Chamberlyns

Insights

Politics and portfolios

November 2018

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"May you live in interesting times…"

Old Chinese Curse

Politics and other seemingly important events might influence portfolios in the short-term, but what about over the long-term? Do they really matter?

What a mess

For a combination of reasons, it is rare that we discuss politics, but it feels like there is much going on in global politics at the moment that is, at one end of the spectrum, unsettling, complex and confusing e.g. Brexit, and at the other end of the spectrum, downright worrying e.g. Russian meddling in the democratic process and the use of nerve agents on the streets of Salisbury.

There is also much in-between that is hard to compute in terms of its impact. Trump's populism feels unpleasant to many, but is his call to NATO members, such as Germany, to meet their commitments to share more of the financial burden of protecting Europe unfair, given Russian aggression? Is his trade war with China wholly a bad thing? A recent leader in *The Economist*[1] supports – at least in part – his tirade against its mercantilism and unfair trade practices.

What about climate change and a host of other politically sensitive and important issues?

Issues closer to home such as Brexit and the potential for material political uncertainty in the event of no satisfactory (or any) deal being reached, feel – at least to UK residents – more prominent in our lives at this moment than some of these wider issues.

The Brexit affair

Whichever way one voted, it is hard not to be dismayed by the subsequent shambles, concocted by all sides. Until recently, the UK appeared to have no clearly defined strategy (indeed, plenty may argue that remains the case). Its negotiations are led by a PM who wanted to remain, receiving criticism from the right wing of her party for not going far enough, and daily criticism from the opposition party, led by a long-time Eurosceptic, that still has no credible alternative aside from six *'have our cake and eat it'* criteria that any deal must meet. For example, Criteria 2 poses the question *'Does it deliver the "exact same benefits" as we currently have as members of the Single Market and Customs Union?'*[2], which is an impossibility, unless the deal is to remain.

What a mess! One might laugh if the consequences for our nation were not so great.

The EU has hardly covered itself in glory either, with their intransigence and deep-seated, implicit desire to make everything so tough that either other EU member states won't dare to follow suit, or UK voters might change their minds. Yanis Varoufakis, the Greek Finance Minister at the time of their debt crisis, revealed the trap that the EU would set for the UK government, in his book about his own experiences of dealing with it. Did any of our politicians read it?

In the event that any deal agreed gets voted down in Parliament, or there is no deal, we face a high chance that the Conservative government could fall (but will turkeys vote for Christmas?) to be replaced by a far-left leaning government led by Jeremy Corbyn and John McDonnell. Whatever your own thoughts and preferences on this, the one certainty is that we would be in for a period of radical change.

1. The Economist, September 22nd – 28th edition, 'Hunker down', page 12.
2. www.labourlist.org (2017) Keir Starmer: Labour has six tests for Brexit – if they're not met we won't back the final deal in parliament. 27th March 2016.
3. Yannis Varoufakis (2016), And the weak suffer what they must The Weak Suffer What They Must? Europe's Crisis and America's Economic Future, New York: Nation Books, 2016.

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Certainly, that means higher personal taxation: in Labour's 2017 manifesto, they proposed a 45% Income Tax rate to kick in at £80,000 pa of income, with a 50% rate above £123,000 pa. This results in marginal tax rates – taking into account National Insurance and the tapering of allowances – of 55% for those earning between £80,000 pa and £100,000 pa, 73% up to £123,000 pa and 58% thereafter, according to the Institute for Fiscal Studies.

Even before these changes, it is interesting to note that 4 in 10 adults currently pay no Income Tax at all, the top 10% of Income Tax payers pay 60% of all Income Tax[4] and around 30% of all personal taxes collected. Corporation Tax is set to rise from 19% to 26% and the 10% shareholding held for employees – announced by John McDonnell at the Labour Party Conference – is likely to be a large new tax on companies, given the £500 limit per employee on dividend income and with the remainder going to HMRC. Renationalisation of some industries, possibly without full compensation, is not beyond the realms of possibility. Wherever you sit in terms of the balance between equity (how the economic pie is sliced up) and efficiency (how big the pie is), there is no doubt that we are living in *'interesting'* times.

The point here is to recognise that the world we live in can be an uncertain and uncomfortable place and it can create anxiety over our future wealth and well-being. Further, it sets the context for why and how a sensibly structured portfolio can provide comfort for longer-term investors, and how we can put the unsettling noise of what's going on in perspective.

"The advance is permanent, the falls temporary."

It is not all bad – in fact, far from it

A recent study by the OECD[5] projects that global real (after inflation) growth will rise by 3.7% in both 2018 and 2019, with major European economies growing by 1% to 2%, including the UK (1.3%). Growth in the US is predicted to be around 3% in 2018 and 2019. In the UK, employment is at a record high, real (after inflation) wage growth has been positive since 2015 and the budget deficit is now around 1% of GDP, compared to 10% before the austerity programme. Global growth leads to a growth in global earnings, which, when added to dividends paid, translates into the economic return due to equity investors for providing capital. That's good news.

The chart below illustrates that markets weather the multitude of World events they experience, rewarding the patient long-term investor with the maintenance or growth of their purchasing power (which is the only sane long-term definition of money and financial security). As such, please take a moment to properly reflect on this (and remind yourself how very real, and how very scary, some of these events felt at the time), as well as the investment principle that the advance is permanent and the falls temporary. As you can see, the capital markets have delivered huge increases in purchasing power and real wealth during the last three and a half decades (as they have over the last century, indeed), despite any and all events that were thrown at them.

The oil crisis in the 70s? The historically high interest rates in the UK in the 80s? The DotCom crash in the 90s? The Credit Crisis in the 2000s? All blips and all long forgotten. The declines were temporary stumbles, punctuating the permanent advance. If you need to preserve or grow your wealth / purchasing power (and everybody needs to do at least one of these things), the great companies and economies of the world are the logical and proven solution, to which no other approach comes close (and yes, that includes, by a wide margin, residential property, despite the classic perception vs reality gap that exists in this respect).

4. IFS (2017) www.ifs.org.uk/publications/10038 Note also that an income of a little over £50,000 put one in the top 10%.
5. OECD Economic Outlook and Interim Economic Outlook (September 2018) http://www.oecd.org/eco/outlook/economic-outlook/

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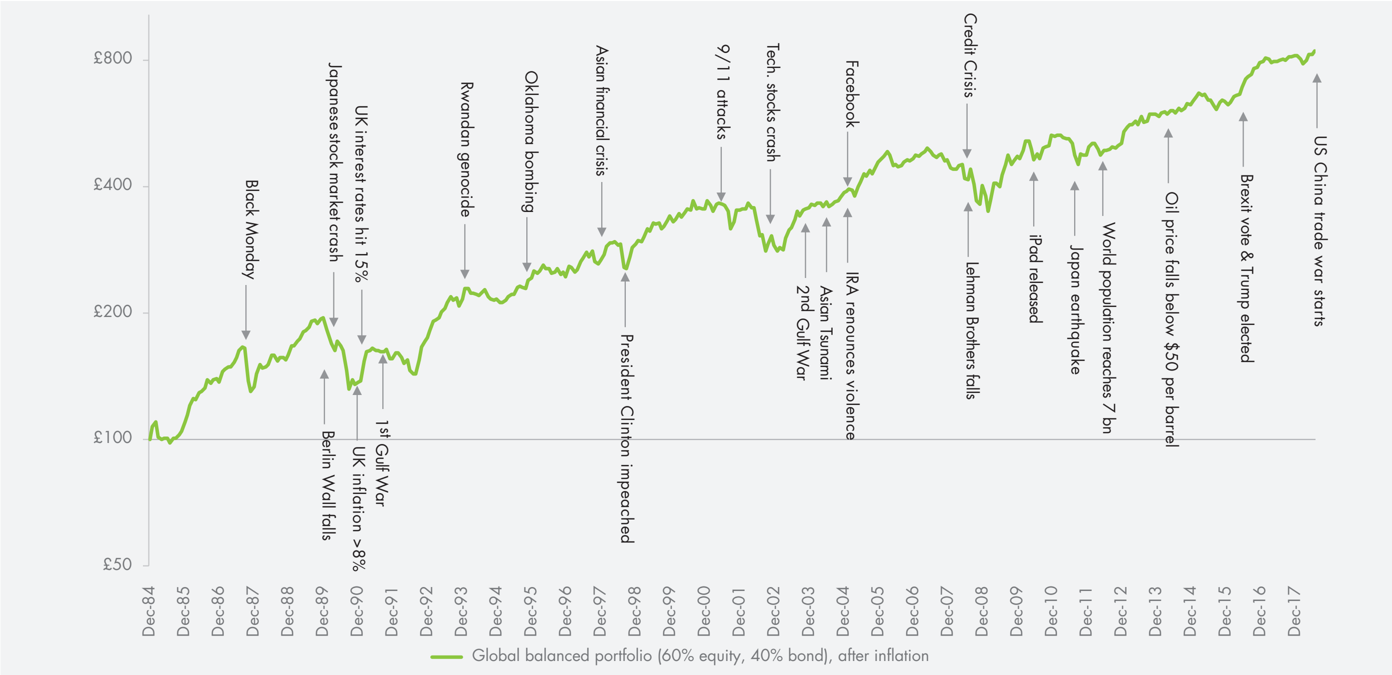
Figure 1: The relentless growth of purchasing power, despite World events (1/1985-7/2018)



Source: Albion Strategic Consulting[6]

The capitalist spirit continues to drive positive change

While few would argue that capitalism is perfect, the evidence suggests it is the best economic system the human race has managed to come up with. In this respect, Churchill's famous quote about democracy comes to mind: *"Democracy is the worst form of government, except for all the others that have been tried"*. As such, despite its imperfections, the advancement of the human race has relied heavily upon capitalism and looks set to continue to do so.

Since 2016 alone, 90 million people have been lifted out of extreme poverty[7], something that afflicts 8% (634 million) of the World's population, most of whom live in Sub-Saharan Africa. South Asia and East Asia and the Pacific have lifted around 0.5 bn and 1 bn people out of extreme poverty respectively since 1990[8]. That is on account of the unleashing of the energy and innovation that capitalism has driven in these regions, including China. In terms of infant mortality, the progress has, again, been staggering. In 1990, on a global basis, infant mortality stood at 65 deaths per 1,000 live births. Today it is less than half of that, at below 30[9]. This is due to the reduction in poverty and improvement in healthcare and education around the globe, again driven and funded by the wealth that capitalism delivers[10].

6. Global balanced portfolio: 36% MSCI World Index (net div.), 26% Dimensional Global Targeted Value Index, 40% Citi World Government Bond Index 1-5 Years (hedged to GBP) – no costs deducted, for illustrative purposes only. Data source: Morningstar Direct © All rights reserved, Dimensional Fund Advisers. Past performance is not indicative of future performance.

7. World Poverty Clock www.worldpoverty.io (worth a look at how poverty is reducing).

8. The Economist, September 22nd – 28th edition, 'Poverty estimates', page 65.

9. World Bank (2017) https://data.worldbank.org/indicator/SP.DYN.IMRT.IN?end=2017&start=1990

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Please take the time to view an amazing data visualisation of the World's progress since 1810 by Hans Rosling, a renowned global health academic, to lift your spirits (see footnote 8). It's a great way to spend four minutes.

We, as humans, tend to hold many misperceptions around important issues, overestimating guesses when an issue worries us and underestimating those that do not. In part, this is because we rely on the fast thinking part of our brains, which are often not overridden by slower, more measured, reasoning[11]. For example, in the UK we guess that 37% of the population is over 65, when in fact it is 17%. We believe that the top 1% of wealthiest people own 59% of the wealth, when in fact it is 23%. Only 13% of the UK's population are immigrants, yet we guess at 25%[12]. As such, one can begin to see how polarised political systems can use facts and misperceptions to their advantage.

So where does all this leave investors and their portfolios?

You may well be asking yourself whether what is going on in the World affects how your money is invested and if any changes need to be made to your portfolio. The question implicitly suggests that we can look into the future and know what is going to happen. If it were that easy, all investors would know what to do and prices would already have moved (remember, markets are forward-looking and extremely rapid mechanisms for pricing information). Indeed, remember that you are not the only person thinking about these global challenges and that all scenarios are reflected in current prices. As a consequence, we need to rely on the structure of our portfolios to see us through.

Below are set out three key risks relating to Brexit and how sensible portfolio structures can mitigate them:

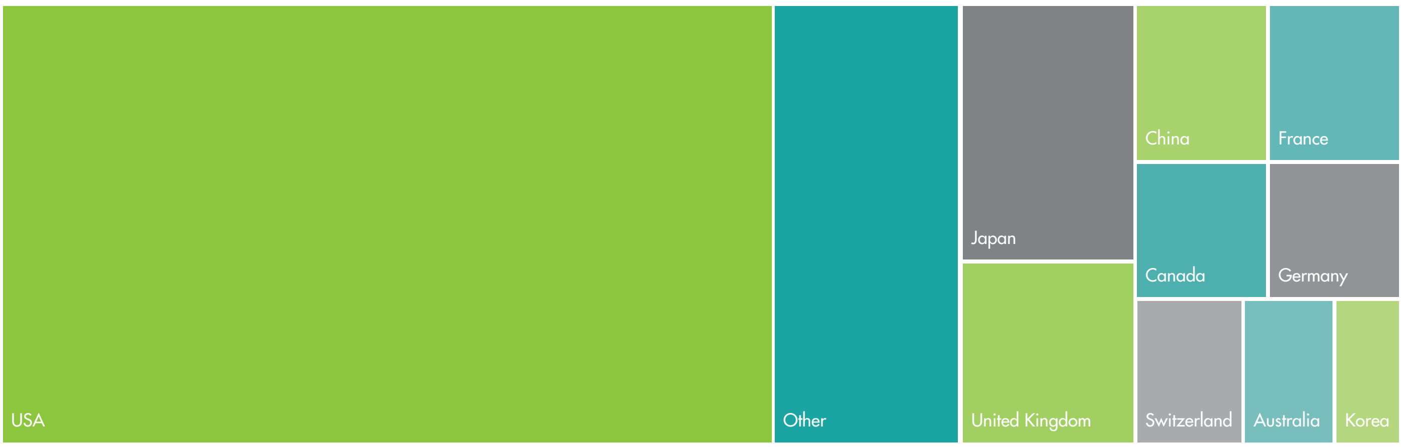
Risk 1: Greater volatility in the UK and possibly other equity markets

In the event of a poorly received deal – or no deal – it is certainly possible that the UK equity market could suffer a fall as it tries to come to terms with what this means for the UK and wider global economy. A collapse of the Conservative government and a Labour victory would add further uncertainty.

Risk 2: A fall in Sterling against other currencies

In 2016, after the referendum, Sterling fell against the major currencies including the US dollar and the Euro. There is certainly a risk that Sterling could fall further in the event of a poor/no deal scenario.

Figure 2: Global market capitalisation (developed and emerging markets) – 2018



Source: Albion Strategic Consulting using data from iShares – August 2018 (MSCI ACWI ETF).

10. For any reader interested in a more positive outlook, Matt Ridley's book 'The Rational Optimist' is a good read
11. Nobel Prize winner, Daniel Kahneman's book 'Thinking, fast and slow' is a great read on this subject.
12. Data source: Bobby Duffy (2018), 'The Perils of Perception: why we are wrong about nearly everything'. Bell & Bain Ltd. Glasgow. A great read on the subject.

Risk 3: A rise in UK bond yields (and thus a fall in bond prices)
The economic impact of a poor/no deal scenario and/or a high-spending socialist government could put pressure on the cost of borrowing, with investors in bonds issued by the UK Government (and UK corporations) demanding higher yields on these bonds in compensation for the greater perceived risks. Bond yield rises mean bond price falls, which will take time to recoup through the higher yields on offer.

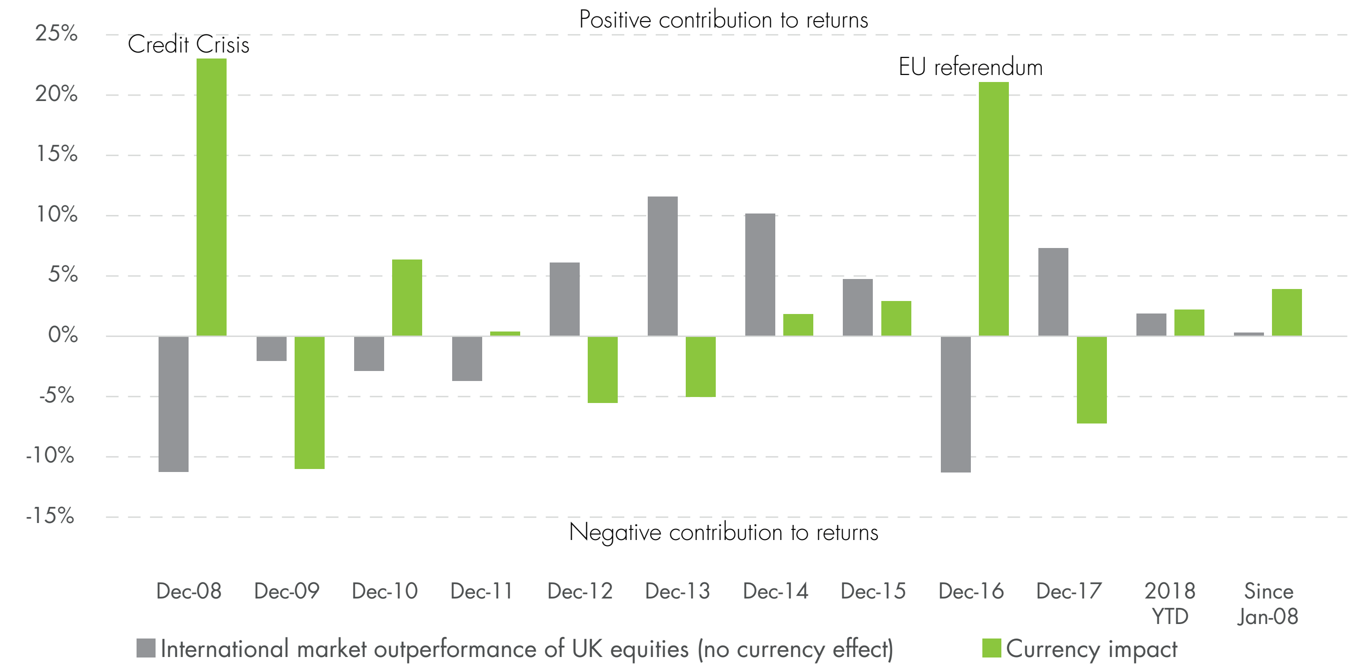
Looked at in isolation, these may appear to be significant risks; however, owning a well-diversified and sensibly constructed portfolio can greatly reduce these risks.

Mitigant 1: Global diversification of equity exposure
Although it is the World's sixth largest economy (depending on how you measure it), the UK only produces 3% to 4% of global GDP, and its equity market is around 6% of global market capitalisation. Many of the companies listed on the London Stock Exchange derive much of their revenue from outside of the UK (c70% - 80%).

For example, HSBC, even though it is often thought of as a British bank, generates over 90% of its revenues from overseas. As such, well-structured portfolios hold diversified exposure to many markets and companies.

Equity markets are always volatile, responding – sometimes materially – to new information. Despite this, changing your mix between bonds and equities would be ill-advised (unless for some other sound financial planning reason). Timing when to get in and out of markets is notoriously difficult. Markets move with speed and magnitude and missing the best days in the markets can have a material impact on long-term returns. Provided you do not need the money today (which you won't, if your financial planning has been properly thought through), you should hold your nerve and stick with your strategy (indeed, not only *should* you hold your nerve, but you *must*, if you don't want to destroy your own wealth and you want to capture the long-term returns that capitalism and compounding can deliver).

Figure 3: A falling pound is a positive contributor to portfolio returns



Source: Morningstar Direct© 2018. All rights reserved. Data derived from MSCI World Index in GBP, MSCI World Index in Local Currency and MSCI UK Index.

Mitigant 2: Owning non-Sterling assets and currencies in your portfolio's growth assets

In the event that Sterling is hit hard, it is worth remembering that the overseas equities you own come with the currency exposure linked to those assets. For example, owning US equities comes with US dollar exposure, as this exposure is not hedged out in the growth assets element of your portfolio. In short, a fall in Sterling has a positive effect on non-UK assets that are unhedged. The chart above illustrates the impact that currency in unhedged, non-UK assets has had over the past decade. As you can see, at times of market crisis, the Pound has fallen against other safe-haven currencies such as the US dollar (which is good for you, as a UK-based investor).

Mitigant 3: Owning short-dated, high quality, globally diversified bonds

Any bonds you own should be predominantly short-dated and high quality, to act as a strong defensive position against falls in equity markets. Avoiding over-exposure to lower quality (e.g. high yield, sub-investment grade) bonds makes sense, as these tend to act more like equities at times of economic and equity market crisis.

Your bond holdings should be diversified across a number of global bond markets and hedged back to Sterling (you don't want the higher volatility of currency movements in the defensive element of your portfolio), which will mitigate the risk of a rise in UK yields (and thus falling Bond prices), as the cost of borrowing in other markets may not be impacted in the same way, at the same time.

Rational optimism

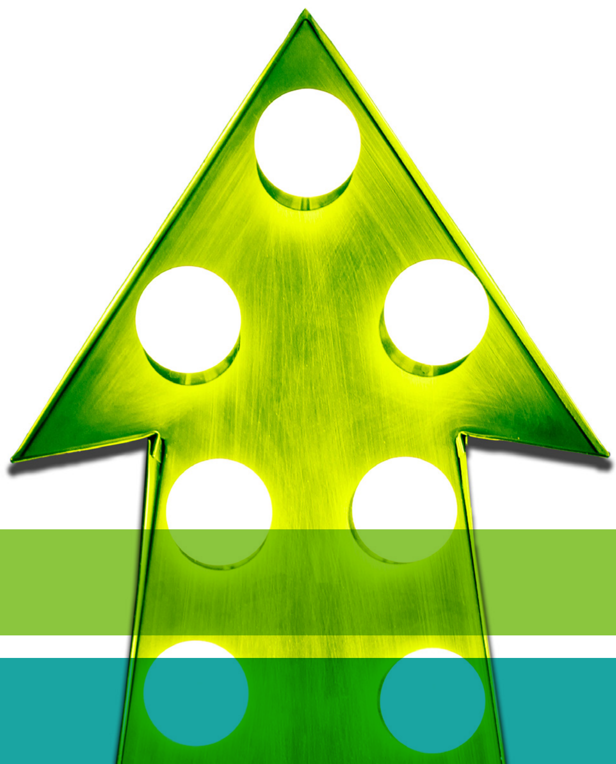
To summarise, even if you cannot avoid watching, hearing or reading the news, it is important to keep things in perspective and you could perhaps help yourself in this regard, by catching up on the news less frequently and / or actively seeking out information on some of the exciting and positive things that are happening in the World.

The UK is a strong economy with a strong democracy; it will survive Brexit, whatever the short-term consequences that we will all have to bear, and so will your portfolio. As such, in investing (as, it might be said, in life), we should aim to foster a mindset of rational optimism; keeping faith with global capitalism and the structure of your portfolio – accompanied by holding your nerve and rebalancing your portfolio periodically – because these have been proven effective, even critical, over and over, particularly in the white heat of extreme and unexpected events, which have always occurred and will continue to do so.

Finally, if events seem especially troubling at a particular time, keep in mind the wise words of investment legend, Jack Bogle (founder of Vanguard): *"This too shall pass"*.

Best regards

Michael



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Michael Smith *CEO*

In addition to being a Chartered Wealth Manager, Michael is a Chartered Financial Planner and holds the globally recognised Certified Financial Planner qualification. He is also a Fellow of both the Personal Finance Society and the Chartered Institute for Securities & Investment and as such, is one of the most highly qualified financial planning professionals in the UK. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of in-depth 'Insights' articles, which explore, explain and demystify often complex wealth planning issues.

Chamberlyns provides a refreshingly different Wealth Management service for executives, senior professionals and business owners, who want to make the most of their money and the life that lies ahead of them.

Bedfordshire / Hertfordshire Office
E 33, Basepoint Business and Innovation Centre,
110 Butterfield, Great Marlings, Luton LU2 8DL
T: 01582 434256

Leicestershire Office
2, The Coach House, Desford Hall
Leicester Lane, Desford, Leicestershire LE9 9JJ
T: 01455 291538

E: enquiries@chamberlyns.co.uk

For more information, please visit our website.