| 26 April 2021 |

John Wyn-Evans
Head of Investment Strategy

What's Cooking

I enjoy cooking, although I would never describe myself as a “chef”. I follow recipes to the milligram, and usually measure out all of the ingredients and have them arrayed in bowls on the kitchen counter, just like they do on TV. My mum was a great cook, and she, too, approached meal preparation with the precision of a structural engineer. My Canadian mother-in-law, though, is a different beast. Amongst other delights, she makes the fluffiest pancake stack in North America (I’m hoping for extra helpings this summer!), which is even better when topped with bacon and maple syrup. However, whenever we ask her how to replicate such deliciousness, she professes not to know exactly how much of everything went into them – or even all of the ingredients, because they change every time depending on what’s in the fridge or cupboard. “Oh, just a bit of this and that”, she airily replies.

It might be stretching an analogy a bit far to say that investing is like cooking, but there are, to my mind, many similarities. There is certainly a library’s worth of books available setting out rules and strategies that “guarantee” investment success, but which, in reality, will probably only guarantee royalties for the authors. I have a book on my desk entitled the “New Book Of Investing Rules”. It contains tips from no fewer than sixty-four well-known investment luminaries, and while there are many practical, common-sense pieces of advice, it fails to provide any sort of magic dust to sprinkle over a portfolio to guarantee positive returns (and especially when one brings relative benchmarks into play). Indeed, I know that pretty much all of the contributors who have run “active” money have, at some point in their careers, fallen well short of both their own and their investors’ expectations.

Perhaps the ultimate expression of “rules based” investing is found in quantitative strategies. “Quant” funds often employ people with backgrounds (and PhDs) in mathematics and physics. Indeed, quant investing really took off in the 1970s when the emergence of the Efficient Market Hypothesis (EMH) from the Chicago School of Economics intersected with the ready availability of unemployed physicists who had been lured to the subject by the excitement of helping to put men on the moon. They suddenly found themselves at a loose

end when NASA had its budget slashed, with funds required for continuing the war in Vietnam and for President Johnson's Great Society initiative (the combination of policies often referred to as "Guns and Butter").

Many Quant funds focus on the mining of historical market data, which they then use to build correlation models that can "predict" the relative movements of different asset classes or individual securities. Others will use high-frequency current data to establish market trends, sometimes lasting just a few seconds. Yet others invest in specific "factors", such as Value or Small Cap, which they believe have an outperformance edge over time. (Factors are a bit like the "dark matter" in the universe. Adherents of the EMH invoke them to describe the excess returns available from the bits of the market that are not actually efficient. Er, so they are not efficient after all, then!) The possibilities are endless. And yet, even these vehicles have their limitations. An article in the Financial Times last week pointed out that since 2010 there have been only three years in which more than half of quant mutual funds have outperformed their benchmark. It described the last decade as a "Quant winter". Even so, the first quarter of 2021 has been more successful for the industry, with 65% of funds reported to have beaten the benchmark. Unsurprisingly, this is being invoked as a new dawn for quants. We shall see.

Suffice to say at this point, then, that we are not rules-based investors. But we do have a philosophy and a process. And we have certain touchstones to guide us. One, which is a fair value model of the S&P 500 Index based on the relationship between projected dividend payments and the current 10-year bond yield, informs us that valuations are looking at bit stretched at the moment, although certainly not in the sort of territory that invites a crash. But we all know that valuation on its own is just about the worst judge of market timing. "Markets can remain irrational longer than you can remain solvent", as John Maynard Keynes pithily said many years ago. Of course the situation could also be resolved either by lower bond yields or an increase in dividend payment expectations (or even, in a perfect world, a combination of the two).

Not that we believe that markets are irrational. The first quarter corporate reporting season has so far been exceptional, at least in terms of beating revenue and earnings expectations, even if not in the reaction of the average share price (possibly a sign of having travelled and arrived). In the US (S&P 500) the average year-on-year earnings growth reported so far (to 23/4/21) by the 18% of companies to report has been 64%. That's a positive surprise of 37%. In Europe (EuroSTOXX 600), the figures are +47% EPS and a 24% positive surprise from 16% of the constituents. These numbers have been achieved on revenue growth of 6% and 3% respectively, testament to the powers of strong positive operating leverage. Markets tend not to fall back very far when earnings are so strong. And we have not even embarked properly on the much vaunted re-opening trade yet.

Then there is monetary support. Up to the plate last week was Christine Lagarde of the European Central Bank. Not a hint of policy tightening here. Indeed, that remains the consistent message from all developed market central banks, with the exception of Canada's, which was the first to announce a tapering of asset purchases last week. Mind you, my spies in Canada inform me that houses are regularly being sold at a 20%-plus premium to the asking price, and also that, apparently, there are more realtors than houses for sale in Toronto! Maybe a bit of froth does need to be taken out of that housing market. Again, markets tend not to have catastrophic reversals when policy remains this loose. Goldman Sachs's Financial Conditions Index (FCI) for the US is at an all-time (post-1998) low – that is, very loose. Of course, the "glass-half-empty" response is that the FCI can't be more accommodative.

Next is fiscal policy. Prime Minister Trudeau in Canada was the latest to announce a bumper proposed budget last week, no doubt with an eye on the next federal elections which must take place by October 2023 at the latest. The Italian Prime Minster, Mario Draghi, also unveiled a €220bn revamp of that economy, this to be

financed with the help of funds from the European Union's pandemic recovery package (now almost a year since conception, but yet to be delivered). In Germany, next September's election seems destined to deliver a new Chancellor who will continue to be supportive of further EU integration, and, if the Green Party ends up having a big say in the formation of the inevitable coalition government, then even more spending on similarly-coloured projects.

Of course, as we have just seen with the UK's record fiscal deficit of £303.1bn in the 2020/21 year, there are plenty of liabilities being stacked up too. And so fears of higher interest rates and bond yields abound. They, in turn, are also influenced by inflation, but the expected second quarter Big Spike in headline consumer prices has yet to materialise. April's data (scheduled for the second week of May) will be very informative, both from the point of view of the reported numbers and from the reaction of markets (in terms of both bond yields and inflation expectations).

On the negative side of the ledger, we cannot ignore the threat of increased taxes. In the UK, Chancellor Sunak, in his March budget, outlined proposals for higher future corporate taxation, as well as introducing some tightening of personal taxes, primarily through lack of indexation to inflation of various allowances. The Democrats in the US have already laid out their plan to reverse the Trump era corporate tax cuts, and there is gathering momentum for a global minimum corporate tax rate to negate the effects of companies transferring intellectual property to low-tax countries, such as Ireland. On the personal taxation front, the Biden administration also floated the idea of a an effective doubling of the Capital Gains Tax rate from the current 20%, to help fund the government's huge fiscal deficit. The policy of squeezing more tax out of those who have benefitted from COVID was recently endorsed by the International Monetary Fund. It would target both companies that have been winners from the shift to online activities and individuals whose wealth has increased thanks to policy support for financial assets. As we have commented before, this attitude towards higher taxes on (unearned) wealth seems to be increasingly popular at the ballot box.

Finally, a monthly Treasury survey of independent economists predicts that the UK is set this year for the sharpest economic growth for 33 years, as the easing of COVID restrictions encourages consumers to spend. It highlighted that City analysts have again upgraded their projections for 2021 growth, with the average forecast this month at 5.7%, up from 4.7% in March. Some economists are predicting more than 7% growth. For those struggling with the arithmetic, 33 years ago was 1988 – the heyday of the yuppie and Harry Enfield's character Loadsamoney. This period is the biggest hole in my UK cultural experience (I mean, who were Bros?), because I was working in the United States at the time, experiencing some very different cultures, but, it seems, few of the excesses that were prevalent in the UK at the time of the "Lawson Boom". The Chancellor of the Exchequer (theoretically) no longer controls monetary policy, but the current members of the Bank of England's Monetary Policy Committee seem content to keep the monetary taps open for the foreseeable future.

And so while following our investment recipe, we also have to keep testing the flavour and adding refinements where necessary. It's quite possible that the pot will keep boiling and it could, indeed, boil over at some point. We are trying to judge when we need to turn down the heat. But we don't think we are cooking a soufflé that is going to collapse at the slightest whiff of cold air.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Polymetal International Plc	3.8%
Johnson Matthey Plc	3.4%
Smith & Nephew PLC	3.3%
AVEVA Group plc	3.2%
Avast Plc	3.1%
Croda International Plc	2.8%
Entain PLC	2.6%

FTSE 100 Weekly Losers

Melrose Industries PLC	-8.6%
Informa Plc	-7.7%
Imperial Brands PLC	-6.0%
Standard Life Aberdeen PLC	-6.0%
British American Tobacco p.l.c.	-5.8%
International Consolidated Airlines Group SA	-5.5%
Associated British Foods plc	-5.5%

FTSE 100 Index, Past 12 months

Source: Factset

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London EC2V 7QN.

Investec