Investec

OUT OF THE ORDINARY

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Portfolio management as artistry

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As I find myself entrusted with writing the Weekly Digest, it feels much like a novice artist being handed a paintbrush for the first time. My aspiration is, while John Wyn-Evans is away, I manage not to smudge his creation.

An intriguing revelation to share might be that I never imagined ending up in the world of investments or anything connected to finance. I've always had a curious and creative mind, and during my youth, aspired to be a writer. Life had other plans though, and luckily, I've ended up building investment portfolios.

Like an artist may approach a blank canvas, portfolio construction can resemble the creative process of painting. By employing a palette of colours and arranging in different combinations with varying brushstrokes, artwork can be rendered distinct. Similarly, bringing together investments in a particular way can align with unique needs of clients.

Portfolio brushstrokes

Portfolio construction commences with defining goals and planning, as clients outline their financial aims and risk tolerance. The next step involves asset allocation, which is similar to a painter choosing a canvas and arranging elements for a well-balanced composition. Just as artists meticulously select colours, brushes, and techniques, portfolio managers opt for stocks and funds to capture specific themes or opportunities. Artists make refinements during painting, and portfolio managers may choose to re-organise portfolio holdings to deliver better risk-adjusted returns. Both must adapt to changing conditions – the artist to lighting and mood, and the portfolio manager to changing client circumstances and long-term market fundamentals. Lastly, just as an artist steps back to assess the overall painting, a portfolio is monitored and rebalanced so it effectively captures client needs throughout life's journey.

The changing 60/40 portrait

Artists throughout history have pushed the boundaries of traditional artistic norms, leading to the emergence of new styles. From the Renaissance's realistic representations to the abstract forms of modernism, artistic movements have evolved in response to changing societal values and innovative techniques. Similarly, investment theories have transitioned from simplistic heuristic rules to more nuanced strategies, incorporating factors like behavioural biases and technological advancements.

Back in 1952, Harold Markowitz, a recipient of the Nobel Prize, developed something called Modern Portfolio Theory, which for many years was the foundation of portfolio construction. This foundation comprised of 60% equity and 40% fixed income and was designed to provide investors with the highest possible return per unit of risk. Markowitz's theory was a game-changer, revealing that the collective performance of a diversified portfolio had greater significance than the outcome of any single security. Despite initial doubts, the 60-40 portfolio's ability to produce a smoother investment experience compared to an all equity counterpart stood the test of time. Not only was this method of building portfolios elegantly simple, but it also yielded favourable risk adjusted returns.

By now, it's well known that 2022 presented challenges for investors, particularly for those with diverse portfolios involving stocks and bonds. Central bank actions have caused unusual dynamics in capital markets, revealing the 60/40 allocation is no longer aligned with modern market conditions. Unlike the typical inverse correlation, where stocks and bonds usually move in opposite directions during market stress, this pattern didn't hold true in 2022. As humans, we often stick with what's familiar instead of reconsidering and adjusting to new situations. It might be wise to view theories as formulated for "the long run, but not for the indefinite long run" (Harry Markowitz).

It's important not to adopt the approach of "once done, leave it unchecked", while also avoiding allocation changes due to market noise. Negative returns from both equity and bonds are generally rare occurrences. Moreover, steep inflation and historic rate hikes are in part a consequence of the pandemic, a rare global outbreak. Indeed, the dramatic reset last year is allowing diverse portfolios to be constructed with a higher allocation of fixed income, a prospect not seen in years. Higher yields enhances bonds usefulness within a 60/40 portfolio, providing a more substantial buffer against potential equity losses.

Most of our client portfolios won't follow a 60/40 structure, this precise allocation may not suit financial circumstances. Additionally, the investment universe is much broader than just stocks and bonds. Our multi-asset portfolios also include other asset exposures like alternatives, meaning there is scope to add genuine diversifiers with return patterns different to traditional assets.

Evaluating factor exposures to examine the detail in the painting

Markowitz's work showed that as more assets are added to the portfolio, unrewarded (asset-specific) risks can be diversified away. These assets, however, are still subject to an inherent return premium that can be explained by some underlying common factors. This challenges traditional asset class thinking that distinct asset categories differ significantly. Instead, they might have more similarities in return drivers than previously thought.

Having an in-house risk team means we can look under the hood of certain asset classes and identify common factors that may be impacting the performance of the portfolio.

Just as a painter looks upon different colours to convey different emotions and textures, we can evaluate specific traits or 'factors' that historically influence returns. Each factor is like a unique colour on a palette, contributing to the overall risk/return profile of the portfolio.

Imagine a factor palette with these colours:
1. Value: Represents stocks that are undervalued. Similar to how a delicate brushstroke enhances a painting, these stocks have the potential for rewarding returns once the market appreciates their true significance.
2. Momentum: Similar to a bold stroke that adds vitality to a painting, these stocks carry the momentum of their past performance based on upward or downward trends.
3. Quality: Like an artist's meticulous detailing, quality has a sharp focus on a high return of capital and accelerating revenue growth. These stocks have strong balance sheets with minimal debt and strong pricing power.
4. Low volatility: Just as a steady paintbrush stroke can maintain a steady line, stocks with low price volatility generally display greater steadiness during market downturns.

The list of factors in which we can have an opinion on is extensive. These include macroeconomic factors which correspond to the principal drivers of asset class returns such as GDP growth, real interest rates and inflation. Factors can also differ between asset classes and fixed income factor exposures could include, duration, convexity, and credit spread to name a few.

Factor diversification is a relatively new concept that is gaining attention. Some portfolio practitioners even view it as a preferred method to traditional asset allocation. We see it as a way to complement the traditional. Factors have the potential to highlight the blind spots that traditional portfolio theory may not cover. By, for example, revealing parallels in characteristics between one subset of fixed income (corporate credit) and a subset of equities, linked by returns to economic growth and company profitability.

The Final brushstroke

Similar to how an artist's muse guides the creation of a painting, portfolio construction should be guided by the unique needs and aspirations of a client. This trumps attempting to predict the unpredictable shifts in market trends and correlations. It's about tailoring rather than theories. It is often said in portfolio management that all you can hope for is being right more often than being wrong. Expanding on this, when wrong, the strategy should at least be the right one for the client.

Question of the week:

Last week's question: Which English Football League One team has its home ground at the Abbey Stadium?
Cambridge United

This week's question: What is the youngest college at Cambridge University?

Economic Commentary

This Week's Forthcoming Events

US	Existing Home Sales SAAR
US	Markit PMI Manufacturing SA (Preliminary)
US	Markit PMI Srvices SA (Preliminary)
US	New Home Sales SAAR
US	Durable Orders SA M/M (Preliminary)
UK	CIPS Manufacturing PMI SA (Preliminary)
UK	CIPS Services PMI SA (Preliminary)
UK	CBI Distributive Trades Survey Realized NSA
EU	Markit PMI Composite SA (Preliminary)
EU	Markit PMI Manufacturing SA (Preliminary)
EU	Markit PMI Services SA (Preliminary)
EU	Consumer Confidence Indicator (Flash)

UK – The Office for National Statistics revealed in April to June 2023, the annual growth rate for regular pay (excluding bonuses) was 7.8%. This is the highest annual growth rate in regular pay since comparable records began in 2001. Total pay, which includes bonuses, increased 8.2%. The annual rate in total pay was lifted by one-off bonus payments by the government to NHS staff in June. The more recent July numbers from HMRC indicated a slowdown in median pay growth, providing some solace.Curiously, wage growth figures appear to have coincided with a decrease in labour market strength. Over the three months leading up to the end of May, the UK unemployment rate increased from 4% to 4.2%. This rise is the sharpest since the three months ending in October 2021 and occurred more quickly than the Bank of England had predicted. The Bank of England projected the unemployment rate to remain below 4% until the end of 2024 in its May monetary report. HMRC numbers and a loosening in the labour market may suggest a more cautious stance could be taken with regards to raising rates. However, it's more likely the Bank of England will remain focused on its mandated 2% inflation target. With consumer price inflation confirmed as 6.8% down from June's 7.9%, there appears to be a need for a further rate hike. Although the government cannot directly manage inflation, they understand fulfilling the inflation pledge is important to voters. Election fortunes are closely tied to actions taken by the Bank of England with Jeremy Hunt remarking last week "while prices are slowing, we're not at the finish line. We must stick to our plan to half inflation this year and get it back to 2%".

US – The two-day Federal Reserve meeting concluded with a 0.25% increase in interest rates. The latest increase brings the target range for the funds rate to 5.25% to 5.50%. Minutes emphasised upside risk to inflation remains, opening the door to additional hikes. All members were in agreement about the decision to increase rates, although two members suggested it may have been premature. Last week, marked one year since the Inflation Reduction Act was passed into law, aimed at assisting the Federal Reserve in combating inflation. The name has posed a branding challenge with Joe Biden himself admitting "I wish I hadn't called it that, because it has less to do with inflation, than it has to do with providing alternatives that generate economic growth". The act reflected an inflection point in US climate policy by dedicating $369 billion to clean energy initiatives. While the act may not have reduced inflation over the last year it has made the US an appealing destination for clean tech manufacturing companies due to the range of tax incentives available.Amidst the coverage of the Federal Reserve meeting and Inflation Reduction Act, numerous reports highlighted remarks from a Fitch ratings analyst. The analyst cautioned if the broader banking industry faces another downgrade, credit ratings of many US banks may need to be re-evaluated.

Europe – Gross Domestic Product in Europe expanded 0.30% in the second quarter of 2023. Industrial production increased 0.5% on the month, surpassing expectations for a 0.2% rise and achieved despite falling output in France and Germany.

China – As China's economy struggles to find momentum, China's central bank has stepped in to defend the renminbi. The daily midpoint for the renminbi was set at 7.2006 against the dollar, while the Hang Seng benchmark index closed in bear market territory in the Friday session, more than 20% below its last highs set in January. China unexpectedly lowered its medium term financing rate by 15 basis points to 2.5%, earlier last week. At the time of writing, China has announced a similar reduction in the one year loan prime rate by 10 basis points, but has kept the five-year loan prime rate unchanged at 4.2%.

Economic Commentary

FTSE 100 weekly winners

Admiral Group plc	7.0%
B&M European Value Retail SA	5.2%
JD Sports Fashion Plc	4.5%
Coca-Cola HBC AG	0.2%
Polymetal International PLC	0.0%
Evraz PLC	0.0%
Sage Group plc	-0.3%

FTSE 100 weekly losers

Abrdn plc	-13.4%
Entain PLC	-10.5%
Persimmon Plc	-9.5%
Antofagasta plc	-9.3%
Ocado Group PLC	-8.6%
Anglo American plc	-8.3%
Schroders PLC	-6.8%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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