PORTFOLIO POSITIONING UPDATE NOVEMBER 2020

19 November 2020

momentum
global investment management

Performance

The Funds protected capital in October, with **Balanced declining -0.3% and Growth declining -0.2%, compared to falls of -2.4% for global equities.** Our option strategy was a key contributor to returns, as the S&P 500 Index dipped below the strike price on our index put options, with the result that these instruments rose in value.

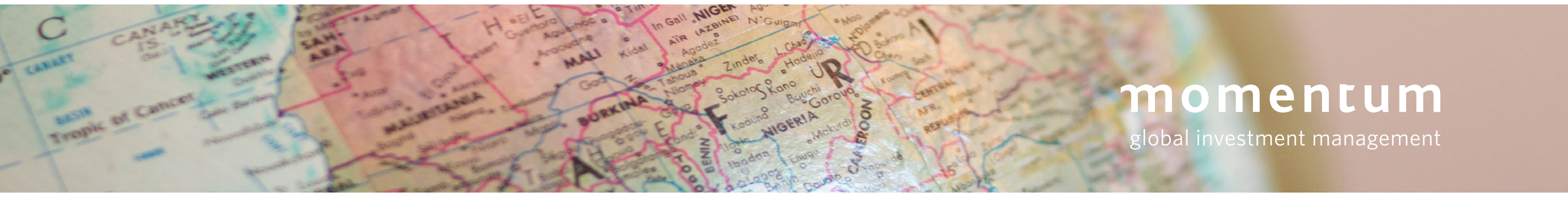
Progress on a vaccine

Given what has happened since the end of October, last month's performance is now ancient history.

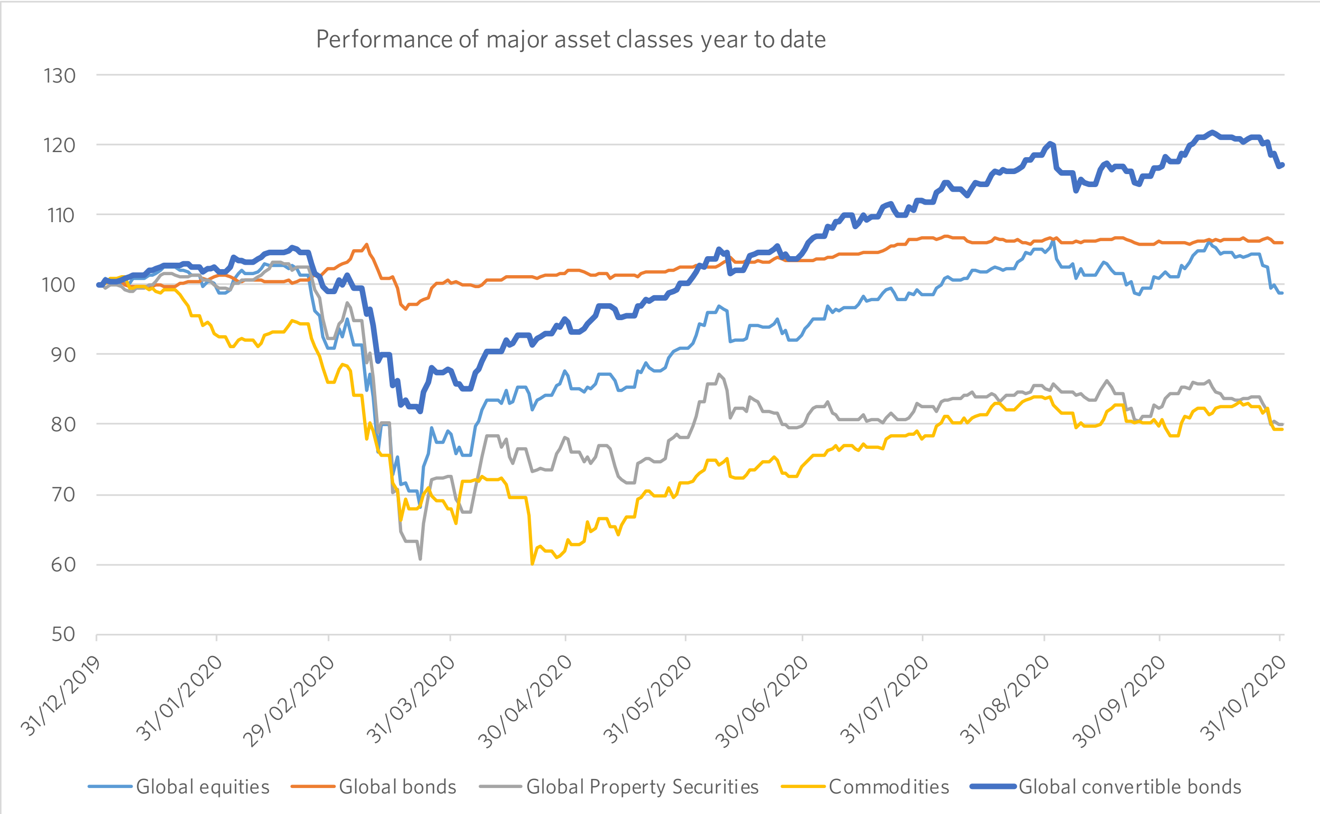
To recap: global equities rallied at the start of November as the US election results began to swing convincingly in Joe Biden's favour. The rally in stock prices was less to do with the relative merits of Biden's policies, and more a reflection of the fact that markets like certainty.

Then at the start of last week, Pfizer announced very encouraging data from its vaccine trial. **We have spoken about the need to retain a balance of equity styles in the portfolios and the reaction to Pfizer's announcement was instantaneous, with energy and financial stocks, favoured by our value managers such as Lyrical, moving up in a matter of minutes.** The prospect of a vaccine brings forward the potential for a return to normality; alongside our value managers, areas like property have been big beneficiaries of the news thus far.

Challenges remain however: will a vaccine arrive in time, with the second wave of the virus accelerating in the US, having already forced a second round of closures in Europe. Longer term, structural challenges like record high debt levels and ageing populations still remain. **Hence now is not the time to be making a wholesale shift into equities and other growth assets in our view.**



Beyond equities and bonds



Source: Bloomberg, MGIM

One asset class that has done extremely well year to date, significantly outperforming both equities and bonds, has been convertible bonds, which we invest in via RWC and Westwood (Aviva).

In its simplest form, a convertible bond is a corporate bond with an embedded call option that allows the bondholder to convert the debt into equity if certain conversion criteria are met. The effect of pairing a call option with a corporate bond is that if the underlying equity goes up, the bond behaves more like equity; if it goes down it behaves more like a corporate bond. This ‘convexity’ effect – which extends to a portfolio of convertibles – thus plays a useful and impartial role in self-allocating into and out of risk as equity markets rise and fall.

Global convertible bonds suffered less than half the drawdown of global equities in March, yet have tracked almost one for one on the way back up as expectations of higher volatility (which serves to make the embedded option more valuable) and a flood of cheap issuance has supported the asset class. While they are not risk free assets, they should provide ballast if and when the next storm whips up.

Outlook

Pfizer's news reinforces our views on the outlook for markets: there is value in areas like property, energy and financials, as economies gradually reopen, and the prospect of higher inflation and a steepening of the yield curve should serve to shift investor attention towards some of these higher yielding areas. Monetary policymakers are explicitly focused on higher inflation and fiscal policy is also working in tandem: despite the prospect of a split Congress, Joe Biden has a track record of working with lawmakers from both parties, hence the chances of a significant bipartisan infrastructure bill remain high.

The Funds are not beholden to any particular macro environment, but with the prospect of a return to normality and higher inflation being brought forward, we expect to participate meaningfully. **There will inevitably be bumps along the way, however, and hence we continue to own assets like convertible bonds, equity put options, Treasuries and gold, in order to protect the Funds during periods of market weakness.**