How to navigate Brexit: taking the long-term view

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Charity Times conference, 10th May 2018

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Overview

Executive summary

- Charity trustees need to take a long-term view – well beyond 2019
- In doing so, they need to lower their sights: likely returns have fallen
- But not necessarily because of Brexit… or other current concerns
- Markets have simply been running out of headroom
- That said, we still think portfolios can deliver inflation-beating returns
- But trustees should avoid letting emotions drive their decisions
- And they should ensure effective diversification and sustainability of their strategy

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Navigating UK secession from the EU

Sovereignty matters – up to a point

“Just give us the facts…”

- UK-EU trade matters more to the UK than to the EU…

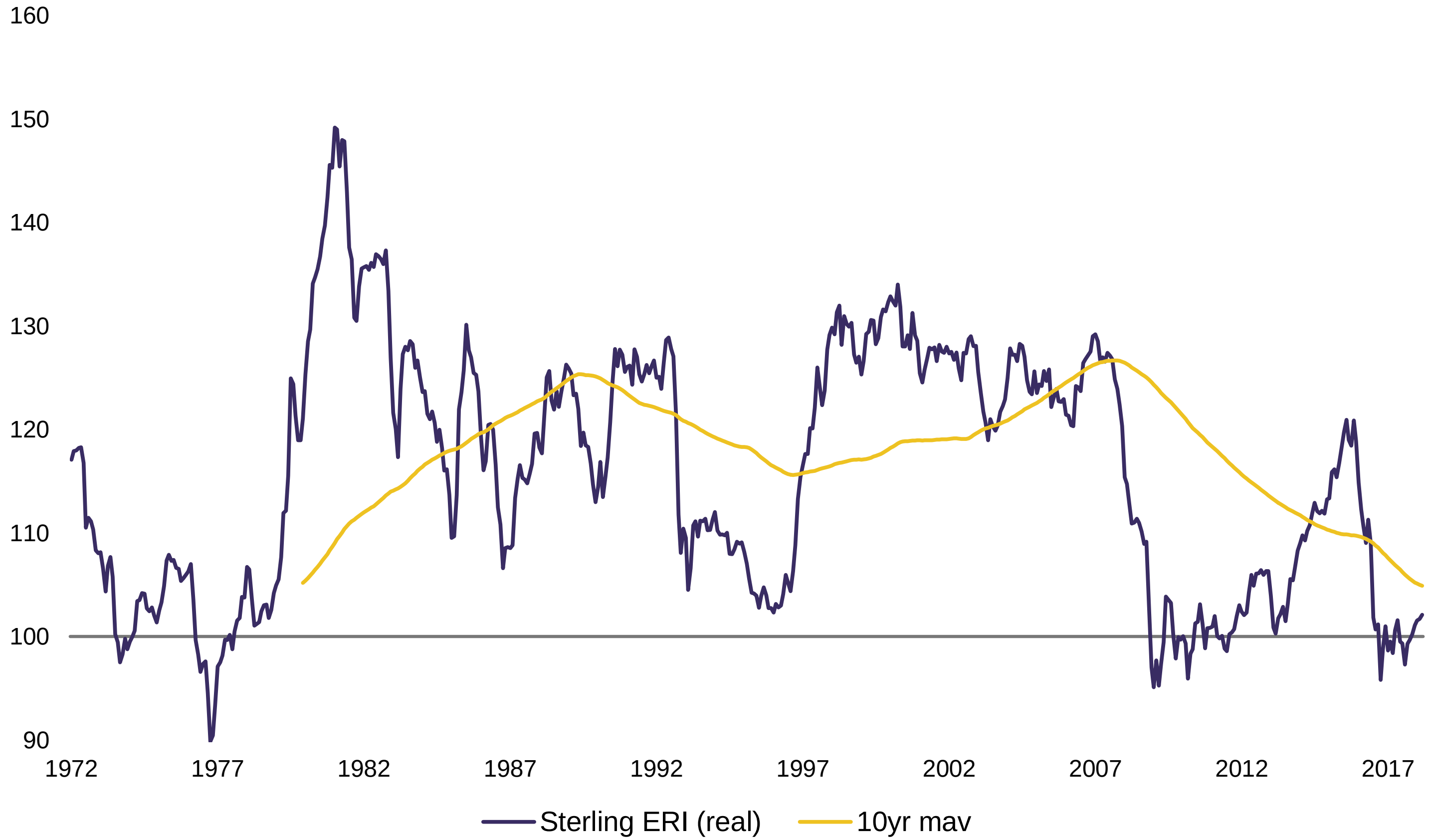
… We already have free trade there, and budget payments are small

- BUT: “secret costs” are underwhelming…

… Population and positioning count too, and the pound is competitive

Likely result? **Damage – but manageable.** And counter-factual invisible

Sterling is competitive



Source: Rothschild & Co, Datastream
Past performance is not a reliable indicator of future results

The City may muddle through too

An established cluster with a continuing competitive edge

EU has "ruled out an ambitious trade deal for financial services and the EU 27 would benefit from a smaller City of London". Financial Times 31st January 2018

"The financial services sector is too important to the British Economy for Brussels to retain control of it under the existing pass porting arrangements". Theresa May 4th March 2018

City may be less vulnerable than feared - it has been a vibrant part of the UK economy for more than 300 years - owes its success more to its global positioning

Portfolios and (hard) Brexit

- Growth a bit weaker *<u>than it otherwise would have been (impact <<1% pa)</u>*
- Exchange rate a little lower
- Inflation a bit higher initially, then falls back to settle lower
- FTSE profits a wash: weaker pound and international exposure largely offsets weaker domestic growth
- Gilt yields a wash: initial inflation risks muted by safe haven status and eventual lower nominal GDP growth. Deficit a little bigger

A softer exit, and/or longer transition => (even) smaller impact

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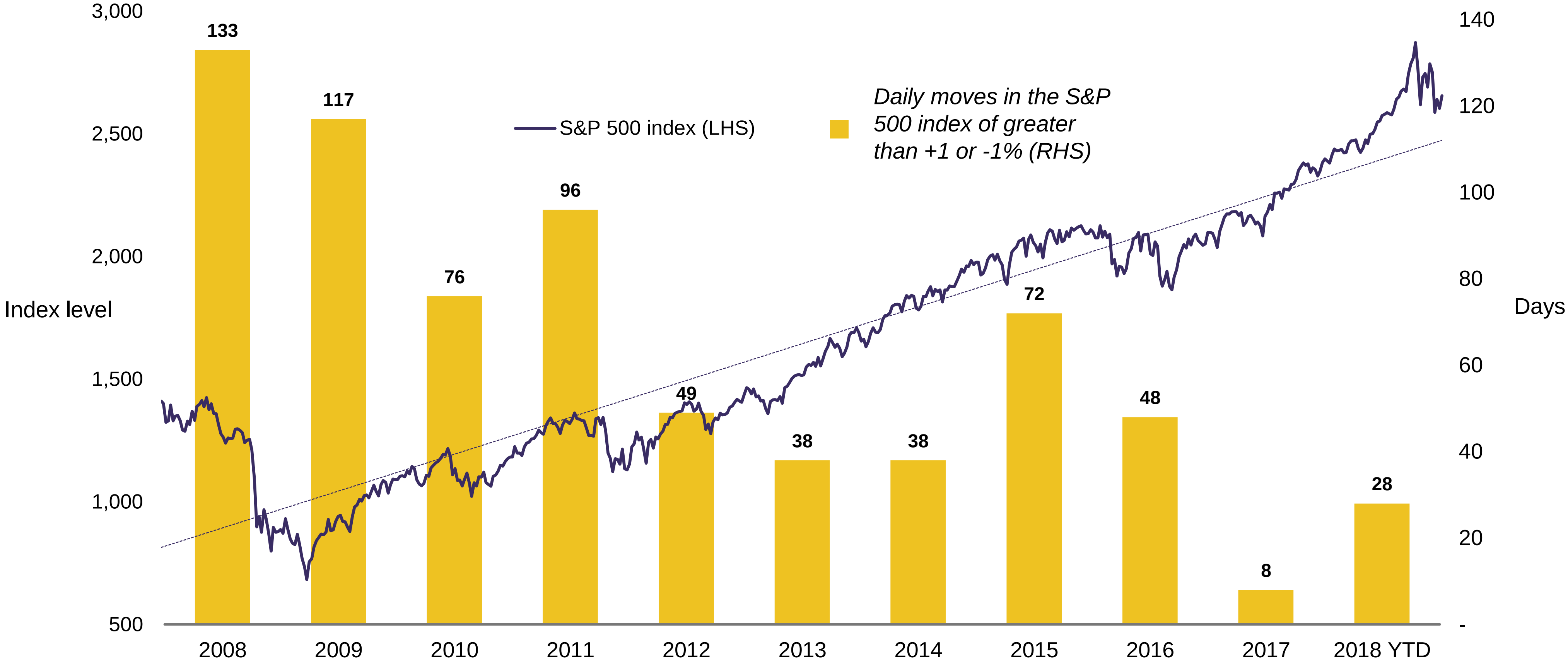
So why should trustees lower their sights?

A setback has been overdue



Source: Rothschild & Co, Bloomberg
Past performance is not a reliable indicator of future results

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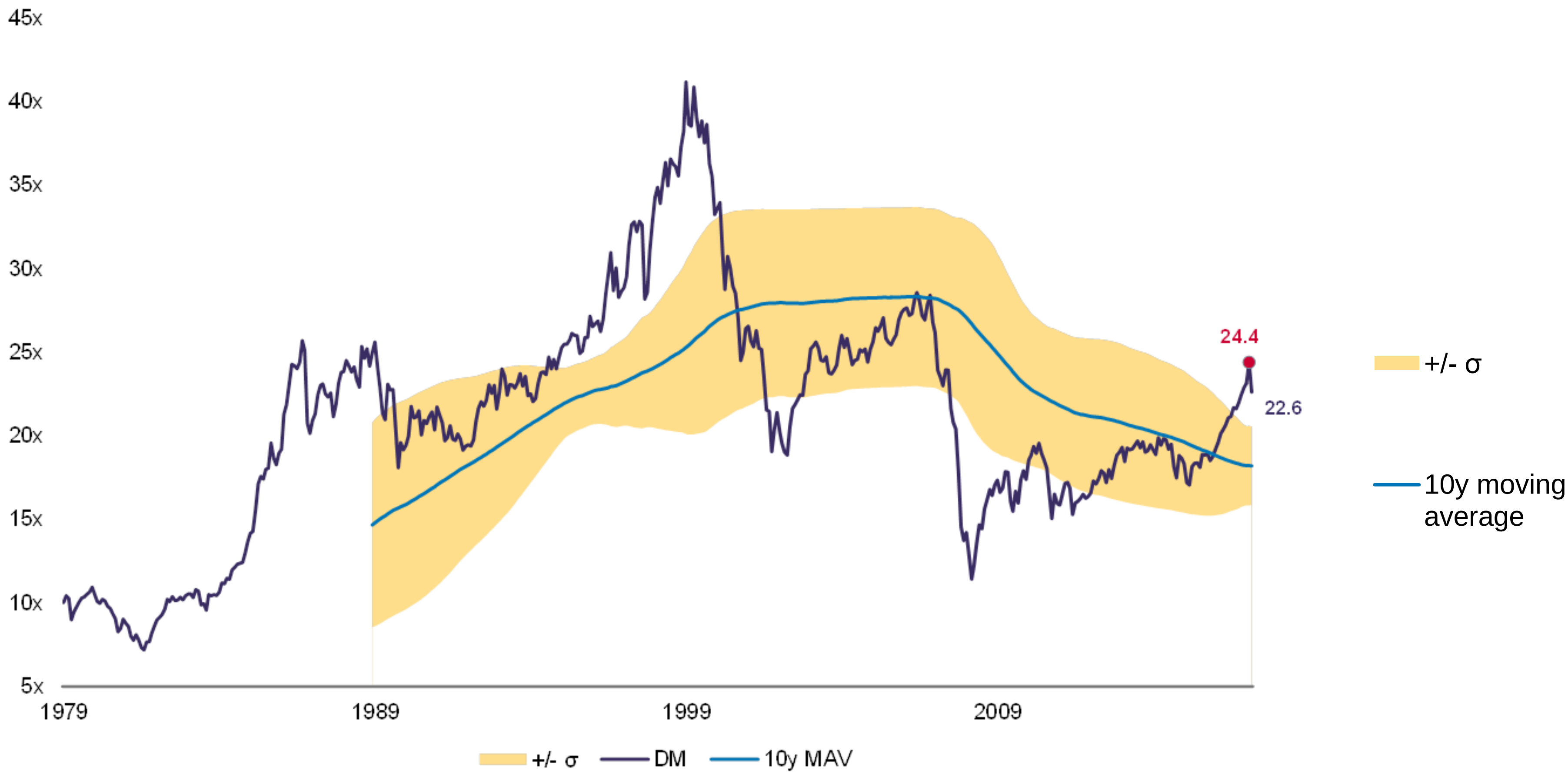
Stocks are no longer cheap…

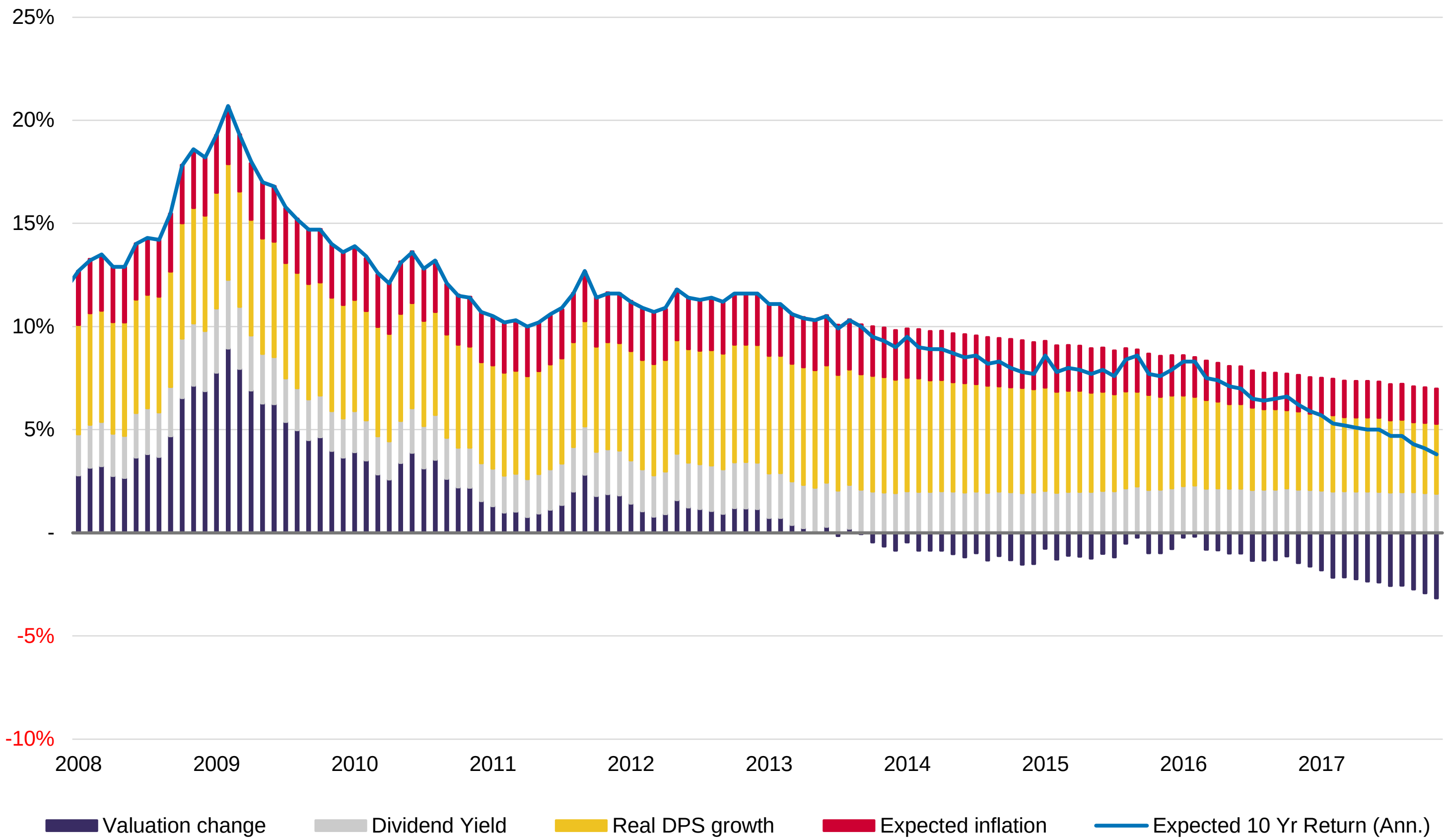
Cyclically-adjusted PE ratio (CAPE) above trend



Source: Rothschild & Co, Datastream
Past performance is not a reliable indicator of future results

… and prospective returns have fallen

Plausible projection for US stocks, next 10 years (% pa)



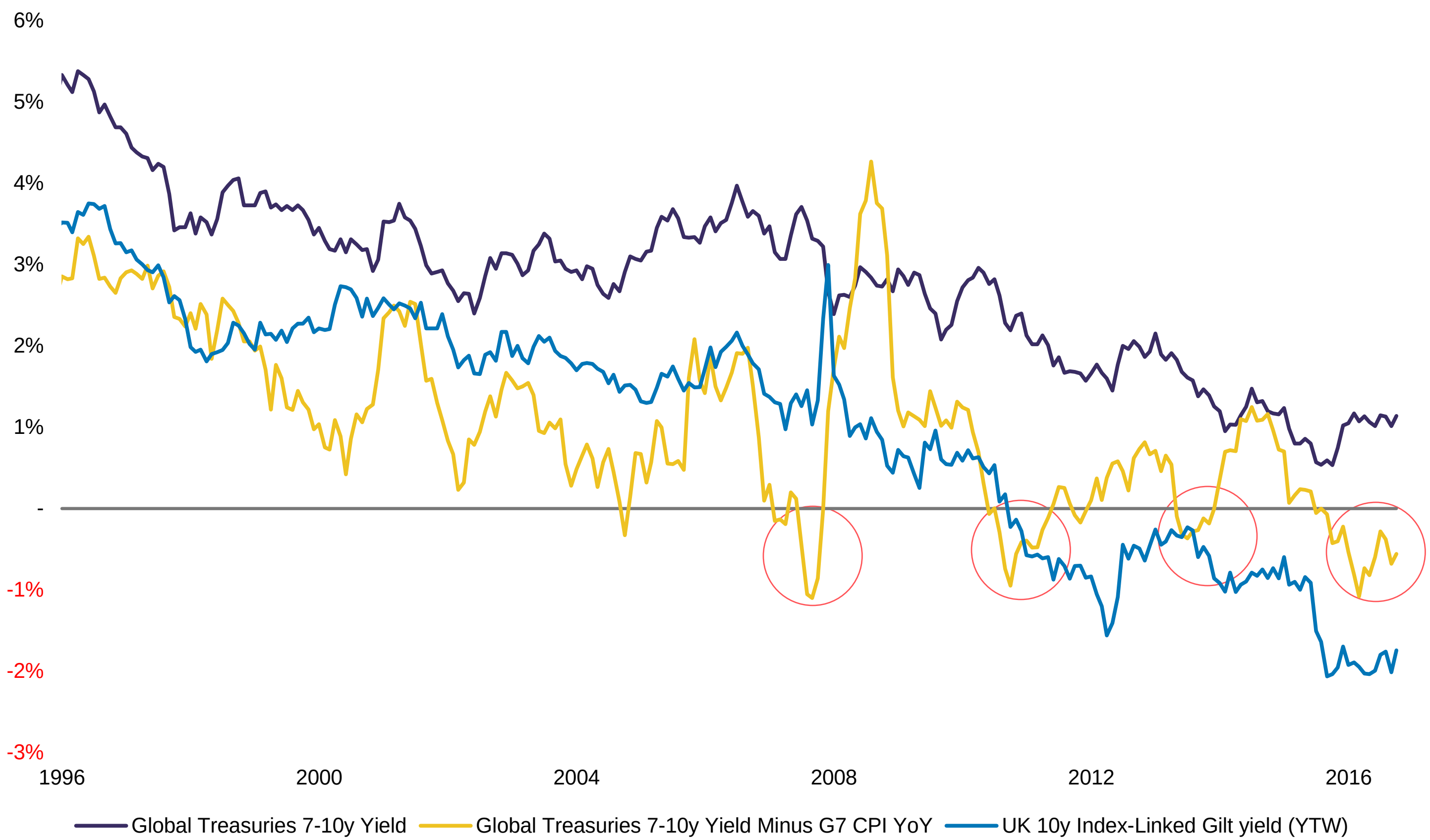
Source: Rothschild & Co, Bloomberg

* Growth in trend earnings driven by IMF long-term forecasts (to six years, extended as above) for real GDP and inflation, adjusted for "globalised" world (the fact that country A's companies benefit from a mix of country A and global GDP growth)

Bonds are expensive and unattractive

Yields are low: most are below current inflation

Global treasury yields (nominal and net of inflation) and UK 10y index-linked gilt yield

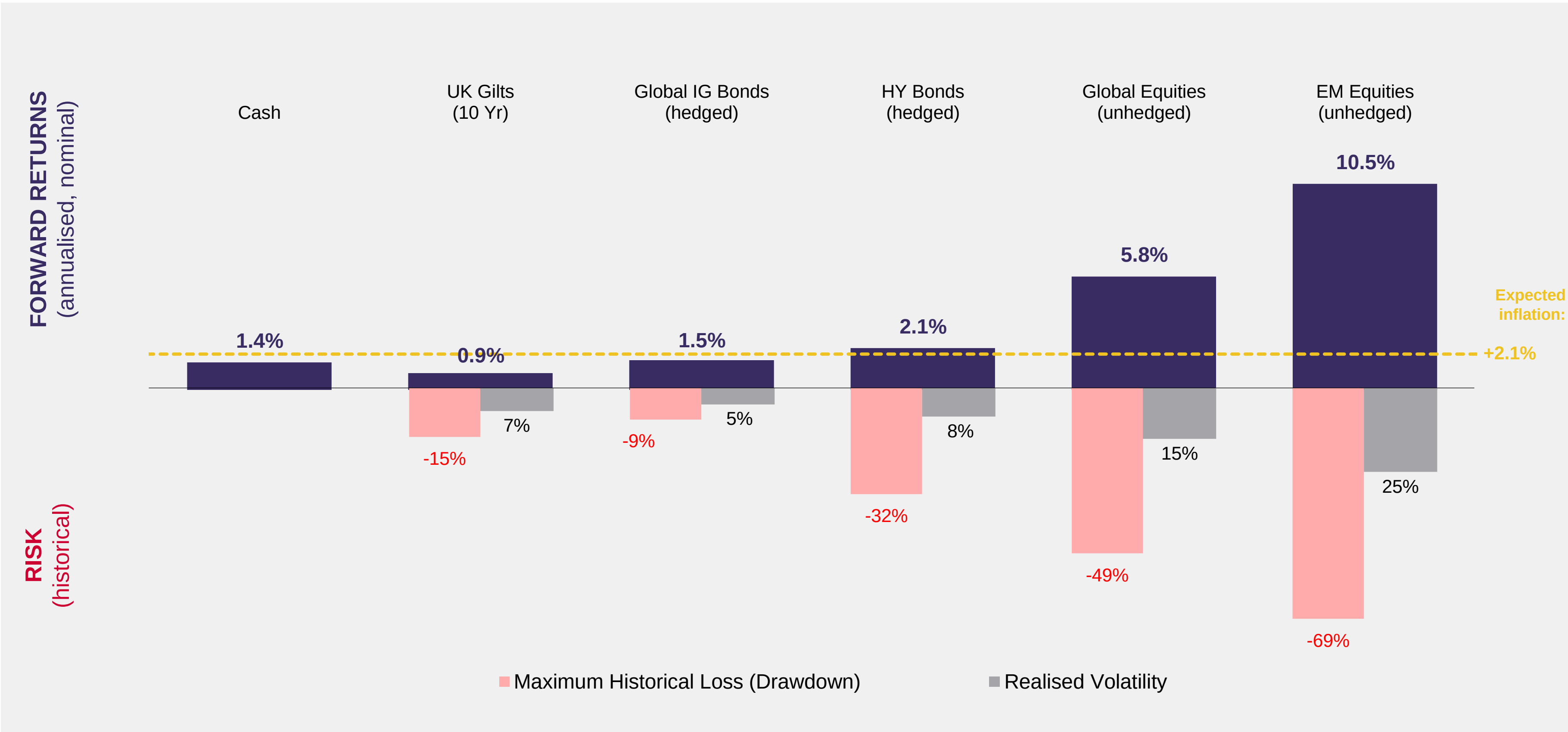


Bond	Price	YTM
UKT 1 ½ 2047	90	1.9%
UKT 4 ¾ 2027	127	1.4%
Swiss 2 2022	112	-0.6%

Source: Rothschild & Co, Bloomberg, Datastream
Past performance is not a reliable indicator of future results

Plausible cross-asset returns

Projected 10-year GBP returns with historic volatility



Source Rothschild & Co, Bloomberg

Notes

1. Forecasts are not a reliable indicator of future performance. Data correct as of 31st December 2017.
2. Data is based on the period 1969 to 2017 and for periods where data is unavailable a suitable alternative index may have been used.
3. Maximum Loss (Drawdown) represents the peak-to-trough loss that occurred over the period. The timing and duration of each drawdown will be different for each asset class.
4. Realised volatility is the annualised standard deviation of monthly returns.

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What should you do?

What you should do

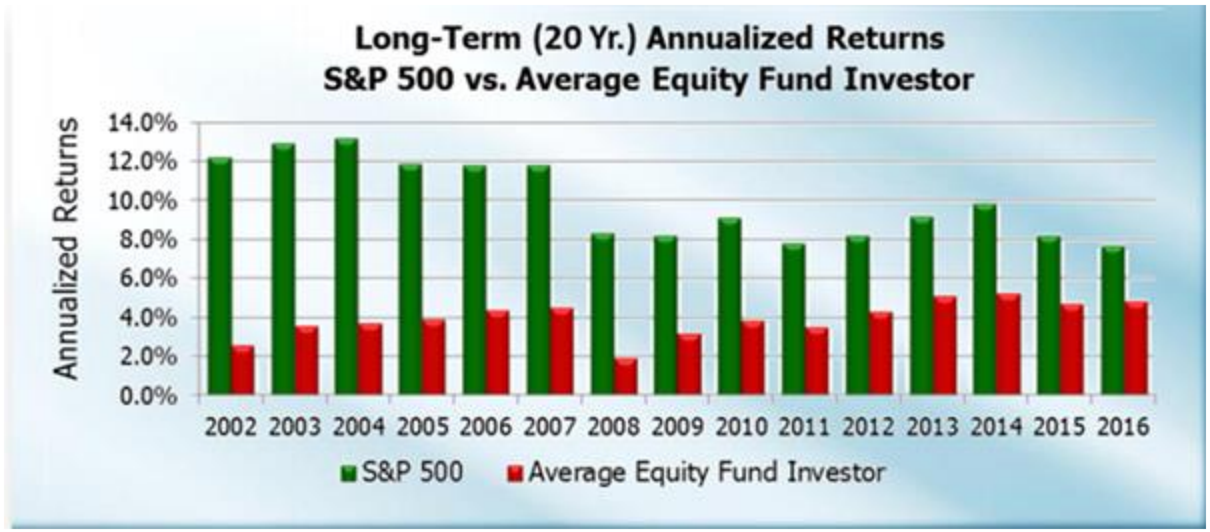
Invest for the long term

Diversify effectively

Make sure the strategy is sustainable

Invest for the long term

Don’t let emotions drive decisions



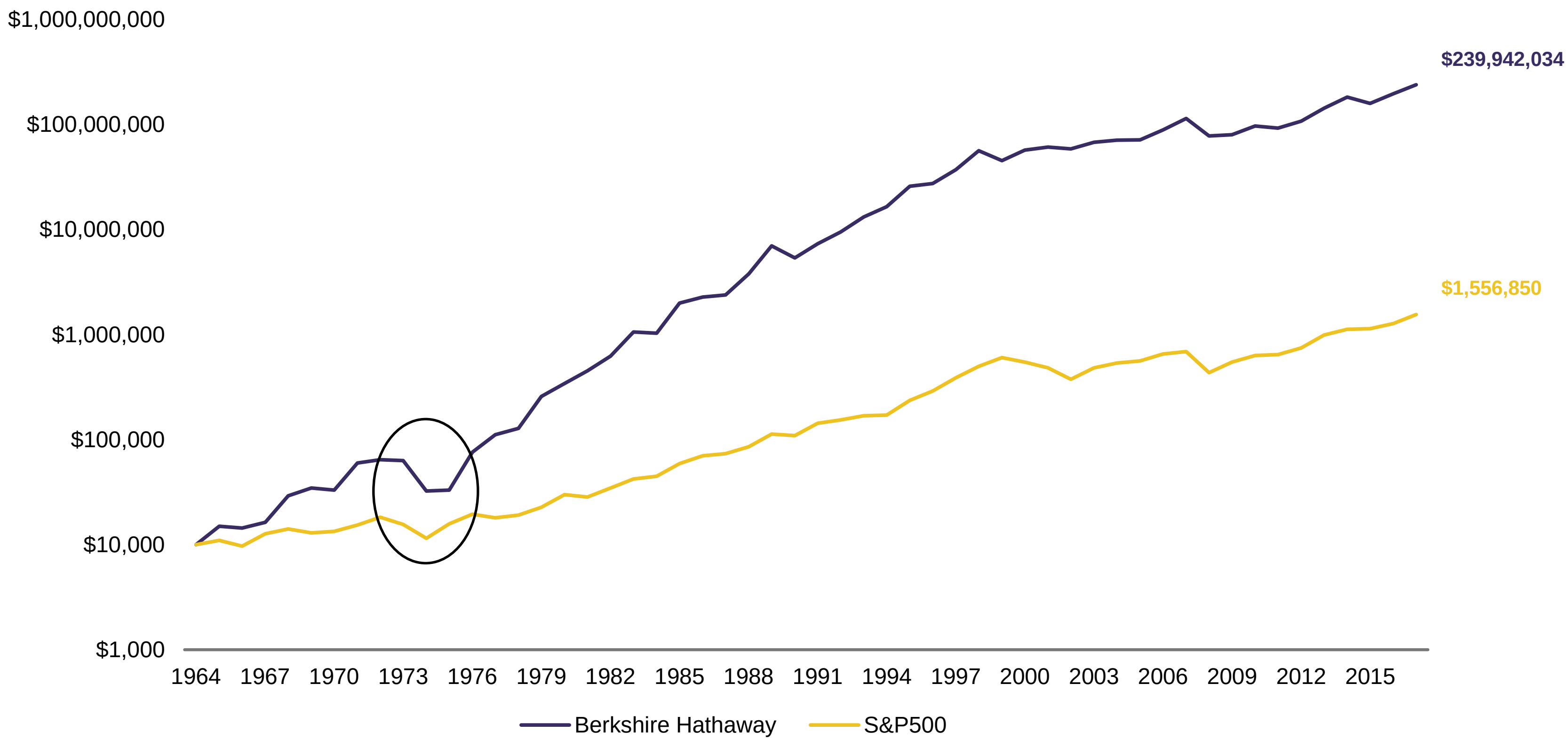
Source: ‘Quantitative analysis of investor behaviour’, Dalbar. Data covers the 30-year period to 31st December 2016

Would you fire this manager?

STANDARD &POOR'S

	Manager X	S&P 500
1972	+8.1%	+18.9%
1973	-2.5%	-14.8%
1974	-48.7%	-26.4%
1975	+2.5%	+37.2%
Total Return 1972 - 1975	**-44.6%**	**+2.3%**

It would have been a mistake…



Source: Berkshire Hathaway

Notes

1. Past performance is not a reliable indicator of future performance and the value of investments and the income from them can fall as well as rise.
2. The chart is shown in logarithmic scale.

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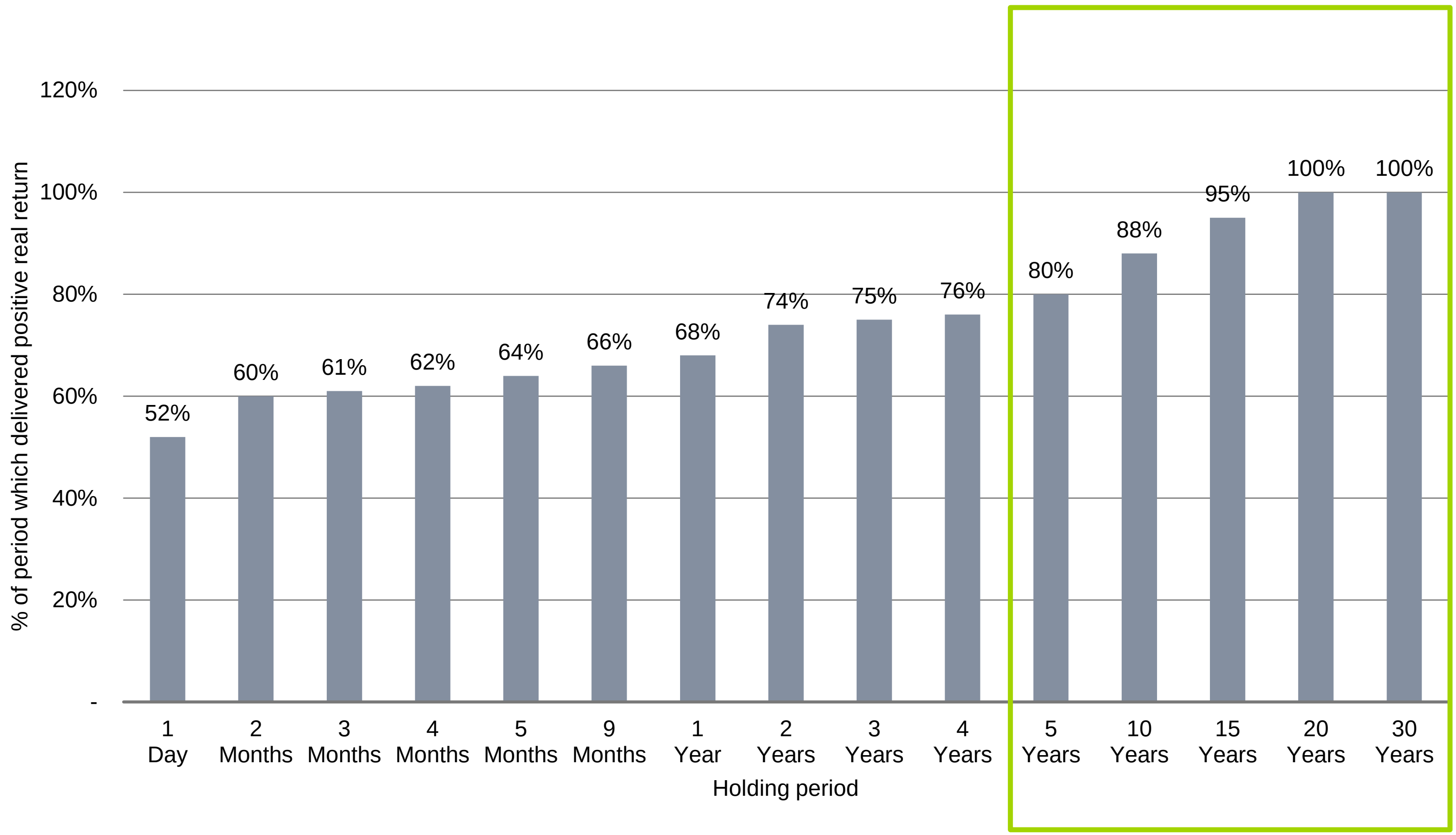
A longer time horizon is rewarded



Source: The Motley Fool
1. Data as at 18th June 2013.
2. 'Total real market returns' based on monthly S&P 500 prices going back to 1871, adjusted for inflation and dividends.
3. Past performance is not indicative of future performance and the value of investments and income from them can fall as well as rise.

Effective diversification

What the Charity Commission says

CHARITY COMMISSION

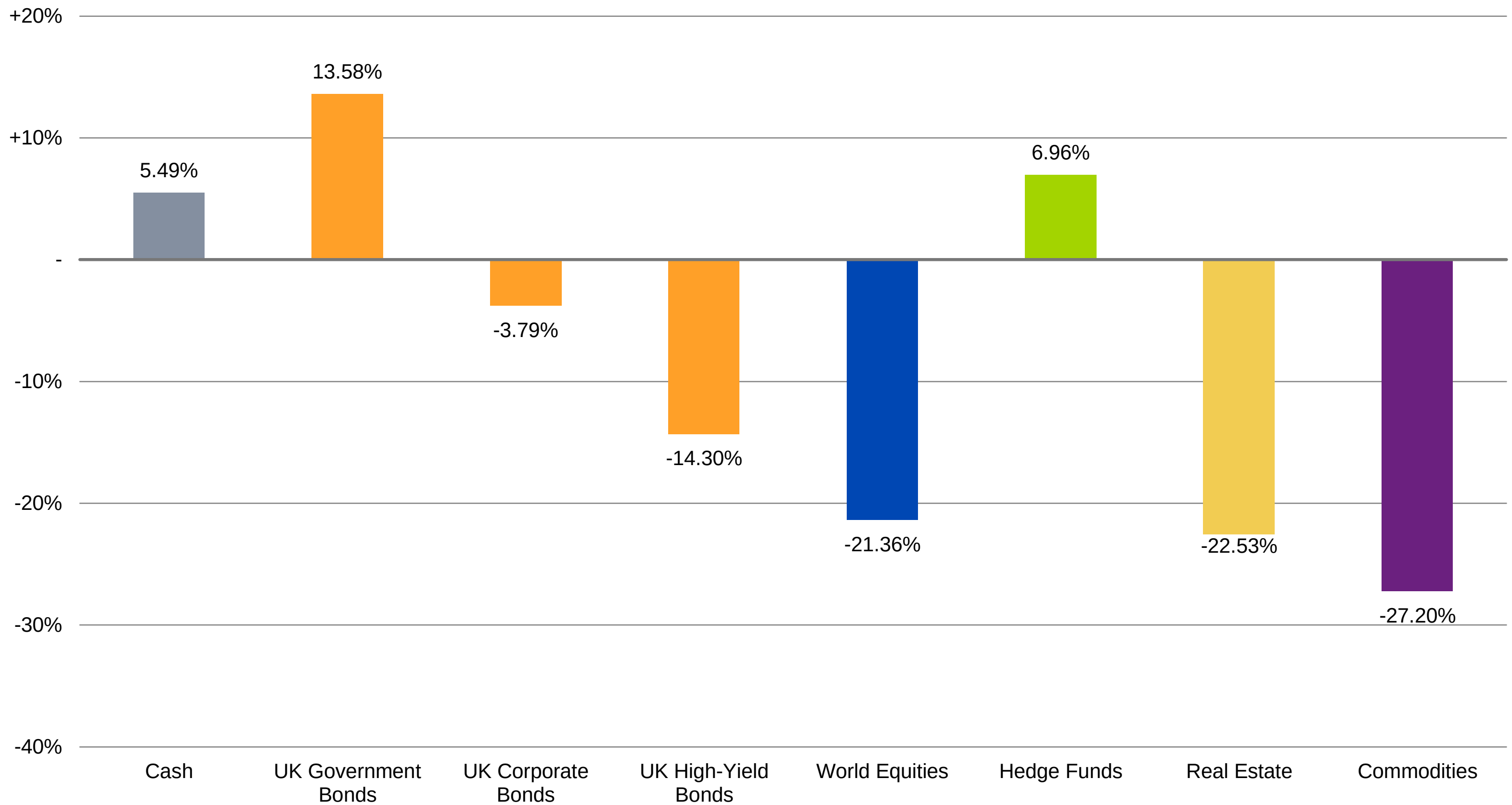
- Trustees must consider the need to diversify investments

- Capital risk can be mitigated by having a diversified portfolio of assets - if the investment return from one asset class falls, the losses may be offset by better investment returns in a different asset class

- A diverse portfolio can help:
  - Reduce the risk that the loss from a single investment, or type of investment, could significantly harm the charity’s viability
  - Protect the charity’s investments from sudden variations in the market by balancing the levels of risk and return in the portfolio
  - Ensure that the charity’s needs for both income and capital growth are met, particularly where permanent endowment is involved

Source:
HMRC – “CC14 Charities and investment matters: a guide for trustees”, October 2011

Diversification did not help in 2008



Source: Rothschild, Bloomberg

Notes

1. Performance figures are total return from 31st December 2007 to 31st December 2008, unhedged in GBP unless otherwise stated.
2. Indices used are: Cash (GBP LIBOR Total Return 1 Month Index); UK Government Bonds (Citigroup UK Government Bonds All Maturities); UK Corporate Bonds (Barclays Sterling Aggregate non-Gilts Bond Index); UK High-Yield Bonds (Barclays Pan-European High Yield Sterling Index); World Equities (MSCI World All Countries TR Net); Hedge Funds (HFRI Fund of Funds Index); Real Estate (IPD UK All Property Total Return); Commodities (S&P Goldman Sachs Commodity Total Return Index).
3. Past performance is not indicative of future performance and the value of investments and income from them can fall as well as rise.
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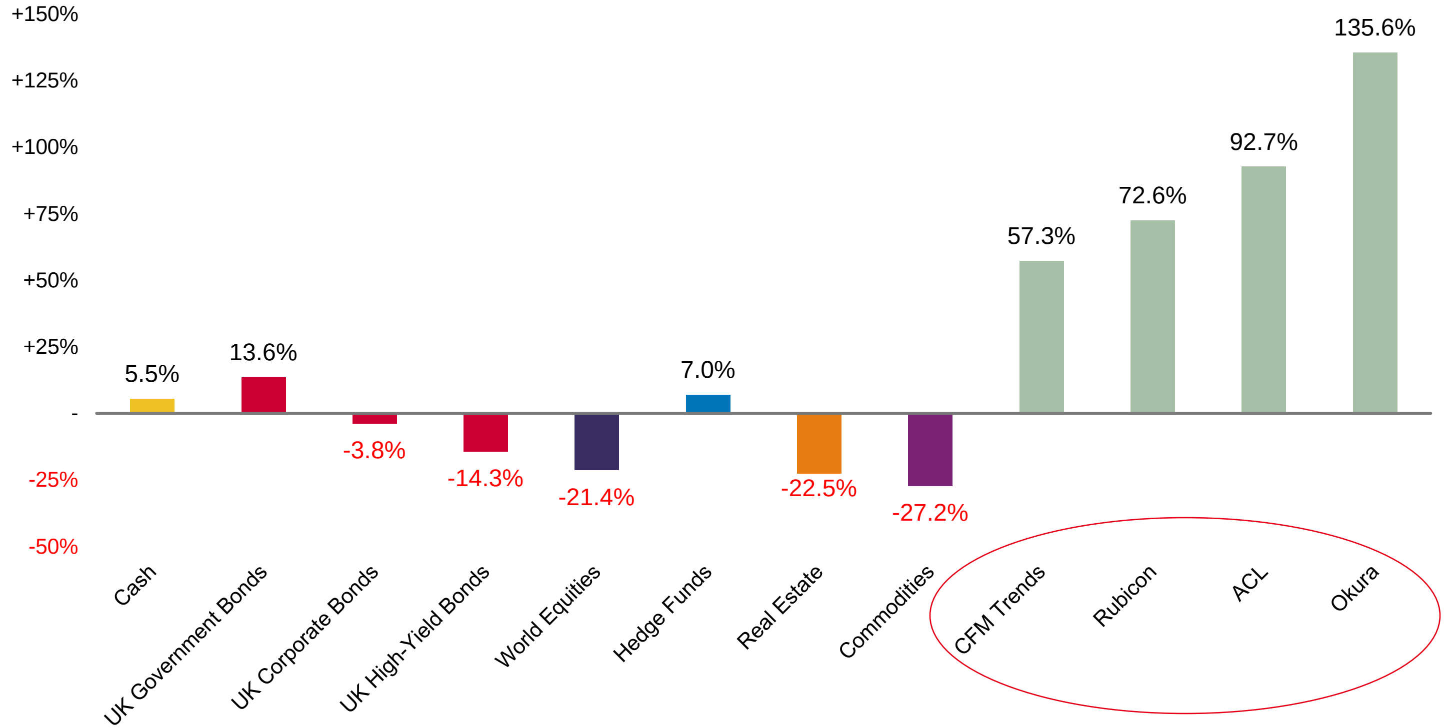
Diversification vs. 'diversifying assets'

Financial markets and illustrative Diversifying Assets' performance in 2008



Source Rothschild & Co, Bloomberg

Notes

- Performance figures are total return from 31st December 2007 to 31st December 2008, unhedged in GBP unless otherwise stated. Please note that performance of CFM Trends is based on a simulation and is for illustrative purpose only.
- Indices used are: Cash (GBP LIBOR Total Return 1 Month Index); UK Government Bonds (Citigroup UK Government Bonds All Maturities); UK Corporate Bonds (Barclays Sterling Aggregate non-Gilts Bond Index); UK High-Yield Bonds (Barclays Pan-European High Yield Sterling Index); World Equities (MSCI World All Countries TR Net); Hedge Funds (HFRI Fund of Funds Index); Real Estate (FTSE All Share REITs); Commodities (S&P Goldman Sachs Commodity Index).
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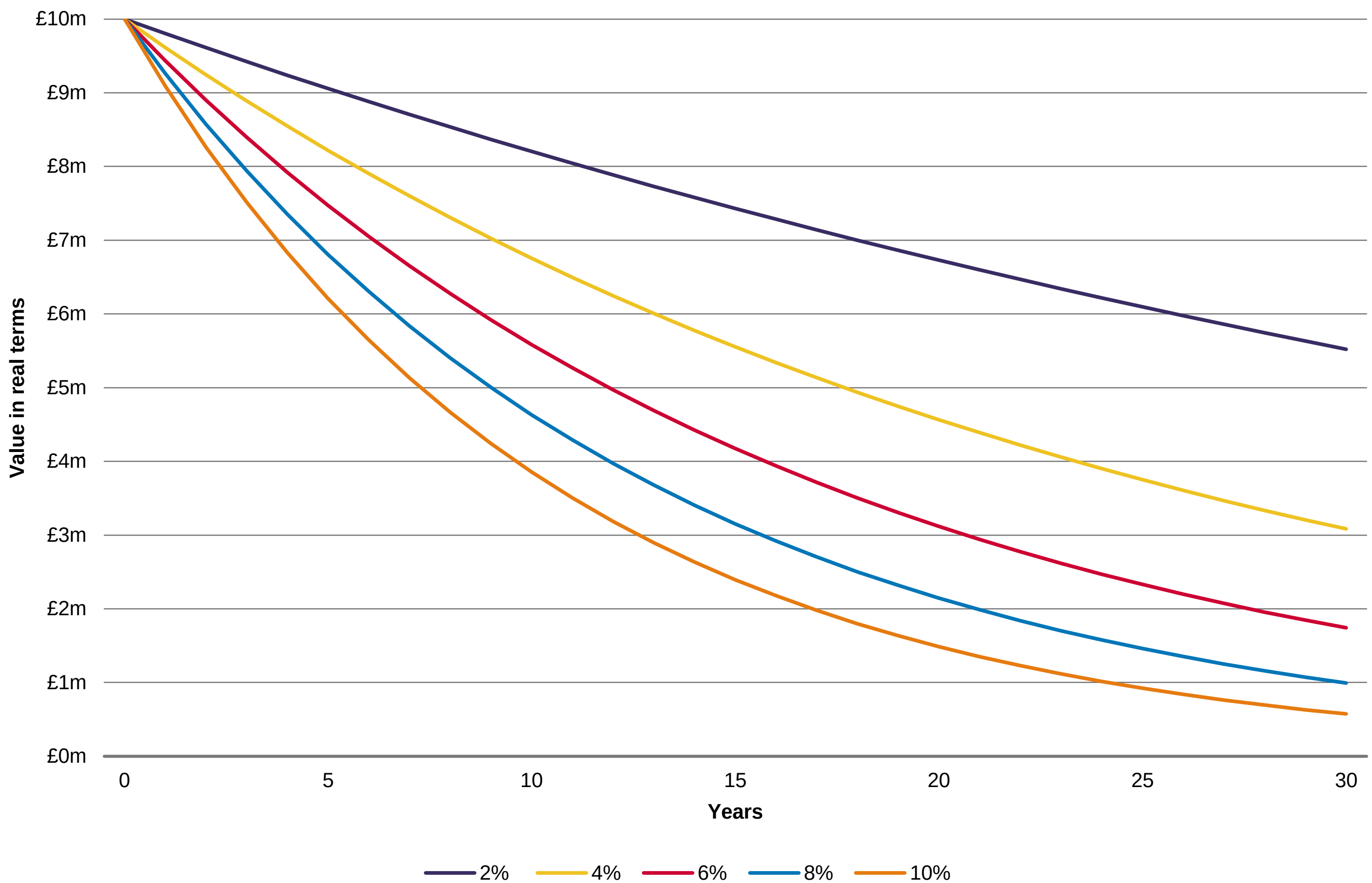
Make sure the strategy is sustainable

What is the role of a charity investment portfolio?

Inflation matters

The chart below shows the impact different rates of inflation have over time on the real value of capital



Inflation destroys capital:

Assuming an inflation rate of 4%, £10m kept under the mattress for 10 years would be worth £6.76m; a 'loss' of £3.24m, simply because the cost of living has risen

Source: Rothschild

Notes

1. Past performance is not indicative of future performance and the value of investments and income from them can fall as well as rise

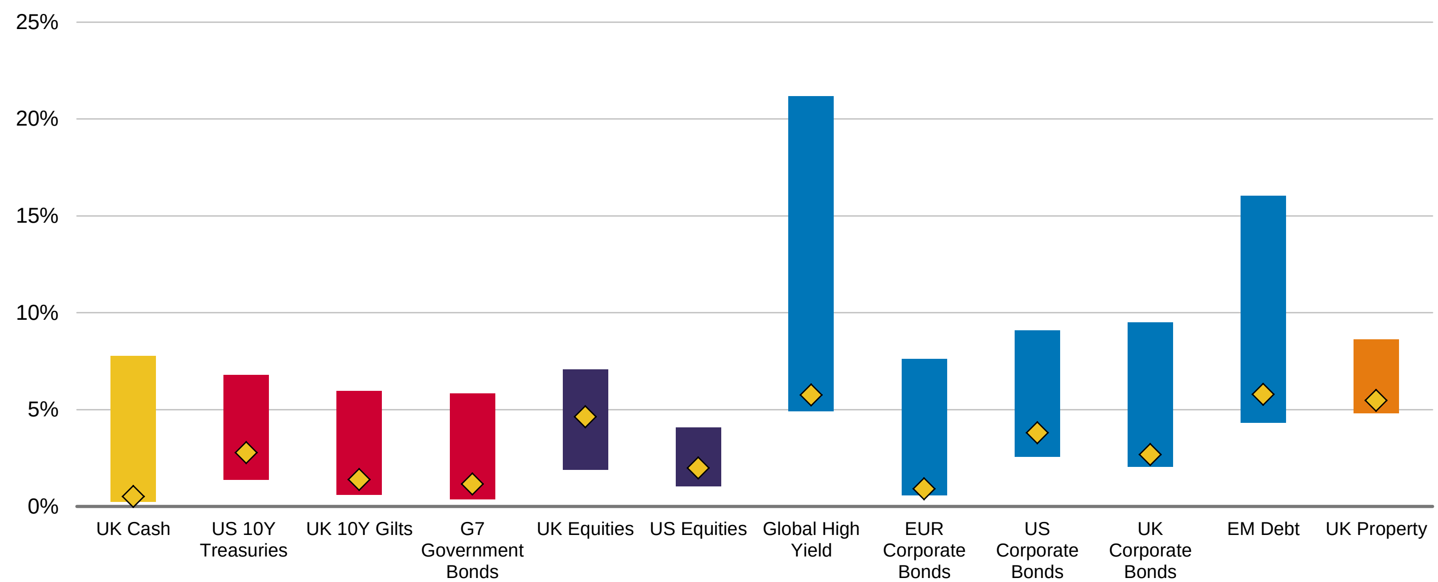
Benefits of a total return approach

Adopting a total return approach to investment and withdrawals is sustainable

Perils of income

- Yields from all major asset classes are at or close to their historical lows
- Prudence dictates a 'total return' strategy combining income and capital growth

Yield ranges over the past 20 years (♦ marks the current yield)



Benefits of total return

- Access to a wider range of investments
- Chasing income can compromise capital growth
- Focusing too narrowly on income can also force investors to take on more risk than they actually want or need
- The level of investment return is important, rather than where it is derived

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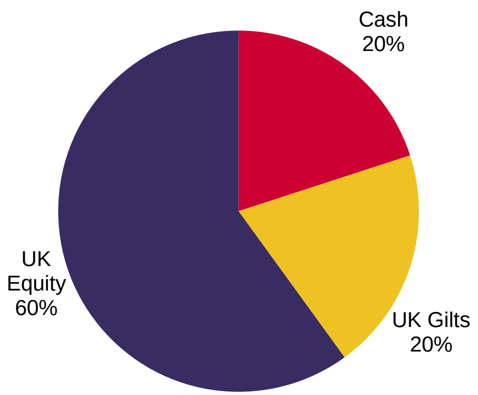
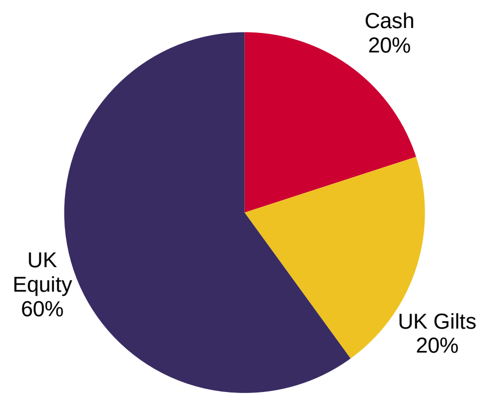
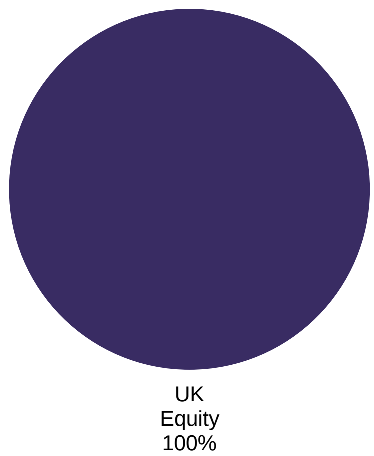
Taking on more risk to achieve a higher income

60:40 portfolio in 2007	Same portfolio today	Portfolio needed today







Portfolio's yield: 4.1%	Portfolio's yield: 2.8%	Portfolio's yield: 4.1%

Source: Bloomberg, Rothschild

1. Past performance is not indicative of future performance and the value of investments and income from them can fall as well as rise.
2. Reference dates are 31st December 2007 and 31st December 2017.
3. Indices used: Cash: 'UK Cash Indices LIBOR Yield 1 Month Index'; UK Gilts: 'BofA ML UK Gilt Index'; UK Equity: 'MSCI UK Index'.

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Conclusion

No trip-up – but less headroom

- Brexit and geopolitical risk is manageable
- Cycle brings profitability with only modest rate risk; no “secular stagnation”
- But valuations leave headroom lower – though still positive

⇒ Braced for setbacks, not collapse: long-term inflation-beating returns still feasible so long as Trustees have a diversified and sustainable strategy

Biggest risk as we see it? Central bank mission creep

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