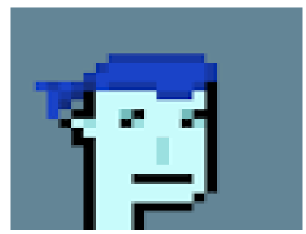
WARNER MATTHEWS
ASSET MANAGEMENT

Newsletter – First Quarter 2023

QUICK TAKE ON 2022

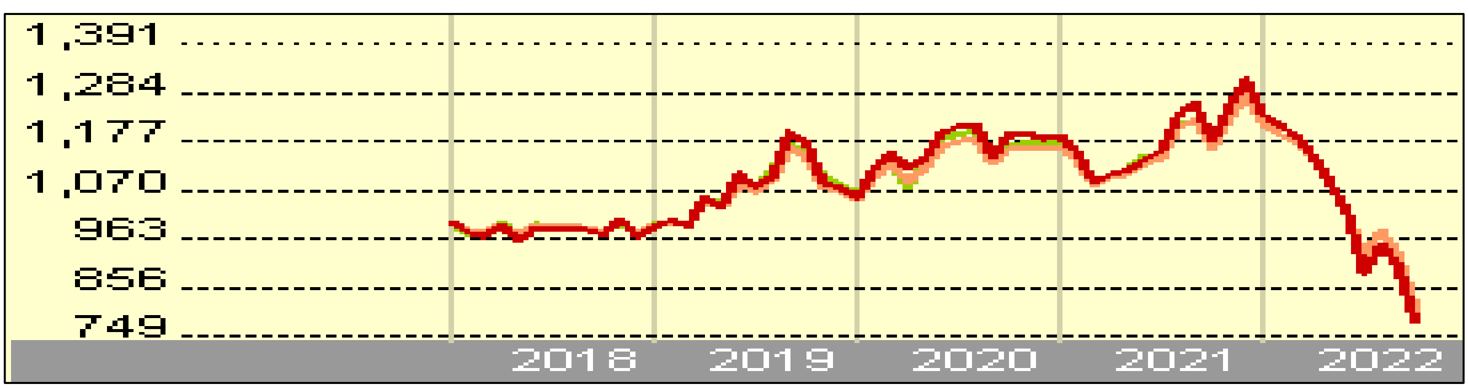
This time last year a new generation of investors, boosted by pandemic support packages, were still piling into all manner of esoteric assets – from cryptos, to NFTs and SPACs. The height of this irrationality occurred when an "investor" acquired a piece of digital art named CryptoPunk#5822 (see image) for a whopping $23.7m. Unfortunately for the buyer, this top-ticked the market euphoria and it is now possible to buy lots of these "artworks" at a 90%+ discount. The years of Quantitative Easing combined with 0% interest rates created the Everything Bubble, but now it is fast deflating.



The dramatic reversal of fortune witnessed was not however an isolated event. The persistence of inflationary pressures combined with rising interest rates meant that even the "safest" asset classes were not spared. The closest thing to a risk-free asset for UK domestic investors is Government Gilts. As you can see from the chart below, even this "safe" asset was subject to extraordinary bouts of volatility in 2022, and although we were wary of fixed income assets in a rising interest rate environment, even the most seasoned investors were perplexed as to the unprecedented losses in this asset class.

LOOK FORWARDS

At the start of a new year, it's good to be able to compartmentalize every hurdle you've encountered and put it away. Investing is not that different; learn from the experience but don't let it determine your fate. Looking for songs about strength and resilience feels appropriate as we enter a new year with hope and optimism that things will improve. As such the list of entries for suitable songs was as long as my arm – Don't Stop Believing (Journey), I'm Still Standing (Elton John), The Show Must Go On (Queen) to name a few. In the end we opted for Don't Give Up by Peter Gabriel (ft Kate Bush) which just happens to be on my playlist.



The recent respite in equity and bond markets has been a welcome relief and was predicated on US inflation data that implied the worst is now behind us. However, as we know, one swallow does not a summer make. Have we therefore witnessed only a bear market rally or is this something more sustainable? We think there are elements of both depending on where you search for new ideas. More of this later in the newsletter.

TRUSSONOMICS – MINI BUDGET TAKE 1

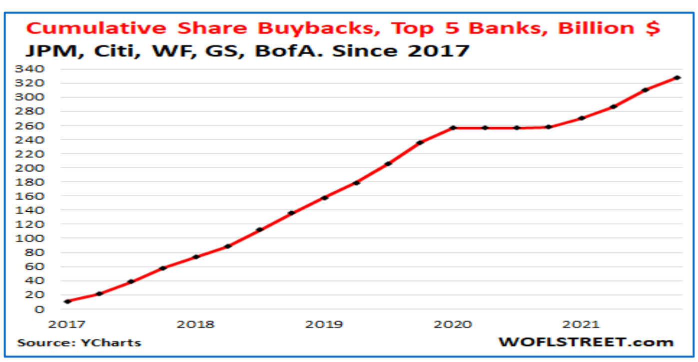
With 4 chancellors in as many months and 3 prime ministers has order now been restored? We were curious as to a traditional Conservative ideology of letting people and businesses keep more of their own money could backfire so spectacularly. What happened to sticking it on the country's credit card as had happened all around the world without so much of a mention. We appear to have trancended into a regime where every penny spent needed to be funded. The problem that arose is that someone needs to lend it to you in the first place, in this instance the government's ability to issue new bonds to pay for it. The higher level of yield (interest rate) needed to garner interest was where it all started to go wrong. The initial headlines "At last a true Tory Budget" (Daily Mail) were quickly replaced by headlines less complimentary.

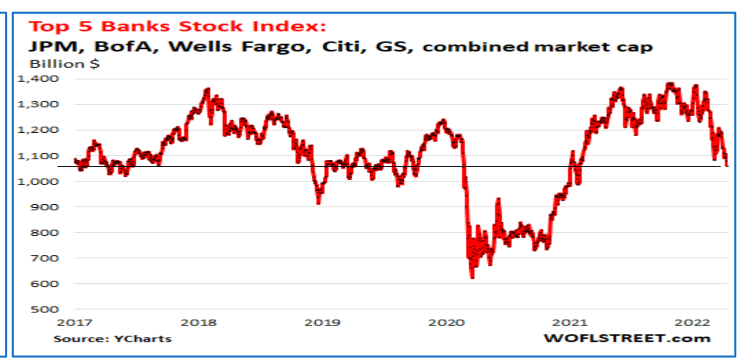
MINI BUDGET TAKE 2 – HUNT'S TURN…

Unsurprisingly, given the media attention, Jeremy Hunt scrapped almost all the tax cuts announced a few weeks earlier and committed to sustainable financing. In doing so, he reversed a cut to income tax and increased corporation tax to 25% this April. He reduced the additional-rate income tax threshold to £125,140 (from £150,000), cut the dividend allowance to £1,000 (from £2,000) and capital gains tax allowances to £6,000 (from £12,300). All these changes will have an impact for our clients. The Daily Mail calling it a "budget to break the back of middle Britain" fearing his budget would crush growth and encourage investment and jobs to lower-tax competitors. Who would want to accept the role of Chancellor…certainly not any of us!

CORPORATE SHARE BUY-BACKS – WHO REALLY BENEFITS?

Our curiosity was piqued this year when the renowned growth manager Nick Train underlined, in one of his missives, the number of holdings in his portfolio that were introducing share buy-backs. This is a manager that had historically expressed a preference that his underlying investee companies reinvest any excess cash back into their businesses as opposed to buying back shares. In theory, or as I remember it in a different life, companies historically deployed share buy-back schemes (at a fixed price) when management and the board felt that their shares were being undervalued by the market. In some cases, the shares bought back would be cancelled (or redistributed to key employees). However, in more recent times, it has been used as a tool for senior management to lift short term key renumeration metrics to ensure that targets are met and bonuses are paid. There is little empirical evidence that share buy-backs either create value or boost share prices in the long term. Take the largest 5 US banks as an example; they spent/wasted over $300 billion in cash on repurchasing their own shares over a 5-year period from 2017-21 and yet their share prices are now below where they were back before they started this program (see the chart below).





The cynic in us also notes that the Oil and Gas sector were admonished for their acquisition strategies in the early noughties and thus pushed into capital management initiatives (namely lift dividends and buy back shares). This lack of investment ultimately contributed to a shortfall in new supply at a time when sanctions against Russia led to an increase in prices and thus inflation…

WHAT IS THE METAVERSE AND CAN I INVEST IN IT?

You may have heard your children or grandchildren refer to it, or even taken note when Facebook changed its name to Meta. For those of you like me, that haven't really explored the true meaning, here is our attempt to simplify it. The term was originally used by author Neal Stephenson in his book Snow Crash. It is essentially a virtual universe with endless possibilities to escape into but whether it creates a Utopian universe where we can escape to virtual realities, only time will tell. The Metaverse exists in parallel with the real world. It is a 3D version of the internet where you can spend your digital life. You can create your own Avatar (icon representing yourself in a video game) and interact with your fellow Avatars. However, it is already much more than just video games. It's a way to grow the digital economy. At present this means how to own "virtual" objects, experiences or land. The Blockchain - the crypto finance hub - makes it possible to precisely define a virtual thing so it can be bought or sold. For example Sotheby's, the UK auction house, permits individuals with Avatars to virtually walk around and view an auction.

GOOGLE SEARCH TRENDS – not much to extrapolate here!

Most popular search: Wordle
Most popular person: Johnny Depp
Most popular recipe: Paneer Pasanda
Top landmark: Buckingham Palace

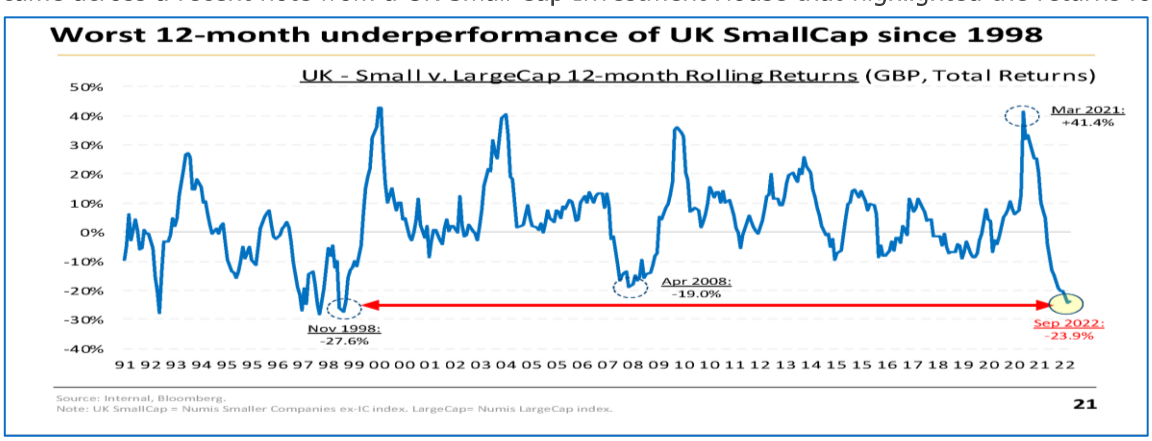
There are various ways to "enjoy" it, but you will need some hardware to begin with (virtual reality headset), and there are multiple platforms for accessing it. The most recognisable avenue is via Meta (Facebook) whose founder, Mark Zuckerberg, pivoted his company towards this new paradigm over a year ago with much gusto. Unfortunately, having committed tens of billions of dollars to pivot to the new paradigm, take up has been less than enthusiastic. Several downgrades to expectations, the disappointments are mirrored in the share price which has fallen 70% from peak to trough during a period where the company bought back $65 billion worth of shares: sounds familiar…

WHAT IS CONTRARIAN INVESTING? HOWARD MARKS INSIGHTS

I'm borrowing a lot from one of the great modern investors, Howard Marks from Oaktree Capital. He opines that to be contrarian is the opposite of doing what others are. The investment "herd" often refers to a set of investors that drive share prices up and down. It's these actions that become most pronounced at inflection points, i.e. the top and bottom of a share price cycle (bubbles and crashes). At these points in a cycle it is logical to act in a contrary fashion, indeed the key to success is to do something different from the crowd. Most great investments begin in discomfort; when equity markets are surging higher, most investors are happy to hold onto the shares leading the charge. Therefore, what they tend to want to invest in is unlikely to be found in the bargain bucket. Howard suggests we ignore the short term (as we have no predictive power) and focus on the long term as we are investors not traders. It is time not timing that leads to real wealth accumulation, as I've highlighted before, the power of compounding is immense.

CONTRARIAN OPPORTUNITIES IN THE UK

Speaking to a school dad friend of mine recently about his day job of investing in the UK small company arena, he was adamant that this is the cheapest the sector has been in his 25 years in the role. Scouting around for more information, I came across a recent note from a UK Small Cap Investment House that highlighted the returns for the sector since 1955.



Historically, UK small cap investors made money 78% of the time and 2022 comes in at the 6th worst year in almost 70 years. The bounce back factor is also strong, so for new investors, betting against the herd seems like an opportunity.

Bear markets tend to end when valuations become so low that investors will no longer sell or are exhausted. This is also the time when long-term investors, namely those either inside the business or buy-out specialists show interest and hunt for bargains. Today, sentiment is already weak and institutional investors are as bearish as they've been at market inflection points. Whether we are at an infection point is hard to know but we are clearly nearer the bottom than the top. This may well be one area that we add to in your portfolio in the new year…

THE ANNUITY COMEBACK TRAIL

Are annuities back in favour after a period in the wilderness? It is certainly feasible given how far interest rates have risen in the last 12 months. As most of you will know, annuities are a type of insurance product that pays out a regular fixed income in retirement in exchange for a lump sum, normally your pension pot. Earlier this year the optimum offer for a 65yr old paying £100,000 upfront provided an annual income of £4,871, this has now risen to over £7,000. On that basis it would take 14 years to make your money back versus 20yrs previously.

As annuity providers buy government gilts to cover future liabilities, it is this asset class that largely determines the direction of annuity rates. If gilt yields (rates) continue to rise in 2023, retirees will likely take advantage of the improved guaranteed returns especially if the underlying market conditions and economy remain volatile.

US LAY-OFFS in NOVEMBER 2022

Here are some interesting facts regarding how technology companies are having to adopt leaner operating bases during this downturn by means of headcount reduction:

Twitter 50%, Robinhood 23%, Intel 20%, Snapchat 20%, Meta 15%

UK vs US HEALTHCARE SYSTEM

Both systems have their inherent issues, but I was shocked to see some key statistics on mortality rates across the world. The US has one of the highest infant and maternal death rates in the developed world and has seen little improvement over the last 50 years. The maternal death rate in the US is now over 5 times higher than comparable nations, the same with infant death rates. This deterioration occurred during a time when the state took less of an active role in administering healthcare. Is it a coincidence that the US has no compulsory free post-delivery care? There is also a strong link with wealth inequality. In simple terms, bringing down the US infant mortality rate to western standards would inject well over $50bn into the healthcare system. This is why there is validity in utilising the public-private model as in the UK…it may not be the perfect model, but the stats imply it should help improve this issue.

ISA & PENSION CONTRIBUTIONS – don't miss out as the deadline is 5th April 2023

It's that time of the year when the Warner Matthews Team readies themselves for the end of the tax year particulars, namely ISA subscriptions and pension contributions for 2022/23. As you will know, ISAs are "tax free wrappers" where you can place money to earn interest or returns without having to pay the tax man any income or capital gains tax. The maximum subscription is £20,000 for this tax year. Similarly pension contributions come with attractive tax relief. This tax relief is paid on your pension contributions at the highest rate of income tax you pay, so if you are a higher-rate taxpayer you can claim 40% pension tax relief. There is a limit of £40,000 for the tax year 2022/23, so any contributions above this will be subject to tax at your marginal rate. You can carry forward unused allowances from the previous three years as long as you were a member of a pension scheme during those years. For anyone not working or earning less than £3,600, the maximum gross contribution is £3,600 (this includes the government top up, so your personal contribution is limited at £2,880). If you intend to sell assets to fund ISA or pension contributions, remember there may be a CGT implication. Feel free to check with us.