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Please note that these are unprecedented times and markets can react very quickly to news. The views expressed are at the time of recording and could change.

[INTRODUCTION]
Ryan Lightfoot-Brown (RLB): Hello and welcome to the Investing on the go podcast brought to you by FundCalibre. I'm Ryan Lightfoot-Brown and today we're speaking to Steve Andrew, the Elite Rated manager of the M&G Episode Income fund. Steve, thank you very much for your time today.

Steven Andrew (SA): Hi Ryan. It's a pleasure to be here.

[INTERVIEW]
[0:18]

RLB: Now first of all, your fund is quite unique in its use of behavioural finance in the investment process, can you just talk us through that a little bit, please?

SA: Yeah, sure. The behavioural finance aspect, it's really a behavioural psychology observation that it's an acknowledgement that the market is made up of a bunch of human beings making decisions, essentially. And so we're looking at price behaviour and correlations. So what moves with and against each other on any given day, week or month. And we're looking at those things in the context of the facts. So how have the facts changed? Along-side those changes in price, changes in correlation and importantly, how does the market describe itself in a sense? So how are people explaining their shifting beliefs and justification around why they see prices going up or down or here or there. And we just try and then knit together, what we then hope is a consistent observation of why is the market doing this or that? So how can we best understand volatility, essentially. So that's mainly the kind of psychological aspect as it applies to market price behaviour.

And then of course we can't get away from the fact that we too are humans. So we're not machines. We can't make decisions like machines. It's simply impossible for us humans to do that. So more and more scientific research explains to us all that our decisions always start and finish in an

emotional base. So essentially you can't disentangle the emotional from the rational, from the logical in that way, so we need to acknowledge those things in ourselves. So we need to have a system whereby we are vigilant about our own behavioural biases. Cause of course unless we acknowledge those things, we can't really get to the heart of what's driving our own investment decision. And this for me is where a team is very important, because if we were all sitting on our own as investment managers, trying to make these decisions, we can convince ourselves of all manner of things in terms of how much we know about this or about that. Whereas if we have a team of individuals that can really challenge us and say, well, you know what, that's not consistent with how you usually look at things and we think you're allowing your fear to dominate your decision. So it's really in that sense that behavioural psychology really is inter-woven throughout our entire observation about how the market works.

[3:01]

RLB: And in that you said there, the markets justifying - or you are justifying the market ups and downs as part of this behavioral psychology approach, has this part of the process being magnified during the pandemic in any way, where we've seen these huge ups and downs? You've said recently that there is ample evidence that human desire is to compare current events with those of the past, what exactly do you mean by this, especially in context of what's recently happened?

SA: Yeah, absolutely. I mean this current phase and the phase we've been going through over recent months, really in many ways is a kind of classic behavioural episode in that sense. And yes of course it's mixed with lots and lots of real stuff. When we're thinking about our desire as humans to kind of explain things, it's how we operate as human beings in terms of our gathering of information, our brains taking in information on a day by day basis from the time we're born until the time we're kind of upright and doing all of our active things in the world. And each time that information comes in, the brain looks around for something that's kind of similar to it in its memory and its programming and responds in a similar fashion with similar emotions firing through you.

So you're seeking of a rationale for these things really does tend to follow a template. It's a useful kind of evolutionary toolkit. It's a useful part of our evolutionary toolkit in terms of adapting to our environment and learning how to respond to threats and opportunities and those sorts of things, but it also needs to be something we're very mindful of in terms of when we see something that looks like something we may have experienced in the past, like rapid price falls, accompanied by very alarming headlines about recession, and the historic nature of that. So the unprecedented nature of many of the kind of the depths explored by much of the economic data, our brains really do go into kind of recession playbook mode.

And I guess we just need to, my comments on that in the past have simply just been to, to try and frame that in a way that says, well, not every recession is the same and this one in particular, whereby the characterisation of the recession as being this tremendously challenging and enduring

event that then economies and societies will take a very long time to get over. Well, that might be the case, and it might not be the case we simply don't know. And I think we need to acknowledge while we're amid the chaos.

[5:40]

RLB: Perhaps with that in mind, I mean, stock markets seem to be incredibly confident at the moment. Perhaps today is a small exception, but the economic data is clearly incredibly weak. We're going to have a huge recession and yet stock markets are touching all-time highs again, in some parts of the world. Do you think this is a human behaviour issue? Or do you think it is, as you said, it's that pulling out the playbook of what's happened in the last 10 years with central banks behaviour?

SA: Well, you're right. I mean, it feels weird and it feels weird because if you had, if you'd be popped back 12 months, and then you rush back from the future. You bump into my Marty McFly or whoever, and he's got the book of what happens in 2020 and he misses out the whole virus thing, but he tells you unemployment rates are all in double digits. He tells you that growth is a -10%, -15% and then he asks you to guess where the equity market is. There's no way we should be talking about it being new highs, you would be utterly terrified.

So that tells us a couple of things in the first instance. It tells us that the market is taking a view here. The market's taking a perspective on that, it's looking at those miserable numbers and truly, truly shocking numbers, and concluding something that is different about those things. So I do think there is a greater degree of circumspection. I would say that the journey that we've undertaken since March and April, we initially had the panic and the fear, and everyone was very despairing about things. And then there was the, kind of the noisy contest to forecast stuff. And now we seem to be and so prices revived for lots of things, not for everything, I mean, the market's been quite discerning in as much as those entities where you could draw a line that said, you know what, not only are these companies and sectors unaffected negatively by what's going on, but they are potential winners in terms of what's going on, in terms of the structure.

So it's kind of the, for the shorthand tech versus old stuff, basically. So if you were relying upon the regular face to face contact with your, with your client, with the person who you're selling your product or services to, then you're in bother. So that in a very kind of rough and ready sense, but if you're someone who can conduct business globally, online and would benefit from more people working remotely or whatever it might be, then your earnings will suddenly be worth, or your valuation consideration, is suddenly worth a great deal more. So there has been that disparity over the market now being more selective over who the market describes as the winners and the losers. So you still have many, many areas that are down kind of 10% or 20% year to date, but then as you say, you've got lots of areas that have not only recaptured their year to date numbers, but now are

showing some positive numbers. And I would say that there has been something of a restoration of a balanced aspect to things.

So the market now feels to me like being in a place where the news about the virus and about the economics. So what happens when economies really open both to the virus numbers, and to the economic demand numbers, the market feels like it's in a position of well let's just wait and see how that pans out, rather than conducting some expedition into optimism or indeed a kind of a period that says, you know what, we're still very fearful because the market certainly does not look very fearful, but neither does it look terribly optimistic. But it certainly feels to me, like we're not in a position where the market's over-stretching and over-optimistic, but neither are we super fearful, which sounds really quite, quite boring now actually. It sounds like you shouldn't really have very many aggressive positions on, and I would say that you probably shouldn't have very many aggressive positions on and as an asset allocator you want to be well-diversified and be across the board. So you want to hold some bonds, you want to hold some equities and within that, you probably want some diversification as well.

[10:16]

RLB: Yeah, well, that sort of neatly brings us on to our next question and your portfolio, you are quite well known for going against the herd and going against consensus and assumptions. So looking at your portfolio, you've got 16% in US equities, which had been leading the rally - one of those markets that are nearing all-time highs and we spoke about, and then just small amounts in corporate bonds but quite a large amount in government bonds. Can you talk us through these in respect to your portfolio?

SA: Absolutely. And we've changed, we've changed that portfolio over the course of the past few months as well. So just to put some of that into context, cause it's been a really kind of super challenging time as all our clients will know, and as all investors will know, it's been a super challenging time, the first six months of this year.

In January, when you're looking at aggregate equity valuations, they weren't super appealing. And so within it was more of a job of looking within markets. So it's about looking at specific sectors. Now the Euro area banks sector stood out to us as being one where we might be able to find at that time some really decent quality banks with some solidly financed balance sheets. And certainly we were able to find those. And that was an absolutely kind of constructive thing to do for the portfolio over the course of the past 18 months or so, but coming into this particular phase, that was really challenging because we had roughly 10% of the portfolio in Euro area banks, handily offset a substantial holding in US 30s. So US 30 year government bonds, which we had about 15% or 16% at the time. So that in terms of effective portfolio diversification, those US treasuries worked quite well to diversify us.

Coming out of, or going through the middle of the crisis then, in terms of the deepest parts of the markets, the markets panicked, we took some opportunities to diversify the equity. So to broaden away from European banks, we added back into some of those US equities that we'd allowed to fall away over the prior 12 months or so. So back into some of the financial names, broadened out more into Japan, where we've now got 12%, and now we've just got 5% in Euro area banks and 10% in the overall Euro area. So the breadth of our equity has changed over the course of the past three months.

Our fixed income you're right, we've got a good bulk in government bonds. I think it's kind of a three way split in a way, dominated by US treasuries, so US treasuries is currently at 17%. Then you've got Emerging market sovereign bonds performing a very, very different role, they're at 16% in the portfolio and that's dominated… those… there are four main holdings in there: Brazil, Columbia, South Africa, and Mexico. They're there more as a kind of strategic contributor to the income side of the portfolio and to a value side of the portfolio, in terms of how the compression of that global bond yield, so the journey that global bonds have been on pretty much over the past 15 years has been one that starts in the top left and finishes in the bottom right. And that's been a journey where the market, and ourselves, have been steadily learning what the value of sovereign bonds truly is.

So if we wind forward to where we are today, where central banks are telling us that these rates aren't going to change for some time, despite the fact that yes, economies look like they're getting back to something closer to - still far away at the moment - but closer to normal activities. So it'll still take some time, but the appetite to be doing anything with those rates is very close to zero. So when we look at our choices of safety asset, because when we're asset allocating, and as I said before, diversification is key. So we want to have a diversified equity portfolio and we want to have an overall diversified portfolio from a risk perspective, and from a volatility perspective, to the extent that we can do that. So if equities suffer another setback, we want something that's going to provide some good diversification. Now US treasuries are currently offering a yield of 1.5%, that's a very, very positive yield curve slope. So you take 1.5% and you take away the current fed funds rate, which is effectively zero, that gives you a pretty hefty premium on that short rate. And that's something that isn't seen in any other developed government bond market. So we're still very comfortable owning a large amount of US 30 year debt. So I think it's important for the diversification point.

[15:15]

RLB: Okay, so a couple of things from that, I mean, you are the Episode Income fund, income is one of the big functions of your portfolio. We've seen and you said about the equity setback that we're having in equity markets at the moment, and whether the dividend cuts, for example, whether we're going to have a threat of those, that income not being there anymore, you've got a large weight in government bonds, which are well protective on a capital side but don't help you much in

the income side. So what are you doing for the income in the portfolio, are your sort of emerging market bonds going to be enough to generate the income for your investors?

SA: Nope, definitely not. It's a really good, really good question because it's, that's the key challenge that lots of income investors have had over the past three, four months, because of course, as you've seen companies cutting their dividends or skipping them for the time being, or for many different reasons.

I guess the benefit for Episode Income is that it's not, it's never really been that, that traditional, we've never followed a traditional income strategy, it's always been about the sustainability of income growth. And by that, I mean, it's just the acknowledgement that the capital wellbeing and the income are integral. So our objective is to grow the income over time, and that remains our objective of course. There will be hiccups along the road. It's helped to be smooth in the sense of we have a 12 month distribution schedule. So we distribute monthly. And that means that we can, there's an element to which we can, we store up some income and then we overpay or then we underpay or overpay given what we need to do in order to manage that income throughout the fiscal year. So it really does depend what happens throughout the entire span of that fiscal year, how the unit holder then experiences any income shortfall overall. So it helps from that perspective, just in terms of the product distinctions, but also in terms of the breadth of our exposures, as you said, some of the EM [emerging markets] bonds, there are really varying yields actually, so we've got a yields in the EM space at 3.5% and then at 10%, so there's a variety. So they, at 16% of the portfolio, yeah, they contribute a reasonable amount, but equally on the equity side, some of the US banks also contribute quite substantially to dividend. Some of the Japanese holdings have begun in recent years to participate more in terms of dividend payouts.

So for us, it really, it still has been a matter of portfolio positioning first and then construction to deliver the dividend second. So it's, I'm not gonna, it's not easy in terms of where you get income from that's for sure. And you just have to make sure that you're doing the best you can in terms of looking everywhere. And part of that, part of doing that actually, in one thing we haven't touched on yet is credit and that we haven't held much credit over the years in the portfolio, equities have done the job in that way. In terms of the nature of the risk from an asset allocation perspective, credit is something that we're getting increasingly curious about, looking more closely at some holdings. We added a bit in US high yield about a month or so ago when, when obviously the markets we're in, where we're still in a phase of distress. That's done okay. That's but it's very, it's very short-term, but I think there is scope for us to find further sources of income on the fixed income side of the book still.

[18:58]

RLB: Okay and perhaps lets go onto your investors, which we touched on, as sort of a final question, have you got any behavioral finance tips for them? We talked about how you use it in a portfolio, perhaps how they can use it in their portfolio and selection?

SA: Yeah, I mean, I think so. I mean, it's always, it's funny that one of the reasons that I feel comfortable with this approach, and one of the reasons that attracts me to this approach is its simplicity, but then it can sound overly simple. So essentially, but much of life is like that. Much of life you need to, you need to take a step back. And I guess thing number one would be, remember how little we all really know. And that's so important when we are, when we turn the radio on or the TV and Robert Peston or Laura Coonsburg or whoever else is saying to us in quite alarming tones that we're in this or that state, that the historical you know, you go back in history and you, you have not encountered anything as bad, but the size of the government debt, when you come out of these, this period is going to be this or that, and that has inevitable consequences for tax. And it has inevitable consequences for future economic growth… Just to, to kind of take a pause and say, well, nobody knows, nobody knows what's going on in the future. All we can do is take a dispassionate or as dispassionate a look as we can about the facts as they appear to us today, before we go rushing to judgment on any of it.

So that would be, and then a development of that, of course, is what I said earlier, which is so as investors, when the market is certain about those things. So when the market is sure about stuff, be very wary, it's a version of the Buffets that fear and greed quote, and it's essentially, it's hard to generate a return being more sure or certain than the market, when the market is sure or certain about, about whatever it is, but it's a lot easier to generate a return being the wary party or vice versa. So it's, it's having that perspective that says, look, if I don't know what's going on, another topic on this front is politics at large, but Brexit in particular, in terms of the certainty that the market expresses about Brexit outcomes and those sorts of things, when that would appear to be driving price, you know, that's an opportunity because no one can truly know the answer. The market might be right, but if it's priced to be right, you not going to benefit from that by standing on, by standing on the more extreme side.

And the second aspect would be, would be that there is always it's behavioural as much as anything it's just obviously, so there's always a need for diversification, always. Otherwise you'll go, otherwise you're being arrogant, otherwise you're saying you need to be right. And that's a, that is innately risky place to be positioning yourself. So if there's no diversification available, just hold less risk. It's as simple as that. So there's always some form of diversification available: that's doing nothing. And so if you, if you don't like the look of the things that will diversify you that are safe, then don't buy them just because they're not what you fear, hold less of what you fear.

RLB: Well see that's been unbelievably useful. Thank you very much. And also a very interesting podcast, so thank you very much for your time this afternoon.

SA: Cheers, Ryan. It's a pleasure.

RLB: And if you'd like more information on the Elite Rated M&G Episode Income fund, please visit FundCalibre.com and don't forget to subscribe to the Investing on the go podcast to get more content from us and our Elite Rated fund managers.