

## Alpha tactical asset allocation

8 January 2021

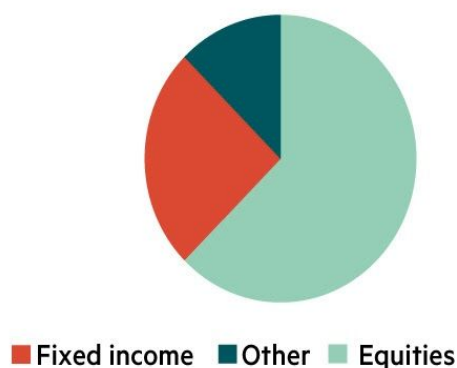
### Risk positive investing for 2021

*In 2020 the Tactical Asset Allocation portfolio made 12.4 per cent total returns before allowing for charges. The challenge for this year is being positioned to capture continued upside for technological and environmental mega-trends, while looking to manage risk. The tactical call we are making is that risk will be rewarded, so we are bullishly positioned. With 62.5 per cent in shares, however, we have to be prepared to stomach large falls in portfolio value if these calls prove wrong.*

#### Summary view:

- Our tactical asset allocation portfolio (TAA) is aggressively positioned for 2021, reflecting possible tailwinds for risk assets amid a great deal of uncertainty.

#### TAA 2021 IS SEEKING OUT RISK



Source: Investors Chronicle

## UK Shares to remain volatile but that could be an opportunity

Positive vaccine news and the early roll out of BioNTech/Pfizer jab in the UK, along with a recovery in commodity stocks has been helpful for the FTSE 100, but so too was renewed weakness in the value of the pound. Moving on from Brexit, unclear though that future is, it is important to really take stock of the UK market and decide where the best opportunities lie, knowing there is light at the end of the Covid-19 tunnel.

Further currency gyrations are likely, and many British businesses will have much weaker balance sheets coming out of the crisis. There will be special situations for stock-pickers to exploit, although UK plc is in poor health overall.

Back in May the TAA sold out of the FTSE 250 mid-cap index. The portfolio is now skewed to more thematic and global opportunities, so a UK value re-rating is one tactical opportunity being passed on. Hopefully this turns out to be a mistake.

We retain our FTSE 100 holding as although many of its bigger constituents are in sectors pummelled in the pandemic – oil & gas majors, banks and miners – a rebound in their fortunes is a bet on recovery. Plus, their earnings are global and not dependent on Britain. Dividends are vastly important to the long-run returns from UK shares, but investors should be prepared that payouts may take some time to recover.

## Looking to overseas shares for quality and growth

Since the global financial crisis, quality growth stocks have shone, with US technology shares outperforming spectacularly. The pandemic not only accelerated revenue growth for the likes of **Microsoft (MSFT)** and **Amazon (AMZN)**, the response from central banks – slashing interest rates and creating money for quantitative easing (QE) – lowered investors' required rate of return from stocks. This made the reliable cash flows from big tech companies, which also include **Apple (AAPL)**, **Alphabet (GOOGL)** and **Facebook (FB)**, relatively more attractive and created scope for them to become even more expensive.

With a 7.5 per cent weighting towards the S&P 500, the TAA has been underweight to US technology relative to a global index this year, which has been a bad call. The benefit of staying invested with this holistic portfolio, however, is that it doesn't seek to exit important markets completely. Our concerns about US valuations last year were proved incorrect, but we still maintained a significant position and didn't miss out on further

upside completely. Antitrust actions against Big Tech are more of an issue for 2021, so we don't rush to increase our allocation.

As well as the S&P 500 exchange traded fund (ETF), the TAA has US exposure through its thematic holdings. These include ETFs in A&I Robotics and investment trusts targeting biotechnology and environmental services, all of which have delivered stellar performance. These niche sectors are likely to continue to benefit from trends driving the world economy. In the case of environmental services, president-elect Biden's green agenda is a tailwind. This will gain further impetus now Democrats have won the state of Georgia's Senate run-off elections.

Financial technology (fintech) is another industry that has become prominent in the pandemic. Our holding, **Augmentum Fintech (AUGM)** is focussed on European opportunities, in the UK and on the continent. Relying on expertise to pick companies (including unlisted businesses) in growth areas of otherwise weakened economies, is a way to play long-term economic recovery.

The TAA's holding in listed eurozone equities, **db X-trackers Eurostoxx (XESC)**, is more of a traditional play on European recovery. The exposure to quality industrial and consumer goods companies give a more diverse value premium than just investing in the UK market. There is a high weighting to European financial stocks, which have been unloved since the financial crisis but have immense support from the European Central Bank. The more attractive elements of the index include industrial and consumer goods and luxury businesses.

French and German businesses have so far benefitted proportionately more than the UK from their relationship with the world's powerhouse economy, China. This year has provided a stark reminder of China's importance economically and, increasingly, in global capital markets. World class technology businesses mirror the steady cash flows and growth of their western counterparts.

The likes of **Tencent (HK:0700)** and **Alibaba (HK:9988)** are not yet on the same valuations (although they're by no means cheap) as the US tech giants. There is reason to be cautious, despite tailwinds for the China internet, gaming and e-commerce growth stories. Chinese regulators are getting much more uneasy about the power of internet companies and antitrust investigations should be taken seriously by investors. The authorities are particularly concerned by the power fintech businesses such as Ant Group (who's world-record IPO they scuppered) could have in the monetary system.

China now has around 50 per cent weighting in the MSCI Emerging Markets index which the TAA invests in. That still leaves the portfolio underweight to China in terms of its contribution to global GDP. Although it has done well this year, we will be selling out of

the ETF and holding a managed investment trust, **Schroder Asian Total Returns (ATR)**, which will give us a more considered exposure, including to Chinese companies. This is a popular trade and shares in ATR are priced at a premium to its net asset value (NAV), so we're not buying in on the cheap, but there are reasons to prefer the managed holding.

Active management is a way of avoiding state-owned enterprises and companies bid up to frothy valuations by domestic retail investors. In the case of China, there is also the complexity of opportunities listed in different jurisdictions to navigate. Holding an active fund also gives us more oversight on crucial developments between Chinese internet companies and regulators.

Balancing a preparedness to pay for management and quality growth in most Asian economies, there is more of a recovery value rationale behind TAA's weighting towards Japan. Although the demographic drag of an ageing population is often cited, Japan has many quality businesses and corporate debt levels were generally lower than at western firms going into the crisis. Reasons to be cautious include rising coronavirus infection rates, but Japan has done well to stymie its epidemic up until vaccines are firmly in the pipeline.

The effect a weakening US dollar and a stronger yen will have on exports to the United States is a headwind, although a positive trading relationship can be expected with a more orthodox US presidential administration next year.

As a signatory of Asia and Australasia's Regional Comprehensive Economic Partnership (RCEP), Japanese companies will have easier access to the closest and fastest growing export markets. Although, that is tempered by the fact that, as a producer of high-quality expensive goods, competition encouraged by the new agreement could hurt some Japanese businesses. Overall, there are still reasons to be positive, but TAA slightly downgrades its Japan exposure to make room for a new holding.

Buying **L&G battery value chain ETF (BATT)** is a way to capture upside from companies in the supply chain of electric vehicles and energy storage. This mega-trend made **Tesla (US:TSLA)** one of the hottest stocks of 2020, but we're aiming to play it from a much lower valuation. As this is in part an infrastructure investment, we trim an existing position to make up the new five per cent allocation.

Aiming for steady and low volatility returns, M&G Listed Infrastructure fund has been a large TAA position, although the fund wasn't immune to the coronavirus sell-off in spring. Longer-term the international holdings in utilities, clean energy (including transitional technologies), renewables and transport infrastructure (a sector that has suffered but has potential to re-rate when Covid-19 is under control), offer potential for capital growth and dividend progression.

This is an equity fund, however, and volatility this year demonstrates the fallibility of the bond proxy argument. Vast government spending to help the world recover from the pandemic and address the climate crisis is supportive of the investment case, but listed infrastructure isn't a perfect substitute for the 'risk-free' returns government bonds used to offer.

## Negative real rates at the heart of a fixed income conundrum

Close-to-maturity UK government bonds (gilts) are so expensive they have a negative nominal yield. The gilt yield curve (the linear relationship between yields and time to maturity) doesn't indicate yields above zero out to eight years, which encourages investors to invest in longer dated bonds that offer positive returns, albeit these are vulnerable to inflation.

The relationship between bond yields and inflation may not be as marked as in the past, however. In their 2021 outlook, the Blackrock Investment Institute stresses the concept of "a new nominal" for rates. Chief Fixed Income Strategist, Scott Thiel, explains: "We see stronger growth and lower real yields going ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields – even as inflation expectations climb. This implies that nominal yields will be less responsive to rising inflation risk than in past episodes – this is central to the theme of policy revolution."

Short-dated UK government bonds hold their place in the TAA, because although they offer a negative real yield, they are a safer asset when the riskier holdings in the portfolio sell-off.

We avoid nominal gilts with longer maturity and we're adding some exposure to inflation-linked gilts ('linkers'), although there are price risks. Index-linked gilts are a crucial asset for UK pension funds which need to match future liabilities but for a tactical portfolio like ours, the worry is fluctuation in prices as interest rates change affect the capital value of the bonds.

Our TAA retains some holdings in investment grade (companies with better credit ratings) corporate bonds but pares back on last year, to reflect the 'spread' compression between yields on corporate and government bonds as credit prices have recovered. We also have a higher risk position in so-called "fallen angel" corporate bonds. This invests in the debt securities of companies – many in the United States – that have seen their credit rating down-graded but where fundamental factors for recovery exist.

Spread compression is a prime consideration in the Blackrock Investment Institute's fixed income strategy. It is the reason, having seen investment grade credit make gains in 2020, their model asset allocation for now redeploys toward high-yield and emerging market bonds. It is a position we are copying for the TAA, in what is another nod to a

bullish view on Asia. We add a US dollar emerging market bond position through iShares JP Morgan \$ emerging market bond (EMHG). We do fully acknowledge, however, that a local currency exposure could be even more rewarding, given the recent trend of dollar weakness.

## Alternative risk assets: real estate, gold and cryptocurrencies

The **HSBC FTSE Epra/Nareit (HPRO)** ETF tracks a global developed market real estate index with a bias towards North America but it also has exposure to Europe and Asia. The type of assets in the underlying index include warehousing businesses and properties that are central to the new economy, not traditional office and retail space. This holding remains attractive as returns are in kilter with the real time economy (the stock market is more forward-looking), so diversifies some cyclical risk.

Gold is traditionally a portfolio diversifier as it rarely moves perfectly in tandem with stocks and bonds. The yellow metal often has a negative relationship with the US dollar, which is partly because it is priced in dollars. Furthermore, should there be an inflation shock in future, the protection gold offers as a store of value is worth considering.

Secular decline of fiat currencies, in a world of mountainous debt and slow growth, is another argument gold-bugs are fond of. With global growth likely to be driven by Asia, it is time for TAA to acknowledge that the US dollar may eventually come under pressure as global reserve currency. The greenback has shown weakness towards the end of 2020 and more money-printing and US government borrowing will continue to add to the bear case.

What replaces the dollar is more up for debate, China's renminbi will become more important but for now we play speculation on the currency theme through cryptocurrencies. Recognising this is indeed a bet on the direction of prices, and therefore a risky play, we would only advocate allocating a slither of the portfolio.

Due to a Financial Conduct Authority (FCA) ruling, the ETF we would like to use to benchmark returns from cryptos is no longer accessible to retail investors. Ironically, concerns about suitability could end up driving investors from a regulated German-listed product to the 'Wild West' of crypto exchanges. Still, this is an asset worth following, so we'll track the Bitcoin price for the 2.5 per cent allocation. Keeping such high-risk speculation to a low proportion of the portfolio, should be the takeaway for investors following the system - as the savage drops since the turn of the year should remind us, Bitcoin and other cryptos aren't a one-way bet.

**The full list of holdings for the TAA are in the performance table below**

Fund (ticker)	% TR since Nov 2019	% TR since May 2020	New % Weight
iShares FTSE 100 (ISF)	-4.34	15.33	5
db X-trackers Eurostoxx (XESC)	6.43	26.04	5
Vanguard S&P 500 (VUSA)	16.79	16.54	7.5
iShares MSCI Japan (IJPA)	15.19	27.84	5
iShares MSCI emerging markets (EMIM)	22.49	30.67	SOLD
M&G Global listed infrastructure Acc	5.06	9.52	7.5
iShares automation and robotics (RBOT)	47.69	49.6	5
Augmentum fintech (AUGM)	26.73	57.14	5
Impax environmental markets (IEM)	40.14	46.99	5
Biotech growth trust (BIOG)	95.52*	36.17	5
Schroder Asian Total Return (ATR)		NEW BUY	7.5
L&G battery value chain (BATT)		NEW BUY	5
Lyxor FTSE actuaries gilts 0-5yr (GIL5)	1.22	0.09	5
iShares £ corporate bonds (IS15)	3.55	4.62	5
iShares 'fallen angels' (WING)	20.96	21.09	5
iShares index-linked gilts (INXG)		NEW BUY	5
iShares JP Morgan \$ EM bond (EMHG)		NEW BUY	5
HSBC FTSE Epra/Nareit developed (HPRO)	-15.18	9.49	5
Invesco Physical Gold (SGLD)	31.02	9.29	5
Bitcoin		NEW BUY	2.5

Portfolio total return (including loss on FTSE 250 sale in May): **12.4 per cent**

\*BIOG was only bought in May 2020 so only the TR from that date was included in the portfolio total return figure.



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