WARNER MATTHEWS
ASSET MANAGEMENT

Warner Matthews Diaries – 2nd Edition

Asset Allocation musings:

Trying to stick with a song title that feels apt, we conclude that the Beatles track *Eleanor Rigby* best fits the melancholy mood in the UK. Thankfully the Brexit and General Election drama have finally been consigned to the back-burner, at least for the time being. Instead investors can once again grapple with the pertinent issues affecting their portfolios. For us, not much has changed on this front as you will read further on. As we were compiling this report, we were cognisant of the possible change of government and the impact that would have. We suspected the stock market reaction to a change from blue to red would be negative given parts of the Labour party's manifesto appeared anti-business. However, by removing politics (and Brexit) from the centre stage it left us wondering what could brighten the investment mood. There remain structural issues affecting many parts of the UK (e.g. retailing) and the low yield world in the bond market has created an asset class that is not quite the safe haven it's normally associated with (see last month's missive). There are, thankfully, still some brighter investment destinations that we have identified.

What's on our Minds:

Searching for diamonds in the rough:

Our last few internal asset allocation meetings have largely centered on where we consider there to be value left in asset classes and whether it makes sense to reposition portfolios towards these "arenas". It's hard to argue against the headlines regarding bond markets - even the Greek Central Bank were able to issue a short-dated bond with a negative yield recently! Similarly, it feels as if the defensive/quality equity trade (think consumer names such as Unilever/Diageo et al) is overcrowded; a lot of the best performing funds have been assisted from having significant exposure in this segment. Whilst your portfolios have benefited from some of these fashionable investments, we strive to remain active. With that in mind we note that the divergence between UK Growth and Value reached extreme levels during the last quarter. In simple language Value stocks are considered undervalued vs. their history, peer group or the wider market, whereas Growth stocks are faster growing and may therefore realise above-average returns.

Whilst we understand that not all Value represents good Value, i.e. things can be cheap for good reason, the bifurcated nature of the UK stock market led us to believe the risk/reward dynamics are favourable. With that in mind trying to select a UK fund with all the right ingredients was taxing. A lot of UK value funds incorporate significant exposure to some of the structurally challenged areas of the market. Digging into the passive investment world unearthed an Exchange Traded Fund (ETF) which looked to balance the value element required with an attractive yield component. The iShares UK Dividend UCITS Fund is a quarterly distributing ETF with direct investment into 50 UK companies, with a current yield in excess of 5.7%. The fund has performed as it should have done in periods where the appetite for growth orientated assets diminishes. Consequently, we will be gradually transferring some of the profits built up in the fashionable funds in portfolios towards this fund. Overleaf we explain our stance on Active vs. Passive investment and why in today's investment world neither should be dismissed.

Planning for the Future:

The Government Office for Science highlighted in their report in July 2019 that the population of the UK has undergone a fundamental change in its age structure, with many people having fewer children and living longer lives. As a result, the average age of the UK population is increasing. This has important implications for the whole of society. Growing up and living in a society where younger people are in a majority is fundamentally different to growing up in a society where the majority of people are in older age groups. These revelations mean that careful tax planning is logical when it comes to transferring assets to younger generations to support them in the future. Additionally, house price increases have risen faster than the Inheritance Tax (IHT) allowances, meaning more and more individuals are being included.

In light of possible changes to the Inheritance System, we recently attended a seminar hosted by Time Investments. It highlighted potential changes to the tax system, especially IHT where the government is considering simplifying the tax rules. Listed overleaf are a number of easy steps to reduce future IHT liabilities aside from utilising the Nil Rate Band (NRB) of £325,000 per individual and also the Residential Nil Rate Band (RNRB) of £150,000 per individual for estates valued at less than £2 million.

- Anything left to a husband, wife or civil partner as long as they reside in the UK is exempt
- Gifts totalling £3,000 each year to people other than exempt beneficiaries (carried forward one year)
- Gifts to registered charities
- Gifts the deceased made over 7 years before their death
- Small gifts of up to £250
- Wedding or civil partnership gifts
- The value of any farms, businesses or commercial properties
- Normal expenditure out of income

The value of these exemptions are excluded from the final value of the estate. For example, if an estate is worth £375,000 but gifts of £50,000 are left to charity then no IHT would be payable at all. Similarly, a person can leave their entire estate to their spouse and they would not need to pay any IHT on their passing. The £325,000 Inheritance Tax exemption would then be passed to the spouse to be utilised on their death giving a total IHT allowance of £650,000. Married couples can therefore leave one another their allowance so a couple could leave £950,000 before tax when the RNRB is included in the IHT calculation. This will increase to £1m next tax year when the RNRB allowance increases to £175,000.

Additionally, there are further avenues available to reduce future IHT liabilities especially for those looking at a shorter time frame than the 7 year gift rule. These include Business Property Relief (BPR) schemes that enable assets to leave an estate after 2 years for IHT purposes. However, there are risks associated with BPRs – the underlying investments are often AIM listed which means they are more volatile and can be illiquid.

Active vs Passive Debate – are the fees really worth it?

In an environment where more and more active managers are struggling to keep up with index returns, should we be considering whether to allocate towards passive products to match index returns and bring down the costs to you? When legendary investor Warren Buffet revealed that he advised his wife (in his will) to invest in low-cost index funds, everyone should take note. His beliefs were no doubt supported by various studies indicating that the majority of active managers fail to beat their target benchmarks over most conventional time periods. Some of that stems from the impact that charges have when compounded over a long time period.

However, there is a misnomer in our view that low cost equates to low risk. The obvious point is that passive funds are unable to outperform the index they are tracking and more importantly cannot protect against sharp falls in the index they track as they must be fully invested. Active managers can however avoid areas of the index where they perceive it to be overvalued. Indeed, by being flexible, active fund managers can diversify to include a cash element or include derivatives to protect against sharp falls.

It has become somewhat fashionable to be a "passive" investor of late. However the ability to incorporate an active role in governance matters is limited. Related to this point it is worth noting passive funds have a distinct inability to deploy the ultimate sanction of selling a holding if the management don't conform to basic environmental, social and governance (ESG) commitments, unless the stock falls out of the index.

There is also a risk that the underlying holdings within an Exchange Traded Fund (ETF) may be synthetic (i.e. not the actual underlying share) which therefore also exposes investors to counterparty risk, because the derivative contracts they rely on are agreements between the ETF and a counterparty to create synthetic instruments to match the index. Investors in synthetic ETFs therefore trust that the swap provider will fulfil its obligation to pay the agreed-upon index return.

One of our underlying concerns with the current stock market cycle are the foundations by which it has been created (supportive monetary policy). The rush of capital into passive funds may also have formed its own set of distortions, creating opportunities for those active managers able to spot pricing anomalies and avoid overpriced securities. At the heart of Warner Matthew's investment philosophy is protecting your capital as best we can. By allocating to fund managers that are prudent in their selection process, keeping valuation discipline at the heart of what they do, we aim to be able to smooth out stock market gyrations to generate stable returns. We do appreciate the role passive funds play in replicating an asset class at a low cost to our clients. Our inclination is to tap into the passive fund world when the market has reflected the bad news (i.e. after a steep fall) rather than joining the herd in the current momentum driven market backdrop. To summarise, we need to be practical and nimble!