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RT FINANCIAL PLANNERS LTD

NEWSLETTER – JULY 2019

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Investment Selection

The first half of 2019 has reminded us that economics in isolation can provide false signals for equity markets. In general, economic data has been weaker than expected but equity markets are close to all-time highs. Last year, the Federal Reserve was gradually increasing interest rates because economic data was stronger. Today the situation has reversed. Fears of rising interest rates and a slowing economy caused a sell-off in shares at the end of last year. This has been reversed in the first half of 2019, supporting the rise in equity markets.

Much has been and continues to be written about Neil Woodford's recent misfortunes. Since the suspension in trading in the Woodford Equity Income fund there has been a flurry of articles publishing liquidity assessments of other funds. It should be said that much of the analysis in these articles is, in our view, sensationalised. We have been passionately independent since inception and remain focused on choosing the most suitable underlying investments through a whole-of-market approach. This enables our Investment Committee to select the best funds for our clients' needs from the entire investment universe. The funds we have selected for you to invest your money in are those we believe demonstrate a clear understanding of fund management, dedicated specialism to their sector, deep experience and loyal fund management teams. Although there will be times when a fund may disappoint, it is more tolerable if part of a well-diversified portfolio.

Internally – and in conjunction with our investment partners – we have reports set up to assess ongoing liquidity in the funds, as well as others to monitor style drift. We remain comfortable with the funds we have advised on and those held in our discretionary portfolios, both from liquidity and exposure perspectives. We also take comfort in our swift ability to remove/reduce exposure if we begin to have concerns over a strategy. We do not shy away from smaller company exposure and we certainly do not feel that unquoted exposure deems a fund 'un-investable'. However, we do ensure that the fund managers we select to invest in these areas of the market have extensive experience, transparent risk management processes and a track record of running these strategies in varied market environments.

Should you wish to discuss the benefits of discretionary management (i.e. removing the need to get your signature to make investment changes) for your portfolio please get in touch and we will be pleased to discuss it with you.

How to Avoid Making Irrational Investment Decisions

When it comes to making investment decisions it is all too easy for us to let our hearts rule our heads – this is very understandable, but it doesn't usually make for the best long-term decisions and planning. At a recent investment seminar this phenomenon was summed up with the acronym MIRRORS, which is explained further below, together with the questions that we should all ask ourselves before proceeding, to help check any decision has been thought through carefully enough.

Reason	Explanation and Questions to Consider
Myopic Loss Aversion	We are more sensitive to losses than gains and can be influenced by short-term considerations, so ask yourself – "Am I only reacting to short term losses?"
Integration	We tend to seek to conform to group behaviour and prevailing "norms", so – "Am I following the crowd, or is this just a flavour of the month trade?"
Recency	We tend to put more weight on the importance of the most recent events, so consider – "Has my decision been overly influenced by recent, prominent news?"
Risk Perception	We tend to be poor at assessing risks and gauging probabilities realistically. So – "Have I considered the best and worst case scenarios in making this decision?"
Over-confidence	We tend to over-estimate our own abilities, so check – "Am I being over-confident in my ability to fully assess the range of possible outcomes?"
Results	We tend to focus on outcomes and performance when assessing our decisions, so ask – "Would I still make the same decision if the historic performance had been different?"
Stories	We are persuaded by captivating stories, so – "Is there a captivating narrative influencing my investment decision?"

In short, we need to carefully sense-check any decision and try to avoid knee-jerk reactions at all costs. With that in mind here are six tips for better investment decision making. They are simple steps that can increase the chance of better outcomes.

1 **Do** have a long-term investment plan
2 **Do** automate saving (it helps avoid emotional decisions)
3 **Do** rebalance portfolios
4 **Don't** check investments too frequently
5 **Don't** make emotional decisions
6 **Don't** trade too frequently – make doing nothing the default

As always, it is best to fully discuss any considerations and decisions with your adviser wherever possible.

How Active Should your Fund Management Be?

Huge amounts of capital have been allocated to passive investment strategies over the past decade as investors continue their desire for products with lower fees. It was recently estimated that Exchange Traded Funds (ETFs) now account for around 25% of all trading volumes in the United States, with around 90% of trading volume now driven by 'non-human' or 'non-discretionary' investors. In other words, only 10% of trading volumes actually originate from discretionary trades actively selected by investors.

Performance across some forms of passive investing hasn't been as strong as you may imagine, particularly when you compare Traditional Index Funds (TIFs) with ETFs.

Passive investors can also create a lot of additional volatility – buyers and sellers drive the price of the share price or index level and are therefore responsible for share price levels. Additionally passive investing is indiscriminate because investors are not driven by the analysis of fundamental factors. Certain ETFs allow investors to invest in a specific sector or style, this can mean that when markets are going up money flows freely into crowded assets that are trading at expensive multiples. Then, when markets subsequently correct, investors withdraw their money and sell at the bottom, creating a cascade effect. The effect of this ever-growing wall of passive money could mean that future bubbles could be bigger and troughs could be deeper, at least temporarily.

Another issue to be wary of is the liquidity mismatch that could impact investors in the instance of a market stress event. Firstly, ETFs are vehicles that are priced and trade continuously, yet they invest in assets that often cannot provide daily liquidity. Investing in assets with poor liquidity can be very easy to get into but very difficult to get out of when you need to escape. History has shown us that liquidity, in the fixed income space in particular, can dry up (as witnessed during the Global Financial Crisis) and most commonly occurs in sectors with the lowest levels of liquidity, such as emerging market debt and high yield.

Finally, investors in synthetic ETFs expose themselves to the risk that one of the derivative counterparties default. Synthetic ETFs are popular because they frequently have a lower tracking error and are sometimes cheaper than physically replicated ETFs. However, it is not uncommon for individuals to underestimate or even misunderstand this counterparty and collateralisation risk, ultimately resulting in the potential loss of all the initial investment.

It's not hard to understand why ETFs and other passive products have been so popular since 2009, particularly as markets have continued to push higher and – for the large part – with low volatility. However, we simply cannot assume a repeat of the last ten years, particularly as central banks begin to batten down the hatches and embark on part two of the most extraordinary money experiment in history (transitioning from Quantitative Easing to Quantitative Tightening). Looking forward, we expect to see an increase in volatility in markets, so believe that it is prudent to invest a major part of portfolios in active managers and at the very least, hold assets that you understand and which have ample liquidity.

Charges – How Important Are They Really?

Investment charges can be complex as they are often made up of a number of layers. Depending on the contract they may include product or platform fees, investment manager charges, discretionary management and adviser fees. They are becoming more of a focus in the press, particularly with the new investment provider notifications being issued under recent legislation. As a result there appears to be more emphasis than ever on trying to reduce the overall charges. Although none of us want to pay more than we need for anything in life we do need to consider that sometimes, higher costs may give a better outcome.

For example, consider if you had held a high interest savings account and had been able to find interest rates of 2% over Bank Base Rate over the last 5 years. A deposit of £10,000 would have given £11,310 – a return of 2.49% per year. This is similar at 2.50% annualised over 10 years – with a balance of £12,804. You will not see or be told of the charges levied in the deposit account as they are not transparent but this is the amount you would have seen returned after any charges.

We have checked on a selection of investment portfolios we have advised on with different account providers and selected four portfolios with varying risk profiles. After all of the charges have been taken, there have been returns at the following levels:

- 6.10% per year over 4 years
- 5.89% per year over 9 years
- 6.35% per year over 10 years

A £10,000 investment at the above returns would have given £12,672 over 4 years, £16,737 over 9 years, and £18,508 over the 10-year term. So, even if there had been charges of over 2% per year taken from these, we believe most people would prefer to have £18,508 after 10 years rather than £12,804. It would not matter what charges had been paid as they would certainly appear to have had good value for money.

We believe that there has been too much focus on the actual level of charges where the question that should be asked is whether the service paid for is good value for money. Put another way, do you have more money at the end of the period having paid the charges than you would have done if you had not paid the charges. So the old adage 'you get what you pay for' is very topical.

While we carefully monitor charges, we also recognise that a statement highlighting charges can sometimes be confusing and would encourage all of our clients to contact us if there are any concerns.