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Investment Letter: 22nd January 2014

It is tempting to read the first few weeks of the year as an augury. Trends sometimes emerge or extend. Alas, there tend also to be many false signals at the same time.

Unless you side with the deflationists, the relative case for equities over bonds remains reasonably easy to make and defend. However, equities *en masse* are not as attractive in absolute terms as they were in 2013 or 2012. Indeed, in the US, equity ratings are suggestive of much lower forward returns that investors have been accustomed to in the past. The work of GMO is useful in this context and their model suggests that 7 year forward returns in the US will be in the region of between 2%-3% above inflation. Still positive, but lower than what investors have become accustomed to.

Throughout last year, our summarised investment thesis was as follows (the below points being extracted from our generic presentation materials):-

- Last year [i.e. 2012], recovery was notional. It is now beginning to establish itself
- US economy: FIFO (first in, first out pattern of recession and recovery)
- "Cycle" replaces "crisis" in the press lexicon
- Inflation is logical, yet we remain of the view that the inflationary threat is overstated. Countervailing factors: shale gas, China?
- Hence low/zero allocation to gold/materials/inflation linked bonds
- Some bubbles are fully inflated: e.g. Asian property, core government bonds
- Fixed income is neither "fixed" nor "income"
- Of the liquid asset classes, equities rank best in terms of our expectation of real returns

Our overriding notion was that recovery would gradually come to be acknowledged and that the US would be at the vanguard of that recovery. The "first-in, first-out" theory was based on the idea that the US was the epicentre of the financial recession but had manhandled the consequential damage more thoroughly than other countries. Consequentially the tenor of commentary would change, with the press beginning to latch onto more positive cyclical stories and crisis anecdotes would begin to fade from consciousness.

Even so, we did not, and do not, translate the gargantuan doses of unorthodox policy into a higher expectation for inflation. This owes in part to our understanding that high inflations are not the direct consequence of bank reserve creation and our observation that whilst UK, US and Japanese Central Bank actions were massive in their scope, they have been most conservative in their application: being directed at sovereign debt and mortgages pools only. We therefore rejected the idea that asset allocation should be made in tune with what we deem to be fallacious understanding of the cause and effect of Central Bank actions. This more than anything accounted for the zero allocation to gold, commodities and inflation linked bonds.

Disappointment in these areas has now been tasted so, all other things being equal, we find ourselves struggling to dislike these investment areas as much as we did last year, even though this reduced dislike hardly translates into a commendation. If Mr Smiley has an emoticon for such a position it would be a crooked mouth below a furrowed brow.

If we were to consider building 2014 themes on the losers of 2013 this would entail a surreal concoction of core bonds and junior miners. It is hard to imagine a more widely spaced set of dumbbells.

Sentiment indicators are suggestive of relatively high participation in equity markets, whilst being short of an outright, clear statistical signal that cover should be taken. We temper these top down observations with recent bottom up work which confirms the average Price Earnings ratio of the equity portion of our portfolios runs to 14x which inverts to an earnings yield of just above 7%. That 7% number gives some clue to what we might expect as an annual nominal return from equities on a forward looking basis.

Returns from equities tend to be somewhat uneven – though bond investors are shy in admitting their asset class provides much more uneven returns when looked on a properly long term, generation-by-generation basis.

In truth, the professional investor <u>should</u> have little to say about forward investment returns on a 12 month forecast. The time period is not long enough for valuation considerations to have their say and short enough for momentum to have a great say. A good deal of the return comes from the "don't know" factor.

We are encouraged by the investments that we own on behalf of our clients. We are encouraged by further signs that falling correlations are suggestive of normalisation running its course. We are not yet minded to gainsay the Central Banks. The winter menu card therefore reads as follows (overleaf):

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Investment beliefs for 2014 and beyond

- The establishment of global recovery means subtle changes to the investment debate
- Within markets: falling correlations are now strongly suggestive of normalisation at work
- The gap between US and European economic performance and earnings generation is now extreme
- The absolute case for Japan is not as strong as in late '12/early '13 but its relative merits against other areas has improved
- We judge the greatest risks to be in Emerging Markets, across the piece in equities, bonds and FX
- Fixed income is neither "fixed" nor "income"
- Of the liquid asset classes, equities rank best in terms of our expectation of real returns

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