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Previously Investec
Asset Management

Why defence still makes sense

The fast view

- Last year, we wrote about why defence makes sense even when markets continued to reach new heights. Then the pandemic hit, bringing with it the fastest, sharpest drawdown yet seen.
- One year on, we're making the same case based on the same underlying concerns we've had about the changing structure of markets since 2008.
- We explain these changes, their causes and their consequences, in this piece. Namely, that we believe investors should continue to expect more frequent and larger drawdowns in future.
- An inherently unstable world, yes, but we think it's the one we've been living in since 2008. It's why we designed a defensive strategy to navigate less stable market conditions and why we believe – whether you are optimistic or not – **defence still makes sense.**



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Introduction

Even before the pandemic, the backdrop for markets and economies was unstable. It is considerably less predictable now. While the dramatic collapse in asset prices in March 2020 was unique, we think investors should expect more and larger drawdowns than prior to 2008.

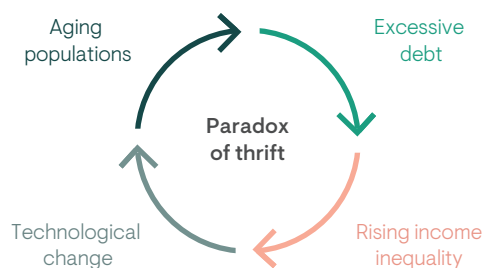
‘Secular stagnation’

‘Secular stagnation’ was first coined by the economist Alvin Hansen in 1938. Back then, the US economy was struggling to escape from the Great Depression. Hansen suggested that slowdowns in population growth and technological advancement were suppressing both investment and consumer spending. This, he believed, would stop the US economy achieving full employment indefinitely. Hansen’s pessimistic thesis turned out to be wrong, but only perhaps because of the outbreak of the Second World War.

"The core problem of secular stagnation is that the neutral real interest rate is too low."

Larry Summers, another prominent US economist, resurrected Hansen’s theory in 2013. He believes that again we live in a world of insufficient demand, where people are saving too much. Deficient demand makes it difficult for an economy to grow at capacity, and excessive savings mean that it requires very low real interest rates to stimulate demand. Together, these effects make it hard to achieve adequate growth, full employment and financial stability simultaneously.

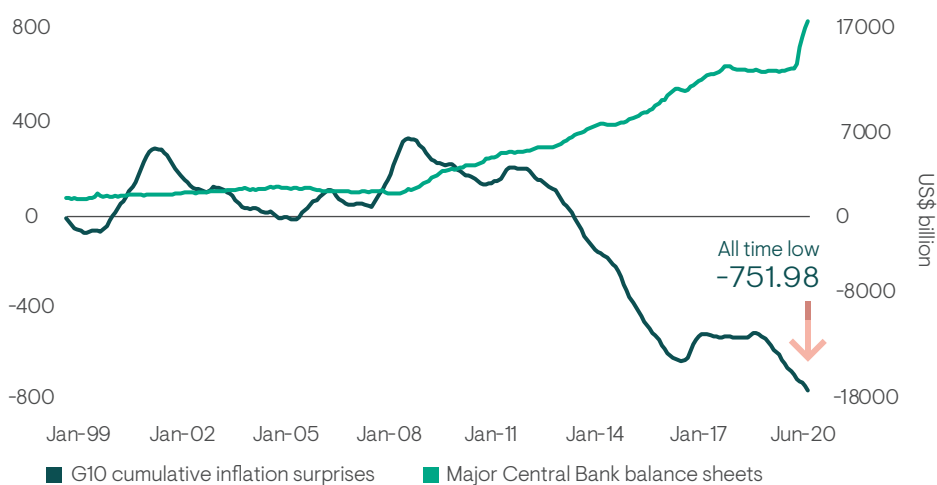
The forces potentially contributing to a lack of demand and excess savings are well established. They include: aging populations, excessive debt, rising income inequality and technological change.



According to Summers, “Secular stagnation occurs when neutral real interest rates that balance saving and investment at full employment are sufficiently low that they cannot be achieved through conventional central bank policies. At that point, desired levels of saving exceed desired levels of investment, leading to shortfalls in demand and stunted growth”.

Since the global financial crisis (GFC), it has become increasingly hard to argue against this thesis. Ever-looser policy has failed to deliver consistently stronger growth or higher inflation.

Inflation has undershot expectations since the GFC



Source: Ninety One, Bloomberg, Citibank Inflation Surprise Indices, June 2020.

The inevitable side effect, Summers says, is that “sustained low rates tend to promote excess leverage, risk taking and asset bubbles.” In other words, the world of secular stagnation is inherently unstable, with the forces which are undermining growth requiring ever-looser policy to offset them, resulting in economic and financial market stress and sharp episodes of volatility.

Worsening liquidity

Since the GFC, other factors have tended to reinforce market instability. In August 2019, Bloomberg reported that, since 2007, average daily turnover in US Treasury bonds had fallen by over 60%, with a similar drop in trading in the corporate bond market. Large declines were also observed in the equity and futures markets. According to Bloomberg, other indicators of worsening liquidity included 'significant intra-day moves, frequent price spikes, higher volatility of bid-offer spreads and the proliferation of flash crashes such as the sharp increase in the Cboe Volatility Index, or 'VIX', at the end of 2018 and the Japanese yen flash in January 2019'.

These trends likely reflect changes in market structure over time, such as the diminished capacity of banks to use capital to support market-making, as well as the growing influence of algorithmic trading and the rise of passive investing. Whatever the causes, the implication is that scarce liquidity can be expected to exaggerate market moves in the future, particularly to the downside.

Evidence of instability

As well as the increased preponderance of sharp market swings highlighted above, there are other signs of increased asset-price instability. For example, the equity bull market following the GFC has been far messier, especially in terms of drawdowns, than the one that preceded it, with many more large falls in price over the past decade than before the crisis.

More extreme drawdowns in MSCI ACWI since the GFC



Source: Ninety One, MSCI data, July 2020.

With poor market liquidity and an even more extreme imbalance between the range of negative impacts on growth and the extraordinary policy adopted by central banks to support economies in the aftermath of the COVID outbreak, investors will likely need to be even more focused on finding ways to live with skittish and vulnerable asset prices.

This supports the case, we believe, even in those periods when risks appear to have diminished, for allocating a portion of portfolio exposure to defensive strategies designed to navigate less stable market conditions – whether you are optimistic or not, in a world that appears inherently unstable, **defence still makes sense**.

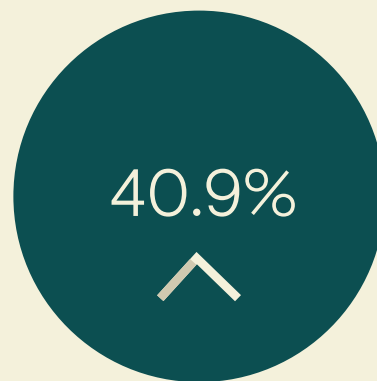
Call us pessimists, or 'cautionists', but we think we have been living in this increasingly unstable world since 2008. With an inception date of September 2012, the Diversified Income Fund (DIF) was born into this world and has navigated some very different, and often challenging, market environments.

In that time, when equity markets fell the Fund only experienced 16% of those losses.



Downside capture

While if the market gained, DIF experienced 41% of those gains.



Upside capture

Past performance is not a reliable indicator of future results, losses may be made. Diversified Income Fund average monthly gain and loss as a proportion of UK Equities average gain and loss.
Source: Ninety One, in GBP gross of fees and taxes with income reinvested, UK Equity returns are for FTSE All Share Index, from 1 September 2012 to 31 July 2020.

By concentrating on minimising this downside correlation to markets, we've produced significantly more upside capture relative to downside. While we have a focus on downside mitigation – which has been a powerful attribute in compounding returns over time – ultimately, we believe a defensive total return is best achieved not by never going down, but by participating to a greater degree when markets are rising than when markets are falling.

Final thoughts

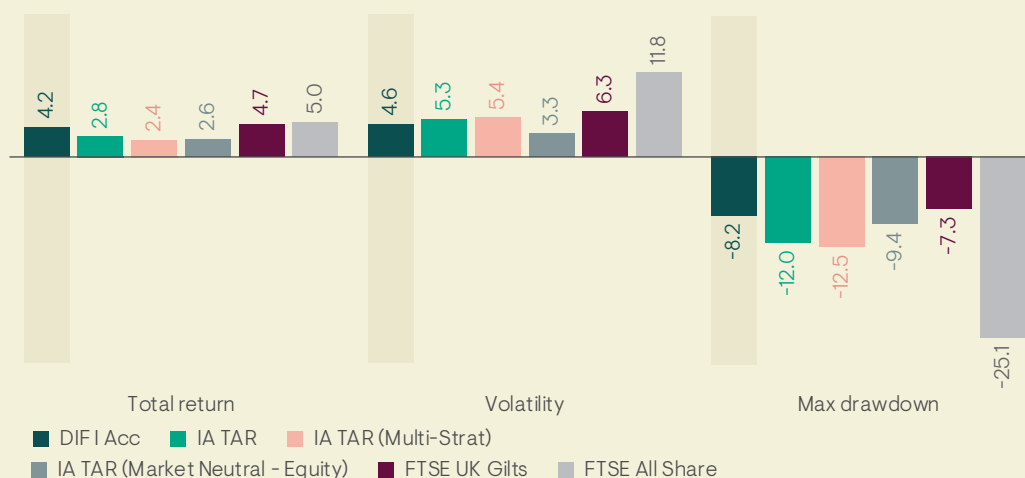
Looking forward, we believe DIF is designed for this hyper uncertain environment where there will likely be big moves in both directions. We believe we have the flexibility that is required in order to navigate increased instability, and an appropriate focus on striking a balance between generating a consistent total return but in a risk-managed way.

Now is not the time to be complacent, but to strive to understand our unstable world – the imbalances, risks and opportunities – to provide investors with a defensive strategy that makes sense, even if the world doesn't.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made..

Specific risks. **Currency exchange:** Changes in the relative values of different currencies may adversely affect the value of investments and any related income. **Default:** There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. **Emerging market:** These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. **Equity investment:** The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. **Government securities exposure:** The Fund may invest more than 35% of its assets in securities issued or guaranteed by a permitted sovereign entity, as defined in the definitions section of the Fund's prospectus. **Interest rate:** The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise.

Since inception: total return, volatility and max drawdown



Total return	2019	2018	2017	2016	2015	2014
DIF I Acc GBP	5.4	0.4	4.8	5.9	2.0	5.4
IA TAR	5.2	-2.7	4.3	3.1	2.6	5.2
IA TAR (Multi-Strat)	7.3	-3.0	3.4	2.3	2.5	7.3
IA TAR (Market Natural - Equity)	-2.4	-2.2	5.0	0.2	3.2	-2.4

Total return	2019	2018	2017	2016	2015	2014
FTSE UK Gilts	6.9	0.6	1.8	10.1	0.6	6.9
FTSE All Share	19.2	-9.5	13.1	16.8	1.0	19.2

Past performance is not a reliable indicator of future results, losses may be made.
 Source: Morningstar, 31 July 2020. Diversified Income Fund performance is based on the I Acc share class, in GBP, net of fees. Sector performance is based on the primary share classes, as defined by the IA, in GBP, net of fees. The Fund does not have a benchmark index or sit within a relevant peer group sector for comparison purposes. The peer group sectors above have been chosen for the similarities of their funds' defensive investor outcomes to those of the Fund. Indices used are proxies for equities and bonds. Inception date: 01 September 2012.

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