

October 2019

Building resilience into a portfolio



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- The outcome for the UK economy is uncertain and resilience is likely to prove important
- Keeping a balance between high growth and higher yield, and between domestic and international builds resilience
- Income is likely to be a driver of returns in a low-growth environment

Uncertain times can leave investors exposed, particularly those who have neglected to build resilience into their portfolio. As the economic cycle matures and the outcome for the UK economy appears more uncertain, what strategies can help shore up a portfolio?

It is easy to paint conflicting scenarios for the UK today. There is plenty of economic uncertainty, as GDP and consumer spending figures deteriorate. On the other hand, the economy has remained resilient and were there to be some resolution to Brexit, it is easy to see how it could start to improve.

With this in mind, it seems like a foolhardy moment to take binary bets on the domestic economy, assuming that one or other scenario will come to pass. It is a moment to ensure that a portfolio is resilient in either outcome, rather than having to worry which way the wind is blowing.

How can you build this resilience into a portfolio? Certainly, income is important. Even if the stock market has further to run, and the economic cycle can continue a little longer, this particular expansion is closer to the end than the beginning. There is less growth on offer and income is likely to become a more important part of an investor's potential return.

“At Shires Income Trust, we shore up our income stream with the use of preference shares.”

At Shires Income Trust, we shore up our income stream with the use of preference shares. While the capital performance is unlikely to deliver significant returns, they aim to pay a steady 6-8% income. Companies generally don't issue them anymore, which helps sustain demand.

Having a high income from the preference shares gives us freedom in the remainder of the portfolio. This has proved important in recent years as investors have favoured high growth equities, at the expense of higher yielding equities. Historically we have been able to hold some successful higher-growth, lower yielding companies, which have supported capital performance.

Today, we believe holding a balance between these two types of company is vital: while valuations for high growth stocks look high, if interest rates stay low it is not clear that this situation will change. Higher yielding and 'value' stocks look cheaper, but are likely to provide less capital growth over the long term.

As such, being able to hold a balance is a way of building resilience into portfolios. We don't want to incorporate significant style bias into the portfolio. There is always a danger that income managers simply load up on the oil majors and healthcare and their portfolio becomes poorly diversified and vulnerable to specific risks.

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We also aim to be diversified by sector, by geography and by source of revenue. For this reason, our top five holdings provide 20% of our income, rather than the top five holdings providing 35% if an investor buys the FTSE All Share.

Another way to build resilience into a portfolio is to focus on quality. We are looking for companies with good, defensible market positions, which give them pricing power. Or we want to see innovation – again, this gives companies pricing power in an otherwise undifferentiated market. Ideally companies should make a high return on the capital they invest and have low levels of debt,

plus a skilled management team. All of these factors can make a meaningful difference when the economic environment changes.

More recently, we have been looking for companies that are not as dependent on the economic cycle. We are keeping a balance between domestic and international companies: on the one hand domestic companies are cheap, but on the other, there are real risks to the UK economy. This has seen us move away from companies with exposure to, say, high street spending, and towards companies that can win market share and sustain their earnings even if there is a broader economic downturn.

These are companies such as fund manager Ashmore. Ashmore specialises in emerging market debt funds. Generally, we are wary of the fund management sector, because earnings tend to ebb and flow with financial markets. If markets drop, revenues fall. Or a key manager will leave and take the funds with them. This makes it a little unpredictable.

However, Ashmore does one thing and does it well. It has managed to build up a loyal client base, who are aware that the asset class is cyclical. Looking at their fund flow data, client assets seem to be very sticky. When emerging market debt markets go up, we have seen them win a disproportionate amount of business, and when they fall, they have historically retained more than their peers.

The economy appears to be entering a late cycle phase. There may still be growth to come, but the economic data is weakening and in the UK, we need to contend with a populist prime minister, who has not always been business-friendly. There is enough reason to believe a more cautious view is warranted. We want to keep a balance in the trust, ensuring that it remains resilient, whatever the economic weather.



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- The Company may accumulate investment positions which represent more than normal trading volumes which may make it difficult to realise investments and may lead to volatility in the market price of the Company's shares.
- The Company may charge expenses to capital which may erode the capital value of the investment.
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- As with all stock exchange investments the value of the Company's shares purchased will immediately fall by the difference between the buying and selling prices, the bid-offer spread. If trading volumes fall, the bid-offer spread can widen.
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121039122 10/19 | DH: GB-301019-102414-1

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