On the Mark – Multi Asset Strategy

Mark Harris – Head of Multi Asset

April 2021 – It's not obvious, and that's the problem.

The disorderly sell off in the US sovereign bond markets, accompanied by a savaging of growth style equities was damaging. However, at our monthly fund meeting, we could see an overwhelming confluence of potential future outperformance signals from several funds that we hold.

On reviewing our commentaries, we refocused our attention on comments we made in our October 2020 on the Mark.

To quote: 'The reward from holding growth style funds has been nothing short of spectacular this year.'

To recap then; we wished to show an example of this characteristic, and without wishing to unfairly single out any particular manager, The Polar Capital Global Technology Fund has a long track record spanning many market cycles and was therefore useful for context and statistical significance. We still believe this manager is 'best in class', but the fund had exhibited one of the most extreme out-performance readings we have seen. With the information ratio (IR) reaching the unprecedented level of 5.0.

Just to remind everyone that the rolling one-year IR – a measure of excess risk and reward for the fund vs. a recognised major global equity index – is constructed using monthly net total returns for both instruments in US$.

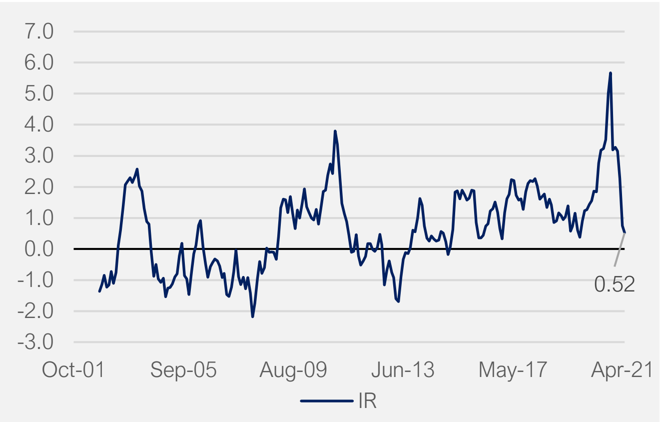
So, if we dial forward and look at this signal now, we can see that the IR has collapsed and now sits around 0.5 (Figure 1).

We can see from the history that there have been instances where the IR continues to fall and bases around the -2 to -2.5 level. However, we have several other observations in the models, and this includes a composite strength indicator. This is an average reading of traditional RSI and Stochastic strength indicators that measure an assets price strength relative to its historical average. Levels above 70 and below 30 indicates extreme overbought or oversold versus history.

We can see below that the fund has only been at or around this level three to four times in a twenty-year history. It is evident that the fund is very oversold and in every other occasion it went on to outperform relative to the Global equity index (Figure 2).

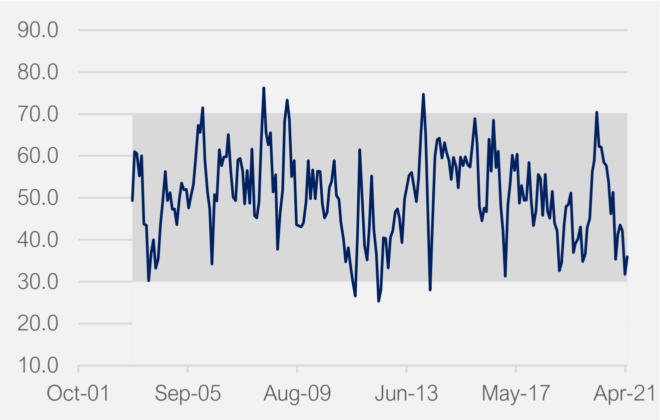
If we combine these indicators, it strongly suggests that the worst of the correction is over, and we should shortly resume outperformance. We are not arguing that it would be at the rates we witnessed in 2020 but a substantial set of opportunities appear to exist.

Figure 1: Polar Cap Global Tech vs Global Equity Index Information Ratio.



Source: Garraway, Bloomberg L.P.

Figure 2: Polar Cap Global Tech Composite Strength Indicator.



Source: Garraway, Bloomberg L.P.

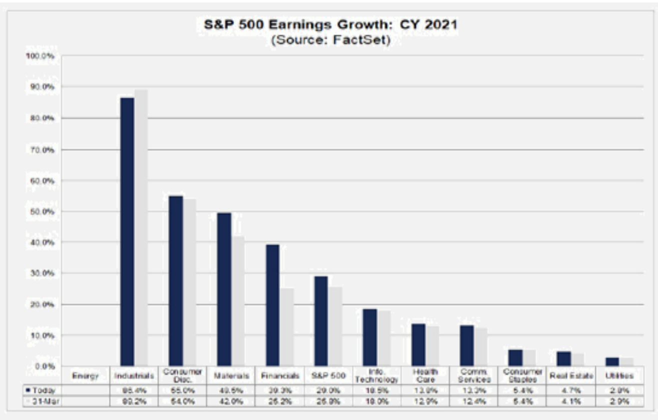
Ned Davis recently stated that 'Since mid-March, however, several early cycle themes have underperformed and are near key support levels. If they break support, they could signal a transition into mid-/late-cycle leadership.'

They conclude that 'The NDR S&P 500 Cycle Composite implies another up leg for some early cycle themes before transitioning in the second half.'

So, the next question would be to look at the fundamental evidence to support such change.

Bloomberg's J. Auther's states 'If the (US earnings per share) growth rate ends at FactSet's current projection of 33.8%, that would be the best of any quarter since the third period of 2010, when the post-Great Recession recovery was beginning to crank into gear. The numbers also show how much this quarter is being driven by cyclical companies that were prime victims of the pandemic, led by financials and consumer discretionary businesses. And if current forecasts are right, industrials still have a lot of growth ahead if they are to partake of this recovery.' (Figure 3.)

Figure 3: US earnings growth CY2021



Source: Garraway, FactSet, Bloomberg L.P.

However, Ned Davis Research point out "that by the time really good (above +20%) or bad (-10% to -25%) earnings are reported, it has been largely priced in." Consequently, we believe that a lot of good news has now been priced into many of the value sectors. Notably industrials could be the litmus test for the sustainability of any further value outperformance.

Whilst we remain optimistic on growth and earnings it is best to understand that markets are discounting mechanisms and surprises might be found in growth stocks rather than value cyclicals. We still feel that Covid has accelerated major transformational shifts and with it higher longer-term earnings for many 'growth' stocks. This could be especially true for many, very different, areas of technology including cutting edge medical developments.

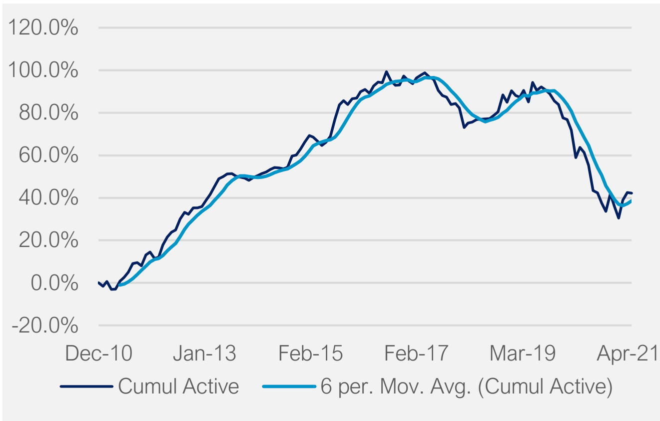
Combine this all together and we see a robust argument that the worst should be behind us for the relative underperformance of growth style equities/funds, with a good opportunity to add to holdings in this space.

Whilst we argued in October 2020 that cyclical stocks could have a big, short-term rebound. We also stated that it was not quite as simple as 'value vs growth'. For longer term investors quality value and growth stocks with some cyclicality are likely to be amongst the best performers.

So, in our review we reduced our exposure in our longstanding holding: Prusik Asian Equity Income Fund.

As you can see in Figure 4, after a blistering start of 6 years outperformance, markets have been very unkind to this strategy from circa mid-2019. We note that this fund, managed by Tom Naughton is full of quality value Asian equities. Equally it looks as though active performance may have reached a turning point, with better time ahead. Ironically, it is now the first time in a long-time you can buy the fund after having soft closed some time close to its peak in performance and massive inflows. Oh, the joys of investors chasing performance.

Figure 4: Prusik Asian Equity Inc. vs Regional Index Active Performance.



Source: Garraway, Bloomberg L.P.

Finally, we should look at a long-term winner for our portfolios, Legg Mason Japan Equity Fund. This fund represents a fascinating study in several ways, but we believe its most recent history shows the returns available to investors in long term secular shifts.

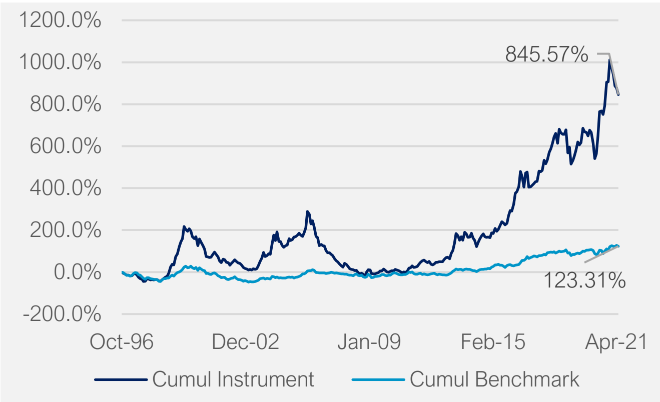
The fund has a truly amazing long term track record having beaten its benchmark by 737% since launch in 1996, albeit with relatively high levels of volatility (rebased to Sterling).

As you can see from the chart below (Figure 5), the fund has suffered several very significant setbacks in relative and absolute terms. It would have been easy to have sold the fund in some of these periods only to subsequently miss out on the exceptional returns for more patient investors.

The manager's bias is to invest in companies benefitting from long term secular changes i.e., 'an ageing population, changing consumers' lifestyles, internet-empowerment and the government liberalizing sectors and encouraging entrepreneurship.'

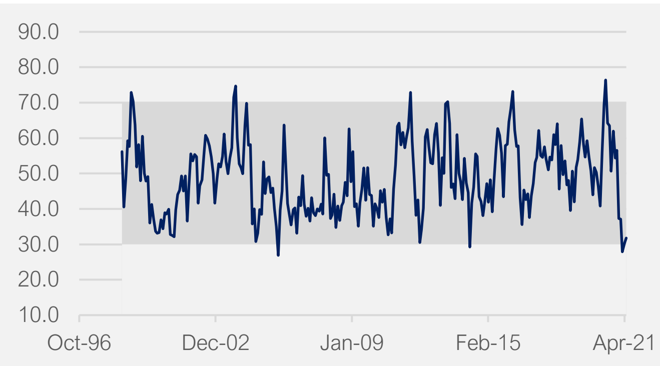
This means the portfolio has a dominant growth style exposure with small cap orientation. Unsurprisingly this means that the fund has struggled very recently as investors have rewarded more cyclical orientated stocks. However, this has left the fund as oversold as it has been in its history as shown (Figure 6). We are hopeful that we have reached a turning point and the fund will strongly reward once again.

Figure 5: LM Japan Equity vs Regional Index (GBP).



Source: Garraway, Bloomberg L.P.

Figure 6: LM Japan Equity Composite Strength Indicator (GBP).



Source: Garraway, Bloomberg L.P.

As the manager Hideo Shiozumi states 'The key is time, which takes great patience; but patience could lead to good investment returns.'

We still believe that risk assets will reward albeit on a bumpier path because of high levels of uncertainty in this unprecedented environment. Rotations will continue for a short while as we progress through further, but they are likely to change in nature as we gain more clarity on the path of expansion and inflation. However, we still believe that the existing structural winners will reward longer term and have positioned accordingly for the longer-term.

The Multi Asset Team.