

Weekly Digest

Week ending 3 September 2017

The value of insurance

Insurance, in everyday life, is well understood. Simplistically, it's something we buy to protect ourselves from losing money in the event of a bad outcome. But when it comes to investments, the managers of our core portfolios would argue that portfolio insurance is often overlooked.

Despite an increasingly turbulent geopolitical environment, from rising tensions with North Korea to an increasingly unpredictable US administration, financial markets have been surprisingly complacent; equity markets globally have returned strong double digit returns year-to-date whilst bond markets have produced high single digit returns, all seemingly at odds with main stream media headlines.

The portfolio managers have written at length in the past about the lack of compelling valuations in markets. Government bonds are expensive as are large swathes of the credit market. Equally, it is becoming increasingly difficult to make a convincing case for overweighting equity markets as valuations are becoming increasingly stretched, particularly in the US. With true diversification increasingly difficult to find and many asset classes looking ever more expensive, portfolios are ultimately arguably riskier.

As outcome based investors, the portfolio managers aim to deliver robust solutions that can meet investors' goals whilst making the journey to that goal as palatable as possible. They understand that many investors have difficulty stomaching large drawdowns and can end up disinvesting at the worst possible time, leading them to lock in those losses. The portfolio manager's aim is to keep clients invested, and it's therefore vital that their portfolios are not hostage to any one particular scenario.

Over the year the managers have done this through two avenues; by increasing the use of liquid alternative strategies – truly uncorrelated strategies that should enhance both the overall risk and return characteristics of a client's portfolio – and more recently by explicitly hedging part of the portfolios against a fall in equity markets. Over the past number of months they have been buying put options, an insurance contract of sorts that pays out should equity markets end up below an agreed level at the end of the insurance contract (usually 3 months). The managers have bought these put options on the US equity market as they offer cheap protection at a time when markets have been fairly complacent, partly evidenced by the extraordinarily low levels of volatility. This in turn results in the cost of this insurance, effectively the premium we pay for this protection, being much lower than usual. Although they think this bull market has further to run – and therefore they are reluctant to sell down our equity exposure – the managers view is that equities are unlikely to continue going up in a straight line as they have recently, and a correction of some magnitude is overdue.

While this form of portfolio insurance is relatively cheap, it is of course not costless. And given that the most liquid contracts tend to be quite short term, this type of insurance needs to be rolled regularly. It is by no means a foregone conclusion that there is a correction in markets in the near term, and as always it's important to have a clear idea of how much you would spend at most and what actions you should take if there is a significant change in the cost of this insurance.

The Marketplace

- Oil prices rose 0.6% on the week with Brent at USD52
- Gold rose 2.3 % to 1322, currently at an 11-month high
- North Korea reignites nuclear tensions
- Inflows into ETFs in 2017 exceed \$400bn
- Investors look to safe haven asset classes

Market Focus

US

- Nonfarm payrolls rose by 156K vs 180k forecast, manufacturing payrolls gained by 36K
- The S&P 500 Index finished the week at 2,476
- The Dow Jones index ended the week at 21987, up 0.8%
- Nasdaq was up +2.84% at 5988
- Unemployment ticked up to 4.4% from 4.3% against expectations placing downward pressure on interest rates

UK

- GBP one of the worst performing G10 currencies in August, continuing a four month consecutive drop against the Euro of 2.2%
- House prices continue to cool with prices dropping 0.1% in August
- UK Equities finished the week up 0.4% with the FTSE 100 closing at 7438
- Brexit talks in apparent deadlock. Two more rounds of negotiations before the Brussels summit in October
- UK manufacturing expands at strongest pace in four months. PMI stands at 56.9 vs 55 forecast.

Europe

- France, Germany, Italy and Spain agree to stem migration flows
- Euro Area Q2 GDP expands 0.6
- German jobless figures extend their decline. 5.7% unemployment is the lowest level since reunification in 1989
- Manufacturing PMIs climbed to 57.4 in August from 56.6 in July
- Euro Stoxx 600 closed the week at 376, up 0.6%.

Asia

- Nikkei closes +1% on the week at 19508
- The Hang Seng finished the week up 0.4%
- China PMI finished ahead of expectations at 51.6 vs 51
- Worries that N Korea is ready to launch an ICBM. US threaten economic sanctions and trade embargoes on any nation trading with the regime. Apparent nuclear test causes 6.3 magnitude earthquake.

Richard Stutley (CFA) & James Jones

Asset Class/Region	Currency	Currency returns			
		Week ending 1 Sep. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	1.4%	0.2%	11.7%	15.8%
United Kingdom	GBP	0.5%	0.1%	7.5%	14.6%
Continental Europe	EUR	0.3%	0.5%	8.5%	15.6%
Japan	JPY	1.4%	0.1%	7.9%	23.7%
Asia Pacific (ex Japan)	USD	0.6%	0.3%	27.7%	23.6%
Australia	AUD	-0.1%	0.2%	4.1%	10.3%
Global	USD	1.1%	0.3%	13.8%	16.3%
Emerging markets equities					
Emerging Europe	USD	2.2%	0.3%	16.5%	29.9%
Emerging Asia	USD	0.5%	0.1%	32.0%	26.0%
Emerging Latin America	USD	0.7%	1.4%	26.5%	24.3%
BRICs	USD	1.1%	0.4%	32.3%	29.1%
MENA countries	USD	0.3%	0.0%	5.4%	15.3%
South Africa	USD	0.6%	0.6%	20.7%	22.8%
India	USD	1.5%	0.8%	31.2%	20.6%
Global Emerging Markets	USD	0.6%	0.3%	28.7%	25.3%
Bonds					
US Treasuries	USD	0.0%	-0.2%	3.1%	-1.3%
US Treasuries (inflation protected)	USD	0.3%	-0.2%	2.4%	0.2%
US Corporate (investment grade)	USD	0.1%	-0.2%	5.1%	1.9%
US High Yield	USD	0.4%	0.1%	6.1%	8.7%
UK Gilts	GBP	-0.1%	-0.3%	2.3%	-3.5%
UK Corporate (investment grade)	GBP	-0.1%	-0.2%	4.4%	0.6%
Euro Government Bonds	EUR	0.1%	-0.2%	-0.1%	-2.7%
Euro Corporate (investment grade)	EUR	-0.1%	-0.1%	1.9%	0.6%
Euro High Yield	EUR	0.1%	0.0%	5.5%	6.9%
Japanese Government	JPY	0.1%	0.0%	0.2%	-1.3%
Australian Government	AUD	0.0%	0.3%	2.8%	-1.7%
Global Government Bonds	USD	0.0%	-0.1%	6.9%	-1.7%
Global Bonds	USD	0.0%	-0.1%	7.1%	0.3%
Global Convertible Bonds	USD	0.7%	0.3%	9.0%	6.6%
Emerging Market Bonds	USD	0.5%	0.1%	8.8%	3.8%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	0.7%	0.4%	3.3%	-1.8%
Australian Property Securities	AUD	1.1%	0.3%	-5.4%	-11.3%
Asia Property Securities	USD	1.1%	-0.2%	21.7%	15.8%
Global Property Securities	USD	1.0%	0.1%	11.6%	4.8%
Currencies					
Euro	USD	-0.2%	-0.2%	12.7%	5.9%
UK Pound Sterling	USD	0.6%	0.5%	4.9%	-2.3%
Japanese Yen	USD	-1.0%	-0.1%	6.1%	-6.4%
Australian Dollar	USD	0.4%	0.6%	10.8%	5.6%
South African Rand	USD	0.7%	0.7%	5.9%	13.1%
Swiss Franc	USD	-0.9%	-0.3%	5.6%	1.6%
Chinese Yuan	USD	1.3%	0.6%	5.9%	1.7%
Commodities & Alternatives					
Commodities	USD	2.0%	0.3%	-2.6%	6.0%
Agricultural Commodities	USD	0.7%	0.1%	-3.6%	0.4%
Oil	USD	0.6%	0.7%	-7.2%	16.1%
Gold	USD	2.3%	0.4%	14.8%	0.7%
Hedge funds	USD	0.4%	0.0%	3.8%	5.6%

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