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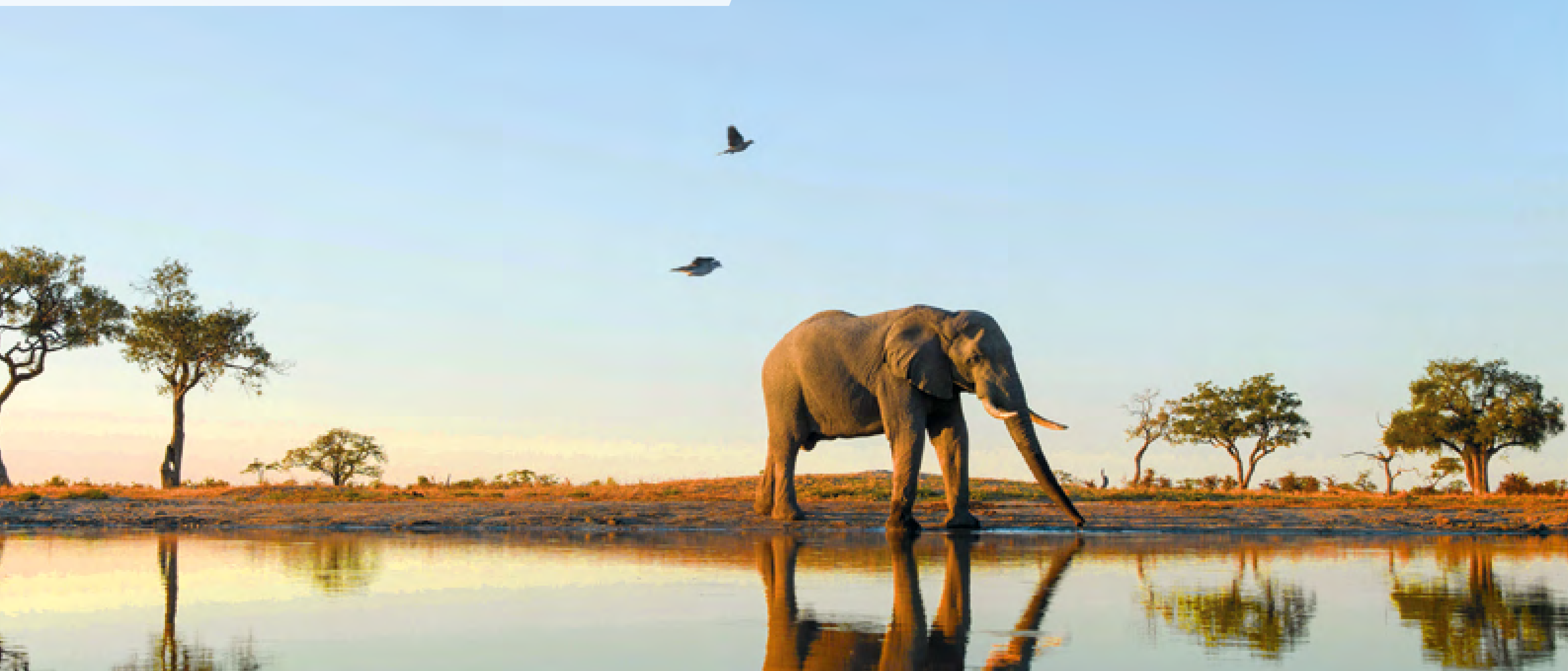
NEWS & VIEWS H2/2022



Discovering calm in turbulent times

Providing stability and reassurance during economic uncertainty

ALSO IN THIS ISSUE:

Inflation – what happens next?

Surviving the 'turbulent twenties'

Energy sources of the future

Putting our trust in bonds

cg Canaccord Genuity Wealth Management

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Welcome

Welcome to the latest edition of News & Views – and I would also like to extend a very warm welcome to our clients from Punter Southall Wealth (PSW), who are receiving this publication for the first time. I am delighted that many of the authors in this issue are our colleagues from PSW, and I am sure you will agree that they make a valuable addition to the breadth and depth of the investment expertise we offer you.

Our theme this issue is how to stay calm and navigate these turbulent times. It has been a roller coaster ride for markets since the beginning of the year: after the onset of the bear market, we saw a brief period of relief for investors in the stock market summer rally before market volatility resurfaced. We understand very well that this may be a worrying period for you. While the world may not have seen this exact combination of factors previously, at CGWM we have a wealth of experience in helping you to navigate market challenges. Markets will invariably fluctuate in the short term, and this only reinforces our view that it is vital not only to invest, but to invest for the long term.

High inflation, the impact it will have on savings and its contribution to the cost-of-living crisis are forefront of our minds – and therefore inflation is the main topic of conversation in this edition. On page 4 Michel Perera gives us his expert insights on how long the period of high inflation could last, how high the inflation rate could get, and how best to invest to try to combat its impact. On page 9 Tom Becket, from our Chief Investment Office, shares his thoughts on what may be in store for investors in the 'turbulent twenties', and how our investment approach can help steer you through them.

An important part of our strategy is fixed income assets. Kay Bendall caught up with Mark Holman, Partner at TwentyFour Asset Management, for an exciting interview on page 16, giving us an overview of inflation-beating investment strategies with fixed interest markets.

Many of us might hold cautious portfolios, but it is worth considering that traditional lower-risk portfolios may be anything but that in the current investment climate. Some have underperformed compared to equity-based portfolios, as Jane Tulloch discusses on page 20. Amid raised inflation rates and market volatility, could it be time to 'rethink cautious'?

Another way that we are tackling the effects of inflation in our discretionary portfolios is by taking a thematic approach to investing in specific sectors that we believe offer significant growth potential. One such sector is the climate transition industry – which we think offers opportunities for investors, as Patrick Thomas explains on page 12.

Have you thought about how best to pass wealth on to your loved ones? By 2047, a staggering £5.5trn will be passed down as inherited wealth. While we might find it difficult to come together as families to think about planning succession of wealth among generations, Andrew Chastney gives us practical advice on this important process on page 23.

I hope you enjoy this edition of News & Views. As ever, if you have any questions or comments, please do not hesitate to get in touch.

David Esfandi, Chief Executive Officer, CGWM

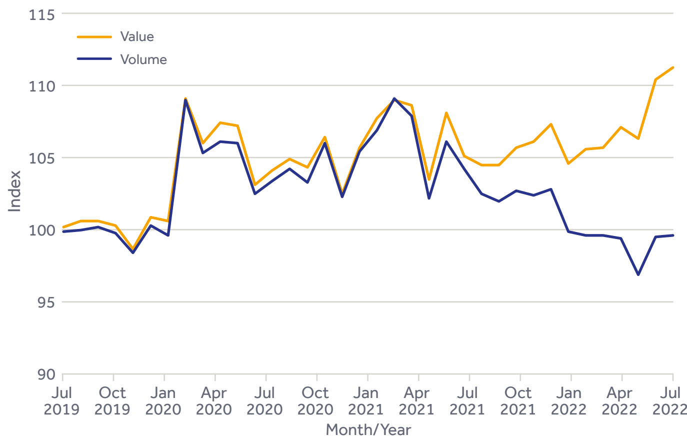
Michel Perera,
Chief Investment Officer

The future of inflation

According to economists, the cure for high prices is high prices, as inflation kills consumer demand and prices return to normal.

This may be accurate over a long period, but not necessarily in the short run. We pay more and consume less, but prices don't come down because the sellers adjust prices so they make the same revenue on a smaller volume.

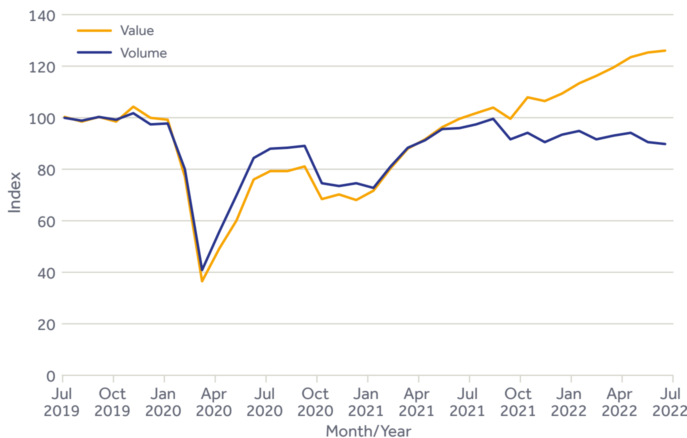
The effect of inflation: value sales of food continue to rise despite a decline in volume sales



Source: UK Office of National Statistics.
Volume and value sales, seasonally adjusted, Great Britain, July 2019 to July 2022.

Nor is inflation an accurate guide to how much people are spending. With energy costs soaring, consumers will cut back on other products or services. For example, if haircuts go up 30%, customers may space out their salon visits, but prices won't necessarily come down.

The rising cost of automotives: value sales increase while volume sales drop



Source: UK Office of National Statistics.
Volume and value sales, seasonally adjusted, Great Britain, July 2019 to July 2022.

How does inflation in the UK compare with other countries?

Let's take Germany and the US as examples.

If we look at Germany, the UK should logically see higher inflation, as we import half of our food, overwhelmingly from the EU, with tariffs and red tape adding costs to those imports. Also, the UK uses more natural gas than Europe in its energy mix.

In the US, inflation is key for investors, as the US Federal Reserve (Fed) drives global interest rates and therefore impacts inflation in the rest of the world.

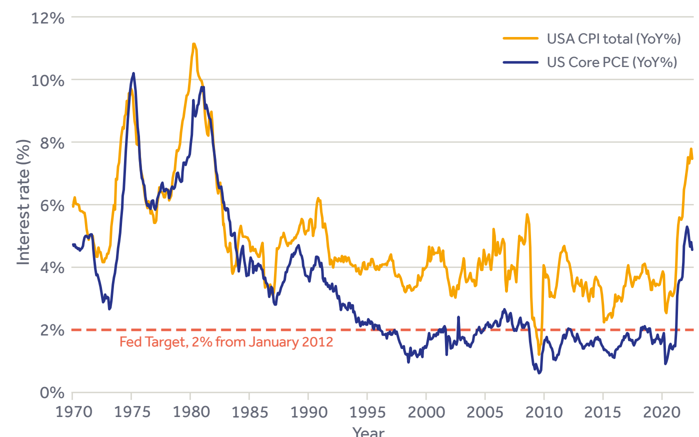
Inflation in the US could be sticky, as it has had time to spread throughout the economy, particularly into services and rents. This is less the case in Europe, where energy and food are still behind the bulk of price increases.

Wages are the long-term inflation setters. Here, the UK experience is worse than the US. In the US, decades of union weakness have made it difficult for the workforce to get pay settlements anywhere near inflation. In the UK, however, we are now seeing strikes from workers in areas such as transport, refuse collection, postal delivery, barristers, call centres and journalists, which bodes ill for wage restraint.

Does the US measure inflation in the same way as the UK?

The Fed's inflation gauge is technically the core Personal Consumption Expenditures (PCE) Price Index excluding energy and food (this is a measure of consumer spending used to track the price of goods over time), currently at 4.6%, rather than the headline Consumer Price Index (CPI) (which tracks consumer prices by measuring the average cost of a 'basket' of goods and services on a monthly basis) at 8.3%. It is hard to believe, however, that the Fed would not acknowledge consumer pain, and focus on bringing down the headline CPI before declaring victory on inflation.

Inflation outcomes: inflation is proving a more serious problem than the market and central banks expected



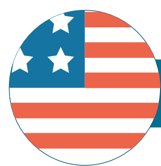
Sources: FactSet, US Bureau of Economic Analysis (BEA).

Which products or services have contributed the most to the rise in inflation?

Looking at the US and Germany highlights the issues, with the UK somewhere in the middle.

In the US, headline CPI is 8.3%, with core inflation (excluding food and energy) at 6.3%, whereas in Germany headline is 8.8% and core 3.5%. The majority of German inflation is driven by energy; in particular natural gas prices. In the US, inflation has spread to other expenditures. This is because the root cause of inflation in the US has been the massive COVID-19 subsidies sent to households in 2020 and 2021 (near US$2trn), allowing consumers to shop like crazy during lockdowns.

The UK lies somewhere in between. Core CPI (excluding energy, food, alcohol and tobacco) is 6.3% out of 9.9% headline CPI. Contagion from energy and food prices into total goods is significant and also starting to impact services.



US CPI details

Product or services	12-month CPI increase %
Energy	23.8
Food	11.4
Transport	11.3
Rent	6.3
Medical services	5.6
Clothing	5.1

Source: Bureau of Labor.

UK CPI details

Product or services	12-month CPI increase %
Energy	69.7
Food	13.4
Total goods	12.9
Total services	5.9

Source: UK Office of National Statistics.

So where is inflation heading?

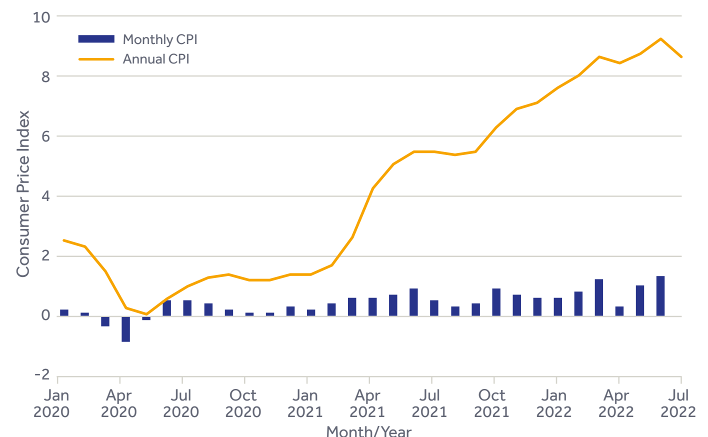
The US has probably seen the peak of inflation, but it may still lie ahead for the UK and Europe. Many investors think that the June 9.1% US CPI was the peak, whereas we might have to wait until early next year to see the peak on our side of the pond.

This is the wrong debate, though. What matters is how fast and far inflation levels come down.

Central banks are under the cosh and need to get inflation under control, lest their independence should be under threat. This should mean it is only a matter of time before inflation abates to more reasonable levels, although a recession might be needed.

If the increase was 'transitory', the rise and fall should be symmetrical; so to understand how inflation could fall, we should look at how it has risen. By comparing monthly Consumer Price Index (CPI) readings in the US with annual data, you can see how the numbers have surged. Once low monthly data (up to January 2021) fell out of the series, it was easy to reach 7-9% in annualised CPI. Conversely, for annual inflation to come down meaningfully, we are likely to have to wait for June 2023, when the high monthly readings at the beginning of 2022 fall off the 12-month numbers.

US monthly vs annual CPI



Source: Bureau of Labor.

Assuming this, US CPI would be back down to the 2% area in Q4 2023. The current spike in the UK has taken exactly one year to move from the 2% level, so, if price rises reach their peak in six months, we could conceivably see 2% UK inflation again in mid-2024 – almost two years away – although the Chancellor's tax cuts and spending plans may affect that timeline.

It is possible that central banks will reconsider their inflation targets. The 2% objective does not have much scientific backing and could easily be amended to 2.5% or 3%.

Where is inflation likely to settle in the long run?

Two opposing factors will influence inflation in the long term.

First, demographics: births in developed countries are now almost systematically below the replacement level of 2.1 children per woman. Long-term inflation is correlated with population growth, with Japan at the low end and African countries at the upper end.

Secondly, and conversely, COVID-19 has accelerated retirements and driven some people back into education or into leaving the country. The result is a much tighter jobs market, which feeds into higher prices.

In the long run, though, high inflation has generally been tied to exceptional events, such as world wars and the creation of the welfare state. Otherwise, steady-state price rises tend to be closer to the 2% central bank target.

Is 2% an acceptable inflation level?

It is possible that central banks will reconsider their inflation targets. The 2% objective does not have much scientific backing and could easily be amended to 2.5% or 3%. Being less dogmatic about inflation could spare the world a damaging economic downturn.

How do you invest to try to beat inflation?

Investment returns this year have been quite instructive as to what works and what doesn't in a high inflation environment.

- On the positive side (or less negative): energy, materials and defensive sectors (utilities, infrastructure, consumer staples); geographically, markets with high exposure to these areas (FTSE 100, Canada, Australia, Mexico, Brazil)
- On the negative side: technology and other growth sectors, notably companies with future rather than current profits; countries exposed to the Ukraine war fallout (Europe).

In addition to the above, Asian equities are likely to be more resilient. Indeed, some markets in the region (China, for example) have emerged from a long bear market and others (such as Japan) have low relative valuations. Renewable energy should also enjoy a tailwind as it complements traditional energy.

Rising and then falling inflation could play havoc with a concentrated portfolio, with some sectors see-sawing sharply against the price backdrop. We believe that portfolios that incorporate a balance of cyclical and defensive sectors with inexpensive valuations are well positioned to combat the effects of inflation. Our focus will remain on actively managing discretionary client portfolios, and investing to try to beat inflation.

If you have any questions or comments on anything in this article, or you would like to discuss your portfolio in more detail, please contact us.

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Tom Becket,
Chief Investment Office

The complex art of prediction

Investing in the 'turbulent twenties'

As an investment strategist, I have to make lots of predictions. When I am right, I hope that people will remember my prescient projections and give me the credit I deserve as Nostradamus reborn – although of course some predictions are easier to make than others.

Some long-term followers of my views would fairly say that I am often too cautious; my central philosophy with investments is to think about what can go wrong before evaluating the positives. Perhaps this goes down to my studying classics and the understanding that nothing, however certain it might seem at the time, is permanent.

Working together to find the best way forward

At Canaccord Genuity Wealth Management (CGWM), we cannot always predict the future. However, following the acquisition of Punter Southall (PSW), we are evolving and uniting our investment approach, based on PSW's 'inflation+' experience, combined with CGWM's expertise and proven investment strategy. We believe this will help to inflation-proof portfolios and give you 'the best of both worlds'.

It will ensure we remain fully focused on making the right investment decisions in the current inflationary situation, and on finding ways to inflation-proof discretionary portfolios over the medium to long term.

A predictive success

One prediction from recent times stands out as a successful prognosis – one that we put forward with a high degree of confidence. It relates to our expectations for the decade that we are presently enduring, and we constructed it in the relatively easy world of the late 2010s.

As we sat around the crystal ball in 2019 and thought about the decade ahead, we foresaw a myriad of uncertainties that would contribute towards a volatile period ahead. We declared that the times they were a-changing; we felt strongly that it would be a more challenging era in which to be a global citizen, consumer or investor. We believed that we would eventually look back on the 2020s as the 'turbulent twenties'.

Causes for concern

Our preeminent concern was around the structural imbalances throughout the global economy and the growing chasm between the fortunes of the rich and the poor. Our view was that the uneven economic experience of the last few decades would lead to greater political and societal friction.

We also recognised that we were moving away from the US-dominated world to a 'multi-polar' scenario where growing tensions would become obvious, not least between the world's two superpowers, the US and China. Trust would be in retreat across the globe.

Other worrisome factors included the realisation that despite a period of relative economic calm and moderate growth, governments had irresponsibly way overspent their incomes. The cupboards were bare, the purses were empty and there was no rainy day fund should any major economic threat arise. Governments had been afforded the opportunity to ramp up their teetering debt piles by the lowest interest rates observed in history and this philosophy of 'spend now, think later' would contribute towards greater inflation uncertainty.

Asset markets have proved in the past that they can cope with geopolitical, political and societal problems, as long as they are not expensive (the asset markets, not the problems). This would be the biggest impediment to returns this decade, as we saw it a few years ago. Investments had broadly been driven to high valuations by ever-supportive central banks, who had also implicitly encouraged governments to load up on debt, and, in many places, these valuations were too expensive.

Amazingly, we are yet to complete three years of this decade but already it feels as if the twenties have brought enough excitement for a lifetime. We've had the COVID-19 pandemic to throw into the heady mix of global risks, as well as the inflation-inspiring response that questionable government and central banks' actions have led to.

As an investor, you might understandably think about all these factors and decide you want to 'get off the ride'. We believe that would be a mistake and we suggest that rather than giving up on investments, you should simply think differently. The good news is that there is an antidote to the poisonous circumstances we are currently living in – and that is attractive investment opportunities.

So, which areas should investors focus on?

We believe there are certain themes that should help to mitigate the effects of inflation through the rest of this decade, aided by many of the global trends that we envisage dominating the economic outlook.

Healthcare

Whether we like it or not, we are all getting older; as a society we are greying. We will also lead longer lives and will want to live life as fully as possible for as long as possible. We expect this to lead to a golden era for medical development and exciting growth opportunities in the healthcare sector. The fact that the industry's earnings are dependable and offer inflation protection strengthens the case for investment. And if cash-strapped governments try to help in every way to keep us out of hospital, that could be the icing on the cake.

Energy

Another area where governments will have no choice but to splurge their taxpayers' cash is energy. The issues with Russia have shown just how badly prepared many countries were for an energy shock. Most governments believe the answer is a massive increase in renewables. Whether that is right or not is a moot point; the simple decision is to follow the governments' money and invest in a sector where there will be growth in the low-growth world that we envisage ahead.

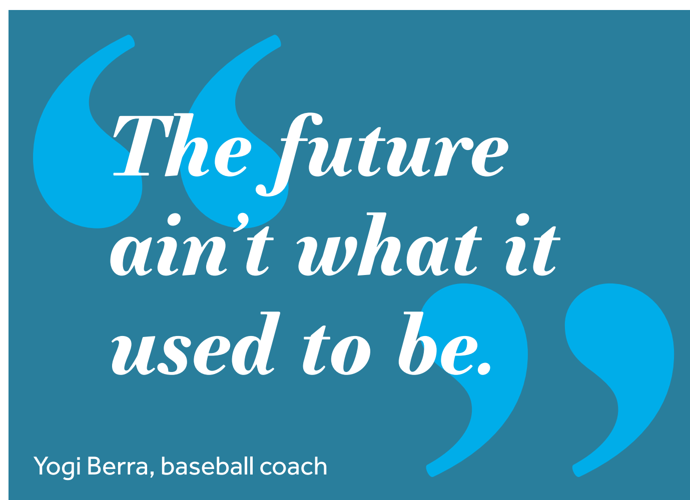
Infrastructure

The same can be said for infrastructure, where we should see the twin benefits of investment in new developments and in improving existing utilities as we reshape our economies. Both themes also offer the prospect of inflation-proofed revenues.

Could there be opportunities in fixed interest markets?

Outside equity investments, there is a growing list of assets that could help drive portfolio returns in the coming years.

This decade is likely to be very difficult in comparison to the last, but that is reflected in various fixed interest markets, where yields have risen aggressively to offer investors compensation. This has afforded investors a generational opportunity in certain corporate and consumer fixed interest markets, where if one is selective and specific there are opportunities in both higher-rated and more speculative companies' bonds. It would be irresponsible not to suggest that things could get worse before they improve (a lesson we have surely learned already this decade), but the seeds for future investment success have been sown in the major bond sell-off we have experienced in the last year.



This famous quote from baseball coach Yogi Berra might still hold true for certain factors across the world, but it doesn't need to apply to investment portfolios. It might be tougher to invest in the 'turbulent twenties' than it was in the 'easy tens', but we are excited by the prospects for our investment strategies.

If you have any questions about our investment strategy, your portfolio or anything else, please do not hesitate to contact us.

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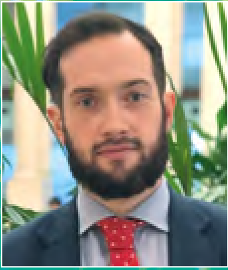
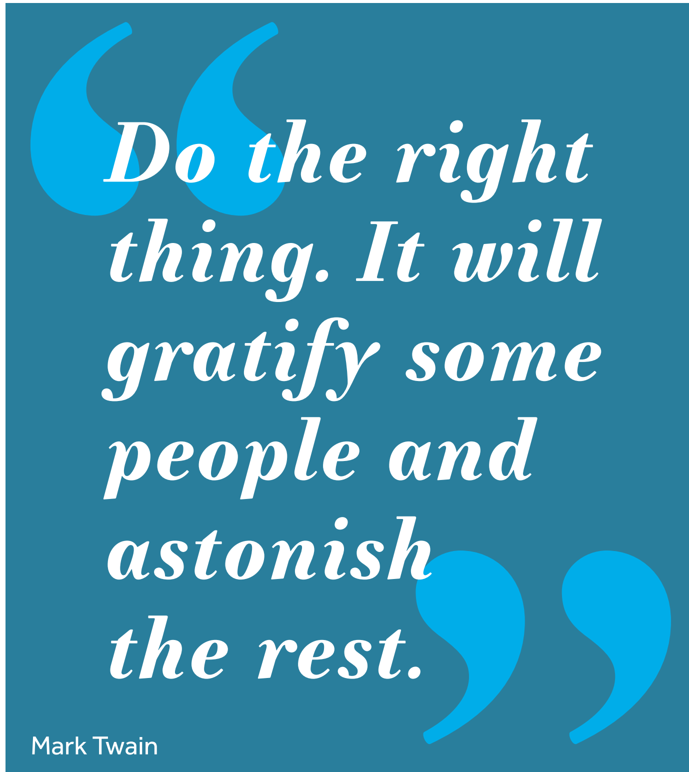


Patrick Thomas,
Head of ESG
Portfolio
Management

The Wright stuff: why we need more climate optimism

Media discussions around investing in clean energy tend to focus on the politics. However, we believe investors are better served by looking at the economics.

Discussions around climate transition often start from the negative premise of "How much is all this going to cost?" We prefer to consider the opportunities created in a changing economy for innovative companies that are helping various sectors to decarbonise. As a useful analogy, looking at the opportunities created by the digital revolution is a good way to think about the investing landscape.



First, some history. The American engineer Theodore Wright deserves more fame. In the 1930s he made an observation about plane manufacturing, noticing that each time the cumulative number of planes produced doubled, the cost of producing each plane fell by a fixed percentage. This went beyond aviation. Similar trends were found all over the manufacturing sector, from the production of semiconductors to the Ford Model T.

What is less well understood by the media is that this is applicable to many technologies at the core of the energy transition, from electric vehicles and solar panels to wind turbines and batteries. The numbers are even more striking than those seen in the manufacture of planes or Model Ts. The cost of solar energy has dropped by some 36% with each doubling of cumulative installed capacity.

However, looking at the energy transition numerically still misses the point about 'virtuous circles'. Cheaper products make customers more likely to adopt a given technology, adoption stimulates greater demand, greater demand leads to higher production volumes, higher production volumes lead to lower unit prices, lower unit prices lead to higher demand.

What could the digital transformation tell us about the transition to cleaner energy sources?

We believe the digital transition provides a useful framework for how the energy transition could unfold.

Back in 1980, Bill Gates defined success as "a computer on every desk and in every home". Over 40 years later, there is not in fact a computer in every home. He was not wrong, though. We have laptops, smartphones, tablets, and wearables. We have devices in our pocket with more processing power than the computers that powered the Apollo space missions. Measured against the targets of 1980, we have succeeded.

The first generation of green energy technologies, such as battery electric vehicles (EVs), solar panels and wind turbines, are now cheaper than fossil fuel equivalents. With plummeting costs and a growing profit incentive from the private market, we should expect an inflection in their deployment. Though the proliferation of digital devices has exploded since 1980, the growth of green technologies is likely to happen even faster because:

- Climate change is seen as an existential risk
- Trillion-dollar government budgets have been set aside for this explicit purpose.

From an investment perspective, the message is that decarbonising electricity production, transport and even food creates enormous and growing markets for companies providing solutions.

The future

When we think about the energy transition, we know the direction of travel (forms of energy that are less carbon intensive) but cannot forecast precisely who will be the winners. The beauty of a thematic approach is that we invest with a view to capturing a group of companies that are changing how we produce and consume our energy. We invest in the knowledge that the technologies helping the world to decarbonise now will evolve.

Much of the political language is unhelpful for investors. Terms like 'net zero' and references to 'pre-industrial levels' do not mean much from a portfolio perspective. This is like counting the number of PCs in people's homes and ignoring the smartphones. There are really two things that matter:

- There is a continuous deflationary trend as the cost of energy eventually falls, making all goods more accessible to consumers by reducing the costs embedded in their manufacture, distribution, use, and disposal
- This fall in the cost of energy will result in new businesses, ideas, and cultural habits that are unimaginable, just as the idea of meeting your significant other online would have been half a century ago.

Just as PCs were gradually replaced by laptops, tablets and smartphones, we expect EVs, solar panels and onshore windfarms to be replaced in turn by newer, cheaper, and better technologies, many of which are already seeing costs move quickly towards commercial viability. Onshore wind demand will slowly be cannibalised by demand for less obstructive and more efficient floating windfarms. Small offshore turbines will be replaced with bigger ones. EVs that take all night to charge may be superseded by ones that can be charged faster and travel further. Solar panels will likely be phased out by 3D-printed solar film which can be put anywhere and everywhere.

> *"I skate to where the puck is going to be, not where it has been."*
>
> Wayne Gretzky

Today

Today new renewable energy projects are cheaper than the cheapest fossil fuels. Major economies are phasing out subsidy programmes because they're simply no longer needed. The cost of solar electricity has fallen by 90% since 2009, and now represents one of the cheapest forms of energy ever produced.

However, there will be obstacles:

- Our grids will need substantial investment after almost half a century of underinvestment
- Supply chains have become creaky since the pandemic
- Storage is also a challenge.

Wind and solar energy are on a clear trajectory towards being radically better than any other form of energy generation available. We are moving to a place where we can absorb a fraction of the sun's energy and use it for energy needs. The next step will be understanding how we can decarbonise huge parts of the economy with very little additional technology.

There will still be some emissions in 2050. Industries like concrete manufacturing and farming are hard to decarbonise. That said, green energy means that they will still be less polluting than they are today, and carbon capture technology could mitigate some of the adverse effects.

If this seems naively utopian, consider the magic of compounding and technological change over time. The difference in 'development' between 2045 and today will be as big as that between today and 1922.

The politics of climate is controversial. The economics is much more settled. We see a thematic approach to investing in the companies that are helping the world decarbonise, as a way to think beyond the noise and invest in profound change. Along the way, maybe Theodore Wright will become more famous, even outside technology investing and scientific circles.

If you would like to find out more about our thematic approach to ESG investing, please speak to your Investment Manager.

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Kay Bendall,
Investment Director,
Adam & Company

There is always a place for bonds

Investing in bond funds to beat inflation

Inflation has reached double digits for the first time in 40 years and several more interest rate hikes are anticipated from the Bank of England.

In a situation like this, bonds might not seem the ideal place to look for investment opportunities. High inflation means interest rate rises and this in turn makes bond values fall. So why might now be exactly the right time to increase your bond exposure? For the answer, we turned to Mark Holman of TwentyFour Asset Management.

Mark has been a bond fund manager for 34 years, and he believes there is always going to be a role for bonds in an investment portfolio.

A change in direction

In general, when you are looking for bonds to provide protection and counterbalance the risk of equities, government bonds can be used as a risk-off* investment. They are normally perceived as lower risk than equities and the prices tend to move in opposite directions.

With the recent sharp increases in inflation, the usual dynamic of falls in equity markets being offset by rises in government bond prices has not held true so far in 2022. The Financial Times Stock Exchange (FTSE) UK Gilts Index (an index of British government securities) fell more than 14% in the first half of 2022, while the FTSE All-Share Index (which tracks around 600 companies traded on the London Stock Exchange) fell less than 5%.

However, bond investing can also be used in a risk-on manner*, by taking credit risk** to achieve higher returns. These two approaches can be blended at different points in the economic cycle to optimise returns from bonds.

*'Risk-on/risk-off' refers to investors' investment patterns in response to the perceived level of economic and market risk. When risk is seen as high, investors tend to move in to lower-risk, or 'risk-off' investments such as government bonds or cash. If investors anticipate that taking a higher risk will lead to a higher reward, they tend to move in to higher-risk instruments; for example, moving from investing in government bonds to equities.

**Credit risk refers to the probability of loss in the event that a borrower fails to make payments on a debt.

Equities vs bonds

What are the differences?

What are they?

Equities: Shares issued by firms

They offer ownership of a fraction of a company and are priced daily and listed on a stock exchange.

Bonds: Bonds are debt instruments

Issued by an institution to raise capital, with a promise to pay back the principal and interest.

Who issues them?

Equities: They are issued by companies

Bonds: Governments, companies and financial institutions

What is the type of return?

Equities: Dividends and capital appreciation

Potential returns on equities are not capped – i.e. there can be capital uplift and/or dividends.

Bonds: Fixed income and possible capital returns

The investor becomes a creditor to the issuer and is entitled to the annual interest rate paid on the bond (the coupon), plus the ultimate repayment of the principal. If investors buy below par (below market value), they also get a capital return when the bond matures and is repaid at par. Returns on bonds are capped to coupon and par/maturity value.

How risky are they?

Equities: Riskier than bond investing because the returns are not guaranteed

Market risk and business risk are the two main risks associated with equities. There is no guarantee of either dividends or capital appreciation.

Bonds: Lower risk than equities

The main risks are:

Interest rate risks – if interest rates rise, bond prices fall

Inflation risk – bonds are generally long-term investments and the value decreases over time

Credit risk – the issuer may not be able to repay the principal when the bond matures.

How liquid are they?

Equities: Highly liquid

Can be bought and sold on the stock exchange.

Bonds: Less liquid

In comparison to equity shares.

What are the added benefits?

Equities: Shareholders have voting rights

Bonds: Bondholders are among the first to claim on a company's assets

If the company defaults on its debt or goes bankrupt.

When 'sensible' makes sense

Mark currently sees conditions as very favourable for a risk-on bond investment style. However, this is not to propose taking a high level of risk in underlying investment instruments. The very rapid repricing of bonds in response to the current economic conditions has made a lot of bonds look very attractive in terms of their valuation, where bonds of 'sensible' companies are trading at prices well below the bond's maturity value.

Mark sees an opportunity to take advantage of these attractive valuations, as investing now means that the coupon paid by the bond will be boosted by a notable capital uplift at maturity. He expects this to lead to the potential for equity-like returns, if a carefully researched set of corporate bond assets is selected. Key characteristics to look for are:

- Bonds that are relatively short-dated, so the time horizon for receiving the full redemption value of the bond is not far away
- Companies with a low likelihood of defaulting
- Companies with pricing power, offering products or services that consumers can still afford.

In terms of opportunities in corporate bonds, he says that it is good to look for these globally. For example, the EU may have very significant energy problems to navigate, but that has been aggressively priced in to European bonds. It is also key to look across the different industry sectors for the best opportunities.

Mark currently sees banks as an interesting area. Banks have rebuilt their capital to what he believes is an extreme level, many times the levels before the financial crisis in 2008/2009. When you have a contingent convertible bond issued by the likes of Barclays, that will only be 'converted' in the highly unlikely event that Barclays' capital levels fell below its regulatory requirements, yielding over 10%, that creates a clear opportunity.

Bonded to the experts

With economic weakness, investors should expect higher default levels on bonds, so it's important to do your research carefully. At CGWM we base our decisions on the expertise of dedicated bond investment teams, such as those at TwentyFour Asset Management, when we invest our discretionary clients' money in bond funds.

We have years of experience in bonds and fixed income markets and are on hand to provide guidance and answer any questions you may have – we can use our expertise to invest directly or via funds depending on whatever is most appropriate for your situation. Please contact your Investment Manager if you would like to find out more or discuss your portfolio.

Investing now means that the coupon paid by the bond will be boosted by a notable capital uplift at maturity.

This is not a recommendation to invest or disinvest in any of the companies, funds or assets mentioned. They are included for illustrative purposes only.

Jane Tulloch,
Investment
Director

The cautious conundrum

This year has certainly proved challenging for investors, with extreme inflationary pressures, supply chain problems and rising interest rates.

These challenges mean that investors who hold 'cautious' (lower-risk) portfolios may have witnessed volatility in their performance. With inflation expected to remain at elevated levels well into 2023, and the likelihood of still tighter monetary policy to combat it, the era of ultra-cheap borrowing could be over. How can investors navigate the risks this presents, and how can we ensure those cautious investment portfolios can still see good returns?

How has market volatility affected cautious portfolios?

Prevailing market conditions have meant that some conventional cautious multi-asset portfolios – typically those with c.70% allocated to low-risk assets – may appear to be struggling to preserve capital as effectively as they have historically. There is also a risk that equities and bonds could become much more correlated than usual. Bonds and equities are typically inversely proportionate – i.e. when bonds go down, equities often rise and vice versa. However rising inflation and interest rates are causing investor nervousness and price falls in both bond and equity markets.

For some time, part of the case for choosing risk assets like equites has been that there was no alternative to achieving a higher yield while bond yields were so low – but this argument may now be harder to make: bond yields are now rising as the price of bonds is falling. Lower-risk assets, such as government and investment grade corporate bonds, have suffered notable capital losses – particularly longer-duration assets, because they have a greater sensitivity to interest rate hikes.

How can we best mitigate the effects of volatility on cautious portfolios?

Our strategy for cautious and lower-risk portfolios is to take a very active approach to asset allocation and stock selection, which is benefiting our cautious/lower-risk profiles (see chart opposite). We are opting for shorter duration assets, which are better able to withstand rising interest rates, and choosing investments that offer fixed income returns.

The benefits of our approach are visible: through careful selection of bonds, the CGWM risk profile 3 portfolio has outpaced the performance of the Vanguard Life Strategy 20% fund, which could be considered as a directly comparable low risk fund (the CGWM risk profile 3 and Vanguard Life Strategy fund are both comprised of 20% equities and 80% lower risk assets).

Risk profile 3 vs Vanguard Life Strategy 20% equity

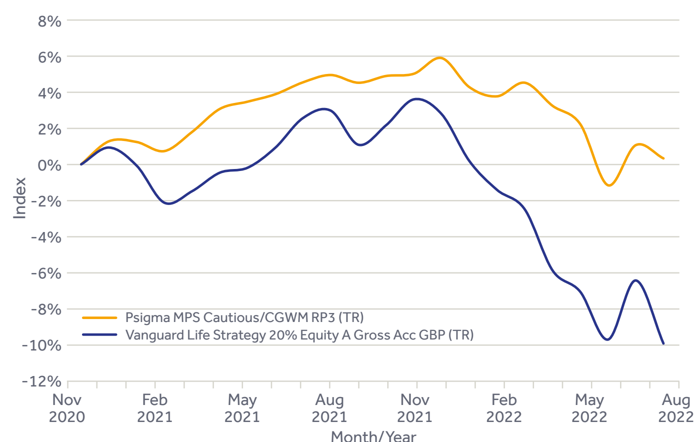

Chart note: following CGWM's acquisition of PSW, the new CGWM risk profile 3 master model incorporating the Psigma Cautious MPS went live in July 2022. Performance shown prior to that date is that of the Psigma Cautious MPS.

What is the outlook for cautious or lower-risk portfolios?

We expect both bond and equity markets to remain volatile, and we believe it will pay to allocate to the appropriate/relevant opportunities carefully and selectively, as and when they present themselves. However, prospective returns from bonds – and by extension lower-risk portfolios, because they typically have a higher exposure to bonds – are potentially more attractive than they have been for some time. For a protracted period it has been challenging to see how fixed income securities would deliver positive real returns for investors after costs, but this may now be changing.

How are government bonds performing compared to corporate bonds?

Rising government bond yields, coupled with a widening in credit spreads, are offering investors more attractive yields than we have seen for a number of years, offering a better risk/reward dynamic.

At present, corporate bonds provide attractive opportunities in fixed income, with some investment-grade corporate bond issuers currently offering higher equity-like returns because of the rise in yields. While corporate bonds carry greater credit risk than government bonds such as UK government gilts (fixed interest loan securities issued by the UK government), corporate balance sheets are generally in good shape, with most companies showing little sign of having overstretched themselves. Corporate debt defaults therefore remain low. Following the moves we have seen in bond markets in the year-to-date, the potential upside now appears more evenly balanced with the potential downside.

How are central banks reacting to raised inflation rates?

Although opportunities have begun to open up, fixed income markets are unlikely to be out of the woods entirely. Inflation has remained elevated for longer than market commentators expected, and central banks are likely to stay in monetary tightening mode for a little longer. It is imperative to be highly selective, to be well diversified across bonds, and to choose assets with a shorter duration (i.e. length of time until redemption or maturity). We have certainly benefited from positioning our cautious discretionary model portfolios to short-duration assets and a lower proportion of gilts, but we continue to review our positioning and will adjust our allocations as and when conditions evolve further.

How could the global economic situation affect bonds in the future?

Despite some positive signs, the wider global economic situation remains very uncertain and recession is an increasingly real possibility – particularly if central banks continue to prioritise inflation over growth and employment. However, the better risk/reward trade-off outlined above should mean that bonds will once again offer greater capital protection benefits. If central banks increase interest rates at a quicker pace and/or to a higher level than markets are currently anticipating, bond yields could rise further still.

Even so, the significant move in yields this year should reduce the chances of suffering further major capital losses, and see the less correlated relationship between equites and bonds re-establish itself.

How are equities performing?

Of course, cautious portfolios will still include equities. And the sell-off in stock markets since the start of the year could also present opportunities for cautious investment portfolios. In the year-to-date, we have seen fairly indiscriminate falls in 'growth' stocks* in the wake of interest rate rises, while 'value' stocks** have significantly outperformed their growth peers on a relative basis.

As global equity investment experts, at CGWM we believe that equities deliver the best real returns over the long term, a view that is supported by evidence. Our long-term active approach to equities allows time for markets to correct pricing inefficiencies in our discretionary clients' favour. Importantly, it also allows us to ride out the volatility inherent in equity investing.

Which sectors could perform best?

Performance has varied across different types of company, so we are careful about the industries and companies we invest in. Energy stocks have outperformed, while other sectors (e.g. utilities) have also contributed to relative returns. However, some more cyclical sectors have suffered with the prospect of recession.

The outcomes for differing styles and sectors within equity markets will depend on geopolitical and economic factors – but defensive*** dividend-paying stocks, often staples of the equity allocation in cautious portfolios, should still be appealing. While inflation is high and stagflation remains a concern, reliable dividend streams could well command a premium, so in equities we focus on long-term assets, taking a thematic approach and investing in areas such as infrastructure and healthcare, which we believe will continue to perform strongly against rising inflation.

Whatever risk level your discretionary portfolio may be, we continue to take an active management approach to ensure that you receive the best possible returns. If you would like to know more, please contact your Investment Manager, who will be delighted to discuss this with you.

* Growth stocks are companies that are expected to deliver better than average organic revenue and earnings growth over the medium term.

** Investors looking for 'value' seek out stocks which they believe have been undervalued by the market and are trading for less than their intrinsic worth. They are viewed as trading at a lower price than justified when measured against metrics such as earnings, profit margins or sales.

*** Defensive stocks typically give stable earnings to investors regardless of trends in the stock market.

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Andrew Chastney,
Senior Paraplanner

A family affair

How wealth succession planning could help safeguard your family's future

Even in the current economic climate, families are working hard to ensure they can leave as much of their estate as possible to their children and grandchildren, to ensure their financial stability in the future. In fact, it is believed that the amount of wealth passed on to younger generations could double over the next 20 years, possibly reaching as much as £5.5trn by 2047[1]. Furthermore, a staggering £15bn inheritance[2] is waiting unclaimed because people haven't told their beneficiaries where their money is kept.

We believe that succession planning should be a key discussion point for many of our clients and, where appropriate, incorporated into financial planning strategies as early as possible. We realise that money can be one of the most awkward topics for many families to discuss, but happily this attitude seems to be changing.

[1] fwu-report-final-version-20-april-2022.pdf (mandg.com)

[2] independent.co.uk/money/spend-save/inheritance-will-investment-pension-assets-life-insurance-a8927966.html

It's time to talk

Having open and informed conversations between generations is an important way to ensure that your assets are handed down as simply and tax efficiently as possible, creating the best outcome for everyone. Together, families are using wealth succession planning to ensure their wealth is passed on as they wish.

However, before you start discussing things with your loved ones, you need to consider four key questions, all of which are interlinked.

- When do you want to transfer your wealth?
- How much?
- To whom?
- How?

Let's look briefly at each question in turn.

1. When?

This isn't simply a question of leaving money in your Will. There are also ways of transferring assets during your lifetime, which may have a range of advantages.

Nevertheless, effective succession planning starts with ensuring that your Will is kept up to date, to reflect your personal circumstances and objectives. It should also reflect the latest legal thinking in the jurisdictions where you hold assets.

We would always recommend that you take professional legal advice, and we generally suggest that you review your Will every two to three years or whenever there is a major change in your or your family circumstances – such as marriage, divorce or the birth of a child or grandchild. For example, in England and Wales marriage revokes any existing Will, unless the Will was made in contemplation of the marriage.

We also suggest that you consider linking the value of any legacies to inflation, to ensure they maintain their 'real' value.

The main advantage of using your Will to transfer wealth is that you won't compromise your own standard of living. On the other side of the coin, making gifts during your lifetime allows you to experience the joy of seeing your chosen beneficiaries benefiting from your funds. What's more, if you are exposed to UK taxes, acting sooner rather than later can also be a more tax-efficient way to pass on your wealth to your loved ones.

While everyone's priorities are different, it's important to strike the right balance between sharing your wealth with your family and keeping enough to maintain your standard of living and make the most of life now and in the future. The last few years have been a jolt to us all, reminding us to expect the unexpected.

> *"Together, families are using wealth succession planning to ensure their wealth is passed on as they wish."*

From a financial planning perspective, in our view this means looking at various scenarios, and financially 'stress testing' the outcomes as part of cashflow planning. This includes, for example, testing against various investment return outcomes as well as inflation projections and potential long-term care costs.

2. How much?

Where larger gifts are being considered, the cash flow 'stress testing' mentioned above is much appreciated by many of our clients. It helps you to make informed decisions by showing how much you can afford to give away during your lifetime, within a set range that allows for the worst and best case scenarios. This approach recognises that no one can accurately predict the future. After all, a year ago who was predicting double digit inflation in major economies?

The changing face of intergenerational wealth

Individuals born after the 1980s are projected to inherit

£200,000-£400,000

Source: Intergenerational rapport fair? Resolution Foundation, February 2022

Wealth passed on to younger generations will double over the next 20 years, and could reach

£5.5trn

by 2047

Intergenerational wealth transfer in the UK, The Kings Court Trust Blog, November 2020

Longer life expectancy means the next generation will now inherit later on average

at age 61

Source: Intergenerational rapport fair? Resolution Foundation, February 2022

Between 1995 and 2018 the total net worth of households increased from £2.8trn to £14.6trn

Source: ONS

3. To whom?

For many of us this is the easiest question to answer and is usually a very personal decision, often linked to the decision about timing. For example, if you have young grandchildren and your main priority is their long-term wellbeing, a trust structure might be an appropriate way forward; this could help with private education costs, university expenses or future property purchases.

Your trustees could have discretion over how much to distribute to the beneficiaries, when and to whom, within the terms of the trust deed. You could also keep some control by being a trustee yourself. This could be particularly relevant where one of your beneficiaries has special needs, as it can be designed to protect their long-term interests.

You might also like to consider benefiting charities close to your heart.

4. How?

By following the above steps, 'How?' will often become clear. Timing plays a big part in this decision, as well as considerations around whether you can really afford to gift during your lifetime. If you can, you then need to decide whether to make absolute transfers or create a trust structure which, while adding complexity, may be the most effective way to achieve your objectives.

Closing thoughts

Above all, it's vital to start having conversations about the future with your loved ones. It's also important to get the right balance between having enough capital and income to enjoy now, while passing on wealth to your family efficiently if you wish to do so – which is something we specialise in at CGWM.

It's never too late to talk to our experts. And we can advise all generations of your family, creating a joined-up approach that benefits everyone, working with existing legal or tax advisers where appropriate.

If you have not already done so, could this be the time to open a conversation?

At CGWM, we are always ready to help. If you want to start the process of talking to your family about intergenerational wealth planning or would like to find out more on how it could be incorporated into your financial planning strategies, please speak to one of our advisers, who will be delighted to discuss this with you. We're always happy to sit down with you and your family to facilitate the initial conversation if you would find that easier.

Above all, it's vital to start having conversations about the future with your loved ones.

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