FPWM

TAILORED FINANCIAL SOLUTIONS

What has happened in Q1 - Style and Geopolitics

This has been a brutal quarter in many ways. The attack on Ukraine is an appalling human tragedy and our hearts go out to all those impacted. Investment losses are secondary and pale in comparison. Nevertheless, it falls to us to examine what has happened over the quarter in investment terms and leave the geopolitics to the politicians.

To explain what has happened to portfolios during Q1 2022, we need to delve into the different types/styles of stocks and provide some insight into where we sit both historically, currently and for the future in terms of our style bias.

For background, below is a brief explanation of the three primary investment styles categorisations used by asset managers today, and how each style affects the construction of an investment portfolio.

An investment style describes the overarching approach taken by the fund manager when assembling a portfolio of assets, and how they're proposing to meet the fund's stated investment objectives. Certain asset managers adhere strictly to a particular investment style and will be very clear about the characteristics that they seek in individual assets and the criteria that they should fulfil, to take a place in their portfolio.

We tend to feel that this categorisation is too narrow and investment styles can be divided, and further sub-divided, in a host of different, and often highly esoteric, ways. But for clarity and brevity this article will be restricted to the three most fundamental investment styles: Value, Growth and Quality.

Value Investing

Value investors aim to acquire shares at a good price, i.e., those that are perceived to be out of favour and under-priced by the market, and which therefore represent 'fair value' if the manager is skilful in his selection. Typically, value managers are looking to own unloved companies through a period of positive change, and so are looking for two things: i) a low price to earnings ratio or P/E ratio, and often generally a higher dividend yield. The P/E ratio is a popular way to determine if a stock is cheap as it tells you how much you are paying for each pound of the company's earnings. For instance, a P/E of 10 means you are paying £10 for £1 of the company's earnings. Value investing has long been the stated approach of Warren Buffett – the 'Oracle of Omaha', and arguably the world's most celebrated investor, who learnt his trade under the guidance of the late Benjamin Graham - the 'father of value Investing'.

Growth Investing

A growth investment strategy focuses on businesses that have the greatest potential to expand substantially in both size and importance within their market sectors. Since the global financial crisis of 2008, much of the market rally has been driven by growth stocks and particularly the 'FAANG' group of Facebook, Apple, Amazon, Netflix and Google (now known as Alphabet). Growth investors prioritise the longer-term outlook, and their stocks typically have a higher P/E ratio relative to the market. Other characteristics of a classic growth stock are high earnings growth rates, high return on equity, high profit margins and low dividend yields, as businesses which exhibit these characteristics can be growing rapidly and reinvesting most or all of their earnings in fuelling that growth. Growth investors are willing to absorb any overvaluation in return for the potential of superior returns.

Quality Investing

This investment style is built on the simple principle that quality businesses have a greater likelihood of delivering quality returns. With capital preservation as always paramount, quality investors seek to own businesses that will stand the test of time. Quality investment managers look for stability of management, uniqueness of the business model, reliable products, or a well-known brand, along with financial metrics such as strong free cash flow, return on equity, return on capital employed, stability of earnings, balance sheet health and low leverage. High quality companies are good at generating free cash flow and quality investing focuses on an old fashioned concept - the ability of a company to generate cash and return some of it to investors, while investing part of the cash into the business to generate further revenue This makes sense to us at FPWM and suits our aims of trying to provide returns with enhanced long term risk return characteristics

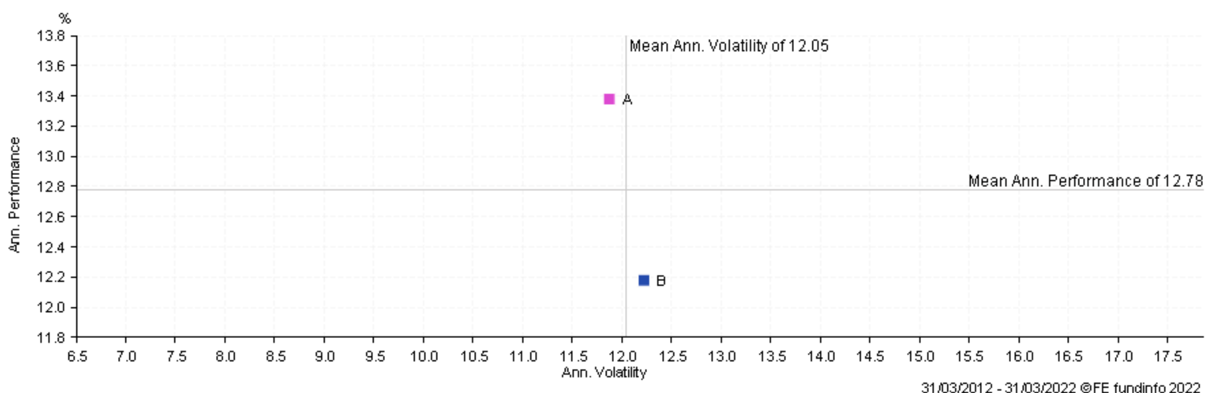
Ironically, it was Benjamin Graham who brought the concept of 'quality' to equity markets in the 1930s when he sought to classify stocks as either 'Quality' or 'Low Quality', observing that - **"the greatest losses result not from buying quality at an excessively high price, but from buying low quality at a price that seems good value."**

Quality investing came to the fore in the aftermath of the dotcom bubble of 2001 after a number of high-profile corporate implosions, which prompted investors to pay closer attention to a host of financial resilience and other sustainable competitive advantage factors which had been recklessly overlooked. In short, quality investing requires a 'tortoise and hare' mindset: slow and steady wins the race. After all, investing is a marathon, not a sprint.

How does style influence our portfolio construction?

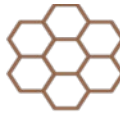
We have a long term style Bias towards Quality which has served us well over the years as can be seen below:

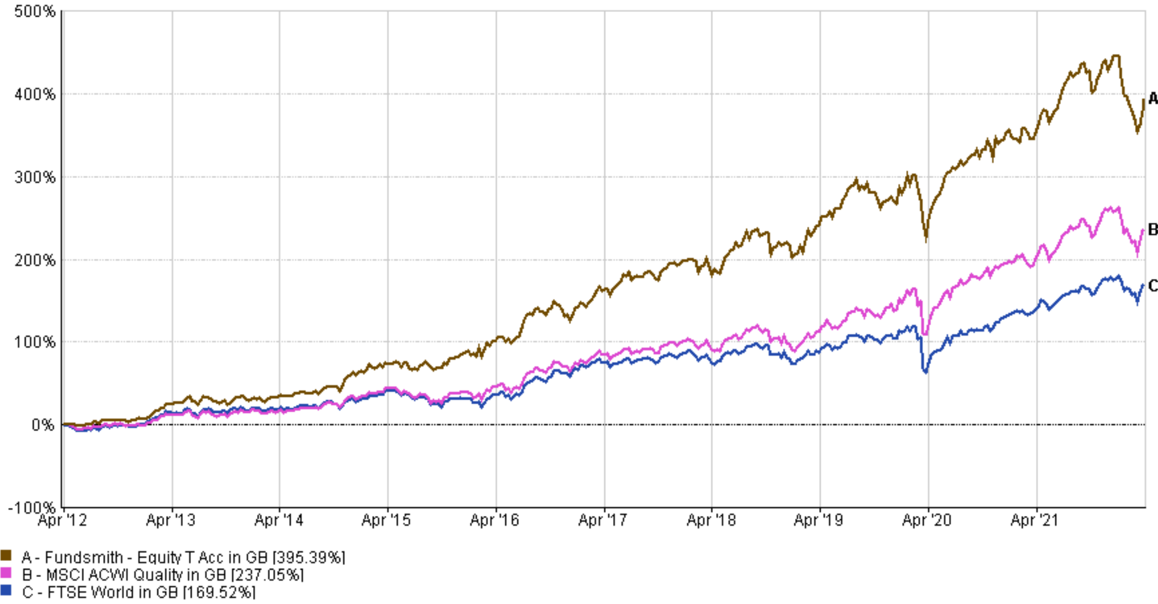
Not only has the Quality Style provided superior performance over the last 10 years or more, but it has done so with lower volatility than the index, showing enhanced the risk/return characteristics that we look for when constructing portfolios:



Key	Name	Annualised Performance	Annualised Volatility
A	MSCI ACWI Quality TR	13.38	11.87
B	FTSE World GTR	12.18	12.22

Done well the Quality strategy delivers impressive returns as can be seen by the 10 year performance of probably the most well-known Quality strategy, Terry Smith's Fundsmith Equity fund:

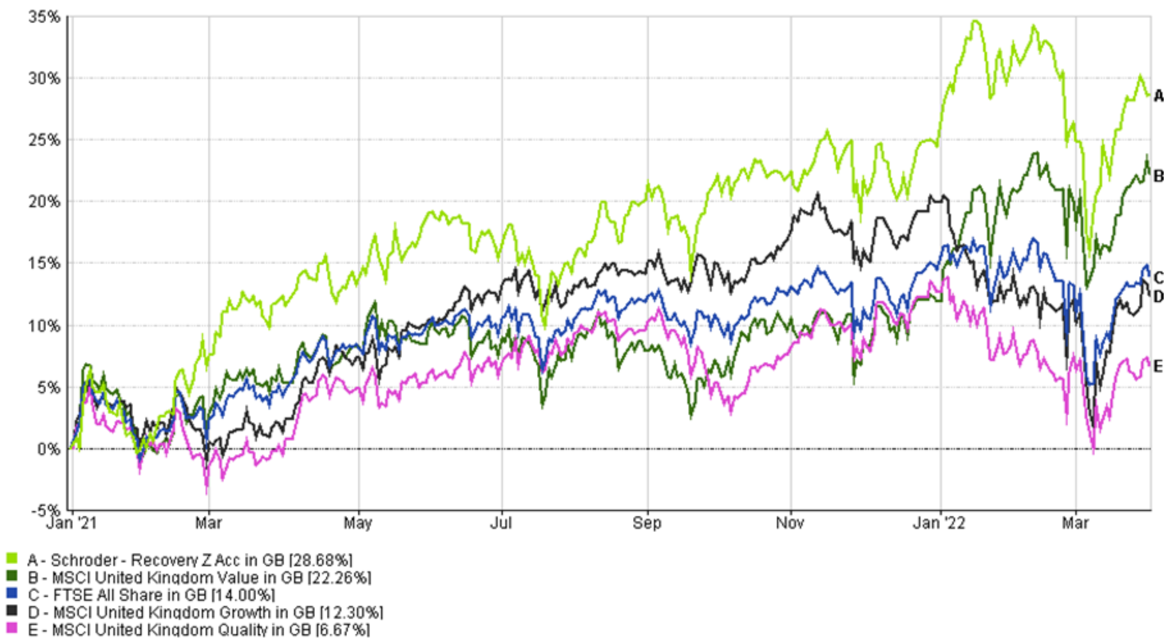




Further, the Quality style (and Fundsmith) have done this with the lowest maximum drawdown of the styles, lowest maximum loss, least negative periods and most positive periods.

Changing our Style Tilt

Given our Quality bias, it was therefore a significant (for us anyway!) shift for us to put specific Value strategies within the majority of portfolios starting in December 2020/January 2021. We recognised that the Pandemic effect was a significant factor and that the subsequent vaccine led recovery would be likely to favour Value stocks. As a result, we have used Schroder Recovery for UK exposure and Schroder Global Recovery for Developed Market exposure, which has worked out well as you can see below in the graphs which shows Schroder UK Recovery and Global Recovery returns since the style tilt:

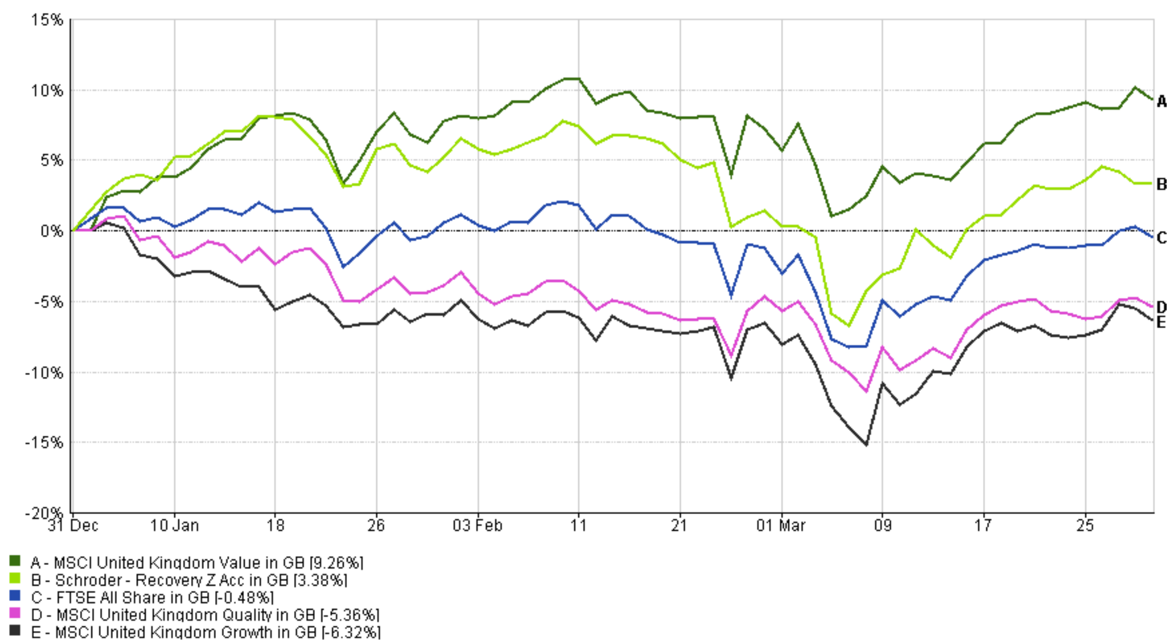


Schroder Global Recovery returns since the style tilt:

Where are we now and what happened during Q1?

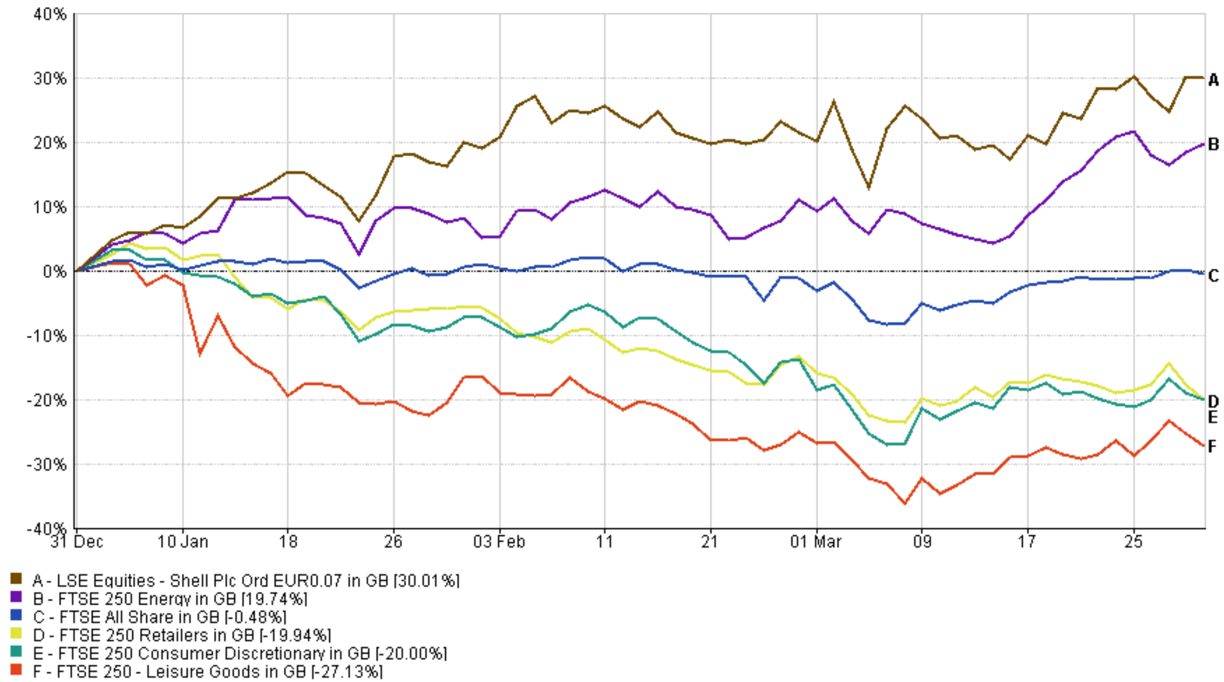
The past quarter was marked with a huge diversion in equity returns with extremely narrow leadership.

In style terms using the UK market as an example, the MSCI Value index outperformed the benchmark FTSE All Share index by 9.79%, while the Growth index underperformed by -5.87%, a differential of -15.66% in 3 months.

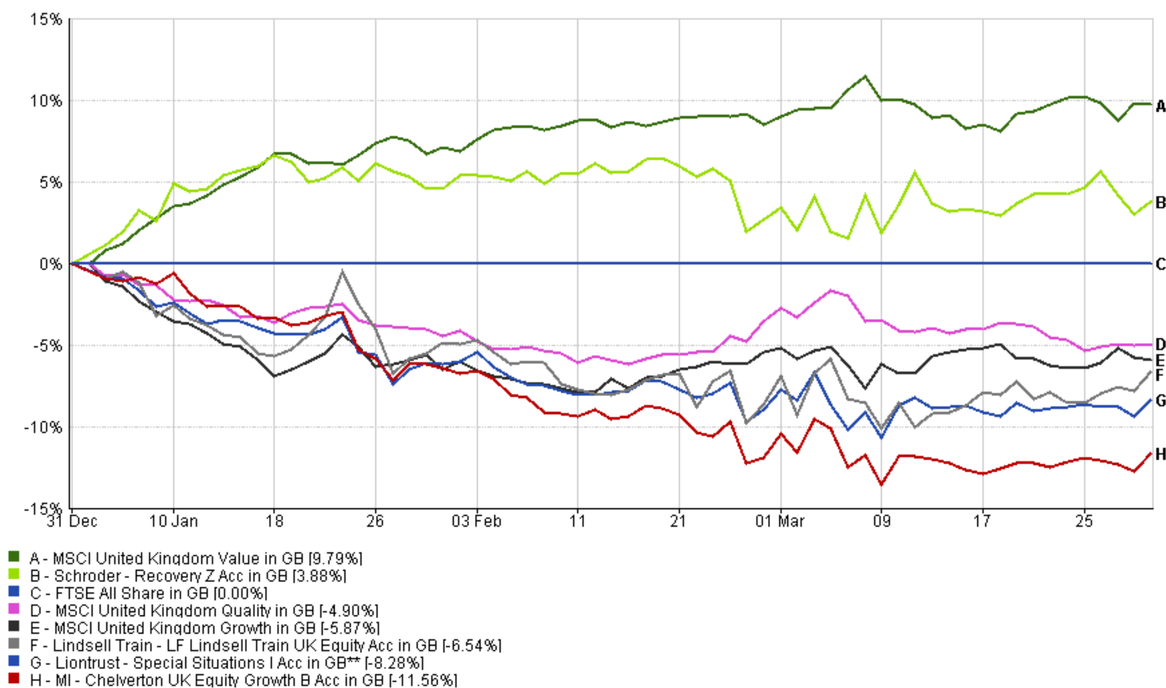


But that doesn't tell the whole story, if we delve deeper into sector returns, we can see what has really happened.

As you will see below, the FTSE250 Energy sector rose +19.74% reflecting the geopolitical crisis and the fears about oil and gas supply which dramatically increased energy prices. At the other end of the spectrum FTSE 250 Consumer Discretionary, Leisure Goods and Retailers fell hard reflecting concerns about the cost of living crisis.

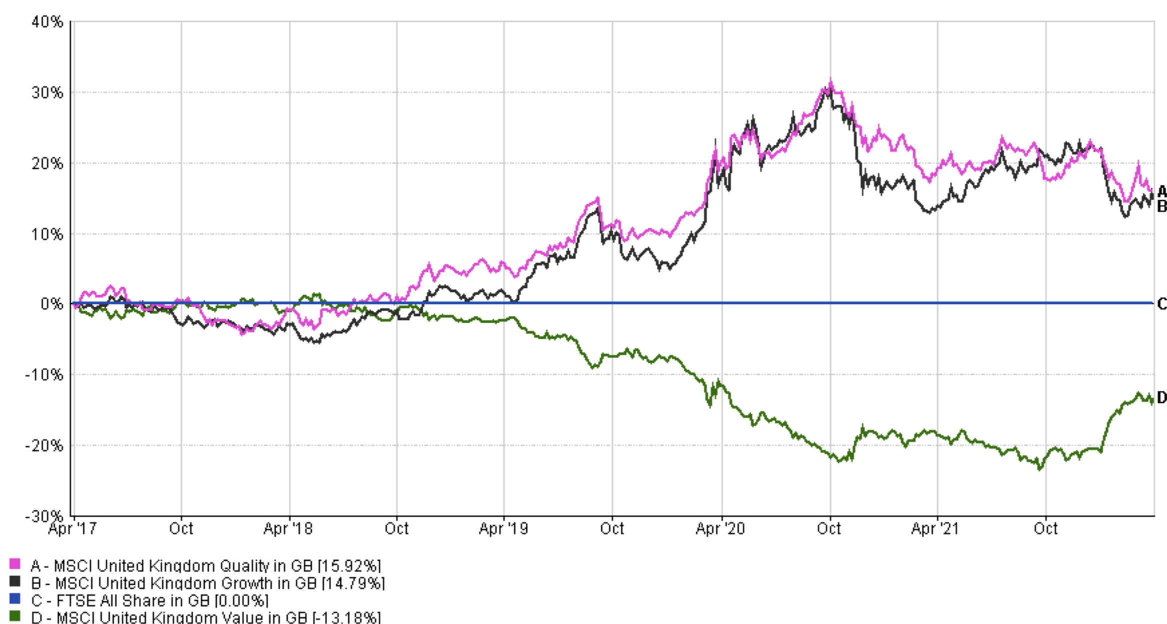


A good way to view this is on a relative value graph, where we can clearly see the performance differential versus the benchmark index, which puts the savage short term effect in focus.



But also, we need to view this specific geopolitical effect in terms of the long term pursuit of portfolio returns that exhibit enhanced risk return characteristics as previously mentioned.

The graph below shows the different style returns over a 5 year period.



31/03/2017 - 31/03/2022 Data from FE fundinfo2022

In summary, over a very short period geopolitics has driven a bifurcation in investment returns to an extreme degree, above and beyond anything we can remember.

Our bias is towards Quality equites (-4.9% vs FTSE All Share) despite embracing a Value tilt post the COVID-19 vaccine announcements. This style has suffered in the quarter as the animal spirits of the investment markets have moved one dimensionally without stopping to consider the relative strengths of those quality companies.

Is it time to abandon our principles? No. Should we test them? Yes, but that is a constant in our investment process.

If you consider a longer term perspective, then it is clear to see that short term effects reduce over time and perhaps a reversion to the longer term characteristics of our favoured style is the route forward for the patient investor.

As we said back at the beginning of 2021, we look to holiday in Value and our decision for now is how long that holiday should continue.

Whilst the brutal rotation of the quarter can't be ignored or written off, we don't believe it is a true long term value rotation that should change our investment thesis. We believe that it is an energy shock that may continue for a little while as the Ukraine crisis continues. If that proves to be the case then recession fears increase, and our view is that we are most comfortable looking towards the strong, quality businesses that we expect to do best through tough times ahead.

In difficult financial times, emotional instincts often drive investors to take actions that make no rational sense but make perfect emotional sense. It is worth remembering the words of legendary investor Peter Lynch ***"Behind all the smoke and noise on the market's surface, it's important to remember that companies — small, medium, and large — make up the market's backbone. And corporate earnings drive stock prices."***

FPWM April 2020