

Ricochet

Cast your minds back to 2014, when the Caribbean Island of Puerto Rico, burdened by a chronic budget deficit, spooked the US municipal bond market by passing legislation to restructure some of its enormous \$73bn debt pile. US Municipal Bond ETFs reeled and wider markets were spooked, the country's debt downgraded to 'junk' status.

Hindered by the devastation of Hurricane Maria in 2017, an aging population, high social care costs and a residential exodus, Puerto Rico only emerged from bankruptcy in May 2021 after an oversight board, created by US Congress in 2016, filed a debt restructuring plan, making it the largest government to seek bankruptcy in US history. Yet, amid all this madness, the country still managed to sell \$3.5bn of debt in the market at a juicy 8.7% yield, the coupon being entirely tax-free for US investors. Some experienced risk-takers could see that a bankruptcy would lead to restructuring and eventual stability.

Shifting further back in time to 2009, I remember a conversation with one client in the wake of the Great Financial Crisis, regarding Barclays' 6% Perpetual Loan Stock, which was due to be repaid (at the earliest) by December 2017. This was one of many perpetual callable bonds issued by a series of UK banks which encountered serious impairments during the dark days when Northern Rock failed and Lloyds was encouraged by the UK government to enter into a shotgun wedding with the Bank of Scotland. With confidence shredded by the events of the past twelve months, this bond issue was trading at only 25% of its face value and the press was in full-on speculation mode about potential defaults. It was at this moment (admittedly following some 'on-the-one-hand, on-the-other-hand' conversations) that we hit the 'buy' button. As interest rates subsequently fell, ZIRP reigned supreme and the banks recovered, this bond issue matured, on my 45th birthday, at 100% of its face value. This was perhaps the last occasion when one could truly describe a bond's holding period return as downright sexy.

For some time now, we have been suggesting that economic data are somewhat divorced from reality and that markets tend to predict the future more accurately than the deluge currently dished up by disoriented economists. One fine example of this arose in early September. On a sunny Friday afternoon, the UK's Office for National Statistics announced that it had retrospectively found some UK growth 'down the back of the sofa' (as one journalistic wag put it), retrieved from the post-pandemic haze of 2021, leaving Britain's economy 2% larger than anyone realised. So what impact did this extraordinary piece of news have on the UK's stock market? Absolutely none whatsoever. 'Old hat, this v-shaped pandemic recovery malarkey, let's move on', appeared to be the message received, loud and clear. While certain other European countries have not yet adjusted their GDP data likewise, it made no difference to the mood on the market floor, traders and investors being far more concerned with the fact that UK interest rates were 'higher for longer' while the UK's economy, at least this year, was hardly growing.

That said, once markets have ruminated for a while about what lies ahead and management has adjusted business models and valuations, this should form a solid basis for recovery, especially where high quality



Bite the bullet while you can.

companies are concerned, the likes of which we have previously expounded (diverse revenues, strong pricing power, low gearing, healthy cash flow and progressive dividends). At around the time the student-loan-backed capuccinos stop flowing and Ryanair's Michael O' Leary starts complaining about falling passenger numbers in Europe, the media will rew up its misery machine, heralding not just a 'cost-of-living' crisis, but an economic crisis to boot. It's 'Tin Hat' time, they will suggest, fetch your guns and gold.

Speaking of guns, a bullet ricochets so fast that you don't get the chance to see where it has gone. While hardly as rapid as a speeding bullet, markets can and often do bounce quite suddenly, finding themselves well north of their nadirs within only a matter of days. It is not difficult to google a graph which shows just how much money you can lose trying to time the market, the initial bounce leaving an erstwhile comfortable-in-cash portfolio suddenly nursing a serious case of 'FOMO'. Based on historic US data from 1993 to 2022, if one missed out on the market's 10 best trading days over the past 30 years, the potential returns on a US equity portfolio would have been halved. Missing the best 30 days would have reduced a potential savings pot by a very unpleasant 83% (and that's not a typo) relative to remaining fully invested for the duration. Transforming that idea into dollars, a 'buy and hold' strategy in US equities during those twenty nine years would have transformed \$10,000 into \$158,434, however if one missed out on the 30 best days, that \$10,000 would have edged up to a far less impressive \$26,925.

Perhaps more importantly for investors today, this same study showed that 78% of the US stock market's best days occurred during a bear market or during the first two months of a bull market. One does not have to adopt the very high level of risk associated with Puerto Rican sovereign debt or Barclays' subordinated bonds to make a hefty profit but as your investment manager, one of our key responsibilities is to ensure that, like those experienced investors and risk-takers, you don't follow the retail trend. Buy good quality assets when it feels least comfortable to do so and don't cash in your risk assets just before a bounce.

MARY TAIT

CHIEF INVESTMENT OFFICER - OCTOBER 2023

The Magnificent Three

It has been nearly two years since the post-pandemic euphoria of rising equity markets was replaced with the cold realisation that shares could go down as well as up. Battered portfolio managers arrived at their desks in 2023 hoping for better times ahead. Expectations have been deflated. It has been a bumpy year with more turbulence likely to come as we move into the final quarter.

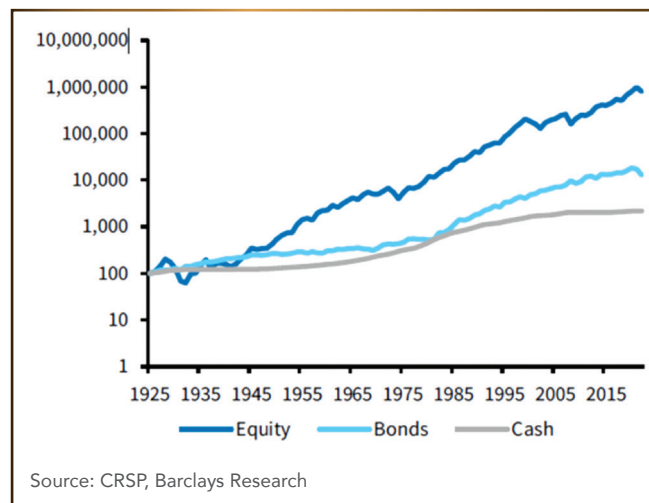
The first magnificent mantra of investment management is diversification. At no point in time has this been more relevant than the last two years. In 2022, as interest rates rose, technology shares led equity markets lower. The pain of falling prices was offset by the performance of the 'old tech' mining sector which rose by 21.1% against the decline of 18.1% recorded by the wider market. This year? Completely the opposite. Mining shares have been toppled by that arrivista collection of magnifica, the Magnificent Seven: a highly concentrated mix of technology shares led by the likes of Nvidia, Microsoft and Meta. These seven behemoths, whose collective market size of \$9.7 trillion is over 3 times the size of the entire UK stockmarket, have been responsible for nearly all of the S&P500's gain of 15.9% so far this year. Diworsification, as Mary Tait would say.

Miners were popular last year because of a belief that the world was facing a shortage of raw materials. This year, that same argument has been self-defeating as, one by one, economies started to fracture under the pressure of higher interest rates. An investor who mistimed the entry and exit points into the technology and mining sectors over the last two years would be sitting on a considerable loss. This connects neatly to mantra number two: that time in markets is the key to prosperity; not trying to time the markets.

Whilst interest rate rises have generally been a drag on equities, they have been a disaster for bond investors. Over the 5 years to the end of September 2023, US Treasuries have fallen by 14.3%. UK Gilts have fared far worse, down by 29.4%, in part thanks to last year's Kwarteng/Truss debacle, the uncelebrated anniversary of which has just passed (us by).

Back to diversification. These falls, uncomfortable though they are for existing holders, have provided an excellent opportunity to bring portfolios back into alignment with traditional cash/bond/equity portfolio ratios for the first time in a decade. Ten-year US Treasuries today yield nearly 4.5%, two-year bonds pay higher still and a portfolio of decent corporate bonds even more.

For yield-hungry investors, income payments from such investments now provide cash flow largely without risk. They should not, however, dominate balanced portfolios. The 'fixed' nature of the income stream offers no protection from inflation. Equities are a vastly better way of achieving this over time. The latest edition of the Barclays Equity Gilt Study (our weekend reading material of choice) notes that \$100 invested into equities 100 years ago would have returned over \$790,000 today versus \$12,800 invested into bonds. Cash would have produced a meagre \$2,100.



Nobody has yet invented a properly calculated 'feel good' index (maybe Artificial Intelligence will help out here). But when they do, it is likely to be inversely correlated with stock market returns. In other words, the momentary euphoria of selling low (when bad news is abundant) and buying high (amidst the excitement). This is a perfect way to destroy wealth, but it is remarkably commonplace.

This brings us to the final magnificent investment mantra and probably the most important: Patience. The Barclays graph reproduced here shows how investor patience can be rewarded. A hundred years is beyond our own human life span, of course, but most of our clients think beyond their own mortality and extrapolate their investment horizons out to their children and their grandchildren. Deafened by the cacophony of media-on-demand, it is easy to be distracted by the news and be beguiled into chopping and changing portfolios to embrace the moment.

Certainly, portfolios need thoughtful updating, as buy-and-hold shareholders in the likes of Kodak will testify. And determining which sectors and companies will remain relevant for the next generation is an art form as much as it is a science. But the strategy of holding dividend paying companies with an assortment of high-quality bonds for balance and diversity is back and the projected returns look very promising. Bring on the next 100 years.

Russell Collister

DIRECTOR OF GROUP INVESTMENT STRATEGY



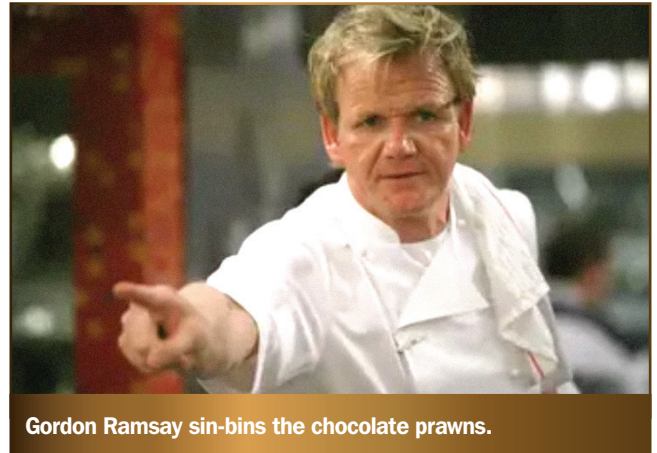
A Set Menu

The Rugby World Cup is well underway and as the tournament is being hosted by France, it presented me with an excellent reason to spend nine days in Nice, though the French coastline does more than enough to sell itself without sport. The food, of course, was fantastic, complimented by efficient and personable staff, all of which were necessary qualities when surrounded by competing restaurants. Holiday goers, after all, want to be pampered.

During a brief visit to a 'Nando's' on my way back to the Isle of Man, I reflected on how the restaurant chain's food, service, and clientele contrasted so sharply with those found along the French Riviera. The kitchens are designed so efficiently that the food (bizarrely) arrived in less time than it took to pour a pint of beer. Orders are paid for immediately on an app and face time with staff is reduced to a minimum. Obviously, this is by design. People know what they are getting and the company doesn't try to complicate what clearly works, by deviating from its specialty (in chicken). With equally specific food chains just around the corner, why would a company bend over backwards catering to tastes that can be better served by visiting the Barburitto (guess what they make...) next door? In the context of Liverpool One, there are more than enough hungry customers to go around, which allows companies to focus on increasingly niche tastes. The narrower the focus, the easier it is to scale.

On that theme, I have also watched my fair share of Gordon Ramsay and despite the stereotypical dramatisation expected of prime-time TV, one recurring pattern always seemed to be that restaurants with a more focused menu generally offered a better experience than those trying to cater to everyone. I recall one episode where chocolate prawns (really?) were advertised as the signature dish, but as the show rolled on, it was clear that none of the food was up to a good enough standard. In these cases, Mr Ramsay's first objective would be to reduce food choices and improve quality to help the restaurant turn a corner. The message was that you can't truly justify going 'off-piste' if you can't get the basics right. To use a guitar metaphor, one must first learn the chords before improvising. This is a truism which could be attributed to any industry or business. At FIM Capital, whilst we could embark on high frequency trading if we so wished, it's certainly never something we would want to offer. Our pièce de résistance is the provision of discretionary investment management services.

The refocusing of a business on its core areas is applicable to every industry and is particularly valid in the current environment, as firms are forced to reassess their business models in the face of rising input costs. For example, **Unilever** is a company whose mammoth list of 400 brands are recognised across the world in both developed and emerging markets. Like many other consumer goods companies, Unilever spent a lot of time cutting prices to maintain market share, however the law of diminishing returns applies here and only so much could be gained from selling more for less. As such, in recent years Unilever has shifted its focus towards specific regions (India, China, the US and Emerging Markets) and higher growth product categories. This also included a decision which might have unsettled a more



Gordon Ramsay sin-bins the chocolate prawns.

sentimental or long-standing investor: the sale of its tea business. Moves by the company in recent years have not been made without a fair dollop of criticism, but a good company can't be all things to all people, and an overly sentimental board may otherwise have done a disservice both to Unilever's shareholders and lovers of PG Tips.

This does not mean that the products or businesses in question are lacking in quality. Rather, it's an acknowledgement that certain business areas, particularly ones that don't fully compliment management's longer-term priorities, are better served in the hands of people who can offer them their undivided attention. A particular example of this can be found in **Melrose Industries** which recently rebranded as a dedicated aerospace company, after spinning out its automotive unit into the separately listed **Dowlais Group**. This is a big change of direction for the company; abandoning the 'buy, improve, sell' business model it had executed with great success since its inception in 2003. However, operating the two businesses together meant that the true value of the company's aerospace component was being diluted by the automotive side, the latter operating in an industry which generally trades on significantly lower earnings multiples by comparison.

A lot of these decisions are rarely as straightforward as they might seem from the outside and when things go right, the benefit of hindsight always makes the directives taken look so obvious. In any case, the importance of communicating a clear direction and leveraging your core skills, before going off-piste, cannot be understated.

Michael Craine

SENIOR INVESTMENT MANAGER

Don't Resort To Another 'Gay Future'

When interest rates rise, capital markets usually struggle. As such, it's surprising that this year's dividend flows and share buybacks from UK companies have been so robust, especially in September.

Once a clear recovery gets underway, this may create an unusual dynamic, as there will be less supply to meet investor demand given that new issues are as rare as hen's teeth these days. While the market yields 3.5% in financial terms, this rises to over 6% when buybacks are included. Of course, this is of no use currently and if the markets are not going up, not everyone will be happy. At times, investment managers wonder if their clients occasionally confuse them for clairvoyants, believing they have a sixth sense. Perhaps those who retired in their 50s really did. Our hunger to build capital for our clients is unrelenting and, my goodness, we do try, but sometimes investors must accept that being patient and harvesting dividend flows is more prudent than taking on excessive risks or seeking other ways of making money. There have been some truly ingenious attempts. One favourite was made into a film (featuring a young Pierce Brosnan), depicting a bunch of wily Irish chancers who attempted to make fools of the British aristocracy's dominance over the horse racing industry, nearly pulling off a betting coup in 1974. They ended up with minor convictions; quite remarkable for Irishmen, at a time when many places in Britain still portrayed signs saying, 'No Irish' and the news was dominated by the troubles in Northern Ireland.

The ringleader, a millionaire Rolls-Royce-owning Irish builder called Tony Murphy, had a plan based on training a decent horse in Ireland to run in a third-tier race at Cartmel in Cumbria, on the August Bank Holiday. It was one of the busiest racing days of the year and he sought to create a 'dead cert' on good odds, where substantial bets would be made. Cartmel was targeted because it didn't have a direct bookmaker's telephone link which would allow them to lay off money and lower the starting odds, if betting sentiment changed nationally. Murphy needed a British trainer to add credibility and chose Tony Collins, a Harrow-educated former stockbroker based in Scotland. A month before the race, Collins received an unnamed chestnut gelding into his yard and although documents indicated it was a horse called 'Gay Future', it wasn't. The real 'Gay Future' was still being trained intensively in Tipperary by Edward O'Grady (played by Brosnan) and was not sent across the Irish Sea until just before the race. Murphy's plan was that 'Gay Future' would feature in double and treble bets with Collins' other horses running at Plumpton and Southwell, but these would be pulled just before the race and become non-runners. This meant double and treble bets all hinged on the outcome of one race. Of course, everyone assumed 'Gay Future' was a lacklustre horse when it was in Collins' yard, so the switch occurred on the M6 on the way to the race. When the real horse arrived, Murphy arranged for soap flakes to be rubbed into its coat to make it look nervy and then, at the very last minute, they also switched to a top jockey. It's believed that Murphy managed to bet about £5,000 before Ladbrokes guessed that

something was up but with no telephone access, they had to resort to a motorbike despatch rider being sent from Manchester to Cartmel with a bundle of cash to try to shorten the course odds, but he failed, due to the Bank Holiday traffic. The horse started at 10-1 and won but Murphy's winnings were multiplied, given that he had used double and treble bets.



Gay Future, 1974: Double (and Treble) Jeopardy.

However, even the most meticulous plan can fall at the final fence. A reporter phoned Collins' yard to ask about the two non-runners only to be told that both were in the yard and could be seen from the window. Although Collins was at Plumpton, he did not take the horses, which was pivotal to the double and treble betting terms being honoured. He had not been kept abreast of the full plan and simply did not want to waste diesel at extortionate 1974 prices. Murphy and Collins were charged with conspiracy to defraud the bookmakers at Preston Crown Court although the judge made evident his feelings about whether there was even a case to answer. They received nominal fines, and whilst O'Grady went on to become a successful trainer, Murphy died just a few years later. As for Tony Collins, he can still be spotted at some meetings.

This was truly a great plan with masses of preparation involving many people but a breakdown in communications was its ultimate downfall. No one was hurt, although 'Gay Future' broke its neck at Wetherby a couple of years later. By contrast, investing (and being patient with it) is easier and the outcome more predictable. Shares of **Legal & General** trade on a modest price to earnings multiple at the bottom of its trading range, offering investors a 9% yield (and growing). Or, how about a **4 1/8% 2030 Index-Linked bond**? A £10,000 nominal holding costing around £33,500 will return investors £37,700 on redemption in 2030, while they will also see their income grow from £1,150 per annum to over £1,500, assuming that inflation averages 5%. Reinvesting income is a sure way to build capital, especially in difficult markets when total return investing can lead to nibbling away at one's seed corn. We all warm towards the likes of a Tony Murphy and while not quite as exciting, there are easier ways of making money. Of course, this all changes once a bull market returns and we may not have that much longer to wait.

Paul Crocker

INVESTMENT DIRECTOR

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