FPSB IRELAND
FINANCIAL PLANNING STANDARDS BOARD

CFP® Investment Series Event 3 – Joe Mottley

Webinar

29th Sept 2020

SETTING A LONG TERM INVESTMENT STRATEGY

Some Issues to Consider

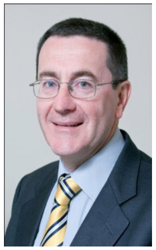
29th September 2020

Clarus Investment Solutions

Principals

Paul McCarville

Joe Mottley



- Independent boutique investment consultancy – CBI regulated
  - Advice on strategic and tactical asset allocation
  - Portfolio design & selection of components
  - Research/due diligence on funds and investment products
  - Due diligence and oversight on investment managers & product providers
  - Education & training services for professional bodies and industry associations
  - Expert witness reports in investment mis-selling disputes
- Client base includes financial brokers, pension schemes, charities and corporates.

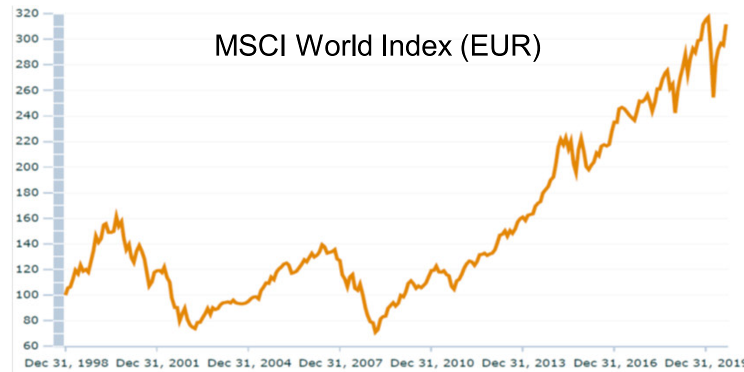
Agenda

- Equities – a long-term perspective
- A word on inflation
- Projecting long-term investment returns
- Diversification: Some alternative asset classes
    - Property
    - Absolute return
    - Gold
    - Emerging market debt
- Q&A

Equity Returns – The Gift that Keeps Giving

Global equities have produced strong returns over a long time, even with severe drawdowns in 2000-2003, 2007-2009 and 2020

Pronounced leadership from North America – now 70% of index weight



MSCI.com

MSCI Returns to 31-Aug-20 *(EUR terms)*					
From	**Feb-09**	**Sep-07**	**Mar-03**	**Aug-00**	**Dec-98**
	<-------------- *% p.a.* -------------->				
MSCI World	**13.7%**	**6.8%**	**8.6%**	**3.3%**	**5.4%**
MSCI North America	16.4%	9.4%	9.5%	4.1%	6.2%
MSCI Eurozone	8.6%	1.3%	6.3%	1.3%	3.1%

MSCI.com

Equity Returns – The Key Drivers

1. Earnings Growth

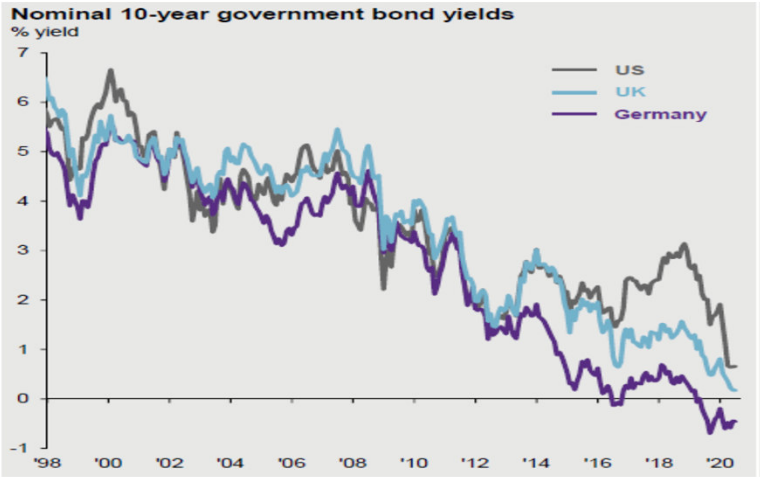
Global EPS growth in latest market cycle c. 10.5% - well ahead of global nominal GDP growth ~ 7%

Growth in Earnings per Share *2009 - 2020*	
FTSE World Index	10.5% p.a.
S&P 500	6.4% p.a.

FTSERussell.com, Yardeni Research

2. Discount Rate

Relentless downward trend in benchmark sovereign bond yields, reaching all-time historic lows



JP Morgan Asset Management

Equity Returns – The Key Drivers

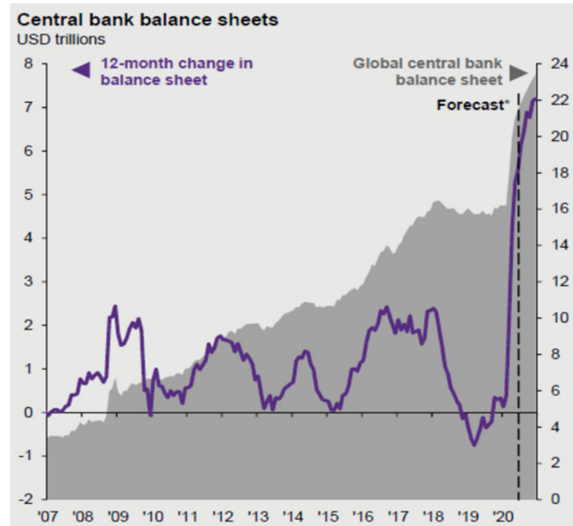
3. Liquidity

Money creation by central banks has fed into asset markets, not the real economy

Aggregate global central bank balance sheet size:

pre-GFC: $4 trillion

2020: €22 trillion



JP Morgan Asset Management

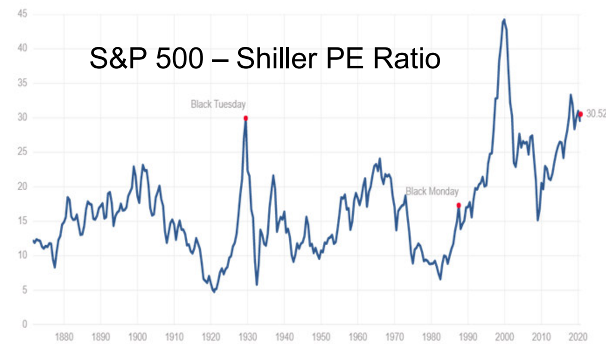
..the response to the financial crisis, and now the pandemic, continues the asymmetric monetary policy which has prevailed since the late 1980s. ***The US Federal Reserve has established a pattern of bailing out markets when they collapse, but failing to cap them when they fail prey to bubbles***.

John Plender, Financial Times, 11-Sep-20

Equity Valuations: On High Ground?

Shiller PE Ratio (CAPE)

Ratio of current market level to 10-year average EPS, inflation-adjusted – S&P500 now at levels only exceeded during Dotcom bubble



Yardeni Research

Market Cap to GDP (US)

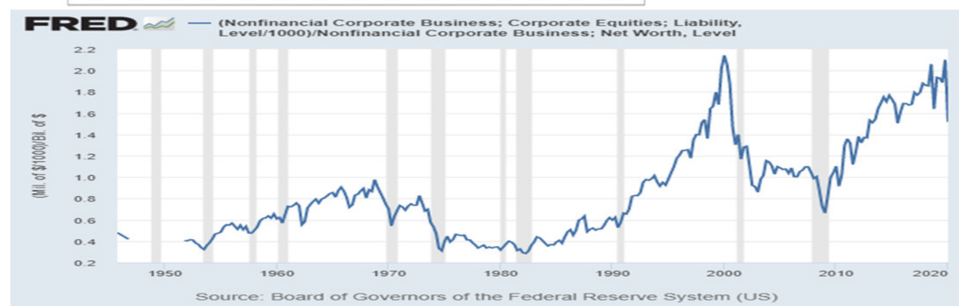
"The Buffett Valuation Indicator"

Also at levels only ever seen late in the DotCom bubble

Advisor Perspectives

Tobin's Q (US)

The ratio of total market value to total replacement cost of assets

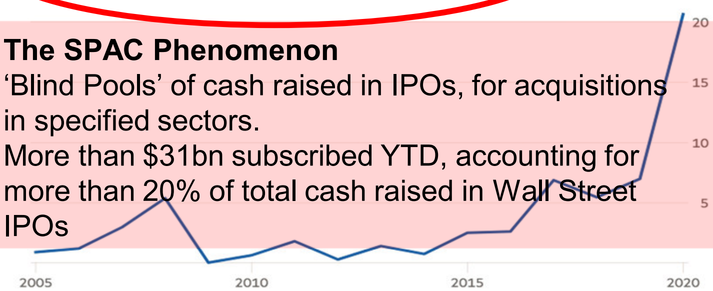


Signs of Irrational Exuberance?

Say it you cowards. Stocks only go up. Stocks only go up. Say the words Ron. I am your King. #DDTG

Spacs make up one in five dollars raised in IPOs this year

Global Spac proceeds as proportion of initial public offerings (%)*



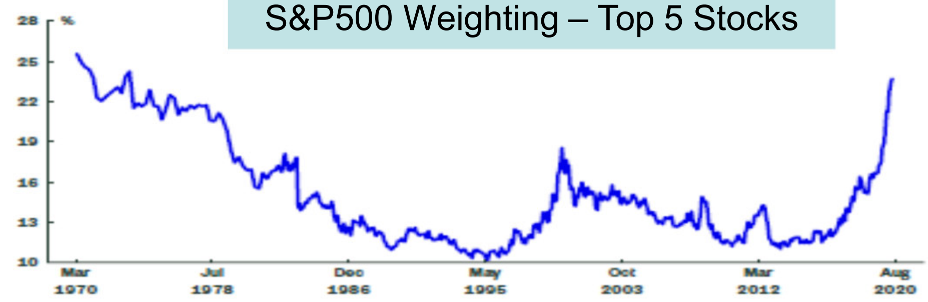
The SPAC Phenomenon
'Blind Pools' of cash raised in IPOs, for acquisitions in specified sectors.
More than $31bn subscribed YTD, accounting for more than 20% of total cash raised in Wall Street IPOs

*2020 data is year to August 5
Source: Refinitiv
© FT

Tesla Inc	
Price/Sales	13.8 x
Price/Book Value	35.2 x
Enterprise Value/Operating Cash Flow	101.3 x

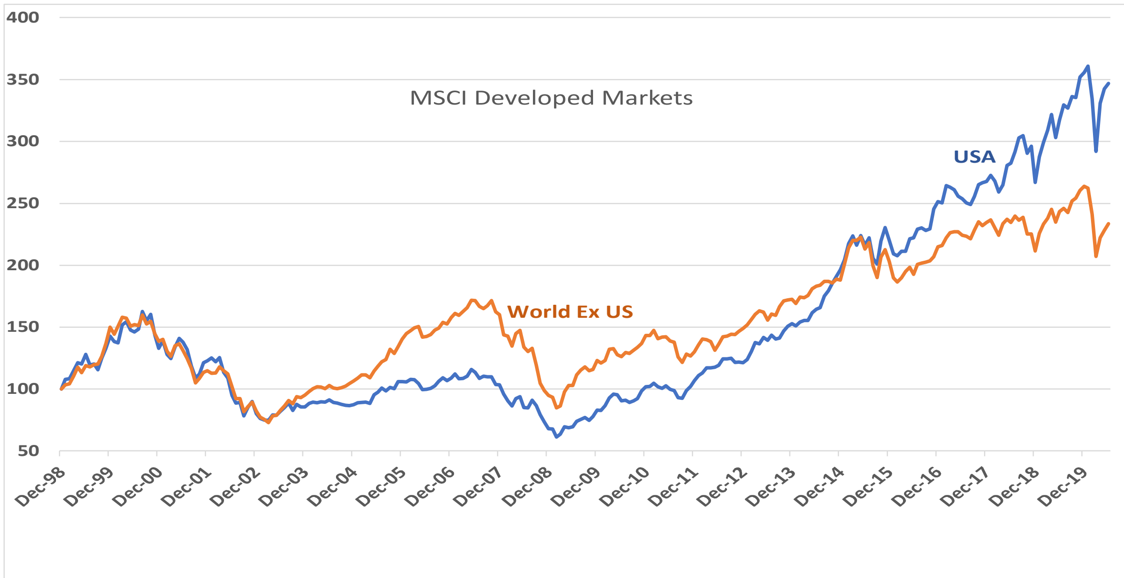
FT.com

S&P500 Weighting – Top 5 Stocks



State Street Global Advisors

Valuation Disparities - Regional



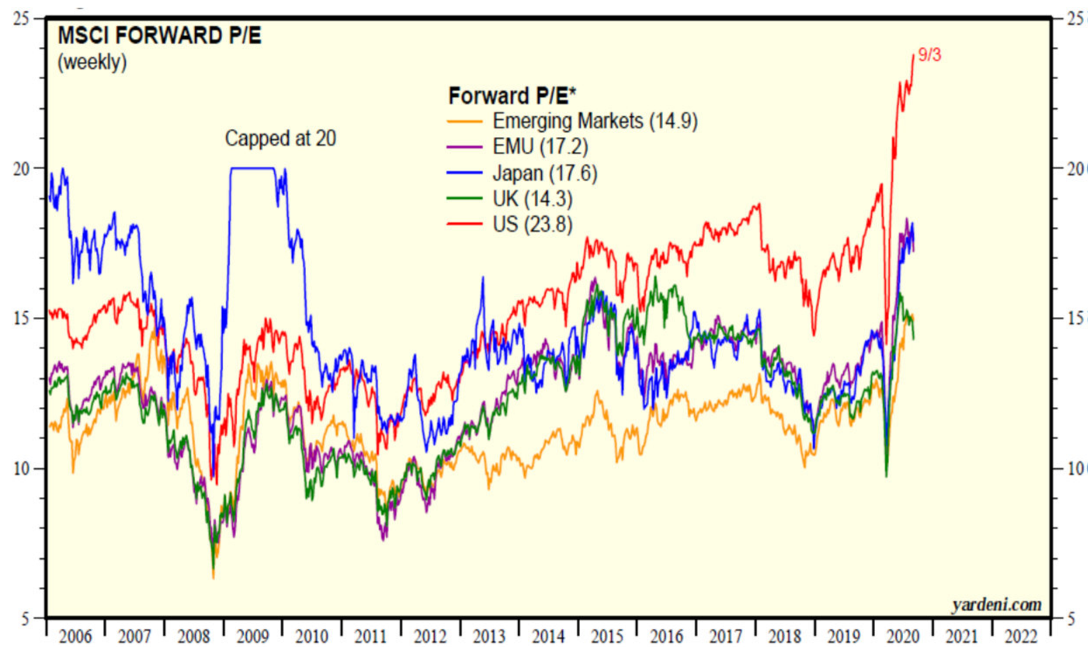
MSCI.com

Extraordinary outperformance by US against Rest of World since 2015

5 Years to 30-Jun-20 (Net Total Return, EUR terms)

US	+60.5%
World ex US	+9.6%

Valuation Disparities - Regional



Yardeni Research

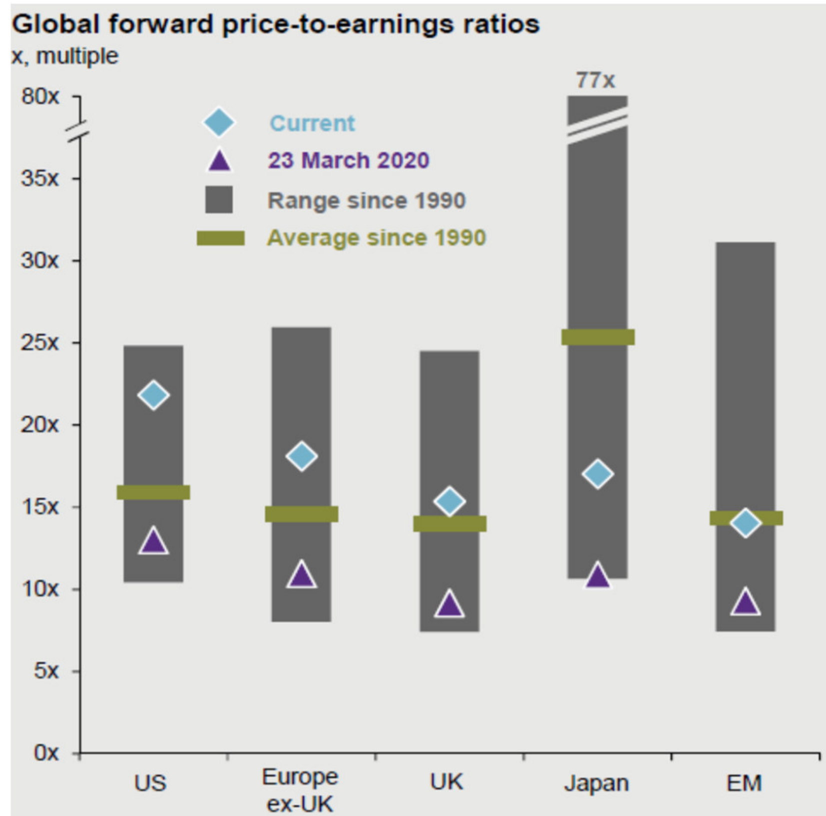
US valuation ratios (illustrated here by P/E) usually tend to be higher than other regions…..but the gap has ballooned more recently

Valuation Disparities - Regional

A longer-term perspective on regional valuations….

US seems on high ground relative to 30-year history

Most other blocs positioned in 'reasonable-to-cheap' territory



JP Morgan Asset Management

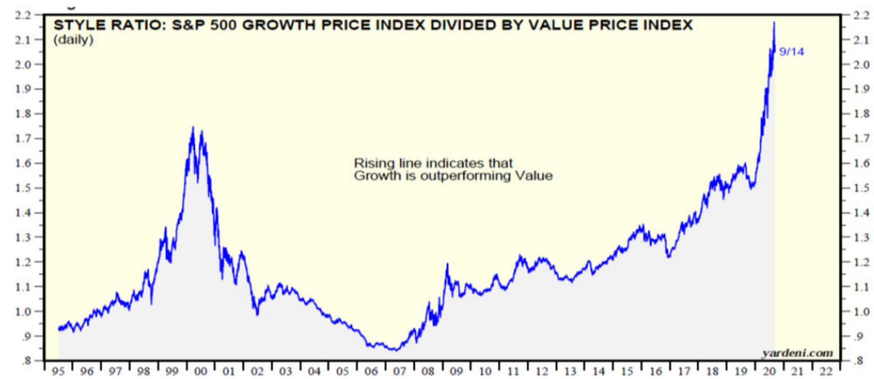
Valuation Disparities - Style

Consistent pattern of outperformance by Growth relative to Value evident since GFC…..

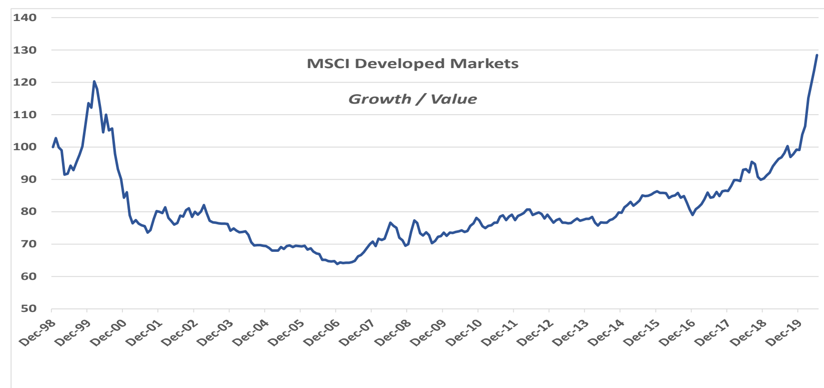
Global phenomenon, especially strong in US…..

Acceleration in recent quarters has been dramatic

We can explain, but can we justify?....

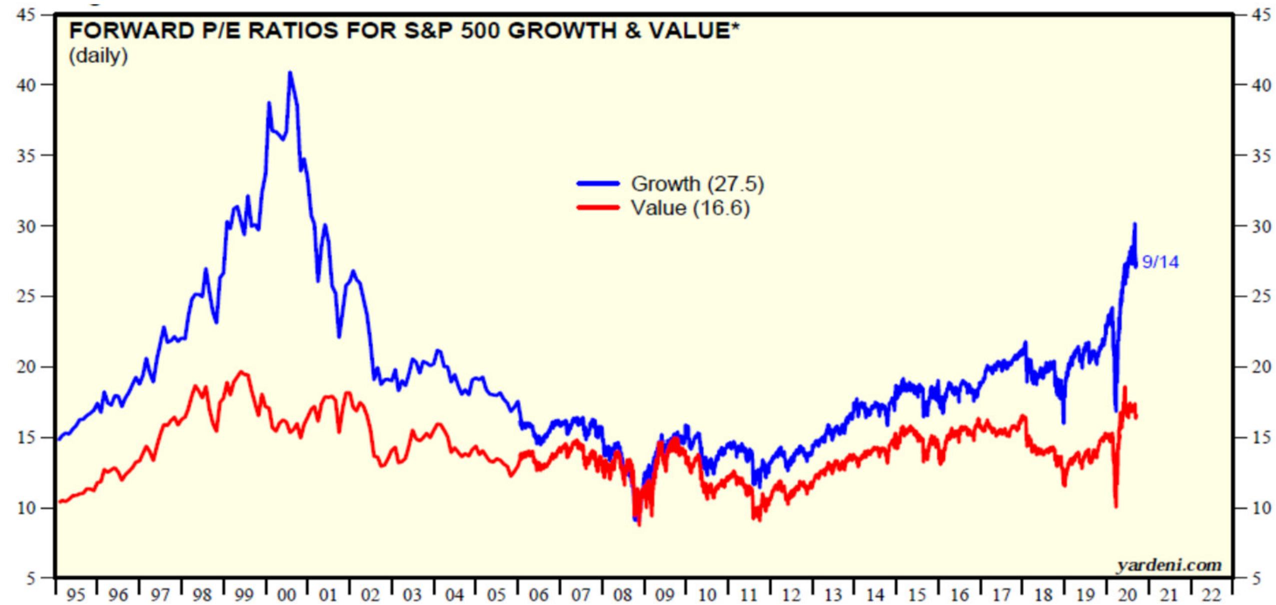


Yardeni Research



MSCI.com

Valuation Disparities - Style

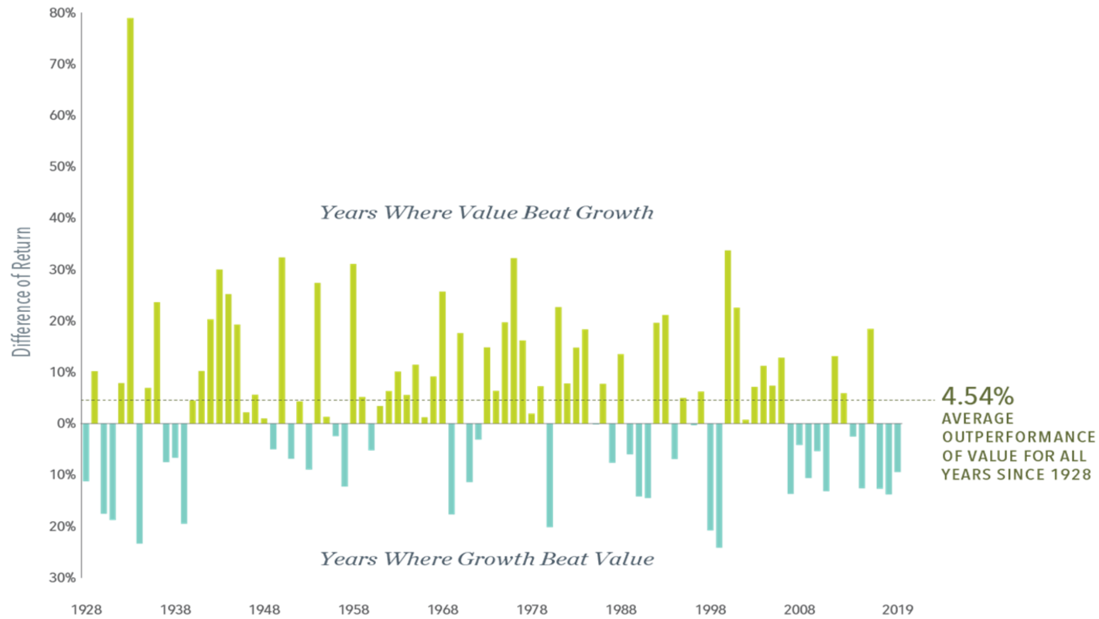


Yardeni Research

Growth can be expected to show a valuation premium over value…..but how much?

Gap is wider than any time since Dotcom era

The Value Return Premium – Long-Term

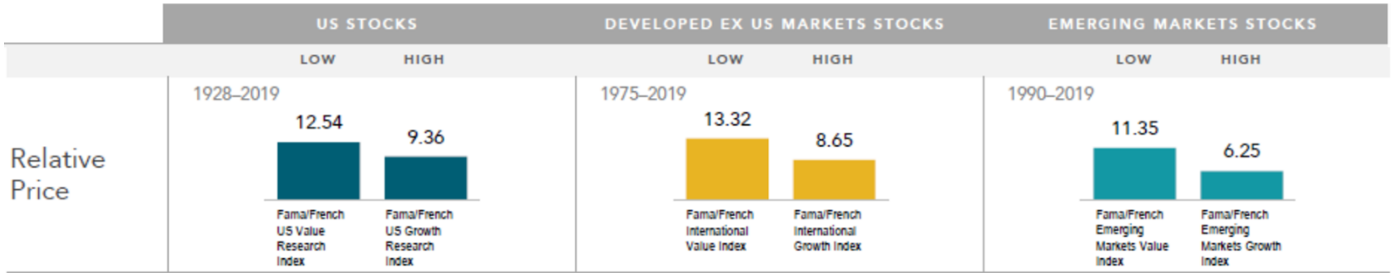


Dimensional Fund Advisors

Compelling evidence that:

Value earns a return premium over Growth over the long term, albeit with much volatility and extended periods of underperformance

The Value Return Premium – A Global Phenomenon



Dimensional Fund Advisors

Long-term outperformance of Value is a global characteristic:

Region	Period	Value Premium (CAGR)
US	1929 - 2019	3.1%
Developed World Ex US	1975 - 2019	4.7%
Emerging Markets	1990 - 2019	5.1%

Dimensional Fund Advisors

Lessons from the Dotcom Bubble

Style Rotation in Action

Period	Cisco	Kroger
Jan-99 - Mar-00	230%	-40%
Apr-00 - Dec-00	-53%	53%

FT.com

1. Reversals of extreme style divergences can be swift and brutal
2. The out-of-favour stocks and sectors can earn positive returns even as headline indices fall

Equities – Summary View

1. Overall future returns likely to be much lower than those enjoyed in the past decade

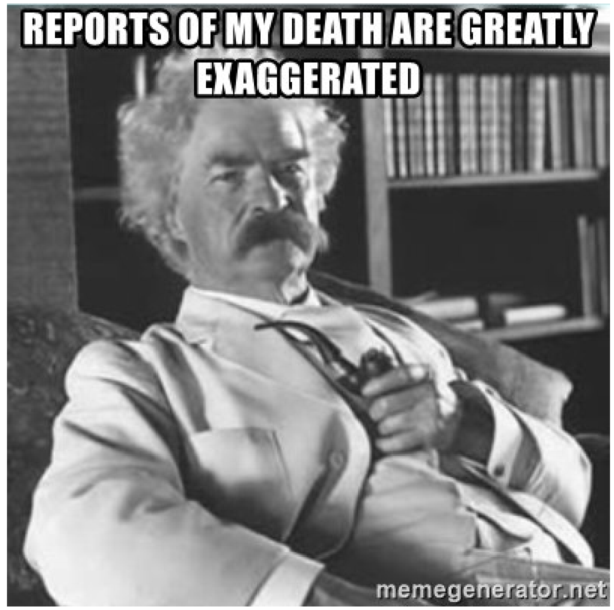
2. More challenging outlook for corporate earnings growth

3. Some worrying signs of stretched valuations and speculative excess

4. Overvaluation and extreme speculation most evident in US / popular mega-cap growth stocks

5. Look to tilt portfolio exposures
   a) Away from US
   b) From Growth towards Value

A Word on Inflation



An <u>existential</u> and <u>asymmetric</u> risk to investors

Stock markets eventually recover from drawdowns, but purchasing power destroyed by inflation is gone forever

Long-Term Potential Inflation Drivers

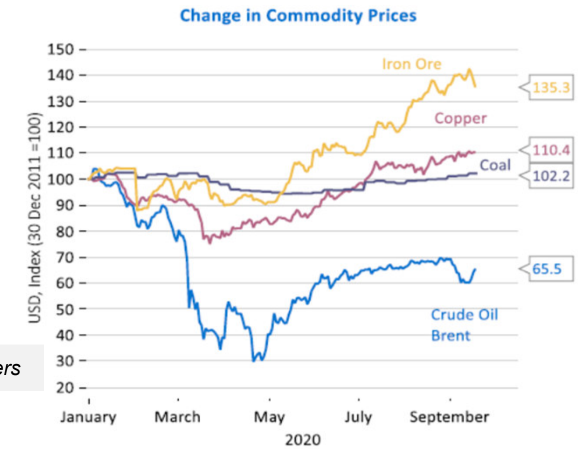
1. Shift of manufacturing to low-cost locations – the trend is largely played out
2. Global trade tensions (especially US/China) => reduced competition in traded goods
3. Post-Covid re-engineering of supply chains – more resilience in place of maximum efficiency
4. Cumulative monetary stimulus since 2008
5. Covid-19 fiscal stimulus – some measures may be hard to unwind as recovery takes hold
6. Populism / inequality – changing political climate could lead to recovery in the bargaining power of labour?
7. Climate change

Recent Potential Inflation Flags

1. Step-change in Fed policy

"With inflation running persistently below this longer-run goal…we will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer"

2. Robust commodity prices YTD



Sarasin & Partners

3. Rebound in market inflation expectations:

US 5Y/5Y forward inflation curve

Federal Reserve Bank of St Louis

4. Gold

World Gold Council

Formulating Projected Investment Returns

Asset Class	Basis of Nominal Return Projection
Equities	Constant-growth dividend discount valuation
Investment-grade nominal bonds	Current gross redemption yield
High-yield nominal bonds	As investment grade, less haircut for credit losses
Inflation-linked bonds	Current real yield + assumed inflation
Property	Current rental yield + assumed real rental growth + assumed inflation

Equity Methodology – Dividend Discount Model

P = price   D = next annual dividend   r = discount rate   g = constant rate of dividend growth

Then, $P = D + D(1+g)/(1+r) + D(1+g)^2/(1+r)^2 + D(1+g)^3/(1+r)^3 + \ldots\ldots\ldots\ldots$

Which reduces to $P = D/(r-g)$, or $r = D/P + g$

Ie. Rate of Return = Dividend Yield + Nominal Dividend Growth

or

Rate of Return = Dividend Yield + Real Dividend Growth + Assumed Inflation

Current Return Projections

Asset Class	*DM Equities*	*EM Equities*	*Euro Svgn Bonds*
Div Yield	2.2%	2.6%	0.3%
Real Growth	1.0%	2.0%	-
Inflation	2.0%	2.0%	-
	--------	--------	--------
Nominal Return	***5.2%***	***6.6%***	***0.3%***

Clarus Investment Solutions

Diversification and Alternative Assets

diversification
[dih-vur-s*uh*-fi-**key**-sh*uh*n, dahy-]

noun

1. Owning some stuff you don't like

Some Key Considerations

1. What might supplant role of bonds in a lower/medium risk balanced portfolio?

2. Inflation hedging?

3. Growth assets with low correlation to global equities

Commercial Property

Now does not seem to be an especially attractive entry point:

- *Structural reduction in demand for office space*
- *Acceleration of trend to online retailing*

BUT….

Long-term investment characteristics of property should not be overlooked:

1. Equity-like returns in the long run
   Irish property funds 1990 – 2019: +6.3% p.a.

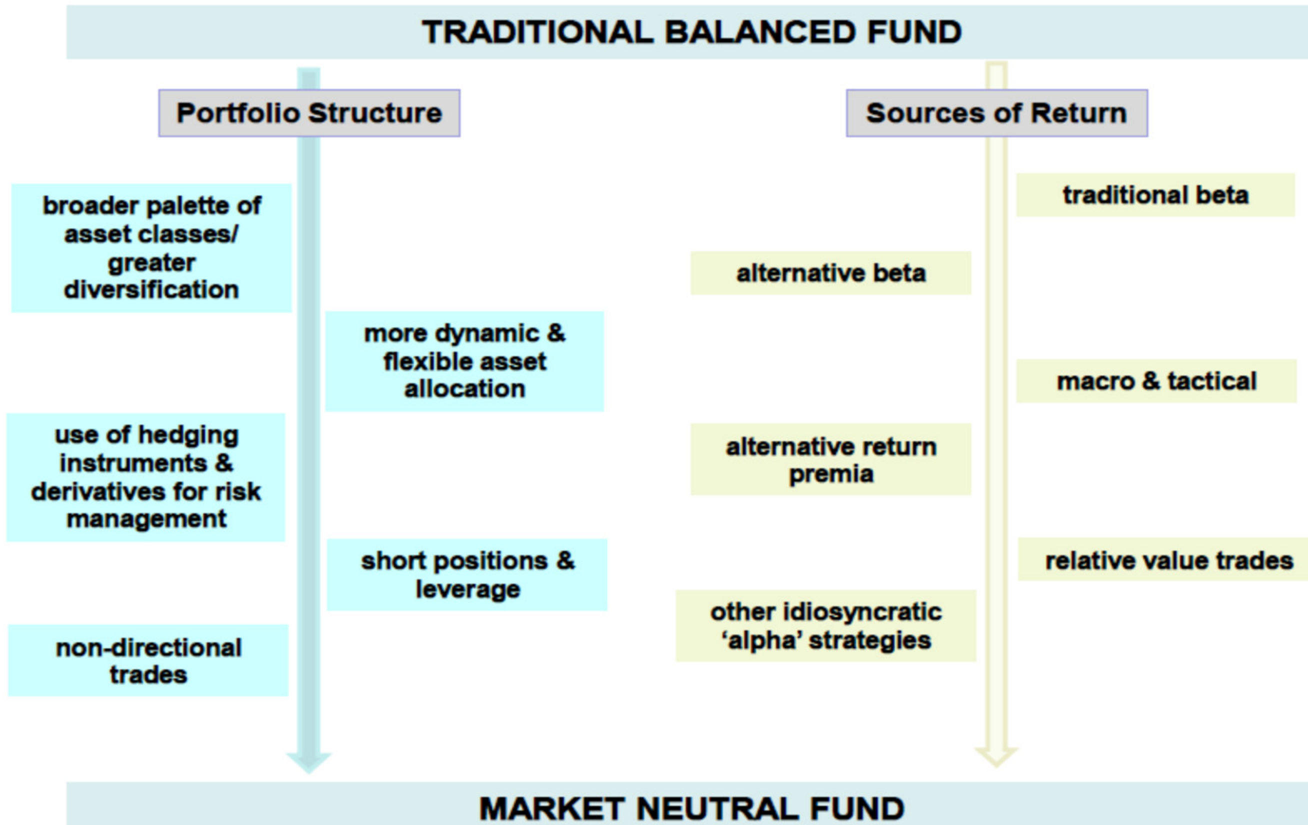
2. Income generation
   Sustainable dividend payouts of 4%+ on prime asset portfolios

3. Diversification
   22-year correlation of Irish Life Property vs. MSCI World Index: 0.16%

4. Inflation hedge

Absolute Return Funds

The Spectrum of Absolute Return Funds



Absolute Return Funds – Investment Rationale

1. Universally disappointing investor experience – almost all funds have fallen short of stated targets (typically cash+3% - cash+5%)

2. Why?
   Manager skill is a rare quality
   Excessively cautious use of risk budgets
   Stated targets grossly over-ambitious

The Clarus View

Difficult to see longer term value in core fixed income at current yield levels….will it even outperform cash?

Need a substitute for traditional allocation to bonds in medium/lower risk portfolios

If AR allocation produces only cash + 1%-2% it will have paid its way

Is cash + 1%-2% a realistic expectation?
Perhaps – can come from diversified beta harvested by even by the unskilled managers

Gold

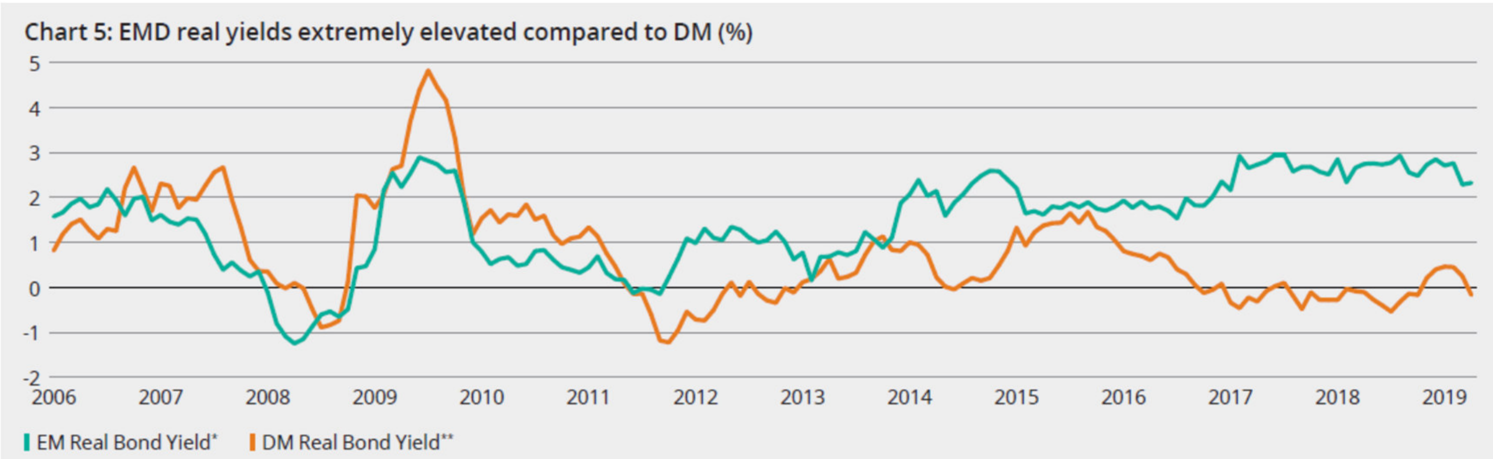
- The premier store of value throughout human history
- Most in demand at times of crisis => natural diversifier in a portfolio of financial assets
- Record of higher returns at times of high inflation
- 50-year return similar to global equities, but almost perfectly uncorrelated

Federal Reserve Bank of St Louis

Annual Return in USD, Jan-70 to Jun-20	
MSCI DM World Index	8.6%
Gold (Spot)	8.0%
Correlation	*0.009*

Federal Reserve Bank of St Louis, MSCI.com

Emerging Market Bonds



Aberdeen Standard Investments

- Emerging markets now contribute ~ 60% of global GDP
- Total EMD market size ~ $10trn
- Average debt/GDP ratios lower than developed markets
- Attractive yield premia with good diversification characteristics and relatively low duration

Metric	***Local Currency EM Debt***	***USD EM Debt***
	iShares SEML	*iShares SEMB*
% Investment Grade	79%	58%
Average Yield	4.3%	4.4%
Average Duration	5.2 Yrs	8.6 Yrs
Correlation with Global Equities	0.53	-

iShares.com, MSCI.com

Q&A

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CONCLUSION