QUARTERLY INVESTMENT LETTER

SEPTEMBER 2020

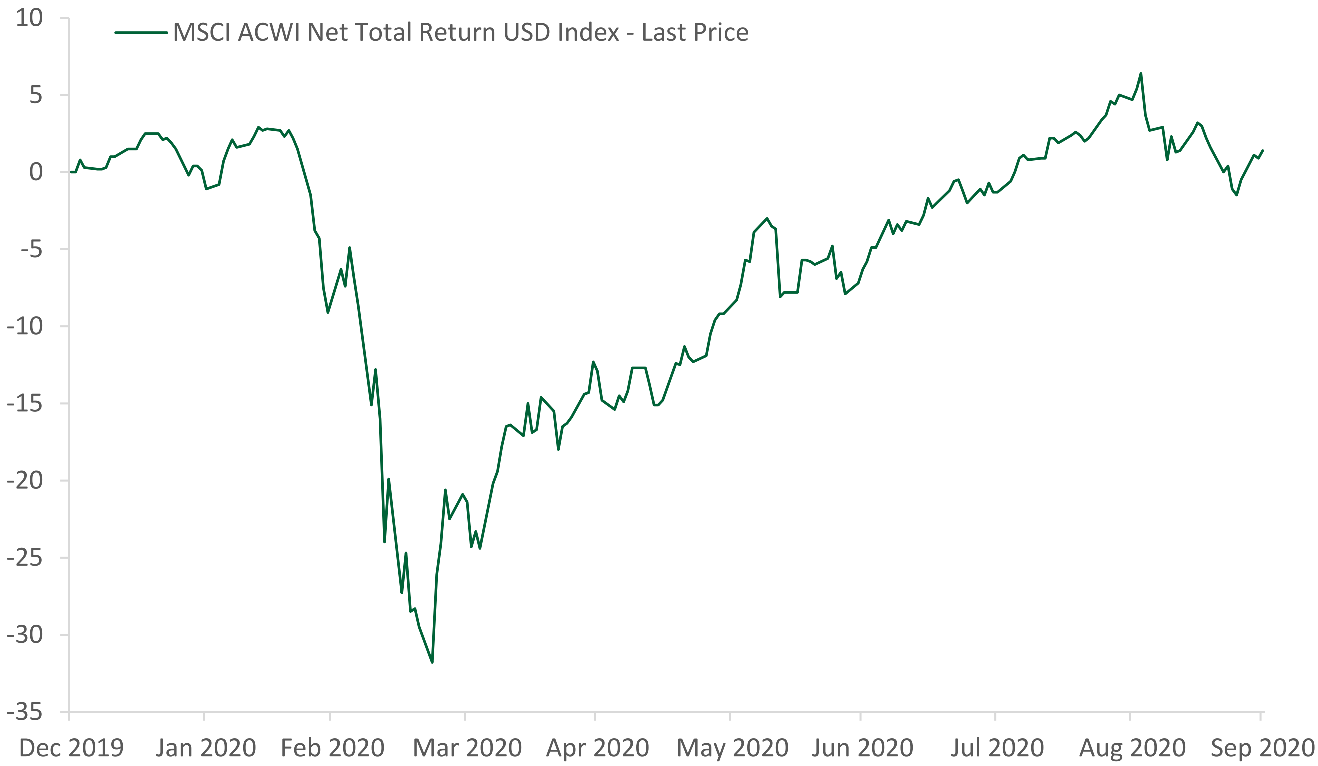
STONEHAGE FLEMING

THE INTERNATIONAL FAMILY OFFICE

INTRODUCTION

As we approach the final months of 2020 the pre-COVID world feels like a distant memory. Daily life has changed considerably, with millions of people still living under severe restrictions. Confirmed virus cases continue to rise at approximately 400,000 per day.

Equity markets, at first glance at least, seem indifferent. The MSCI All Country World Index is up 1.4% for the year - unthinkable back in late March when markets bottomed at -33.6% from the peak.



Source: Bloomberg, Stonehage Fleming 2020

In last quarter's letter we highlighted some of the reasons for this strong market recovery. In particular, the dominance of mega-cap technology stocks, which sit at the top of market indices and have proved extremely resilient to this crisis.

> Consumer behaviour has shifted in a way that benefits the likes of Apple, Amazon, Netflix and Microsoft. In addition, fiscal and monetary stimulus has been vast and rapidly deployed, injecting liquidity into the financial system and supporting risk appetite.

Our newsletter this quarter focuses on answering five of the most commonly asked questions we currently receive from clients, when considering the outlook for their portfolios.

Question 1: How have you repositioned portfolios this year to reflect the new economic and investment environment?

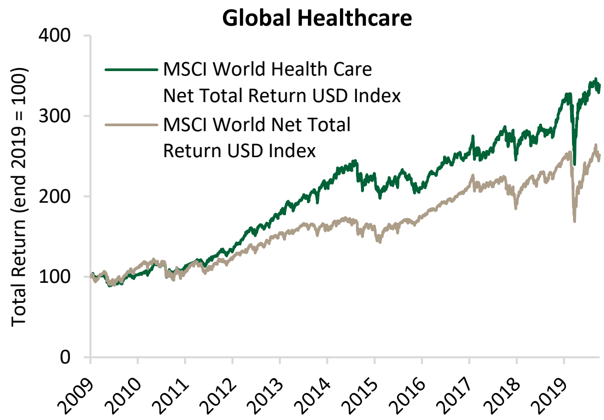
Early on in this crisis we reaffirmed our philosophy not to aggressively time the market. Timing any period of volatility is extremely difficult to get right, and the unprecedented nature of this pandemic makes such discipline even more valid.

In its absence, what often happens is that risk allocations are removed at the height of uncertainty, only for them to be added back once it is lifted and markets have moved higher. The fact that Boris Johnson announced a nationwide UK lockdown on the 23rd March, the same day that equity markets bottomed, highlights the point well.

> Resisting the temptation to de-risk in the first quarter has resulted in our multi-asset portfolios recovering most if not all of the capital drawdowns suffered in the first quarter.

However, this does not mean that capital should not be recycled as the outlook changes. In recent years we have tilted allocations towards US technology through both passive and active vehicles. We accentuated this bias in April by increasing our allocations to the S&P 500 at the expense of more economically-sensitive managers, including in Japan. Leveraged loans, a form of sub-investment grade credit, were removed at the end of February, and two long / short equity managers, where our conviction in their prospects for attractive returns had diminished, were also redeemed. A key addition was physical gold, aiming to strengthen the diversifying characteristics of portfolios and protect against the threat of rising inflation (see question 5).

We are also emphasising healthcare as a dedicated theme within portfolios. Healthcare has a number of structural tailwinds, benefiting from supportive demographic trends, favourable ESG[1] dynamics, technological advancement (i.e. robotics and 'telehealth') and a post-COVID future raising its profile for consumers and governments. Despite periods of underperformance, long-term results reflect the sector's combination of high return on equity and defensive characteristics. We expect this trend to continue.



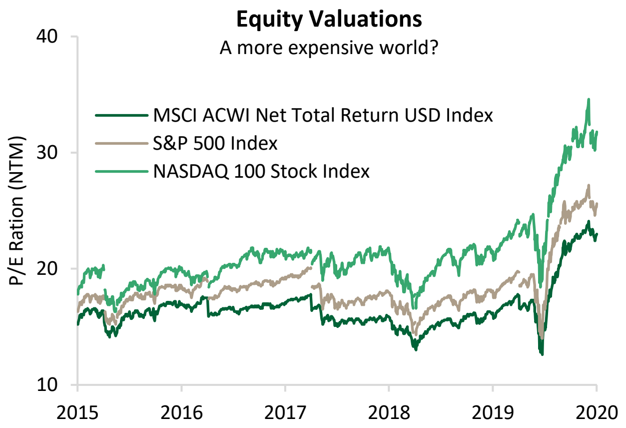
Source: Bloomberg Finance, Stonehage Fleming, 2020

Our portfolios are therefore not significantly changed from early 2020; we have not materially changed our allocation to risk-assets, and continue to hold a blend of managers across regions, style and asset classes. However, we have rotated capital away from areas facing emerging headwinds to those benefiting from long-term tailwinds, while ensuring a robust mix in the face of a still very uncertain outlook.

[1] Environmental, Social and Governance factors

Question 2: How can higher equity valuations be justified against such an uncertain backdrop?

The question of why equities should trade at higher valuations compared with the pre-COVID era is a common one. Coming into 2020 global equities traded at a valuation of 17.6x expected earnings[2] – slightly higher than long term averages but set against a constructive economic and policy backdrop. Today, as the world faces a global health crisis and a devastating rise in unemployment, the same market trades at 23.4x expected earnings[2]. How can the world today command a premium to the world before COVID-19?



Source: Bloomberg Finance, Stonehage Fleming, 2020

> This situation gives us reason to be cautious in our allocations. Any worsening in the outlook that has not so far been understood, and therefore factored in by investors, could lead to markets being re-priced at lower multiples once again.

However it is important not to confuse equity prices and valuations as a reflection of the immediate outlook. Whilst analysts will differ in their approach to equity valuation, a company's 'fair value' is ultimately a function of long term cash flows discounted to the present at an appropriate rate. Any change in that rate can have a powerful impact on share prices. The Federal Reserve acted quickly in the first quarter to drop interest rates from 1.75% to 0.25%[3] and signalled clearly that this measure would not be reversed anytime soon. Jerome Powell, Chair of the Federal Reserve, made this clear in early June when he told reporters they were *"not even thinking about thinking about raising rates"*.

Whilst earnings for many companies in the next 1 or 2 years may be materially lower as they adjust to the reality of COVID-19, equity prices consider a much longer time horizon and are 'pricing in' a return to trend before long. When these future cash flows are discounted at an appropriately lower rate, it is justifiable for them to trade, temporarily at least, on a higher price-to-earnings ratio.

Peter Berezin, Chief Global Strategist at BCA Research, argues that *"even if one assumes that it will take the rest of the decade for S&P 500 earnings to return to their pre-pandemic trend, the deep drop in the risk-free component of the discount rate has still raised the present value of future S&P 500 cash flows by nearly 20% since the start of the year."*[4]

Of course, this does not mean that equities cannot suffer further bouts of volatility as investors react to future developments. This is not unlikely over the course of the winter months. However it highlights the significant market impact of central banking action. During the 2008/09 Global Financial Crisis the Federal Reserve did not cut interest rates to near zero until December 2008 – almost 18 months after the crisis began to unfold and two months after Lehman Brothers failed. This allowed the valuation of global equities to fall below 9x forward earnings before investors' confidence started to recover, and equities were re-priced higher over time.

> The speed and size of central banking actions in 2020 has meant that, even in the face of the bleakest of circumstances, such broad based value never arrived and markets have stabilised at much higher multiples.

[2] MSCI AC World Index, P/E ratio at 31/12/2019 and 12/10/2020. Bloomberg estimated earnings for the next 12 months

[3] The Fed Funds Rate upper bound.

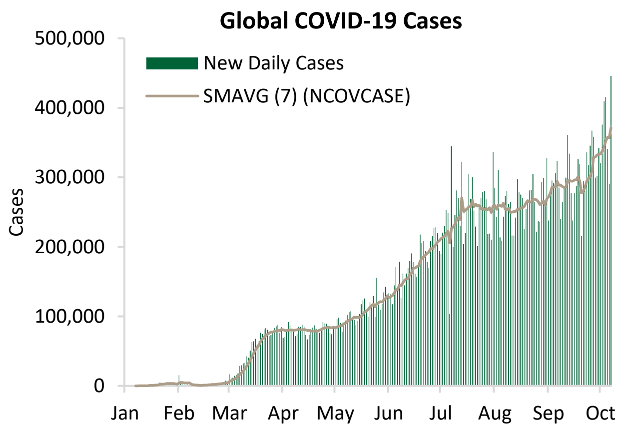
[4] Source: BCA Research, Global Investment Strategy, Fourth Quarter 2020 Strategy Outlook: A Post-Pandemic Regime Shift, September 29th 2020.

Question 3: With the COVID-19 pandemic getting worse why not concentrate portfolio allocations in large technology winners and exclude traditional businesses from portfolios?

When the pandemic struck in late February the hope was the summer months would see it subside. The combination of pent up demand and fiscal stimulus could drive a rapid 'V-shaped' recovery to the prior trend.

> As economies have reopened the spread of the virus has again intensified, meaning that whilst we saw an initial jump in economic activity, the winter months will be slower.

In the short term at least, that 'V' now looks more like a 'square-root'. Reimposed restrictions, evening curfews on the service sector, and localised lockdowns all threaten a repeat of the second quarter's economic contraction.



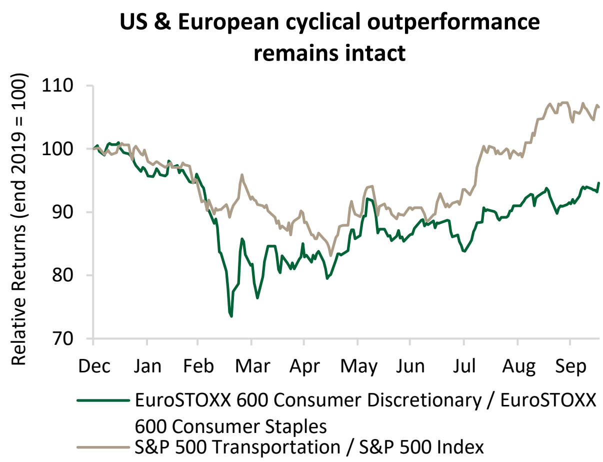
Source: Bloomberg Finance, John Hopkins University, Stonehage Fleming, 2020

The temptation is to assume the winners in the 'first wave' will be the winners in the 'second wave'. Indeed, it is a common behavioural bias when investing to extrapolate the current environment into the future ad-infinitum. The pandemic of 2020 has been extremely disruptive and, with such a significant impact on the prospects for company earnings, there is logic in taking shelter by investing only with those that are benefiting. Market leaders in cloud computing, home-office computer goods, streamed entertainment, online retail, and others, fall firmly into this category and have strengthened their position.

Whilst we continue to emphasise 'quality growth' segments of the market through managers that find many compelling opportunities in the technology sector, there are two things to say in support of a balanced approach. The first is that the ability of technology giants to benefit from a pandemic-related surge in sales, and consume more market share, has a limit. Close to 75% of US households have already subscribed to Amazon prime, and more than 50% are Netflix users. Alphabet (Google) operates 92% of internet searches. This is not to say that such market leaders cannot continue to deliver strong results, and take advantage of their enviable competitive advantage. However, the sudden surge in demand for their services is unlikely to repeat. Despite daily COVID-19 cases exceeding those in the April peak by some margin, restrictions remain less stringent. Businesses remain open in most regions.

> Whilst consumers may have invested in a Netflix and Amazon subscription earlier in the year, and upgraded their home-office or home-gym equipment to support remote working, they are unlikely to need to do so again over the winter.

Secondly, it is important to listen to what the markets are telling us. Logic would imply that, upon seeing cases rise and restrictions reinforced, companies in the transportation and traditional consumer-facing sectors would be sold-off once again and underperform the broader market. However, even as the outlook remains challenging, many of these cyclically sensitive industries have continued to outperform into the fourth quarter, building on their momentum of the past six months.



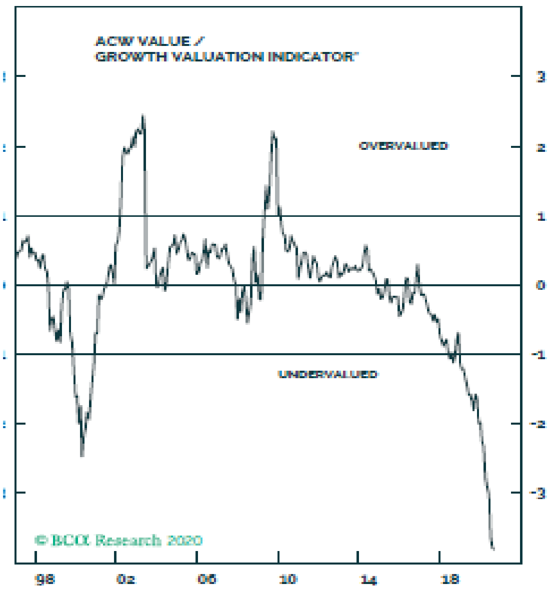
Source: Bloomberg, Stonehage Fleming, 2020

Why might this be the case? Importantly, markets tend to price-in the worst case scenario when uncertainty first emerges. In March, the shock was substantial, and companies in these sectors were re-priced with much lower share prices. Compared to the start of the year, earnings expectations for the coming year are already c. 50% lower for US industrials, and almost 40% lower for consumer discretionary. Despite a similar trend in the spread of the virus, we now know more about what to expect. While restrictions remain tight in many areas the focus has shifted from ‘lockdown’ to ‘learning to live with COVID-19’, and this supports gradual but positive improvement for these companies, with earnings expectations continuing to drift higher.

Markets are also looking further out, and reflecting a resumption of normal activity by spring / summer next year.

We cannot know how close to the ‘2019 normal’ that will be, but with improving treatments, vaccine progress and the natural evolution of the virus over time, the expectation is that the ‘pandemic trade’ will make way for the ‘reopening trade’ in 2021. Earnings expectations are for a strong revival in ‘value’ stocks relative to ‘growth’ stocks when that happens. When combined with the historically cheap nature of these unpopular stocks (see ‘chart below, courtesy of BCA Research), it is another reason not to shun the former completely.

Value Stocks Are Extremely Cheap Relative To Growth Stocks

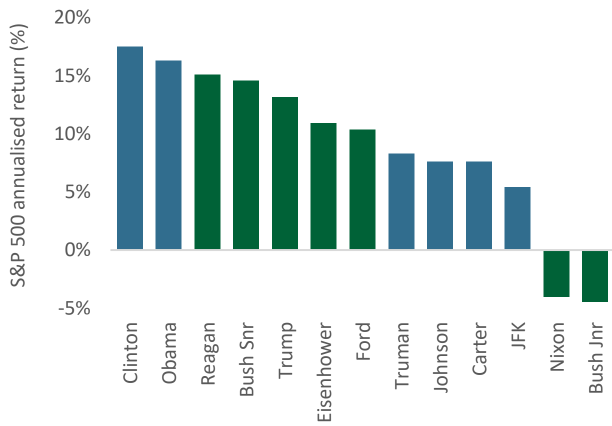


* BASED ON RELATIVE PRICE/BOOK, PRICE/EARNINGS, AND DIVIDEND YIELDS.
SOURCE: IBES / THOMSON REUTERS AND MSCI INC. (SEE COPYRIGHT DECLARATION).

Question 4: The US Presidential election is just a few weeks away. How might markets react to different outcomes and will it change your investment strategy?

The US presidential election is always a potentially market moving event. A shift in leadership at the top of the US government can change the landscape for different industries in different ways, and for that reason we need to pay close attention. However we know how futile it is to base investment strategy on the outcome of any political or geopolitical event. The outcome is unknown, regardless of polling data, and market reaction to that unknown outcome is also unknown. Trump’s election win in 2016, which was considered highly improbable and likely to be negative for markets, is a good case in point – it happened, and the opposite market reaction was true.

> We also know that there is no evidence of long term equity returns being significantly better or worse under Republican or Democratic presidents. The below chart of S&P 500 returns under each US president since the Second World War makes this clear:



Source: Bloomberg, Stonehage Fleming, 2020

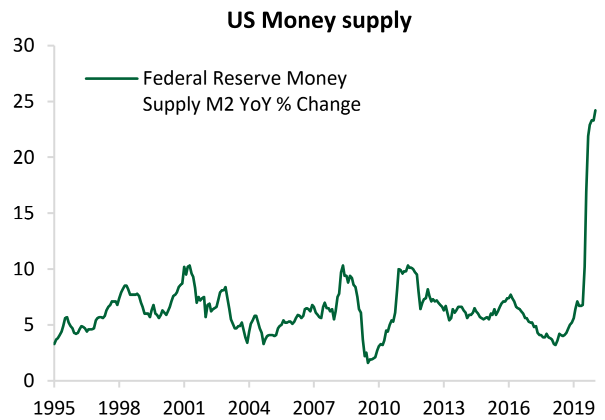
Whilst we do not attempt to forecast the outcome next month, and are not making portfolio changes in anticipation, we are cognisant of the potential for market disruption. The most prominent threat in this case is that of a contested election. Against the backdrop of the pandemic, mailed ballots are expected to be used by more voters than before. This raises the prospect of claims that the election has been ‘rigged’. With President Trump railing against the process as ‘fraudulent’ we could see election night become 'election weeks' as votes are recounted and the winner is verified. Like in 2000, when the state of Florida was the focus of a disputed result in the race between Al Gore and George W Bush, equity markets are likely to shift lower until this new source of uncertainty lifts. This kind of political event, which we cannot predict with any certainty, speaks to our philosophy to diversify core investments with uncorrelated sources of return.

> Our investment in physical gold earlier this year is a good example of how we have strengthened the diversifying elements of portfolios.

Like in late 2000, we would expect gold to perform well should such a drama unfold and investors to seek safety.

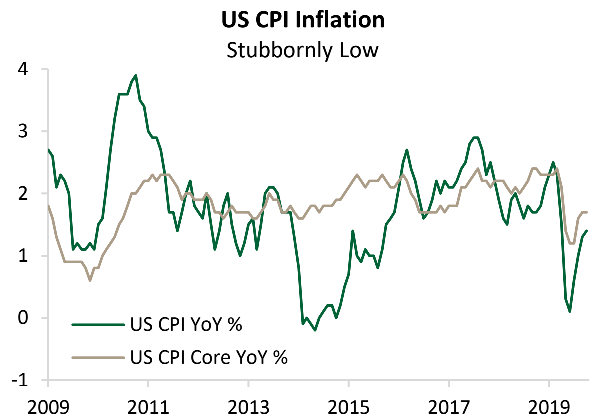
Question 5: With interest rates at near zero for the foreseeable future inflation is surely to follow?

The policy environment today is aggressive and broadly expansionary. Money printing has become conventional central banking policy, driving up the supply of money like never before, and the world is getting used to seemingly unlimited government deficit spending. The age of austerity is well and truly over.



Source: Bloomberg, Stonehage Fleming, 2020

Economic theory suggests that the outcome should be price inflation. Milton Friedman, the American Nobel prize winning economist of 1976, argued that *"Inflation is always and everywhere a monetary phenomenon in the sense that it is and* ***can be produced only by a more rapid increase in the quantity of money than in output****".* If this theory holds, the current policy mix is a recipe for higher inflation. Furthermore, the Federal Reserve recently formalised their position on 'average inflation targeting' by announcing a new Monetary Policy Framework (MPF). This states that, rather than raising rates as inflation rises towards the target of 2% per annum, the Federal Reserve will tolerate inflation above this level for a period of time to compensate for periods when, like the past 10 years, it has been stubbornly low.



Source: Bloomberg, Stonehage Fleming, 2020

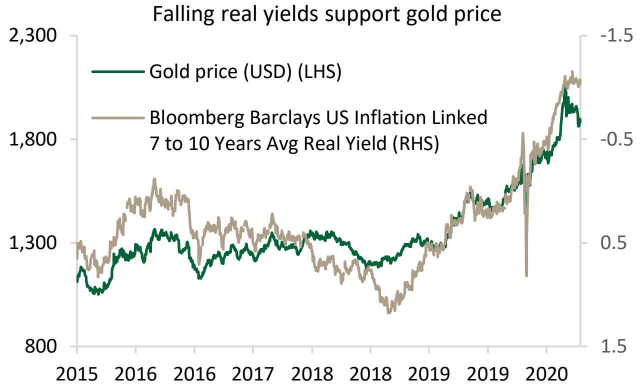
Whilst the theory supports building inflationary pressures, it is unlikely to be a near term issue. This is because the world is suffering from a severe demand shock. Relative to 2019, there is ample spare capacity across industries and regions which will take time to diminish as the recovery gathers momentum and slack in the labour market is used up. Even when the US unemployment rate fell to 3.5% before the crisis, considered full-employment by most measures, inflation remained subdued. It might take years before we get back to this level.

> Whilst the risk of rising inflation might not be an imminent threat, it is nonetheless one we guard against through appropriate portfolio allocations.

There are three main ways in which we aim to achieve this. Firstly, by avoiding conventional government bonds, which historically would form a key part of a balanced multi-asset strategy. Sovereign bonds maturing in 10 years, such as US Treasuries and UK Gilts, are now trading with yields well below 1% per annum and reflect a complete absence of inflation and growth over this period. They can play a role in some portfolios to achieve diversification, but represent a good long term investment only if a sustained period of deflation (i.e. falling prices, rather than rising prices) and economic stagnation plays out.

Secondly, we allocate to investments expected to do well in the event of sharply lower real yields – a function of higher inflation expectations and contained bond yields. In the event that inflation expectations continue to rise and bond yields do not, as the Federal Reserve resist raising interest rates to engineer an inflation overshoot, we would see a continuation of the below trend. Real yields fall further into negative territory, and this is supportive for physical gold – a key diversifier in our portfolios (see chart below).

US Real Yields and Physical Gold
Falling real yields support gold price



Source: Bloomberg, Stonehage Fleming, 2020

The quality growth components of our equity allocations are also beneficiaries of this trend, generating higher revenues in an inflationary scenario provided a 1970's style upward spiral does not repeat. The below table highlights the point.

> If the consequence of today's aggressive fiscal and monetary expansion is tomorrow's inflation, gold and equities are the assets to emphasise. Cash and bonds are those to avoid.

If inflation comes without any associated economic growth, i.e. stagflation, our physical gold position will provide very valuable.

Annualized Real Returns

	Cash	Bonds	Equities	Gold
Insufficient/Ineffective/Depression	**3.7%**	**7.2%**	**-8.6%**	**2.7%**
US 1929-1932	10.6%	13.9%	-22.0%	8.8%
JP 1994-2003	0.6%	3.7%	-3.1%	-0.2%
US 1936-1939	-0.2%	3.9%	-0.7%	-0.4%
Successful Reflation	**-1.4%**	**2.3%**	**11.9%**	**6.5%**
UK 1931-1936	1.8%	7.1%	13.5%	9.5%
US 1933-1936	-1.4%	3.9%	27.1%	14.4%
US 1940-1951	-4.7%	-2.4%	5.8%	-4.2%
UK 1947-1959	-1.6%	-1.5%	8.1%	-2.5%
US 2008-2012	-1.0%	4.6%	4.8%	15.2%
Stagflation	**-1.7%**	**-2.1%**	**-1.6%**	**21.7%**
UK 1970-1979	-2.6%	-2.5%	-1.7%	18.0%
US 1971-1979	-0.8%	-1.7%	-1.4%	25.4%

Source: Bridgewater Partners LP

Finally, we are mindful of the potential impact on the US Dollar over the longer term. Rapidly rising inflation could lead to currency depreciation, should confidence be lost in the reserve currency to maintain its purchasing power. In addition to physical gold, we hold a dedicated position in emerging markets local currency debt. This asset class not only delivers valuable running yields of c. 6% per annum, but also offers valuable diversification in the event of US Dollar weakness. Emerging market currencies typically strengthen as their dollar-denominated liabilities become less constraining and capital flows away from the US. It is another example of how our allocations have multiple drivers and play differentiating roles in the overall portfolio.

We continue to be vigilant during this highly uncertain period, and scrutinise our managers to ensure discipline at all levels. We see further opportunities and risks ahead, and are positioning to balance them accordingly with risk management at the core of our process. Most importantly, we hope you all have a safe and healthy autumn.

SFIM Investment Committee
September 2020

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