTSE-250 to a new high:

Japan - no gold for its stock market

Weeks before the Olympics started there were still concerns over whether it would be cancelled due to high levels of infection. While the Japanese athletes have been wining lots of golds, the Japanese stock market has begun a downward trend, due to concerns that the economy may suffer from a resurgence in infections:

China - slumps

A series of crackdowns by the Chinese authorities against some of the country's biggest companies, as well as some of the less well-known ones, has caused the Chinese stock market to slump with some big daily losses towards the end of the month. There is now a clear limit on how large companies can grow and while we might argue about the merits of this move from a societal perspective, it makes investing in China even more risky.

Bond yields fall - great news for lower risk investors

Investors in Government bonds have been losing money due to rising yields and therefore bond values falling. This was due to the volume of positive news and the expectation that we could have a 'boom' period over the next few years, which would cause interest rates to rise. However, the increase in global infections has reduced the chances of interest rate rises and so the yield on bonds have fallen, with the 10-year US rate dropping from 1.7% to nearly 1.2%:

In Summary

Last month there were some clear winner and losers within global stock markets. Developed countries with high vaccination rates have generally been the winners, and those countries with lower vaccination rates and/or that had previously had a low infection rate, have been the losers. Our trend-following investment philosophy helps to reduce exposure to those countries and regions that fall below a certain level – as a result, this month. exposure to Japan and Emerging markets was cut.

What is Quality?

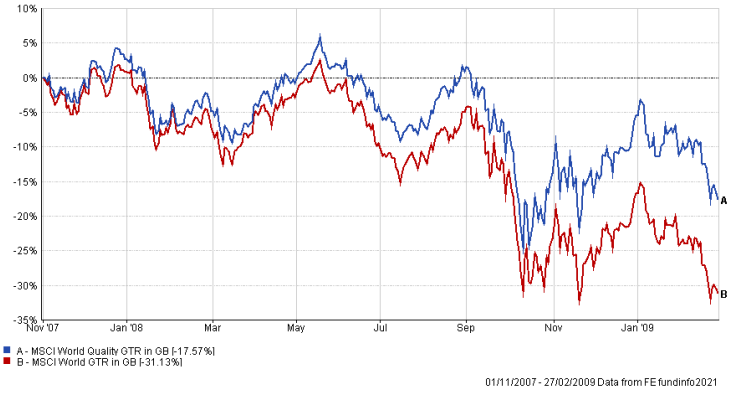
Last month we looked at the next problem that could cause stock markets to crash again - inflation. We don't know whether the recent rise in inflation is short-term (transitory) and will then fall back, or whether it will become a longer-term problem. However, we concluded that:

"The best way to protect your wealth against the fear of inflation is to invest in those companies that can easily increase the prices of what they sell. Think of companies such as Nestle, Coca Cola and Microsoft. These companies are known as 'quality' companies."

This month, we thought it might be useful for us to go into a bit more detail about quality companies and what they actually are. While there is no rigid criteria defining them, so-called 'quality' companies typically exhibit the characteristics of market-leading products/services with strong brands that mean that they can achieve higher margins than their lower-quality peers. These companies often demonstrate high levels of pricing power, meaning they can raise prices in line with, or above, inflation, for continued real growth.

Often well-established and profitable businesses, quality companies typically operate without the reliance of high levels of debt within the business. Free cashflow levels are typically higher than lower-quality or growth-focused stocks and, rather than simply returning most or all profit generated to shareholders in the form of dividends, the majority of cash is reinvested in the business to generate additional returns over the long-term (known as 'return on capital employed'). For many, it is this factor, the return on capital employed, that provides the best indication of a company's overall quality and differentiates it from other investment approaches.

The red line is the MSCI world index which shows the return if you had invested in the top 1300+ companies in the world over the last 15 years. The blue line is the return if you invested in the top 300 quality companies. You would have made 3.65% more each year by investing in quality over the last 15 years. Over 40 years the outperformance has been 2.41%, showing that it has worked over the very long term.



Perhaps another important characteristic of quality is the fact that it tends to provide defensive attributes during difficult periods. The chart to the left shows that during the 2007-09 crash, the quality index fell 13.56% less than the MSCI World. Quality also outperformed by 4.2% during last year's crash. Obviously, there will be times of underperformance, and this can be during periods in which stock markets are moving significantly higher.

Why does it work?

It is difficult to pinpoint, but we feel that investors generally chase future winners and want to catch the next Google, Facebook or Amazon. They allocate more money to find these hidden gems and tend to pay a premium for doing so. Quality companies are more boring and attract less money, so they tend to be undervalued. This creates the opportunity to invest in already profitable companies that can grow organically, as well as by buying smaller competitors and plugging them into their infrastructure. Quality investing works and appears to be an anomaly. It isn't a secret and therefore why wouldn't everyone just do it? Our portfolios recognise this and have a bias towards investing in quality companies.

Final Comment

The global economy is continuing to grow despite the rapid rise in infections from the 'Delta' variant. The Delta variant has actually helped to grow our wealth as it has reduced the chances of interest rate rises and played a part in ensuring continued economic support by governments during these uncertain times. This has contributed to the boosting of prices for most asset classes, with the exception of mainly Asian and emerging market equities. These regions have been the hardest hit by the Delta variant.

We remain bullish about our portfolios for the following reasons:

- The G7 group of leading nations pledged to donate one billion coronavirus vaccines to poorer countries, thereby ensuring every country can participate in strong economic growth over the next year.
- The $1 trillion + infrastructure deal in the US will further support the economy and confirm that Governments will continue to print money.
- The savings rate has been extremely high during lockdown for those who have remained employed, so this could be a catalyst for a surge in spending. For example, it has been very difficult to book a summer holiday in the UK.
- Confidence has returned to the UK, and we are seeing smaller UK companies benefitting with the FTSE 250 hitting new all-time highs.
- Those companies that have survived this year are likely to have implemented cost savings and may find less competition due to other companies falling by the wayside. Therefore, the profitability of some of these could increase significantly. This is simple Darwinian theory being applied to economics.
- Inflation is currently only expected to increase in the short-term and therefore we should only experience modest, (if any), increases in interest rates. Higher inflation will help reduce the value of debt each year in real terms. The Delta variant has helped reduce the chances of interest rates rising.

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