



Changing drivers of returns

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This year to date has provided one of the most challenging periods. Globally, we have seen an increase in inflation, sparking rises in interest rates (and consequential losses in fixed income) and risk aversion has grown with concerns over the strength of the global economy. All these factors have weighed heavily on equity prices. There have been precious few bright spots amid the melee and, conversely, plenty of disappointments. This market vacillation has been catalysed by a spike in geopolitical tensions and comes less than two years since the Covid pandemic sent shock waves through the global economy and stock markets.

There are two important themes that we will reflect on when considering drivers of investment returns.

It is constructive to compare the performance of the gilts market against other global developed market bonds. All major global sovereign bonds have seen yields rise year to date. Yields are inversely related to price and, consequently, global government bonds have sold off in 2022. The yield increases on gilts, however, have been significantly greater than most other majors, not least the largest bond issuer in the world, the US government. As a result, gilts have significantly underperformed global bonds.

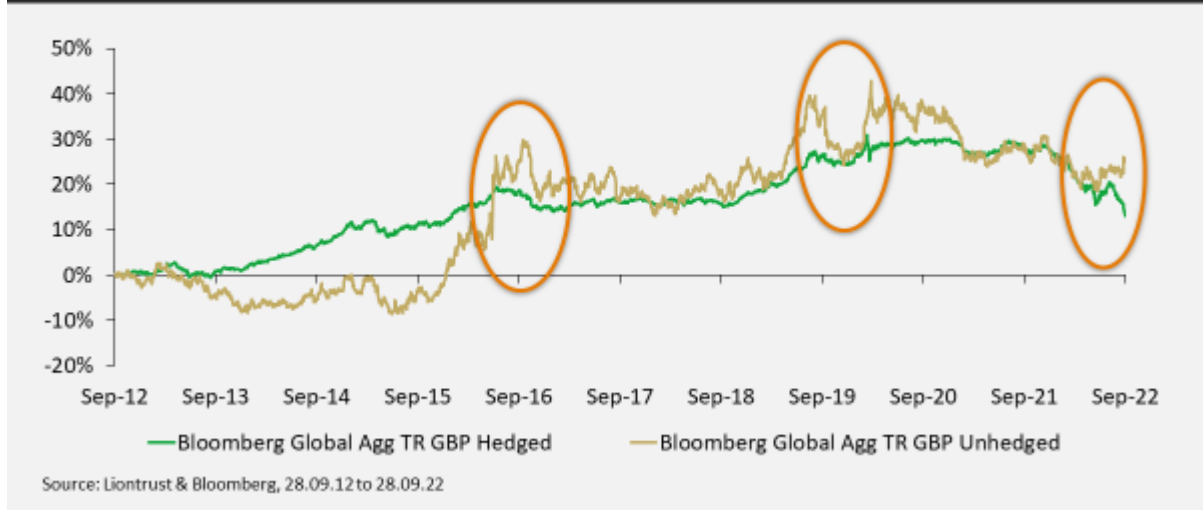
For the sake of comparison, UK gilts account for less than 10% of all outstanding major government debt. In the past couple of decades, gilts outperformed global bonds hedged into GBP and our clients will have benefitted over the long run from this bias in the Strategic Asset Allocation (SAA) to the UK.

More recently, however, the converse has been the case and, year to date, global bonds have delivered negative performance, but they are still significantly ahead of gilts. In fact, gilts have lost 20% more than global bonds hedged into sterling.

Unhedged global bond investors have performed better still because sterling weakness results in a tailwind to foreign currency returns priced in sterling. We take the view that accessing the global government bond market is most effectively done on a currency-hedged basis. This is because over the long run the ebb and flow of currencies tend to revert to the asset class trend, so the impact of the currency moves comes in the form of volatility rather than structural returns. The volatilities of currencies are significantly higher than the underlying asset class, so we believe it is appropriate for these low risk / diversifying assets to be utilised but hedged so as to avoid the volatility 'taint' from currency moves.

We have had three unpredictable episodes of the pound weakening in the forex markets in the past decade, starting with the Brexit vote in 2016; the beginnings of the pandemic in 2020 and, in September, the surprise tax cuts in the UK that posted a significant change in fiscal policy. We know that some managers are comfortable taking on additional foreign exchange volatility and have benefited year to date as a result. Below **(Figure 1)** we demonstrate the long-term returns of global bonds hedged and unhedged. It is evident that during periods of sterling weakness, the unhedged index will outperform but that this outperformance has historically been clawed back over time.

Figure 1 | Global bonds hedged and unhedged in GBP



The three periods in the 10-year chart highlighted depict the surprise EU referendum result, the Covid shock and the latest volatility caused by the war in Ukraine and the global inflation shock.

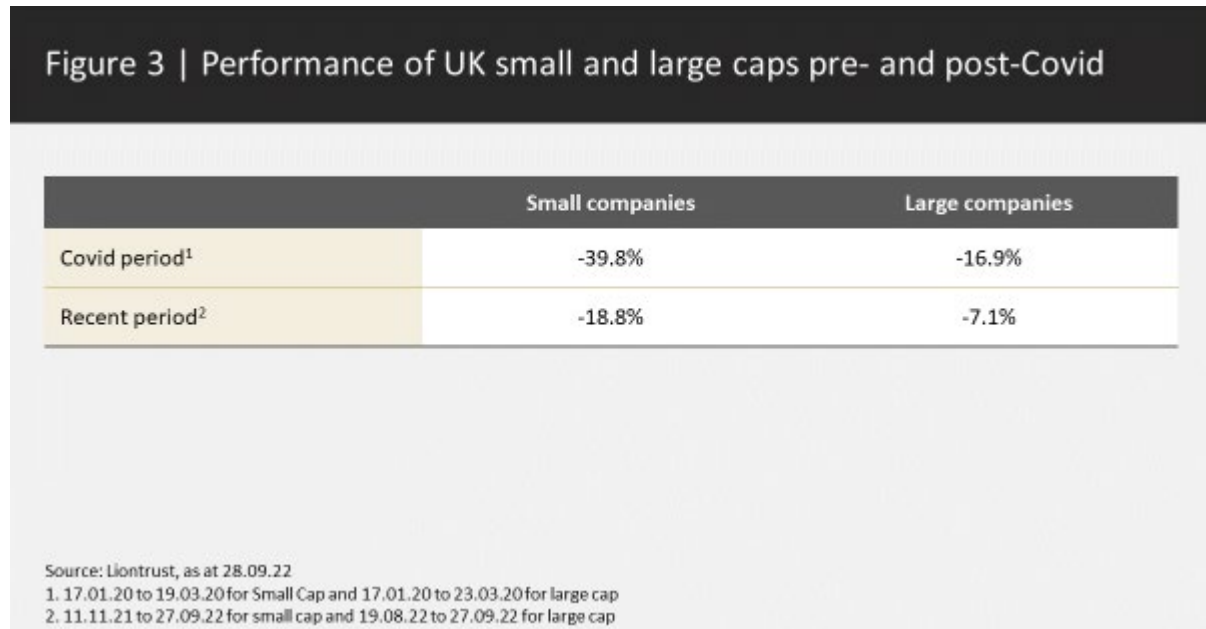
In both the Brexit and Covid related periods of weakness, the unhedged line surges ahead of the hedged line, but the 'outperformance' through reporting currency weakness have proven to be transitory in both instances. As ever, we believe the pound will recover from this very oversold position and it would not be prudent to remove the hedge now based upon short-term sentimental moves in markets.

To provide greater context on how poorly UK government bonds have performed in a 'risk off' environment it is constructive to consider the underperformance of gilts versus smaller companies. Even before the Liz Truss' government unveiled its mini-budget, gilts had been under pressure due to rising inflationary fears. We have already noted that smaller companies can be higher risk and may not provide strong capital protection in terms of investor anxiety but **Figure 2** below shows that supposedly 'safe haven' gilts have underperformed them. This demonstrates the difficulty experienced by multi-asset investors because traditional sources of diversification, or portfolio ballast, have not provided a meaningful store of value year to date. Indeed, since the start of 2022 the gilts market has underperformed smaller companies by nearly 14%.

Figure 2 | UK Smaller companies and global bonds



Figure 3 below shows the average returns from Investment Association sectors. It highlights the differences in returns from small cap to large cap equity sectors and the effect of Sterling weakness on bond investing over the last year and year to date. The months of July and August have been added to demonstrate how quickly sentiment can change towards small caps when investors become more optimistic about the future, or in this case, the peak in interest rate hikes. Our portfolios noticeably responded to this change in direction.



We also believe that investing in the future will be very different from the last 10 years or so. We see the global economic landscape experiencing higher inflation as globalisation contracts and international relationships deteriorate, along with populations being no longer willing to tolerate periods of austerity. The one-way bet since the Global Financial Crisis of being overweight US equities and other US dollar assets could be replaced by the necessity to hold a much wider range of investments at the asset class level as well as the selection of countries, sectors and stocks. If this is the case then this will support portfolios that are well diversified and capable of delivering multiple sources of returns, and this should also generally favour active over passive management.

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