Q4 2018 GAM Multi-Asset Solutions Letter

Marketing Material

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Review

The MSCI AC World index was down -7.2% in local currency terms in 2018, having compounded at over +10% a year from 2010 to 2017. Volatility and uncertainty made an unwelcome comeback and in the eyes of the current US administration, the fault lay squarely with the Federal Reserve's excessively hawkish stance on interest rates. While we concur that there was no inflationary threat to justify the unquestioning monetary tightening cycle that characterised Fed policy in 2018, this was only one of several anxieties the market faced during the year, including - inter alia – US-China trade disputes, US dollar strength, European political turmoil comprising Brexit, Italy and more recently France's gilets jaunes, falling commodity prices, the higher cost of corporate credit, an emerging markets crisis and now a US government shutdown. Unlike the last serious growth fright of 2015-2016, neither the US or China appeared able to do anything this time around. This left investors with the challenge of determining whether the market volatility was truly justified by a corresponding deterioration in economic and corporate fundamentals. Looking at economic growth, the markets may have had a point. Global trade slowed in 2018, with a corresponding impact on world growth projections generally. In the US, the economy had reached a healthy 3.4% growth rate thanks in part to the Trump tax and spending bills but the median growth consensus for 2019 was a much lower 2.6% by the end of the year. However, this slowdown had been anticipated for some time and hardly represented a recession or depression scenario. US corporate earnings meanwhile continued to grow at a healthy pace in the latter half of 2018 even if they couldn't match the peak reached in the second quarter of the year. Finally, the market sell-off that came at the end of the year saw stocks with sound fundamentals aggressively marked down by investors determined to sell what they could rather than what they wanted. This spoke of excessively negative sentiment, even adjusting for the softening of fundamentals described.

Portfolio positioning *

With the above in mind, we have avoided any panic-sale of equity allocations within strategies. For all their intrinsic volatility, equities are an asset class with a proven and reliable long-run associated rate of return. This is both crucial and reassuring to know, given the well-established futility of market timing. Any casual observation of historic equity fund flows reveals a positive correlation with recent returns, demonstrating that to their detriment investors tend to add to rising markets and redeem out of falling ones. A contrarian investment policy which adds to the market as it sells off is generally preferable but to do so meaningfully still carries risks in the event that the market continues to deteriorate after initial downward lurches. Instead, we focus on the risk profile of our given strategies, complementing this by regularly rebalancing portfolios in order to incrementally add to distressed areas and sell out of overheated ones. We are confident that over time this is the best way to meet our stated investment objectives.

* Where relevant, since not all our clients are invested in the same strategies. Nonetheless, common themes run across our allocations, so we trust that an overall flavour of our positioning will be informative.

Within equities, we maintain a meaningful allocation to the US – in particular Quality stocks – while our ex-US exposure is focused on Emerging Markets, Asia and Japan. We are cautious on Europe, both the UK for Brexit uncertainty and the continent for its slowing growth, fragile politics and over-reliance on overseas demand for its industrials, chemicals and auto sectors. Away from equities, we prefer cash proxies where appropriate, along with mortgage-backed security (MBS), insurance-linked and high yield bonds. While the latter offers a higher correlation to equities we believe that the combination of low default rates and wider spreads bode well for total returns in 2019. We are sceptical of many Alternative Investments and 2018's tough year for the industry appeared to confirm our doubts. Here, we concentrate only on a few select areas which we believe can deliver reliable, low correlation returns in the medium term.

Conclusion

Investment commentary around the start of a new year is invariably laden with predictions but this year's represents perhaps the most diverse set of views seen for nearly a decade. We believe that it is perfectly possible for the early months of 2019 to see stabilisation in markets. Better liquidity levels will return after the holiday break while the US Federal Reserve will no longer be under self-imposed pressure to raise interest rates further, having done so in December. And concerted efforts to achieve a trade accommodation of some sort between the US and China are in plain evidence. It is also worth noting that for all the concern about slowing global growth, this is hardly 'new news' and markets have already made a significant adjustment. But more important than whether our own forecasts come to pass is the suitability of a given strategy for an investor. Those who found themselves worried and sleepless over the recent market ructions may be holding an inappropriately high equity allocation relative to their objectives. Conversely, being able to absorb every twist and turn of recent market developments suggests that an elevated equity allocation might be appropriate over time. The real value of volatility therefore lies less in any perceived market timing opportunity than in its ability to test suitability against long term objectives. As such, 2018 was a welcome reminder that the appropriate combination of assets for the long term will be of far more profound consequence than the appropriate combination of assets for 2019.