

TRANSCRIPT: EPISODE 261

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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Today we dive into the world of multi-asset investing with a comprehensive look at risk management. We also discuss inflation in detail and the long-term implications - including the impact of China's working population, the influence of digitalisation and the growing area of artificial intelligence.

Chris Salih (CS): I'm Chris Salih and today we're joined by James Mee, who's co-head of Multi-Asset Strategies at Waverton, and also lead manager of the Elite Rated Waverton Multi-Asset Income fund. James, thank you for joining us.

James Mee (JM): Thank you for having me. Delighted to be here.

[INTERVIEW]

CS: Let's talk about this fund; obviously it's recently been given an Elite Rating. The core purpose of this fund is all about managing risk. So, for the listeners, just tell us how do you define risk? And how do you go about managing it?

JM: Yeah, that's right. So, thanks for the question. Philosophically then, really is that we start with risk, to your point. So, the way we think about risk is not volatility per se, which is how the industry would define it. Obviously, we look at that as part of how we manage the risks within the fund. But we don't think about risk as volatility. We think about risk really in two key ways. First is underperforming inflation over the time horizon of the fund, or over the time horizon of the ultimate investor, ensuring that a hundred or a thousand pounds invested today, or at our inception nine years ago, is worth at least as much in 10, 20, 30 years' time, or could buy you as much stuff or travel or whatever else it might be as it did when it was originally invested.

And then the second way we think about risk is permanent capital loss. So, crystallising a loss or investing in something that perhaps might go to zero. They're the two key risks as we see them.

In terms of how we think about managing out those risks. In terms of risk number one, underperforming inflation over the time horizon, we're invested in equities, we're invested in real assets, so, you know, in terms of real assets, I mean property, infrastructure, commodities, specialist lending and finance. And these have an implicit or an explicit inflation linkage. And so, we think that over time we can compound your capital at least in line with, if not ahead of, inflation. And we have a track record of doing that.

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And in terms of permanent capital loss, how do we manage this risk? Clearly, we're a multi-asset fund, so we start with diversification across asset classes, sub-asset classes, currency, sector, style, et cetera. But we also employ hedging strategies. So, strategies that are designed to generate a positive return in negative markets and limit left tail risk, if you like. So, that's how we think about risk in the fund.

CS: So, you kind of touched on it then, can we go into a bit more detail? Obviously, the last few years have been very up and down for markets to keep it very, you know, low level in terms of just how busy things have been in that period. But in terms of protecting capital and markets, you mentioned using those hedging strategies. Could you explain how you use them and maybe give us an example, perhaps even of an opportunity to use that strategy that's paid off?

JM: Yeah, happily. I mean, I'll just back up a second. If we think about the majority of our allocation in the fund, it will probably always be equities. So, the first way to mitigate risk and protect on the downside is to invest in quality businesses. So, we invest in individual securities, we're not invested in funds. That enables us more control over the risk that we're taking. And we believe that from a bottom-up perspective, that a value of a business is all of its future cash flows discounted back at an appropriate discount rate to provide you a present value of those future cash flows. That's how we define the value of the business. So, we want the cash flows to be predictable; we want them to be relatively defendable, so, we're looking for a durable competitive advantage. We want management to be aligned. We're looking for companies to be able or to have opportunities to grow this free cash flow, and we want to invest in businesses at an appropriate valuation. And if we do all of that well, we should protect capital in periods of acute market stress, to some extent anyway. Quality businesses tend to have pricing power. Oftentimes, they actually benefit from periods of market stress, from periods of economic stress. They tend to deepen their moats or improve their competitive advantage. So, investing in high quality businesses certainly will help we think over time, and actually again, we have a track record of doing that.

We will allocate to fixed income. So, within fixed income, really what we're talking about there is duration, government bonds, usually US government bonds, US Treasuries, sometimes UK gilts, perhaps we can come back to that a bit later on. We do use cash as an asset class; you know, there is an opportunity cost to owning cash. Of course, that opportunity cost when cash is yielding zero is relatively high. Now, today of course, cash is yielding four [per cent], so we're getting paid to wait.

But to answer your question specifically, so hedging, what are we talking about here? Well, we're looking to find positions that go up when the market's going down effectively. So, they benefit generally from either falling markets, so risk assets, equities, credit, or rising volatility, or both. And they're structured to be convex. So, rather than have a one-to-one relationship with equity markets, for example, so equity markets down 10, protection is up 10 or hedging is up 10, what we are looking for is, as it gets worse than 10, so equity markets down 10, 15, 20, 35, these positions tend to be up more like 150. And to give you a real example of that, we have a sort of proprietary internally-managed protection strategy at Waverton: in Q1, in the worst 14 trading days of Q1 2020, equity market in sterling terms was down 35% peak to trough - and the protection strategy was up 150%. We held something in the multi-asset income fund, it was a credit hedge, so, it was a put option on credit risk in Europe. You know, again, equity market down, systemic risk was certainly prevalent and that position was up three and a half thousand percent. Now we own these positions at the margin in a very small weight ...

CS: That I was just going to ask. So, in terms of that small weight, so just give an example. So, for example, you're not piling into these hedging strategies, it's a small allocation within the fund to try and get that precise sort of advantage that you talked about in Q1 2020 ...

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JM: Exactly right. So, using that example then, is that was a put option on the iTraxx Crossover credit position, it went in in January at a 0.1% position. Over the course of those 14 days, it went up three and a half thousand percent. We were taking profits as it was happening. That was providing us cash, providing us liquidity with which to go to a market desperately seeking liquidity, and so we can provide liquidity into a market. We can pick up some of those businesses, [those] high quality businesses I mentioned, at a much more attractive valuation given our long-term time horizon. It also, you know, hedging also provides psychological breathing room for us as investors, certainly if you have that liquidity and you know that you can reallocate capital, there's an opportunity value of having a pound at the bottom versus an opportunity cost of owning cash at the time. But also, for our investor base, it's psychological breathing room as the market's down 35 and we're down perhaps 5 - 8 you know, it provides some comfort, we think.

CS: Let's talk about inflation as the sort of the big word in markets still. So, the fund obviously has an inflation target, which I'll let you talk about, but we've seen a lot of people talking recently about, you know, higher for longer and perhaps when inflation does come down, maybe 4% is the new 2% in the new world. First of all, what is your take on inflation - how do you go about targeting it? And then also maybe, how are you going to go about managing it, if inflation is higher for longer?

JM: Yeah, so we, you know ... given how we think about risk and risk number one being underperforming inflation over the investment time horizon over the medium to long-term, over the time horizon of our investors, it's probably unsurprising that we have a CPI [Consumer Prices Index] + x target for the fund. So, what we're trying to achieve through the cycle is CPI +2.5% on the multi-asset income fund. And we do that by investing across a number of different asset classes, as I've mentioned. I'll come back to that though.

Just to answer the first part of your question. You know, will inflation be 4%, not 2% going forward? It's incredibly difficult to predict any individual economic variable over any kind of time horizon. You know, the economy is global, even if you're looking at just the UK economy, UK CPI, the economy is global, UK economy is global. It's complex, the global economy is complex, and it's an adaptive system. So, it means that the range of possible outcomes is not only extremely wide, but also essentially impossible to predict, especially in the long-term.

So, with that caveat I suppose in place, that said you know, many of the drivers of long-term disinflation, which we've seen over the last 30, 40 years, we think may well be shifting. So, there was a huge introduction of labour or the labour supply increased materially, particularly from China, and particularly after China joined the WTO [World Trade Organisation] in the early 2000s. That increase in supply of labour means that there is a depressive effect on the price of labour in developed markets. So, essentially wage inflation is flat to zero, certainly in real terms, if not negative in real terms, so, after inflation. And that may well be changing.

Globalisation, globalisation of supply chains, we got to a point of just-in-time inventory systems; all of that meant that the cost of goods to the consumer ultimately declined over time. It had a disinflationary impact at the aggregate level. And digitalisation itself had a very similar impact. Today we're in an environment where possibly we're going into de-globalisation, so you've got reshoring or nearshoring or friend-shoring or however you want to define it; this should in and of itself raise the cost of goods sold to businesses, and usually those businesses try to pass those on to the consumer. So, that has an inflationary impact. There is a disaggregation of the inventory systems, as we know.

Geopolitical tensions means that there's more investment in defence and in energy security, that in and of itself should have an inflationary impact at the national level.

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And then, now we have a demographic headwind. So, the working age population is actually in decline. Labour supply is down, lower supply generally [means] higher prices, and that would include China. So, working age population I believe peaked in China in 2019, which not many people are aware of, so that speaks to the inflationary dynamics.

There are two things really that we think will continue to be disinflationary. One is debt. Normally, when you go from a low level of debt to a high level of debt, using debt can have an inflationary impulse. When you get to a high level of debt, it can be disinflationary in and of itself. If you think about, you know, [the] cost of debt now is, let's call it 4% round numbers: you borrow a hundred pounds, you now have to use four pounds of your income just to service the debt, not even to pay it off and to pay it back. Whereas three years ago, you could have used three of those four pounds to invest in the economy, to spend in the economy, you know, which would generate growth. And we think that high levels of debt has a disinflationary impact over time.

And the second is digitalisation. Digitalisation was a disinflationary force over the last 40 years. You know, I think it's a very risky thing to suggest that that trend is over. Just think about what we've seen, you know, this year in particular with the onset, I suppose the wrong word for it, but of AI, artificial intelligence. And that ought to really, over the long term, have a disinflationary impact as well.

So, what's the view? I mean, I've kind of hedged my bets there. The best way to answer those questions really is to look at what we're doing and what we're invested in. So, in the portfolio, you know, we've added to fixed income and we're adding to duration at 4% yield. So, that should be telling you really that in the medium-term time horizon, we think inflation is going to fall, [so it's] not as transitory as we thought it might be. But certainly, we think that that it's going to fall from the levels that we're at today,

CS: But not necessarily to 2%.

JM: Possibly to 2%, possibly below 2% at the headline inflation level. But I would argue that it's unlikely to stay there in the medium term. I think AI is a structural force. I think digitalisation in general is a structural force, and that will put downward pressure. But certainly, there are some cyclical pressures, labour, supply of labour - particularly in the US - being a very obvious one, that ought to keep that elevated.

And then, sorry, just thinking about the second part of your question, can we still achieve these returns? You know, the CPI plus 2.5% in the wake of inflation, or if inflation is 4%, we believe that we can. So, if you think that roughly 50% in aggregate of our exposure is in equities, roughly 20% is in real assets, and we believe that these have explicit or implicit inflation linkage, you know, at 70% of the portfolio. We think that the capital allocated to this fund, actually you can compound at or above inflation over time. And we're invested in companies, individual businesses, high quality businesses that we believe have pricing power.

CS: Just quickly on a couple of points you made there, firstly, the increase of exposure to fixed income: has that come at the expense of the alternatives or the real assets bucket or where has that come from? I guess what I'm looking at is, are alternatives perhaps not as essential as they once were in a portfolio? We've been talking a lot about that recently within FundCalibre as a view. I mean, where do you stand on that?

JM: So, the increase in fixed income has come partly from equity. So, you know, to give you a range of where we've been allocated to equities. So, since the end of 2019 to this sort of Covid volatile period, as you mentioned, we've been as low as 41 - 42% in equity, as high as 58 - 59% in equity. So, if you take a midpoint of about 50 as neutral, we're currently about 46 - 47% in equities. So, we've taken a little bit out of equity

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and allocated into fixed income. And we got as high as 15 - 16% in cash more recently. That's been brought down to 10[%]. And we're running at a slightly higher fixed income allocation of about 24 - 25% today.

CS: Just to sort of round off then, you mentioned that focus on quality. Maybe give us an example of some of the companies and underlying holdings you have in the portfolio. So, maybe talk us through one in each area, so equities, alternatives, and also maybe a fixed income holding to explain what you're looking for within each bucket?

JM: Yeah, sure. So, we're running 46 - 47% in equities. And one of our largest allocations within equities is in the US. We don't do that from a benchmark perspective. All of our ideas come from the bottom up. So, we're running a relatively large position, but if you look at us relative to our peers, we're running more in the US, and relative to the index we're running less. Nonetheless, we find a lot of great ideas. And, CME, the Chicago Mercantile Exchange, is a very good example. So, CME is the largest derivatives exchange in North America. So, its products are essentially interest rate swaps, equity futures, options et cetera. And it actually has a pseudo-monopoly on certain contracts. So, it has tremendous pricing power over the long-term. It hasn't used that significantly in its history, but it continues to build pricing power, and we think it certainly has the optionality of doing so. Or there is optionality to it doing so, it has the option of doing so.

Its competitive advantage comes from its scale, and from an inherent network effect, which pulls buyers and sellers into its ecosystem. So, more buyers increases liquidity, increased liquidity attracts more sellers, more sellers increases liquidity and attracts more buyers and so on. It has a sort of virtuous cycle to it, and it's a very asset light business model. So that means that really the focus should be on revenue growth. Revenue growth is key to the growth in free cash flow. If you recall that the way we value businesses is a discount of its all the future cash flows that the business will generate over its life. So, revenue growth is driven essentially by average daily volume growth - so the amount of volume traded - and the company, and to some extent pricing, and the company's investing in this. So, it's investing in its sales to maintain scale advantage and in so doing that furthers the economics of the network effect that I mentioned. And it's investing in innovation, so it's bringing out new products. New products tend to attract more volume. It's reducing the amount of money one would need to invest in each individual contract if you like. So, from a hundred thousand dollars, which means you and I probably can't trade that individually, to a thousand dollars, means we might well be able to if we wanted to. And we think the business is relatively cheap, certainly versus its own history. We think that it's got meaningful upside over any reasonable time horizon, which for equities, for us, is [for] equities and real assets, is five years plus.

CS: In the alternatives bucket, are there any areas you are particularly favouring at the moment then?

JM: Yeah, so in the alternative space, the majority of our 19 - 20% allocation to alternatives is in real assets. A lot of these are in investment trusts, UK listed investment trusts, a lot of which have had a really tough time of it, of late. And we think that there's been some indiscriminate selling.

So, one name in particular that we like, that we own and that we've been adding to is PRS REIT. So PRS REIT builds and rents family homes for the private rental market. Their passing rents are how much they charge the tenant, is 25% of the tenant's disposable income, which is well below the 35% government target. So, we think that provides some upside to pricing and therefore to revenue growth. And the leases are generally on a one-to-two-year time horizon. So, each of those leases comes up every 12 or 24 months. It provides the company an opportunity to raise rents, to raise the cost or to raise the revenue in the face of inflation. So, an implicit link to inflation over time.

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And the weakness in the share price, we think is really inconsistent with the economic backdrop. If you think about it, in a cost-of-living crisis, this is exactly the environment where demand for these sorts of properties really should rise. So, the problem has been a rise in gilt yields, has been a rise in the cost of capital, clearly we have modeled for that in our model. And we think notwithstanding, you know, some pretty conservatively high assumptions, in terms of the cost of capital, cost of doing business for the company, we think there's a 50% upside to the price out to sort of 2026, 2027.

CS: Okay. And, and just lastly bonds, obviously a very topical area in the market at the moment. Are you at the safer end? Do you not, you don't need to take a number of risks? Or are you looking for opportunities sort of in the investment grade areas in the market as well?

JM: Yeah, I'd say the investment grade area, well, so first thing to say is 25% allocated to fixed income. We have an investment grade average rating. We have been increasingly, we have been de-risking over the last 12-24 months. We've increased our allocation to fixed income, as I mentioned. And, while we've done that, we've increased the level of duration that we are carrying, so, the level of protection, if you like; bonds move inversely to, you know, to equity prices in periods of market stress. So, we've increased the weight of extended duration, a fair bit in US treasuries, and to some extent in UK gilts. And the way we actually do that in US treasuries, we can either buy the bonds themselves to cash bonds, or we can buy options on the bonds. So, we've done both; we've increased our allocation to the cash bonds, and we've bought options on the bonds which provide, again, some convexity in the event that we do see recession, for example, and bond yields come down [and] bond prices rise.

CS: Okay. And, just lastly James, to round it all off quickly, is it easy to invest for the long term at the moment, given the sort of uncertainty in markets? Do you have to just sort of stick to your principles or are there any, is there anything in particular you have to do differently?

JM: It's never more easy or less easy. Actually, what you find is if the longer your time horizon, the higher predictive power you have in terms of how certainly individual securities should perform. Macro is slightly different because of the complexity and the adaptive nature of the economic system and the market system predictability actually goes down over time. In terms of the companies that we own shares in actually perversely the predictability rises. So, you know, that's why we have a preference for investing in individual equities, individual bonds.

CS: Okay. James, once again, thank you very much for joining us today.

JM: Thank you for having me.

SW: Since its inception in 2014, the Waverton Multi-Asset Income fund has demonstrated strong performance. We appreciate the collaborative approach taken in designing this fund, as well as its emphasis on effectively managing potential losses. Being a global multi-asset fund, it strategically incorporates various asset classes to ensure genuine diversification. For more information on the Waverton Multi-Asset Income fund visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.