Current Focus

December 2022

A monthly market comment from Rivers Capital Management. Views expressed here are subject to change and for professional advisors only

INTELLIGENT INTUITIVE INVESTING

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Summary

- The transition from ultra-low interest rates to normal interest rates devalued most assets
- Diversifiers outperformed both Anchors and Enhancers during a transitional year
- Inflation and interest rates will remain elevated for longer than currently expected
- T.I.N.A. is over. Illiquid and high multiple assets likely to suffer further devaluation
- In 2023 the opportunity for positive real returns from a diversified portfolio is high

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Market Comment

In the final Current Focus of 2022 we look back on a tumultuous year and give some perspective as to how we expect 2023 to unfold. Looking forward, we will consider the investment opportunity given the prevailing risks within the market. Economically it is going to be a challenging year with higher interest rates than most consumers have been used to. On the other hand for investors higher rates will provide more opportunity for positive real portfolio returns. First we will consider how 2022 has marked the biggest change in the investment environment for many years, certainly since the financial crisis of 2008 and possibly since the 1980s. Inflation has proved not to be transitory but systemic and it is unlikely to return to the Bank of England target of 2% for a long time, although it may already have peaked. Our Focus will be on how can the additional costs and administration of a diversified portfolio be justified, given interest rates are likely to be around or higher than 4% going forward. We think it can be justified and moreover, that persistently high inflation not only increases the need to be invested but also increases the need for a dynamically diversified approach.

At the start of 2022 each Rivers Portfolio was tactically positioned in its most defensive allocation (within respective risk grade boundaries). Our thinking was that equity valuations were too high and that inflation was a burgeoning problem. We were correct about that, but we underestimated how high valuations were everywhere else, not just in equities. The problem was, even within the overweight Anchor allocation, there were not many places in which capital could be protected. By the start of December, global equities (measured in US Dollars), had lost nearly 18% year to date. In Sterling terms equity losses were lower but only due to Sterling depreciation. In the Rivers portfolios both Anchors and Enhancers have struggled. The exceptions have been, by design, Absolute return funds within Anchors, and UK large cap, the FTSE100 sitting within the Enhancer allocation. Having relatively underperformed for the best part of a decade, the combination of oil, commodity and financial companies that dominate the FTSE100 fared better than other sectors. Diversifier assets have provided some protection with Gold up, at least in Sterling terms, and commodities offering varying opportunities. Commodity prices were supercharged by Russia's invasion of Ukraine in February, although much of that has already reversed. Overall in 2022 there have been few places to hide. The tactical changes we have made have helped, but it has been a year in which even cash, in real terms, has waned.

More fundamental than the challenge of investing during the year, has been the resulting change to the investment environment by the end of the year. This is not a temporary change. The economic experiment of free money and endless stimulus, which started in 2009, has come to an end. High inflation, not seen since the 1980s, is back. To combat this, the ten years of near-zero interest rates is finished. Protecting capital from real value loss, not really considered whilst the primary concern was protracted Japanese style deflation, is now a prime consideration. The return of systemic inflation has changed the investment environment for years to come. The impact of this cannot be overstated. Rising 'risk-free' government-bond yields fundamentally change the cost of money and the opportunity cost of illiquidity. This will have the most material impact on highly leveraged (geared) private equity investments – many of which are not yet pricing in this impact – but the ongoing impact to traditional liquid growth assets, widely held within diversified portfolios, needs to be recognised.

Before 2022, as bond yields retreated ever lower, the desperation of yield-hungry investors was justified by the acronym TINA: There Is No Alternative (to riskier assets such as equities). This approach helped to propel 'growth orientated' equities ever higher. While the FTSE100 may have missed out on much of this growth, and subsequent fall, it was best seen in the US Technology index the Nasdaq and, to a lesser extent the S&P500. From its low point in 2009 to its peak at the end of 2021, the S&P 500 rose by 600%. This was driven primarily by technology and led famously by the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google), who together with Microsoft and Tesla made up over one third of the market capitalisation of the 500 stock index at the end of 2021. However profitable these companies are, at multiples of over 25 they are susceptible to weaker performance as government bond yields approach 4%.

The increase in the "risk-free" rate raises the hurdle rate against which all other returns are measured. TINA is finished if you can get the same nominal return without risk, even if that return is still negative in real terms. The raised hurdle rate is inescapable and for assets with high valuations the justification must be that rates are set to fall again. If they do not, and there is no sign they will get anywhere near zero again soon, then the present-day value of future earnings falls further still. As equity markets have tumbled growth stocks have tumbled the most but by our reckoning they remain the most expensive

Whilst devaluing the most expensive investment, the increase in interest rates now provides a far more favourable Anchor to a multi asset portfolio. Many equities are currently attractively priced. Many Enhancer assets including corporate bonds now offer real (inflation adjusted) returns. Lower equity valuations increase the likelihood of returns in 2023, outside technology, being above average. Diversifiers are of increasing importance in our allocation for 2023. The availability of liquid hard asset, insurance and energy related funds increases the tools available to us as investors. These amplify the opportunity for return above inflation and also diversify risk should increased market volatility continue.

Looking towards 2023 we expect the recent rally in growth stocks and the fall in interest rates to be tested during the first quarter. We expect the next change in risk rating to be to a lower risk position within the portfolios. The consensus is now that inflation will fall sharply from here. We, however expect that to take much longer than is currently priced in. This will lead to a further improvement in equity valuations. While interest rates may rise further during 2023 than is currently expected, the risk to bonds is now much lower than it was during 2022. If, as we expect, there is an improvement in values during the first quarter, we think there will be a good opportunity to add risk. In summary we finish this year with a more positive outlook than we had when it started.

We wish all our readers a Happy Christmas and a prosperous New Year.

Market Returns (£) - 30th Nov 2022	1 Month	YTD	1 Year	3 Year	5 Year	S/I*
Anchors						30/06/2016*
Cash	0.3%	1.0%	1.0%	1.5%	2.6%	2.8%
Inflation Linked UK Bonds	3.9%	-30.9%	-34.9%	-21.6%	-13.5%	-6.9%
Gilts	3.0%	-21.7%	-23.8%	-20.4%	-11.6%	-12.3%
Global Government Bonds (hedged)	1.7%	-10.1%	-10.8%	-8.4%	-1.6%	-3.6%
Enhancers						
Global Corporate Bonds (hedged)	4.2%	-14.6%	-14.7%	-9.2%	-1.9%	1.4%
Global High Yield (hedged)	4.1%	-12.3%	-10.9%	-4.6%	-0.6%	12.6%
Emerging Market Bonds (hedged)	-0.7%	0.2%	-0.9%	-2.7%	6.1%	15.6%
FTSE 100 TR Index	7.1%	6.3%	11.3%	14.4%	25.2%	49.1%
FTSE All-Share	7.1%	1.8%	6.5%	12.2%	22.8%	48.4%
Global Equity (MSCI)	3.4%	-2.8%	-1.0%	35.0%	62.1%	106.5%
European Equity (MSCI)	7.7%	-5.7%	-2.0%	14.0%	23.3%	58.1%
US Equity (S&P)	2.0%	-1.6%	0.4%	46.0%	86.3%	137.0%
Japan Equity (Topix)	6.0%	-4.4%	-4.8%	5.8%	11.7%	49.1%
Pacific Ex Japan Equity (MSCI)	18.0%	-11.6%	-12.8%	4.5%	5.9%	50.7%
Emerging Market Equity (MSCI)	11.0%	-7.8%	-8.3%	9.1%	11.3%	52.2%
Chinese Equity (Hang Sang)	23.3%	-6.6%	-9.1%	-15.8%	-14.8%	23.2%
Indian Equity (Nifty)	1.7%	10.8%	12.2%	56.6%	68.9%	115.0%
Diversifiers						
Commodity Index	-2.2%	33.3%	34.8%	64.7%	61.5%	55.4%
Gold	3.2%	8.4%	9.0%	24.1%	47.7%	38.9%
Silver	9.7%	5.3%	5.3%	31.9%	40.2%	19.5%
Brent Oil	-2.2%	33.3%	34.8%	64.7%	61.5%	55.4%
UK Property	-4.2%	-6.7%	-4.4%	3.5%	9.6%	17.9%
Global Property Shares	3.8%	-30.4%	-27.7%	-21.0%	-7.2%	2.0%
Rivers Model Portfolios						
Rivers Preservation Portfolio	2.7%	-5.1%	-5.3%	0.7%	4.1%	12.9%
Rivers Cautious Portfolio	3.3%	-4.2%	-4.0%	7.9%	15.5%	32.1%
Rivers Balanced Portfolio	3.9%	-4.3%	-4.0%	11.7%	22.4%	43.8%
Rivers Adventurous Portfolio	4.6%	-4.8%	-4.2%	16.2%	28.1%	53.0%
Rivers Aggressive Portfolio	5.5%	-5.2%	-4.4%	17.7%	30.3%	62.8%
Rivers Cautious Income Portfolio	3.7%	-8.2%	-7.9%	-2.4%	3.6%	11.5%
Rivers Balanced Income Portfolio	4.3%	-6.1%	-5.4%	2.4%	9.9%	24.3%

Source: Financial Express in GBP (unhedged unless stated) as at 30th November 2022. *Rivers Portfolios since launch June 30th 2016

Model Performance is indicative only and is net of Rivers Capital Management Charge and Underlying Fund charge but not advisor or platform costs.