

Insight 41: ‘Pack up your troubles in your old kit bag and smile, smile, smile...’

The world today feels like a troubled place, with populism on the rise, Donald Trump in the White House, Kim Jong-un with his finger on a nuclear button, the looming Brexit cliff edge and the prospect of higher, even punitive, taxation of a Marxist-inspired Chancellor-in-waiting. We risk getting things out of perspective; it has always been thus. Remember, bad news hits the headlines, whilst good news is often boring and unsensational. Experts, pundits and reporters all dabble in futurology (trying to second guess the future). Remember too that all news – good and bad - is already reflected in the price of the investments that you own. A well-structured portfolio allows you to pack away your troubles (well, at least those that relate to the markets).

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'Pack up your troubles in your old kit bag and smile, smile, smile...'

"When I look back on all these worries, I remember the story of the old man who said on his deathbed that he had had a lot of trouble in his life, most of which had never happened."

Winston Churchill

Remembering the past

As we remember and commemorate, one century on, the awful slaughter of the Battle of Passchendaele in 1917 – an event that is deeply etched on the British psyche and war memorials in every city, town, village and hamlet - we can, and perhaps should, reflect on how lucky we are today. By the time the battle was over, around 585,000 soldiers on both sides had died. Over the course of WW1, around 20 million civilians and 20 million soldiers were killed. The numbers are almost incomprehensible.

To compare life today to just after the Second World War is also enlightening. Today the average person on the planet earns three times as much (adjusted for inflation), eats one-third more calories, lives one-third longer and has seen a dramatic two-thirds fall in infant mortality compared to the 1950s.

'All this during a half-century when the world population has doubled, so that far from being rationed by population pressure, the goods and services available to the people of the world have expanded. It is, by any standard, an astonishing human achievement.'

Matt Ridley, author of *'The Rational Optimist'*¹

Worries over the present can cloud our logic (and ruin our day)

Gaining perspective is sometimes not that easy. Modern life provides us - some would say swamps us - with so much news, information and punditry, which focuses on the here-and-now, that it is easy to be overwhelmed with the feeling of doom and gloom. The list of things to concern us is long and worrisome; Donald Trump leading the free world, a nuclear-armed North Korea; an increasingly fractious Brexit process and looming cliff-edge; a Marxist-inspired Chancellor-in-waiting; global warming and the US withdrawal from the Paris Accord; Islamist terror and the centuries-old Shia-Sunni schism in Islam, to name a few. If we don't worry for ourselves, we do so on behalf of our children and their children in turn. That is only natural, but it can feel a little overwhelming and unsettling at times.

The natural extension of this is to worry about what the impact of all this doom, gloom and uncertainty will have on your portfolio and in turn, on your future wealth and expenditure goals. The first mistake is to believe that the world is falling apart around our ears. It most certainly is not. Donald Trump is being contained by the sensible constraints put in place by the Founding Fathers of the United States of America, Islamic State had been severely constrained, according to the IMF growth in the EU and other advanced economies is estimated at 2.2% and that in the developed and emerging economies is estimated at 4.6% giving a global rise in real output of 3.6%. That's not bad!

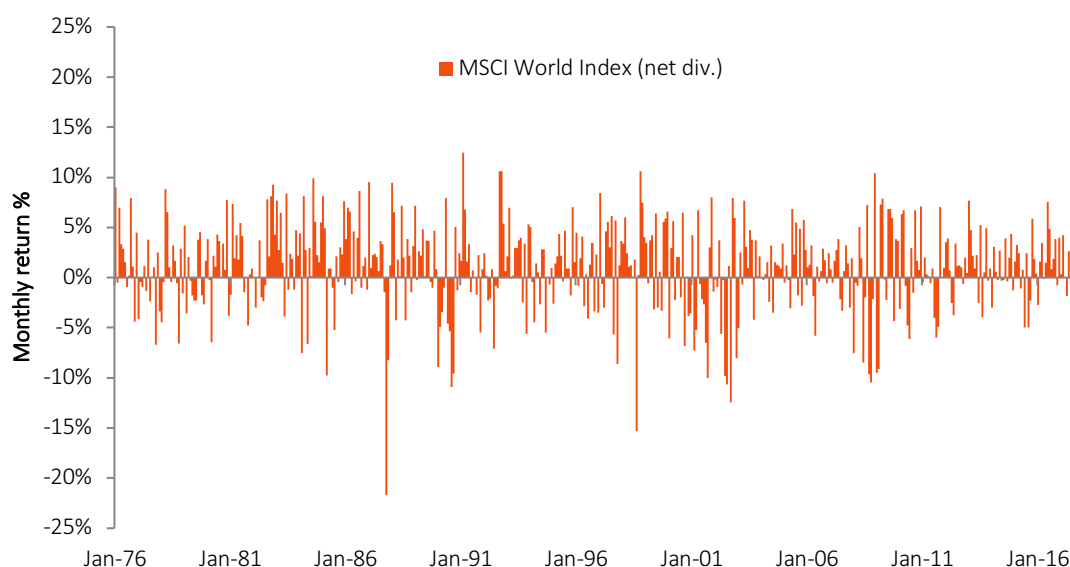
¹ This is a fabulous, positive and alternative view of the world, and the source of the statistics above. It is well worth a read.

Focusing only on the downside exacerbates the level of stress and worry and may tempt some into repositioning their portfolio based on what might - or might not - happen in the world. At worst, some might retreat to 'safe' cash, something it most certainly is not, having lost more than 15% of its purchasing power since the Credit Crisis. There are a number of reasons why portfolio tinkering is unlikely to be a sensible course of action.

Reason 1: today's 'unprecedented' turmoil is no different to how it's always been

Today's worries dominate our thinking; but can you remember what you were worrying about a year ago, or two years ago? Probably not. It has ever been thus. If you don't believe me, take a look at the chart below, which provides the monthly performance data for global equities. Does any time in the past look any less volatile than returns of late? It is for that very reason why most investors do not own 100% risky assets, such as equities. Holding short-dated high-quality bonds is an insurance policy that dampens portfolio return volatility and provides resilience at times of true equity market trauma, like the technology stock crash of the early 2000s and the credit crisis in 2007-8.

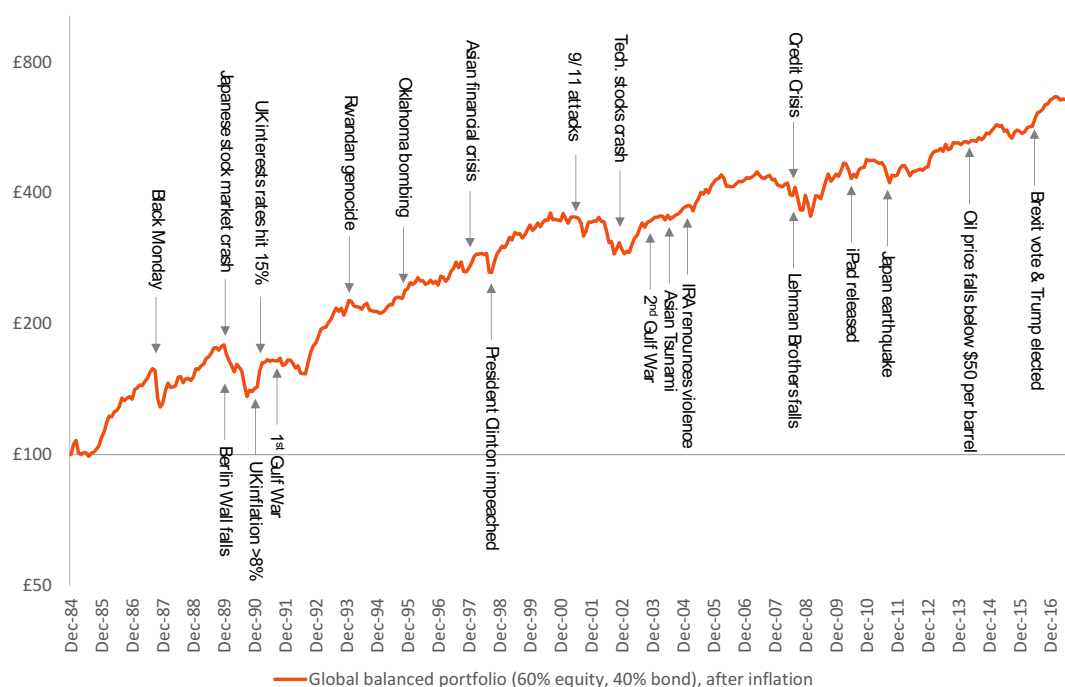
Figure 1: Equity markets are always volatile



Data source: Morningstar Direct © All rights reserved. MSCI World Index (net. div.) Jan-76 to June-2017

Another way to place worries in perspective is to look at the long-term data for a global balanced portfolio with 60% in equity-like assets and 40% in safe bond assets since 1985, after the effects of inflation. On a gross basis, every £100 of purchasing power at the start grew to over £600 by October 2017, despite all the major economic and political events that occurred over this 30-year period. The overwhelming take-away is to acknowledge the relentless upward trajectory of purchasing power for those patient enough, and disciplined enough, to stay the course.

Figure 2: The relentless growth of purchasing power, despite World events



Source: Albion Strategic Consulting²

Reason 2: bad news sells – so don't ignore the underreported good news

We are all aware that bad news sells. For example, the Office for Budget Responsibility (OBR) - set up in 2010 to monitor and forecast the progress of the UK economy - has a 'gloomy' forecast for growth of 'only' 1.4% for 2018. Sky News, for example, led with the depressing headline 'Gloomy budget as UK slashes growth outlook'. This needs to be balanced out by the good news that one rarely hears about.

The UK economy is still growing; remember that this slow down comes after a period of growth that has outstripped much of the developed world – particularly the rest of the EU - for the past few years. We seldom hear about the fact that the UK GDP regained its previous high of 2008 in 2013. Why are we still so depressed about the UK economy today, when everyone was pretty cheery with its size in 2008? Unemployment is now at a 40-year low at 4.3%; 32 million people are in employment compared to 30 million in the 2008 boom times of the Gordon Brown era³. We spend more on health care than the OECD average despite the 'savage' cuts to our healthcare system reported by the media. It is instructive to note that the Department of Health in England's budget is £123 billion in real terms for 2017/18, whereas in 2008/9 the budget was £112 billion⁴.

Irrespective of political persuasion, most would acknowledge that the budget deficit (the amount that the government outspends its receipts) in 2009-10 of £152 billion (9.9% of the UK's GDP) had to be tackled urgently. Today it has been brought down to around

² Global balanced portfolio: 36% MSCI World Index (net div.), 26% Dimensional Global Targeted Value Index, 40% Citi World Government Bond Index 1-5 Years (hedged to GBP) – no costs deducted, for illustrative purposes only. Data source: Morningstar Direct © All rights reserved, Dimensional Fund Advisers.

³ <https://ig.ft.com/sites/numbers/economies/uk>

⁴ <https://www.kingsfund.org.uk/projects/nhs-in-a-nutshell/nhs-budget>

£45bn (2.3% of GDP), a much more manageable level⁵ through the Government's austerity plan. It is important not to lose sight of what has been accomplished (and recognise what still needs to be done to balance the books). It is not all bad news.

Reason 3: the danger of conflation of 'what ifs'

The human mind likes stories and in themselves these stories may lead to what appear to be rational outcomes on which some action, or another, could or should be taken. What we often fail to realise is that the seemingly logical outcome is highly unlikely; we have failed to multiply the probabilities of each sequential outcome together. Imagine that there is a chance that we fall off the Brexit cliff-edge without a deal. A sensationalist news story might go something like: ensuing chaos at the ports, food supplies fail, supermarket shelves stripped bare, rioting ensues, followed by the violent overthrow of the government. The reality is that this seemingly plausible scenario is based on a succession of low probability events. Even if each of these has a 50% individual chance of happening, when we multiply them together we find that the chance of this sequence of six events coming true is less than 2% (50% to the power of 6), so there is a 98% chance some other outcome will be experienced. Think hard about the stories you read and hear.

Reason 4: the futility of futurology

Futurology is the financial markets' version of astrology. There is a huge industry out there from the IMF and the UK's Office for Budget Responsibility (OBR) to investment banks, academics and BBC reporters all peddling their own view of the future. These futurologists have one thing in common; they are nearly always wrong in their predictions, and are rarely held to account for their poor forecasts. The OBR, for example, who recently pronounced on the state of the UK economy – which the Chancellor used as the baseline in his November budget – has a pretty poor record of forecasting the UK's economy. The conflation of 'what ifs' adds to the problem.

'The futurology fixation has also distorted the public's understanding of how economies really grow – not by government diktat but by liberating entrepreneurs to create businesses that will develop in ways no statistician can predict. The Georgians understood this and managed to unleash the Industrial Revolution without the aid of economic forecasting.'

Iain Martin, The Times, 23rd November 2013

The UK is a highly entrepreneurial economy; in 2016 in the UK a staggering 650,000 new companies were launched, which is a new record⁶. Supporting and unleashing this dynamism, energy and potential could deliver amazing results for all. Take the futurologists with a pinch of salt.

Reason 5: the framing of data

As we all know, data is used to score points in support of the data-user's viewpoint. A recent example of how the use of true facts can materially alter perceptions bears witness to this danger. The Institute for Fiscal Studies – a well-known, respected and influential body – ran a (non-scientific) straw poll to illustrate the point⁷. They asked the question: *Broadly, do you think the UK tax system is fair?*

⁵ <https://www.economicshelp.org/blog/5922/economics/uk-budget-deficit-2/>

⁶ Centre for Entrepreneurs (CFE)'s analysis of the latest Companies House data

⁷ <https://www.ifs.org.uk/publications/10038>

The participants were randomly divided into three groups. Group 1 were just given the question. The second Group 2 (defined as the 'rich pay a lot' group) were given two true facts:

- *The point at which income tax starts to be paid has increased in recent years. 4 in 10 adults now pay no income tax.*
- *The income tax system is top-heavy. The top 10% of income taxpayers pay 60% of all income tax.*

The third Group 3 (defined as the 'rich don't pay a lot' group) also received these two true statistics:

- *The richest 10% of income taxpayers earn more income than the entire bottom 50%.*
- *Someone earning £45,000 faces the same income tax on an extra £1 of earnings as someone earning £145,000.*

The results were interesting: 51% of Group 1 thought that the tax system was unfair; only 33% of Group 2 thought it was unfair; whereas 72% of Group 3 thought it unfair. Be aware that simple statements of fact can be both very influential and misleading.

Reason 6: the news is already in market prices

It is normal to be worried about the potential impact of what is going on in the world and how this will affect markets. The reality is that you are not alone; in fact, all active investors have some view on how Trump, Brexit, Merkel's problems in Germany, or the Federal Reserve in the US – to name a few - will impact bond and equity prices. These global, diversified view-points are already reflected in the equilibrium price of securities, agreed freely between buyers and sellers. If all known information is reflected in market prices, then it is only the release of new and unknown information that should move prices. The release of this new news is, by definition random and thus security prices are too. The title of Professor Burton Malkiel's book 'A Random Walk Down Wall Street' describes this perfectly.

If markets only move when new information is released, it may be evident why very few investment managers exhibit persistent skills in either stock picking or timing when to be in or out of markets.

Your portfolio is already structured to manage uncertainty

Today's concerns such as Brexit, Sterling's weakness, potential tax rises in the event of a Labour government, and Donald Trump in general, are endlessly recycled through the 24/7 media soundbite process, alarming some who are invested in the markets. Well-structured investment portfolios seek to ensure that any market conditions can be weathered in the future, whatever drives these storms. It might be helpful to reiterate the core structural strengths of your portfolio.

Your portfolio is globally diversified

Your portfolio has well-diversified exposure to developed equity markets and emerging market economies and companies, which will help to mitigate any UK-specific market falls. Equity markets as a whole might be volatile, but that is the nature of equity investing, and being diversified will help.

It is also exposed to non-Sterling currencies such as the US dollar, the Yen and the Euro. In the event of, say, a messy Brexit divorce and/or the collapse of the Conservative government, a fall in the value of Sterling is possible. Ironically, any fall is beneficial to

your portfolio as the non-Sterling denominated overseas assets that you own are now worth more in Sterling terms. In addition, the overseas earnings of any UK companies (about 70% of all earnings of FTSE 100 companies) will convert back to higher levels of Sterling.

Owning short-dated, high quality global bonds delivers strong defensive qualities

The primary defensive assets in your portfolio – designed to provide protection at times of equity market trauma - are short-dated, high quality bonds. At times of market uncertainty, money tends to flood from more risky assets (equities and low quality bonds) into high quality bonds, driving yields down and prices up. These bonds are diversified across global bond markets, reducing the risk of falls in bond prices in the UK, perhaps due to credit downgrades in response to Brexit concerns.

Conclusion: listen to the news less and find the good news

We absolutely understand that the news barrage we all face can be unsettling and create uncertainty and stress. If you feel this way, then try not to listen to the news as much, seek out alternative viewpoints and facts and be confident in the power of capitalism – and the dynamism of the UK – to see us through. Finally, and most importantly, feel comforted that your portfolio is already structured to manage whatever the markets might throw at it down the line and tinkering with it is unnecessary and most likely detrimental. We leave you with the wise words of an old Chinese proverb:

‘That the birds of worry and care fly over your head, this you cannot change, but that they build nests in your hair, this you can prevent.’

Chinese Proverb

If you are feeling concerned, please feel free to get and in touch to talk further.

Other notes and risk warnings

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