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investing ON THE go

TRANSCRIPT: EPISODE 246

16 March 2023 (pre-recorded 7 March 2023)

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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. This week we're considering one of my favourite topics: investor behaviour — both rational and irrational. From the shunning of UK equities to the polarising topic of Japan and property, today's episode is a great look into the emotional volatility feeding markets today.

Chris Salih (CS): I'm Chris Salih, and today we're joined by Steven Andrews, manager of the Elite Rated M&G Episode Income fund. Thank you for joining us today, Steven.

Steven Andrews (SA): No problem, Chris, nice to see you.

CS: It's been a while since I've spoken to you. I think the last time we talked, we spoke about Mike Tyson and the idea that everyone's got a plan until they get punched in the face, and we used that to describe emotional volatility and irrational behaviour.

SA: <laugh> Yeah!

[INTERVIEW]

CS: Mike might be retired from the ring, but he's been throwing a few punches to investors in 2023 and the back end of 2022. Are you seeing a bit of the emotional volatility in the markets at the moment? Is it at a peak? How are you sort of perceiving things in the last [months]?

SA: Yeah, I mean it's a really good starting point here because we all had such a rough experience of 2022, and then you come into 2023 with investors feeling pretty beaten up and, if not on the deck, there's kind of in the mood for the ref to get you back to the corner and get the towel out and flap it around your face just so that you feel a little bit more energised!

So, we enter into the new year and markets actually start to cheer up. Markets actually start to say, 'Well, you know what? Maybe the future isn't as bad.' And that, I guess, there's been partly a reflection of things just got so bad and so challenging in 2022 that there was an element of a relief rally, so, there's an extent to which

you can't really project that too far and extend it too far. But then there's another extent in which it's reasonably rational, you know, because the stuff that we look for are things that can't easily be explained by the facts. But the facts, to be fair, have been by and large, better than people had been expecting. Economies haven't slowed down to the degree that they were expected to, and so some of the data has been quite supportive. So, in that sense, it's not something that I've wanted to fight against in that way, so, it doesn't feel as if it's something that's been overwhelmingly driven by an emotional or behavioral response. It feels like a fairly coherent response to saying, right, well that data reassured me that stuff isn't deteriorating very quickly. And so it's reasonable to say things might be better than we expected.

Now where we've moved to, is on the fringes of a bit of complacency, on the fringes of saying, well, hang on a sec, the longer run here … globally, you've had the, what would be called the sharpest tightening in monetary conditions, so, the biggest whack from interest rates in 40 years. It's very unlikely that you get out unscathed from that. So, what we can interpret the experience of the first quarter or the first part of it, feels more like we get a bit of a rest - we get three minutes rest before the next round starts - but we need to get ready to get back in there, because it will remain volatile, there will still be opportunity.

CS: We'll get back to Mike Tyson and outlooks, etc. and how we're going to weather his punches in a bit. Can we maybe talk about the UK; you mentioned sentiment - everyone hates the UK, but you've got a bit of an allocation to them. Are they a bad investment? Are they a contrarian investment or is it a case of simply waiting for the sun to shine in the UK?

SA: I think so. I mean, so why is everybody gloomy about the UK? Again, that feels like a fairly rational level of gloom, given where the fundamental economy is facing. So, you have the lowest growth and the highest inflation mix. That's an unpleasant mix. And you have a policy maker that's still facing towards tighter, rather than looser. Now that can change, that can absolutely change reasonably quickly.

What I would say in the UK's favour would be, whenever you see this sort of clustering of misery, you see the clustering of pessimism, you don't really have to have a very different view to say, well the chances are you might get surprised on the one side of things; is the UK going to be even worse than everybody expects? Or might it be not so bad as everybody expects? Or at least look not as bad as everybody [expects].

CS: Over the last few years, we've had that valuation versus history chart and it seems to be getting bigger and bigger [how the valuation gap between the UK stock market and the rest of the world has widened as the UK has got cheaper]. Eventually, at some point it has to become attractive, doesn't it?

SA: It does. And to an extent the UK's hampered a little bit by the fact that it's shrunk in the global economy, in the global market - it's halved! The UK's proportion of the global market, the All Country World Index [MSCI ACWI] has pretty much halved over the past decade. So, in that sense, a reasonable benchmark allocation to it is now 4% or 5%. Whereas 10 years ago it was closer to 10%. So, in that sense, there's less of a structural appetite for the UK anyway. But absolutely, that doesn't mean that… that might mean it's anymore [an] easily-ignored market. So, yes, there might be more excitement there. From a fundamental perspective, I would say there are a few things that you'd really want to see in place. You'd want to see the

visibility of the end of the tightening cycle. You'd want to see some of the fundamental macro data start to improve a little bit. And I think we've still got a bit of a painful journey to go before we get to that stage.

CS: Okay. I'm going to talk about a couple other asset classes in a minute, but just to stick with equities. So, obviously you seem to have a bit more of exposure to Japan, Europe, and the US. Maybe just give us a quick line on each of those and what type of companies you're looking at there?

SA: Sure. Absolutely. So, let's start with Europe at the top of that. So, Europe has had a thoroughly, thoroughly miserable time; miserable pandemic, miserable post-pandemic, and it's only really quite recently become, if not flavour of the month, much more highly regarded or much kind of less poorly regarded than by global investors. So, attention has turned away from the US as an aggregate overvalued market that everyone has been concentrated in, to one that says, well, you know what, areas outside of the US look more fundamentally well supported, and moreover they're cheaper. So, the thing in Europe's favour has been - up until recently - it's been pretty cheap, pessimism abounds, so, everyone's been facing in the same direction. So, our allocations to Europe, they were concentrated in the bank sector. So, that was while the market was still adjusting its interest rate expectations upward, you had some solid balance sheets to the European bank sector, as incidentally you do in the US and in Japan. And it's a theme in the portfolio to have participation in those global banks, the area that caused - and oftentimes you get this - the area that caused the harm the last time, is the one that's done the repair and is still in an era of kind of distaste - so, when the market isn't really wanting to pay up for things in that sense, banks remain good value and are growing their earnings, so, whether they're in Europe, Japan, or the US.

CS: Are they a good example of what you are doing, banks, because, you know, it's 15 years since the credit crunch now and the sentiment still seems to be negative on them despite the fact that they're in a totally different position to what they were going into that in terms of capital allocation?

SA: It is, and that just shows, I guess, from a human perspective, that just shows how long it takes some scars to heal. You know, given the profound nature of the financial crisis; the queues around the block of Northern Rock; people hoarding cash; worrying about the collapse of the system of capital that people had operated under - these were real and plausible [worries] and they're making films about it for heaven's sake!

So, in that sense, it takes a while, and it certainly takes a big cycle, so, every cycle up to that point - and we've discussed this before - every cycle up to that point, relied upon credit, further credit expansion, then you got to the end of the road and pop! Something went. This time [what's] different about this time is you've not had that big explosion of credit. So, you've got some solidly-financed banks that aren't overextended in any way, who are growing their earnings and they can do that much more easily in a higher interest rate environment than they can in a zero interest rate environment.

CS: Just quickly before we move off equities, we talked about the Europe and US and a little bit on Japan. Can we get a bit more on Japan? It seems to always polarise opinion, but there seems to be growing sentiment towards the region?

SA: I think there is, and also in Japan, that's where we've got a broader equity allocation. So, it's not just the banks – [we've] only got a couple of percent in banks - the majority of the holding is spread across that real economic exposure in Japan, where we have seen an element of insulation from some of those global headwinds, particularly around the inflation chasing, inflation punishment, the cost punishment loop, that the more western economies have gotten themselves into. So, there does seem to be an idiosyncratic Japanese element going on. So yeah, we want to make sure we're engaged with that.

CS: And let's touch on a couple of other sectors before we go to the outlook and forward. First of all, property - no allocations there, is it the same reasons as most? Just give us a couple of lines on what you are seeing as the main …

SA: Two big, well, the two main factors. One, liquidity. Second would be fundamentals, essentially. So, the things that we'd look for as a sort of global multi-asset, you want to make sure that you have enough liquidity in the sense that if something shocking happens in one area of the market, that you can sell down certain other areas to go and exploit whatever that opportunity might have been presenting you with.

With property, I don't really want to treat it like that. It's a different asset class that has a longer-term payoff. It has its role from time to time, within a multi-asset portfolio, to be sure, but not at a time when we want to remain as nimble, where it doesn't pay us to have really high conviction views at the moment. Because thinking that you know what's around the corner, particularly right now, feels like a pretty perilous thing to be doing. So, at the moment, no thank you, but if we have better valuation, if we have a clearer sight of that global market outlook, then absolutely, we could in the future have some property.

CS: OK. And lastly, in terms of sectors - bonds, I mean we've gone from a sort of shop of dearth, with nothing on the shelves, to a sweet shop almost. You've got some emerging market bonds and a bit in high yield; I mean, I'm almost tempted to ask you, why take the risk if we're going into a global recession? You're getting quite good returns in investment grade [so] just tell me why you're … the term that comes to mind is sort of going [the] extra mile. Well, tell me why you feel that?

SA: Yeah, why bother? I know exactly what you mean. Yeah, yeah, yeah. Absolutely.

CS: Sleepless nights! Why give you[rself] the sleepless nights?!

SA: Well, it does get to the heart of diversification, and it gets to the heart of what being a kind of global multi-asset portfolio [is].

So, in a portfolio context, while certain entities wouldn't be all you would own, because you are right, going into a global recession customarily, you would think, well, those guys usually suffer quite a lot if you're in a global recession. But let's wind it back a little bit and see what the journey has looked like so far. The central banks in many of those emerging markets were quicker to tighten interest rates, quicker to see through the inflation, so, inflation rose, started to come down again, and are already further along that journey than the

Fed [Federal Reserve], the Bank of England, the ECB. And that has also been manifested in the price of those bonds. So, the price of their bonds has already fallen, and the yields are sold off, so, there's a great deal already in the price.

And the further reason would be … one of the reasons why these areas have sold off in the past during a kind of global downturn, would be the dollar would be strengthening at that time, many of their liabilities are in dollars, so they have bother funding themselves, and so, there's a bit of a doom loop that then gets created. In a similar way to the post-financial crisis recapitalisation of the bank's sector, you've seen much less vulnerability about the funding of emerging market nations. And so, in that sense, you don't have that kind of itchy trigger finger that says, whoops, these guys are vulnerable if the dollar goes up. We've already seen the dollar go up, and they were absolutely fine because a lot of their funding is now done in local currency rather than in foreign currency. So, in that sense, there's greater resilience and there's a lot in the price. So, we want that diversification.

CS: And in the high yield side, is it a case of - obviously the yields are attractive at high single digits in certain cases but also - the market's matured a bit. You know, it's not, I think I read somewhere that triple C [they're] a lot larger allocations to the market now it's a lot more mature, fewer defaults, etc, etc.

SA: It is, yeah. And as you know, we've always trod lightly in credit. It's not something that, as again, the features that you want are liquidity, dynamism and that's not always the home of credit. If you want to be in a hurry, it's not really the place to be. So, we want to calmly engage with these areas. We've seen a really quite substantial restoration of value in the credit market - not just high yield, but also investment grade. And we have stepped into that, but it's a stepping into that that we're doing on the basis that it's more of a strategic ownership than it is to say, yeah, they're going to make us some money this year or they're going to make us some money in the next six months.

CS: So, just briefly, could you maybe tell us about the fund's positioning and what you think is relevant or unique for investors?

SA: I think in terms of the … it's about the dynamism. So, it's about being prepared to act amid volatility there. And that can sometimes be a painful thing to do. And it can always be a painful thing to do, frankly. Because if it feels good, you're probably getting it wrong because it feels like everyone thinks you're popular, everyone thinks you're making a winning call, and then that's very consensus.

The real challenge is when the market is huddled in one corner, certain about things, and when, as we know, as in life, if you have too much certainty about things, then you're ready for a surprise. You should be ready to be disappointed in some way and other factors that can come left of field. So, in that sense it's about that vigilance and understanding of the volatility, and the breadth of opportunity set that we can look at.

CS: I'm going to finish by going back to Iron Mike. He's getting back off his stool for the next round. Could you maybe give us your view on markets for the rest of the year, should investors be ducking and diving? Do you expect a lot more opportunities from this sort of emotional uncertainty and volatility in markets?

SA: Yeah, I mean, when we think about … so, as a general principle, when we think about any of this stuff, we can't lose sight of or it's really important to have in your mind all of the time, what are these prices trying to reflect? They're trying to reflect the real, economic policy fundamentals. So, we have been through the single most resonating shock, both to real economies, society, [and] financial markets. Then we had an enormous policy response to that - all of that, at the very least, messes up your data. Equally, it messes up the pushes and the pulls of policy and the real economy; it causes changes in the labour market; it causes changes in society's behaviour and its consumption and credit patterns, all of that stuff. And what has tended to happen in the past, over a very long period of time, is bouts of fundamental volatility then are followed by more fundamental volatility because you overshoot, you undershoot, you overshoot, you undershoot until you get back to some kind of equilibrium. So, when we think about that, when we think about what the market's reflecting, absolutely yes, you're going to get overshoot and undershoot in the price.

CS: Do you think there's an element of confusion because it's been, you know, a couple of decades at least since we've had a traditional recession and not some sort of crazy [SA: <laugh>] hard landing beyond belief and that's also going to cause a lot of sort of emotional uncertainty?

SA: Yeah, there is. And you would say people have lost their anchor. So, we've lost an anchor. We don't know what home looks like. We don't know what normal looks like. And amid all … and of course, there's so much that we normally don't know, but we think we know certain things. But now even the things that we thought we knew, we've got to throw those out as well because we might not be right about that. So, yeah, absolutely. And that again begets volatility in price behaviour.

CS: Okay. And, just lastly, obviously we've talked a lot about how you sort of operate the fund in terms of taking advantage of those behavioural finance opportunities: if you were to give our listeners one behavioural finance tip or how they perhaps can use it in their portfolio that's prevalent - it's always prevalent, but particularly now - what would you say?

SA: Well, I would say I would adopt that general rule that says you're looking at price, you're looking at prices - let's not forget what they should be reflecting; they're reflecting the nature of the world. What do we know about the nature of the world, or the economies or companies or whatever that might be? We know it's uncertain and we know it takes its time to change. Rarely do these things change very, very quickly ie. days and weeks. Usually, they take longer than that. So, if you can see in price behaviour, a contradiction to that. So, if you see price behaviour and everyone talking about the same thing and everyone being confident about the same thing, ie. too much certainty. So, there's too much certainty of recession, there's too much certainty of growth - if there's too much certainty that the Bank of England's going to do this and that - here's the time to step back and say, well hang on a minute, where's the opportunity amid this certainty? So that's one thing.

The other thing would be if prices are moving really quickly. So, if prices are moving really quickly and you can't find - and you don't, shouldn't have to look very far because it should be blindingly obvious - if you can't find facts that support that and it's just a made-up story that supports that, alarm bells should be ringing there. And on the upside and on the downside, the flag that says you might be interested in buying this,

should be raised. So, I'd tell you that those are the two aspects, but generally speaking, it's when markets lose sight of what they're trying to reflect.

CS: Alright, Steven, once again, thank you very much for your time today, that's great.

SA: Not at all, it's a pleasure, nice to see you.

SW: The M&G Episode Income fund is a multi-asset fund that invests directly in individual stocks and bonds, as well as property funds. This interview demonstrates how Steven uses behavioural finance to find pockets of value to invest against the herd. The use of the word "Episode" in the name of the fund is to reflect the periods of time when investors' emotions cause them to act irrationally and provide these attractive opportunities. For more information on the M&G Episode Income fund visit fundcalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.

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