Watson Moore
INDEPENDENT FINANCIAL ADVISERS LIMITED

Monthly Investment Update

October 2021

Contents:

Performance Update

The portfolios gave up some of their previous month's gains, falling between 1.48% and 2.86%. The FTSE 100 and S&P 500 fell 0.16% and 4.65% respectively. Bonds also suffered relatively big losses.

Stock markets were jittery in September. Although the FTSE 100 performed relatively well, this was mainly due to sterling falling, thus increasing the profits of our companies' overseas earnings when converted back into sterling. However, the FTSE 250 fell significantly (4.27%) as the UK is suffering from several local issues linked to low storage levels of natural gas and a shortage of lorry drivers – triggering the panic buying of petrol.

Most bond markets also suffered relatively high losses, with UK Gilts falling 4.10%, due to fears that inflation is returning and will last longer than expected. This has triggered higher bond yields globally and thus the price of most bonds fell. Analysts now expect the Bank of England to raise interest rates to 0.25% in February with a further hike in November to 0.5%. The UK is in a relatively good position as the average length of Government Debt is 14 years, compared to the US which is just 5 years. This means the US has to refinance sooner.

Gas, oil and food prices are up significantly this year, and the Bank of England expects inflation to hit 4% soon. No one knows whether this will be short-term (transitory) or whether this will be a longer-term inflation problem. Economists still believe that this will be short-term caused by problems in the supply chain. For example, a chip shortage has reduced the number of new cars produced and thus second-hand cars have increased in value. The longer this goes on though, the higher the chance that higher prices remain. Wages will then need to increase to compensate and then inflation will become permanent.

The fight against Covid has made further progress with Merck receiving approval for a pill that is effective in cutting the risk of death by 50%. It is believed that this will be available in local pharmacies shortly. This is extremely positive for the global economy as it further supports the "back to normal" reopening of the economy. Once we have control of this virus then we should expect further medical breakthroughs in other viruses and diseases.

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	-1.48	5.37	8.48
Cautious	-1.77	4.92	10.95
Balanced	-1.80	5.59	13.51
Adventurous	-2.25	6.91	15.57
Dynamic Equity	-2.86	9.24	15.70
Income Generating	-1.51	6.08	18.53
Fourth Industrial Revolution	-2.80	10.28	22.03
Retirement Investment Solution 1	-1.95	6.12	11.86
Retirement Investment Solution 2	-2.12	6.57	12.44
Retirement Investment Solution 3	-2.27	6.98	12.97

Please note that these figures do not include the platform or Watson Moore's fees.*All figures are sourced from Financial Express to 30.09.2021.

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	x
US Equity	✓	UK Corporate Bonds (Short dated)	x
Japan Equity	✓	UK Index-Linked Bonds	✓
Pacific Equity	x	Global Bonds	x
Gold	x	UK Gilts	x
Global Property	✓	Emerging Market Bonds	✓
Global Infrastructure	✓	Overseas Corporate Bonds	✓

This month we saw Pacific Equities, Gold, UK Gilts, UK Corporate Bonds and Global Bonds fall below trend.

Cautious, Balanced and Adventurous portfolios

Both bonds and equities fell significantly last month, and we saw most bond markets fall below trend. This has resulted in the Balanced portfolio holding no bonds at all and the Cautious portfolio allocating only 10% to bonds. Gold was also sold in both portfolios, as was Pacific Equities. The Adventurous portfolio remains fully invested in equities, as well as having a 5% allocation to corporate bonds. This is because it takes on a higher risk level than the Cautious and Balanced portfolios.

Dynamic Equity portfolio

No changes were made this month and smaller UK, European and US companies, as well as US and North American larger companies, and technology remain the leaders, so we have a full allocation to them.

Foundation portfolio

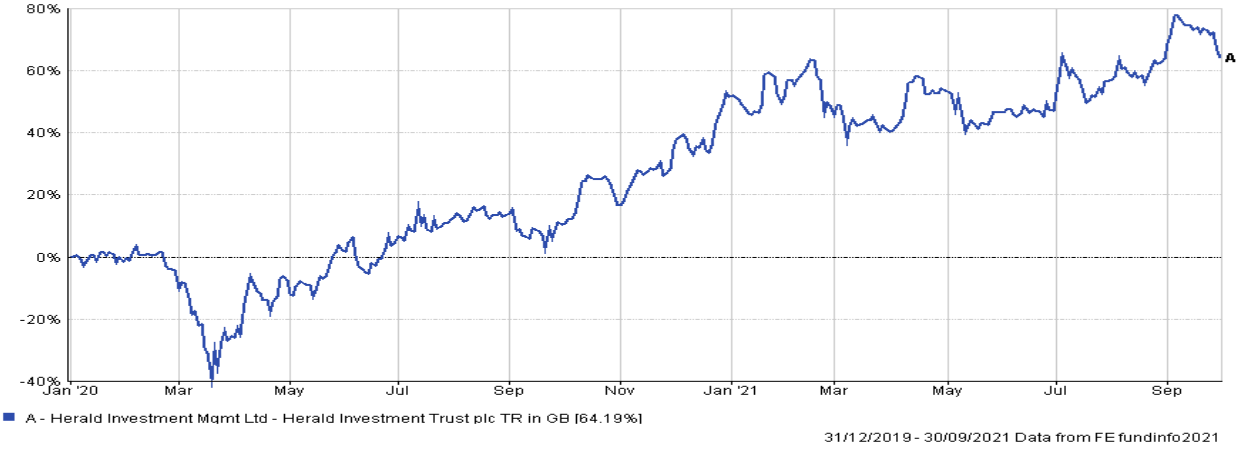
Bond exposure was significantly cut this month from 40% to 28.5%. Bonds have historically tended to go up when equities experience a pull back, and vice versa. Portfolios have therefore tended to include a significant amount in bonds to smooth returns and reduce the volatility associated with investing. However, recently we have experienced more periods in which bonds and equities have been more correlated and this has caused more cautious investors some concern. Whilst the Foundation portfolio is very diversified, it will significantly reduce its allocation to bonds if they start trending lower, which we have just seen. This will hopefully protect the portfolio if we see further negative returns in both bonds and equities.

Income Generating portfolio

The portfolio fell but was still our second-best performer last month. Whilst it still suffered losses in the bond part of the portfolio, some of the underlying UK holdings proved to be more resilient. This is because we are beginning to see overseas investors investing money into some of our smaller companies as they are so undervalued in comparison to the rest of the world. The portfolio has rebounded well and is now up 18.53% over the last year. However, if we experience rising interest rates, it could prove a headwind for this portfolio.

Fourth Industrial Revolution portfolio

The portfolio gave up some of last month's strong gains, with all but one of the underlying funds that make up our portfolio falling. The Herald Investment Trust was the only positive performer. This trust tends to invest around half in smaller UK companies, with the balance in global smaller companies. All the companies it invests in have a bias towards technology. The Trust has performed exceptionally well since the start of the pandemic:



However, as you can see, it can fall significantly from time to time, with losses of around 40% at the start of the pandemic and an 8% fall recently. The good times have seen significant gains, though. This typifies the underlying holdings within the Fourth Industrial Revolution portfolio as individually they all tend to be very volatile. However, the strategy within the portfolio is to diversify between different sectors so that some of this volatility is dampened.

Retirement Investment Solutions

The Solutions gave up some of last month's gains. Like the other trend following portfolios, exposure to bonds has been cut significantly. This will help to protect the Solutions somewhat if we do indeed see bonds fall further. At this stage of the interest rate cycle, we are expecting bonds to be much more volatile than normal, and they have the potential to fall significantly.

Summary of Portfolios

There has been a trend over the last couple of years where bonds and equities fall together during times of stress. One of the most reliable strategies for investing conservatively over the decades has been to create a balanced portfolio in the hope that weakness in bonds would be compensated for by strength in equities and vice versa. It seems reasonable to conclude that at some point these instances when bonds and equities fall together, will increase due to the leverage in the system and the bubble in the bond markets. We may experience instances in which interest rates begin to rise and this causes bonds to fall significantly, as well as equities. Therefore, investors will need to make a decision about what assets to hold during times of stress.

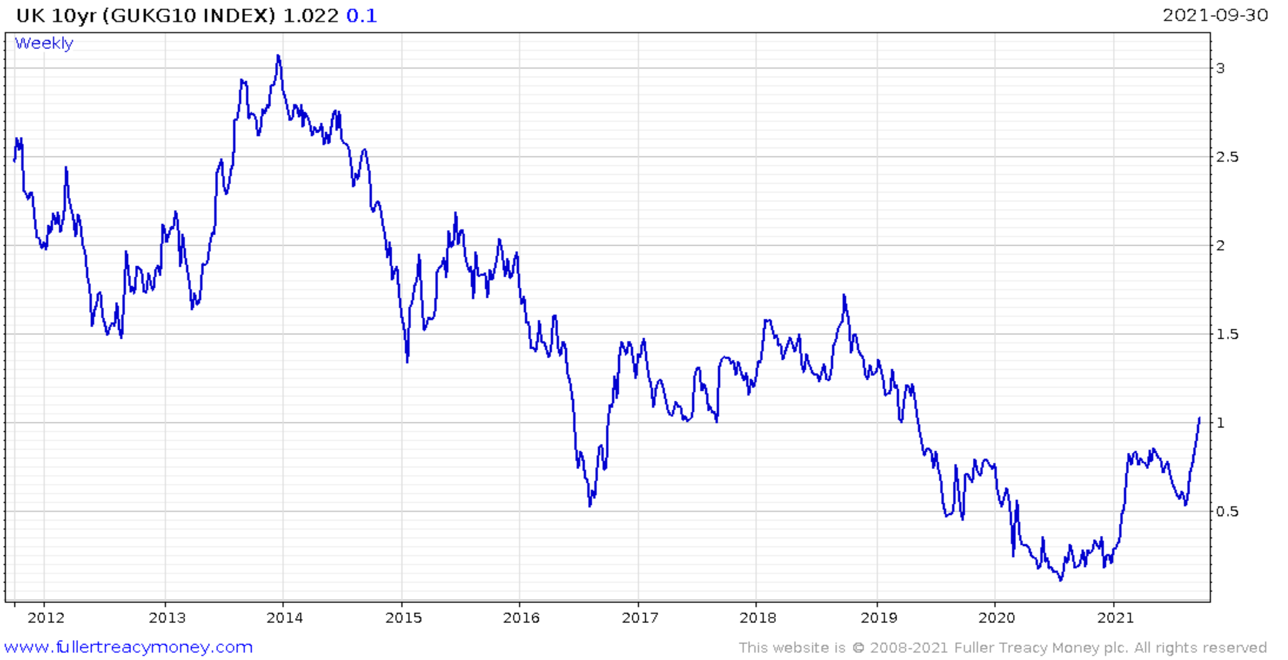
Our trend following portfolios will hopefully mitigate some of this risk by using cash as an asset class. We will sell out of an asset class when it falls below trend and move that portion of the portfolio into cash until we experience the start of a new upward trend. By doing this we hope to avoid some of the big losses that asset classes experience from time to time.

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. This month we look at the effects of inflation.

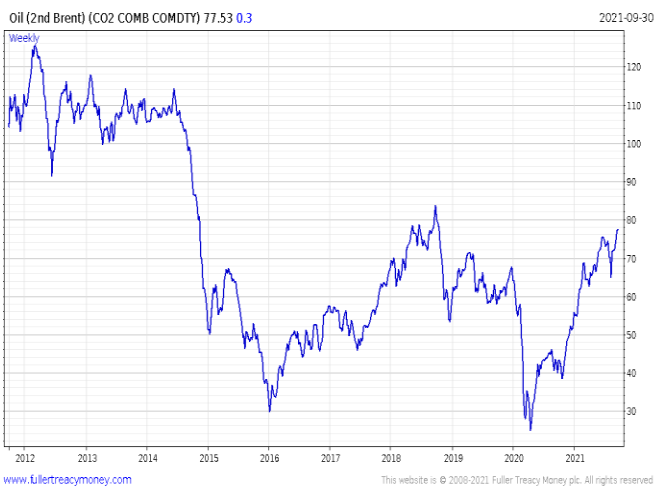
Higher UK Inflation, leading to higher borrowing rates

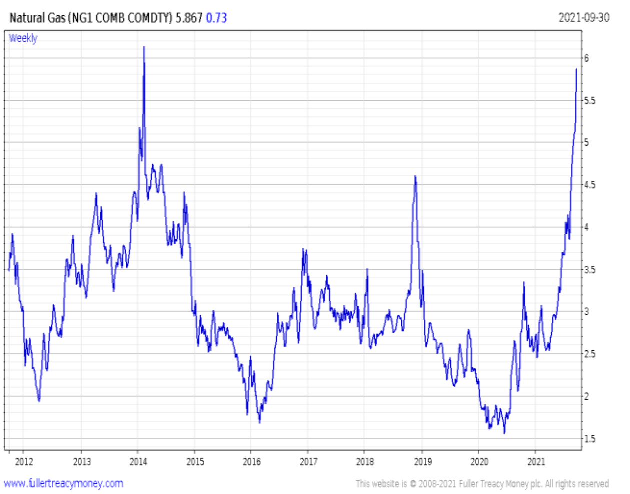
The biggest concern in financial markets is inflation. Whether this rise is temporary or whether we will have more permanent inflation, is the biggest question. Higher inflation will lead to higher interest rates, but Governments have so much debt and therefore need interest rates to stay low. The chart below shows the interest rate that the UK Government has to pay when borrowing over the next 10 years. You can see how low it fell, but last month we saw a sharp rise to 1%. Most other Government bonds also jumped higher. This is what caused the “jitters” in most markets last month:



Rising Oil and Gas prices

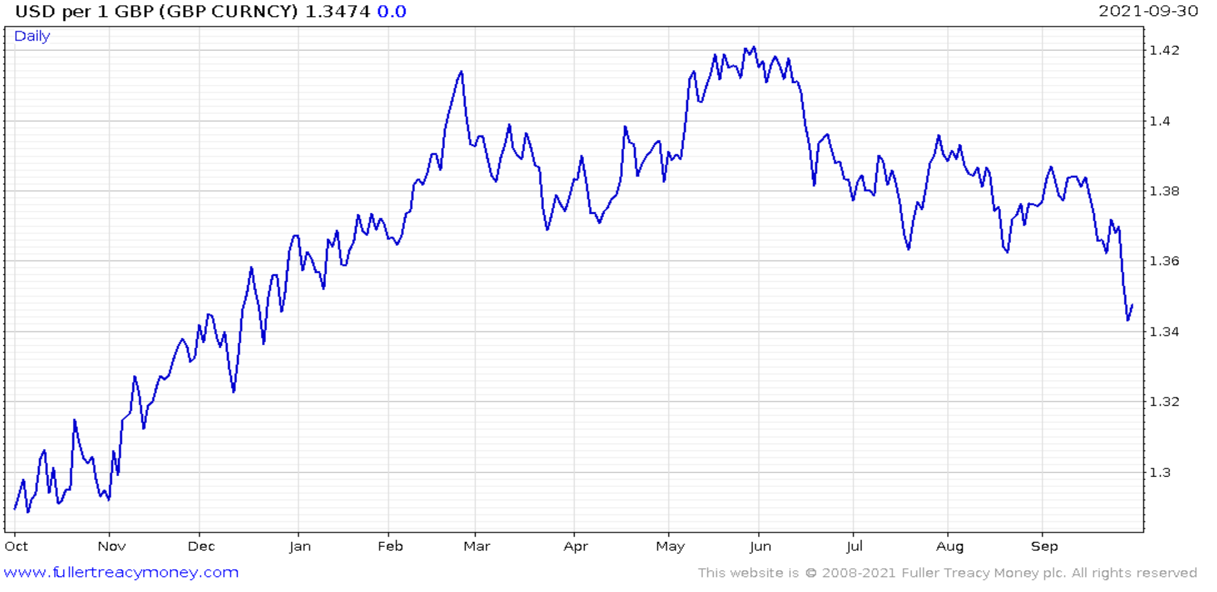
The charts below show how our energy costs are rising. Whilst this might help with the transition to green energy in the long term, it could potentially put the brakes on the current global recovery. Some investment commentators have argued that the stock market crash and recession in 2008 was amplified by the rise in oil prices to nearly $150 by June 2008. The rise in gas prices has been particularly steep over the last month:





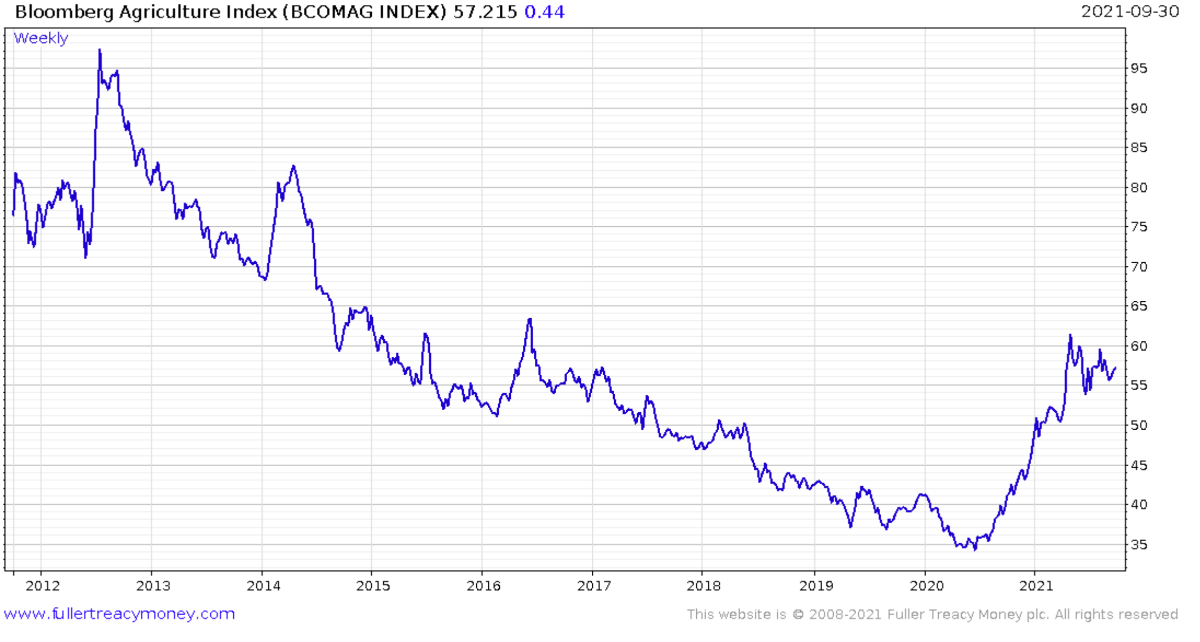
Sterling weakens

Sterling against the US Dollar is now at the lowest level this year as investors worry that stagflation will hit the UK. Stagflation is simply when you have high inflation but little or no economic growth. The problems at petrol pumps has also focussed investors to look at the labour supply issues that Brexit has caused, and this is leading to a lack of confidence in the UK. However, sterling falling is good news for our overseas investments as it increases the value of them when converted back to sterling.



The price of Food has stopped going up

The Bloomberg Agriculture Index measures the price of a basket of products such as Corn, Soybeans, Coffee and Sugar. Whilst we have seen it rise over 60% since its low, the index has now stopped going up. However, it is still well below the high of 2012 and could be set up for another hike higher:



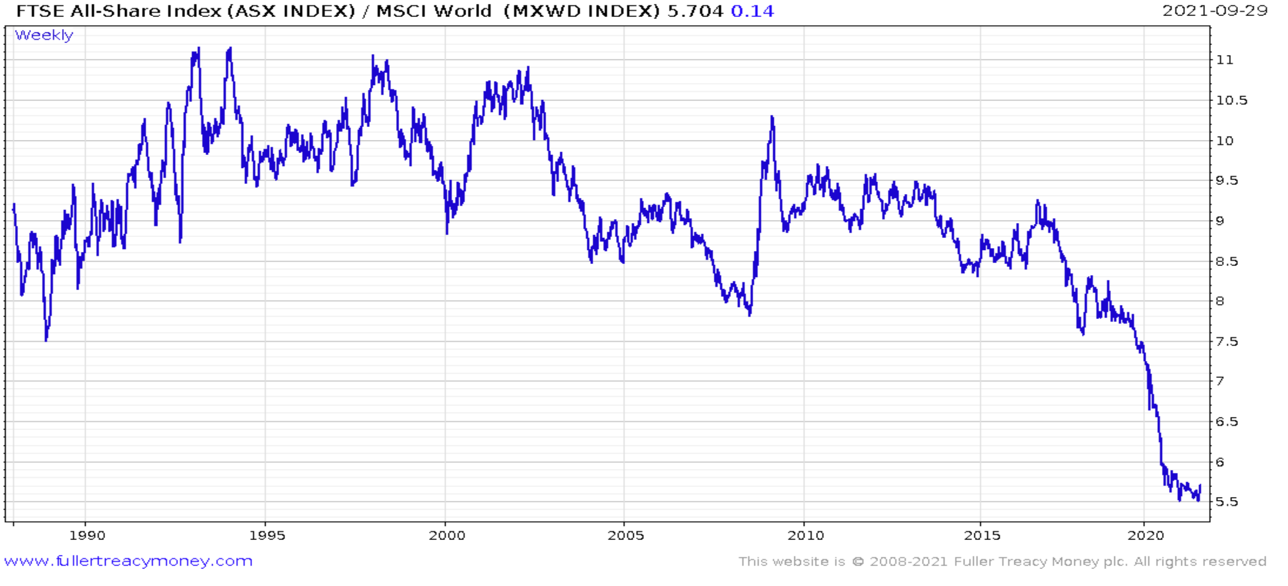
In Summary

Inflation is starting to cause concern globally and this is causing bond yields to go up. Governments globally have so much debt that a small increase in borrowing costs could cause long-term economic problems. The UK has additional problems that has caused sterling to fall – this in turn further increases the price of oil, gas and food for UK consumers.

Best Value Ever!

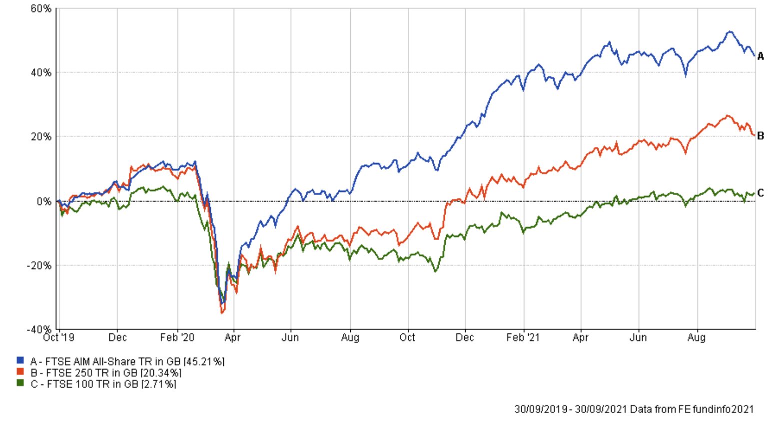
There has been a confluence of negative surprises that are affecting the UK economy at present. Some are related to pandemic supply chain issues; others are due to a lack of qualified drivers and others because the wind stopped blowing (how ridiculous that latter point sounds!).

Even in the best of times, these events would contribute to the perception that inflationary pressures are taking off. When twinned with the massive spending over the last year, the idea that inflation in the UK is transitory, is looking less than credible. Island nations generally have higher inflation than their continental neighbours because supply chains are less efficient when large bodies of water need to be transgressed. The post Brexit customs relationship has introduced an additional efficiency wrinkle. This has caused sterling to fall and borrowing costs to go up. Whilst it is very easy to be negative about the UK, investors have created a great opportunity as UK stocks are now at the lowest level when compared to global stock markets. The chart below shows the comparison of the FTSE All-Share Index (top 350 UK companies) against the global stock market. The lower the blue line goes then the lower UK stocks have performed by comparison:



As you can see, the relationship began to break down after the Brexit vote in 2016, and you could argue from the chart that the UK is nearly 40% undervalued when compared to other stock markets. This anomaly is being seen across many different sectors and overseas investors are beginning to take advantage of it. We have seen numerous bids for smaller UK companies, with the highest profile one being the bid for Morrisons by American private equity firms. Very simply, if you buy a UK company that is valued at 12 times the money it earns, but a similar company in the US is valued at 18 times the money it earns, then you can make a large profit by purchasing the UK company and merging it with the US one. We expect many more bids to be made over the coming months and years for good quality UK companies.

We have already seen the smallest UK companies (AIM stock market) outperform significantly since the crash last year (up 45.21% over two years), compared to the FTSE 100 which is up 2.71%. The FTSE 250 is in-between these two in terms of performance. We believe that a bid for some of the FTSE 100 companies may occur shortly and that will make big headlines. The UK is at its "best value ever" and our portfolios have a significant amount invested in the UK which will hopefully benefit from any future take overs.



Final Comment

The recovery in global stock markets since the lows last year has been strong and rapid, as Governments have pumped money into the system. Government spending shows no signs of abating and consumers have also saved significant sums of money, which is now acting as a catalyst for a surge in spending. On top of this we now have a supply side issue. A global shortage of some goods due to Covid-19, as well as a lack of labour in the UK due to Brexit, has helped inflation jump higher. The fear that inflation will remain higher for longer and that economic growth will stall in the UK, has caused sterling to fall. This, in turn, has created a great opportunity for overseas investors to start buying UK companies cheaply.

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