Watson Moore
INDEPENDENT FINANCIAL ADVISERS LIMITED

Monthly Investment Update
February 2022

Contents:

Performance Update

The FTSE 100 actually rose in January by 1.12%, but most stock markets suffered significant falls. The FTSE 250, S&P500, Japan, Europe and US Smaller companies all fell 6.53%, 4.27%, 4.17%, 5.24% and 7.15% respectively. Our portfolios fell between 1.59% and 6.00%. The Fourth Industrial Revolution portfolio suffered a more significant loss of 11.23% as technology-based companies fell even further.

Most of the falls can be attributed to increasing concerns that central banks will start to reign in the monetary support (interest rate rises and no more money printing) that they gave economies through the pandemic in order to combat inflation. Interest rates are expected to go up again in the UK this month, and in the US next month.

Rapidly rising interest rates are typically bad news for companies that have expectations of profits a long way into the future (e.g. technology companies). This is because higher interest rates reduce the current value of future profits as well as increasing the cost of borrowing. It particularly hits companies that are yet to make a profit. A lot of these companies are based in the US and make up a large part of the Fourth Industrial Revolution portfolio. The good news is that we saw technology companies rise significantly in the last few trading hours of the month and these gains have not been included in our figures.

Bonds also suffered losses for their second consecutive month, with inflation-linked gilts falling by 1.96% and UK Gilts by 3.32%. This again shows the concern that interest rates will have to rise more aggressively than expected due to the inflation being stickier than originally anticipated.

The potential Russian invasion of the Ukraine is also causing some concern with investors as it has helped push the oil price higher. Back in December, Brent Crude Oil was below $70 and now it is over $85. A higher oil price is inflationary, although it helps companies such as BP and Shell and thus the FTSE 100.

With birthday cake, a broken swing and a suitcase of wine hitting the headlines, we must not forget the good news that the Omicron variant is proving to have milder symptoms in most people. Denmark lifted all restrictions, and the Danish PM said the “country was returning to life as we knew it before corona”. Other countries will follow.

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	-2.30	0.08	5.70
Cautious	-3.03	-0.29	6.44
Balanced	-3.27	0.22	7.54
Adventurous	-4.47	0.30	8.88
Dynamic Equity	-6.00	0.79	10.12
Income Generating	-1.59	2.88	12.11
Fourth Industrial Revolution	-11.47	-7.96	-5.49
Retirement Investment Solution 1	-3.91	0.15	7.18
Retirement Investment Solution 2	-4.29	0.21	7.58
Retirement Investment Solution 3	-4.62	0.27	7.94

Please note that these figures do not include the platform or Watson Moore’s fees.*All figures are sourced from Financial Express to 31.01.2022.

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

This month we saw many equity markets move below trend, including Europe and Japan. All bond markets are now below trend except for inflation-linked UK Gilts.

Cautious, Balanced and Adventurous portfolios

These portfolios are now more defensive, having a higher weighting in cash. The Cautious and Balanced portfolios saw a reduction in equity exposure of 10% as Japan, Europe, UK smaller companies and healthcare moved below trend. Bond exposure was also dramatically cut with the only exposure being in inflation-linked UK bonds.

The portfolios have been harvesting strong returns in 2021 as they were overweight equities, but now, after falling in January, are sat in a much more defensive position.

Dynamic Equity portfolio

The portfolio has still returned over 10% during the last 12 months, but suffered a fall of 6% in January. We exited UK smaller companies and replaced with UK larger companies, which are performing well during this difficult period. While US companies are still high up on the momentum scale, we do feel that there could be a shift in momentum away from them. If this happens, then we would expect the portfolio to change dramatically over the next few months.

Foundation portfolio

The portfolio fell 2.3%. Exposure to equities and bonds fell this month, in line with the reversal of many markets from positive to negative trends. This portfolio will always have a much more diversified approach and will not negate exposure to an asset class entirely. In this way we can attempt to achieve steadier returns. The chart below compares the Foundation portfolio to the Dynamic Equity portfolio, and you can see how much more volatile the Dynamic Equity portfolio is:

Income Generating portfolio

This was our best performing portfolio over the last year as it fell the least last month. The Income Generating portfolio has a history of falling less than other similar risk portfolios during difficult times. By investing in income producing assets, the portfolio is better equipped when we are faced with a downturn in the stock market. This is because, as stock markets fall, the income that is generated from the underlying companies increases as a percentage of their value. Eventually this income yield becomes very attractive and buyers' step in, thus cushioning the falls. This does not work every time and during the Covid-19 related crash in March 2020, dividend paying companies were hit the hardest as they were forced to cut dividends.

Fourth Industrial Revolution portfolio

The fear of rising interest rates is hurting the portfolio and we have suffered significant falls. Many technology-orientated companies are classified as growth companies, with profits that will increase a long time in the future. When interest rates are low the opportunity cost of waiting for those profits is less relevant (i.e. if we invest in a business, we are not losing any/much interest, so we are not worried about receiving a dividend for a while). However, when interest rates go up, we lose, say, 4% interest that we could have achieved in a bank. Therefore, we are looking to receive dividends sooner rather than later and so are less willing to pay as much for future profits (share prices go down). It does appear that this correction could be a great buying opportunity, but only time will tell.

The chart below shows how much more volatile the Fourth Industrial Revolution portfolio has been when compared to the Income Generating portfolio over the last 18 months:

Retirement Investment Solutions

The Solutions have produced returns of over 7% during the last 12 months. They have become much more defensive this month as exposure to bonds and equities has reduced.

Summary of Portfolios

After a strong 2021, stock markets fell – in many cases quite sharply – in January. The falls have been driven by increasing concerns that Central Banks will raise interest rates quicker and higher than anticipated, due to rising inflation figures. We appear to be at an inflection point in which after 20 years or more of interest rates generally falling, we must expect them to rise over the next few years. Economists are not predicting them to exceed 3% in the UK and are also predicting inflation to fall to around the 3% level as well. This would be really good news, but we all know that predicting the future is hard, even impossible.

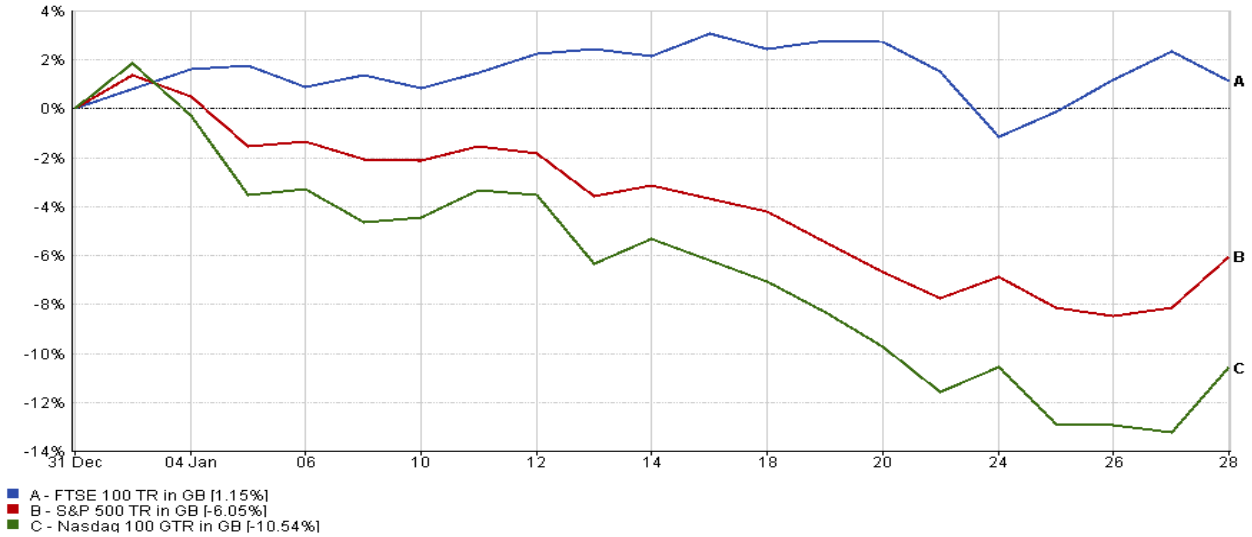
During any major change there will be winners and losers. We have already seen technology companies fall significantly from their highs and bonds begin to drift lower in value. Currently the winner so far has been the FTSE 100. While we do believe that the current correction in technology companies may be a good buying opportunity, the change in the direction of interest rates is likely to continue to cause more volatility in investment markets.

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 focus on the January falls in stock markets.

S&P 500 and Nasdaq 100 suffer falls; FTSE 100 holds up

There is a huge difference between the types of companies in each index. S&P 500/Nasdaq are very US technology based and the FTSE 100 is oil, mining, banks, tobacco and consumer goods. The FTSE 100 has underperformed significantly over the years as technology has raced ahead. The reversal in January could just be a simple rotation from "overvalued" companies to "undervalued" companies. This happens from time to time when investors are locking in profits and reinvesting in cheaper companies. We could expect Europe, UK, China and just about everything else non-US to catch up.



Nasdaq (technology) falls the most

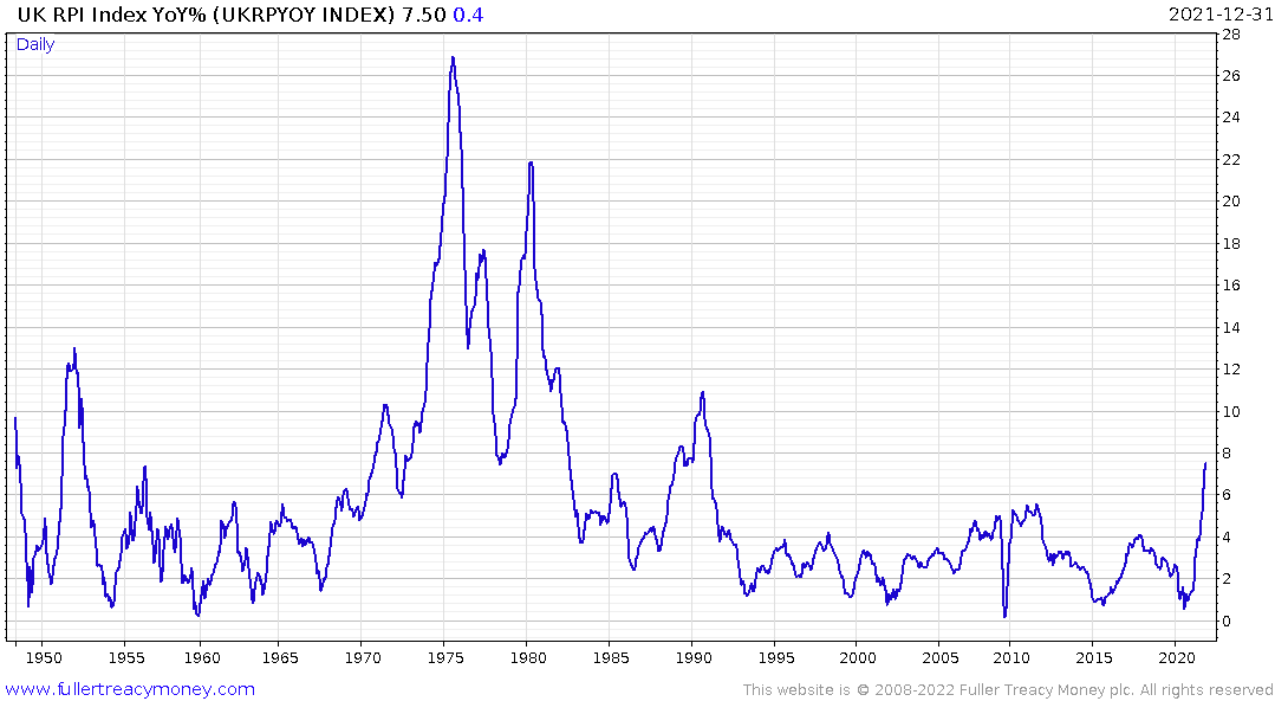
The falls could also be attributed to the fact that interest rates are going up/expected to go up faster than first thought. If you are a growth company with earnings that will increase a long time in the future (typically technology companies), if interest rates are low, the opportunity cost of waiting for those profits is less relevant. However, when interest rates go up, then investors have to factor in the loss of interest they could receive on their money and thus pay a lower price for future profits. This leads to companies like technology falling in comparison to longer-established companies that are paying dividends. The Nasdaq has thus fallen significantly.

UK Bond Yields rising

The chart below is the yield that can be achieved by lending money to the UK Government over the next 10 years. From the low of below 0.2% last summer, the yield has risen to above 1.3%. Effectively this chart is signalling to us that interest rates are rising in the future, but are still not above 2018 levels:

Inflation - rising rapidly

The chart below shows how inflation (RPI) has changed since the late 1940s. Although it is expected to fall over the next few years, you can see how it has spiked up to reach the same levels last achieved in the early 1990's. It is this that has led to the expectation of future interest rates rises:



In Summary

Increasing inflation is causing interest rates to rise and this has caused a negative reaction in those growth-orientated companies. So far, technology-based companies have suffered the biggest falls. This could be a great buying opportunity as inflation is expected to fall and interest rates to peak at a low figure. However, inflation has exceeded expectations over the last few months and could continue to do so.

AIM to Reduce your Inheritance Tax Bill

With house prices increasing rapidly over the last 10 years, many families have been pushed above the inheritance tax allowance (the allowance can be between £325,000 and £1 million depending on your personal situation). Any assets above this allowance will be taxed at 40% on your death. However, it is possible to reduce, or even completely wipe out the final tax bill with careful planning. The most common way to reduce your inheritance tax liability is to gift money away, but there are two strategies that allow you to retain control of your wealth while reducing your future tax bill. The simplest way is to invest money into a pension or to stop drawing money out of your pension (as pensions are outside of your estate for inheritance tax). However, you are limited to how much you can put into a pension and anyone over 75 cannot pay into one.

Another solution is to invest in shares listed on AIM, which is the junior market of the London Stock Exchange and qualifies for business property relief (BPR). This means that if you own them for at least two years and you still hold them on death, you can pass them on to your heirs with no inheritance tax to pay. The relief was originally offered to avoid families having to sell family-owned businesses to pay an inheritance tax bill following the death of the business owner, but now the tax relief is much more widely available with most AIM shares qualifying.

One of the problems with investing in AIM shares is that they can be risky, and the AIM stock market is full of companies that do not make a profit (what we would call "speculative" companies). However, there are also some very profitable, well-established companies. The most well-known companies are Boohoo, Abcam, Asos, Fevertree Drinks, Young & Co Brewery, Jet2, Virgin Wines and Hotel Chocolate.

One of the best ways to avoid investing in speculative companies is to employ a fund management company to select the companies for you and to manage them on an ongoing basis. The fund management companies tend to select the stocks that have the best cash flow, are the most profitable, are run on a sensible basis and are performing well. ARC is an index that measures the performance of AIM IHT portfolios (blue line) and the performance since launch has been fantastic when compared to the FTSE 100 (red line):

When investing in AIM shares, you are investing in smaller companies, which tend to do well in rising global stock markets but when stock markets suffer corrections then small companies and AIM shares can fall a lot further. In the crash of 2007-09 the FTSE 100 fell by 43.32%, whereas UK Smaller Companies (Numis Smaller Companies plus AIM index) fell over 55%. However, if your AIM shares fall by less than 40%, your heirs will still inherit more.

Summary

If you want to consider reducing your potential inheritance tax bill, then investing in a pension and AIM shares can assist greatly. AIM shares are riskier than investing in larger companies, but they also have the potential of high rewards. One of the best ways to reduce your risk is to use a fund manager to select the best quality AIM stocks. If you want to discuss this further, then please do not hesitate to contact us.

Final Comment

January has reminded us that stock markets tend to move higher slowly, but fall very quickly. Technology companies have been hit the hardest as investors consider the implications of how rising interest rates will affect their profitability. However, we have known that interest rates will have to rise for many months now, so this could be a simple case of the locking-in of profits from the best performing sectors and a reinvesting into the cheapest regions such as the FTSE 100. The yield on the FTSE 100 is now 3.21%, whereas most technology companies do not pay any dividends. This is perhaps the reason why we are seeing this rotation as well.

2022 has certainly begun in an interesting way, despite the easing of lockdowns and the good news surrounding the mildness of omicron.

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