# Time for change

## Simple has worked – but for how long?

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## At a glance:

- Cost considerations have pushed simple passive portfolios to the fore
- And stiff tailwinds have helped them outperform
- Will that continue or are we heading for a new market regime?
- Time to get active – considering risks and opportunities
- Flexibility and balance matter – are your 'simple' recommendations unbalanced?

Think simple, shorten your perspective and investment can seem easy. Build or select your clients a portfolio that's a straightforward blend of equities and government bonds, invests in each asset class passively, and in the last 10 years or so you've likely made a recommendation that's resulted in impressive returns.

But there are reasons why 'simple' has delivered the goods:

- We've been in an era of unprecedented quantitative easing (QE) – the purchase of financial assets by central banks has boosted prices and fuelled a long bull market in equities and bonds. Those sensibly diversifying into alternatives meanwhile, may have seen their strategy struggle to keep pace.
- When it comes to 'style' – growth is all that's mattered – sensible in low interest rate and inflation conditions but momentum can (and arguably has) become self-fulfilling and driven prices beyond fundamentals. With indices dominated by the likes of Facebook, Apple, Alphabet and Amazon, passive orientated investors have likely profited over those with a more value focused mindset.

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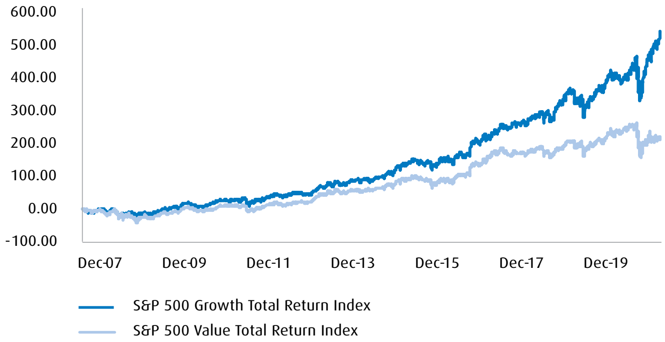
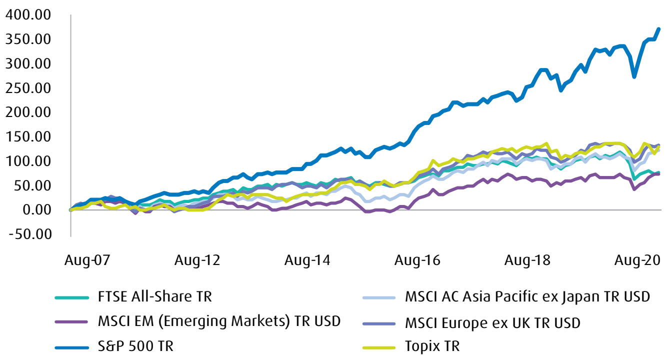
### Growth v value




Source: Lipper IM, Total Return in sterling

- The US has outperformed many other countries – simply weight your portfolio to reflect market size and the outperformance of the world's largest economy and index driven in no small part by its tech leaders would have been a fruitful approach. It will also have benefited a strong dollar.

### US v other markets




Source: Lipper IM, Total Return in sterling

Throw low costs into the mix and the last decade suggests that you can have you cake and eat it. But is it really that straightforward and will such a strategy continue to deliver from here? As the risk warning rightly points out, 'past performance is not an indication of future performance!'

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## Same again for simple in the 20s?

So, what might serve to disrupt the performance of 'simple'? First off, we think it wise to extend your time horizon. Look at lessons from history and there's a strong argument for considering the potential impact of a shift in the market regime and future returns potential. Changes in market leadership can be rapid and for those blindsided by their emergence painful. Japan in the 80s, commodities and tech in the 90s and 00s all illustrate how swift a change in market regime can be. Now of course we're not suggesting we can predict with any real accuracy the timing of any shift, but we think it's sensible to question whether the factors that have proven so dominant in recent years are set to maintain their influence over returns. Perhaps a balance is more appropriate now than ever, as the duration-driven regime gets very long in the tooth?

## Tailwinds for 'simple' set to fade?

QE has been a powerful tool but the extent and duration over which it has been deployed leads many to question its effectiveness from here. Interest rates are already low (and in some cases negative) meaning it would be hard to envisage bonds rallying significantly from what are arguably already elevated levels. If the QE tailwind becomes less powerful, then simply 'buying the market' seem less attractive and perhaps, investors will refocus on fundamentals?

And, with the power of QE fading, what about governments turning on the fiscal taps to stimulate economies impacted by COVID-19? This in turn has implications for interest rates and inflation – if they start to tick upwards then many of the assets that have benefited in a 'lower for longer' world could come under pressure and those (like value orientated equities) that have lagged may well begin to prosper. It's hard to predict these outcomes with any real certainty but the combination of QE and fiscal measures in Japan during the Abenomics era briefly triggered an increase in economic activity a rise in inflation on all three times it was tried. In each case it was quickly choked off by sales tax increases – a lesson all central bankers will have heeded in their studies. We are not saying that the cost of borrowing or inflation are set to tick rapidly upwards but a number of the managers we speak to – including some that correctly called the low rate world we've found ourselves in – are beginning to view an environment in which higher inflation is a feature as more likely. At the same time central bankers are indicating they would allow it.

## Opportunity cost – simple set to pay a performance price?

When selecting an investment solution – a predominant focus on cost inevitably results in a preference for simple. As we all know, active investing comes at a higher price – a price that in the conditions we've seen in recent years hasn't been, in the eyes of many, worth paying. But could a shift in regime see investors pay a more painful price when picking a low-cost route? We think it's a possibility, especially when passive investing results in over-exposure to expensive assets with limited potential and an under-representation in cheaper assets that could well prosper as different drivers of markets pick up the baton.

So, what's the answer? Well in terms of timing and the extent of any change we can offer little in terms of specifics. What we can do is be mindful of a potential shift, the risks it poses and the potential opportunities it presents. To us the answer – as it always is – is all about balance and being active. Sure, there will be times when themes can overpower these principles but eventually – as borne out by our long-term track record – they will bear fruit.

We think for example, that active consideration of 'valuation' is critical. After all, it is the ultimate determinant of returns and is something that a low-cost passive approach simply doesn't and can't do. What about companies that have seen their share prices rise largely on falling interest rates as opposed to their actual earnings and profits? There are many companies that have done exceptionally well in terms of share price performance but are yet to make a profit. Equally so, there are plenty of businesses that are doing well but haven't seen that performance reflected in their share price. Allocate to the former because they make up a big chunk of the index and capital becomes more at risk should rates reverse and valuation comes under scrutiny. The reverse applies to business where potential hasn't been reflected in price. Both scenarios, in our view, underline the importance of fundamentally based active investment, in a portfolio with a blend of styles and a flexible approach. Time will tell if the duration asset boom is over, but the scale of the impact of COVID-19 and the extreme fiscal and monetary measures taken are likely to have consequences.

It's these potential consequences as well as other factors that we consider when building our portfolios. We can be nimble and actively reposition when we deem the time is right but more importantly, we work to maintain balance – a key characteristic long-term and especially so in markets that have been heavily influenced by factors beyond fundamentals. In our view, advisers would be wise to consider potential (and from their perspective unintended) imbalances in a simple passive portfolio and what any regime change may mean in the context of ensuring their clients achieve their objectives.

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