CIO BLOG

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PASTURES OLD, AND NEW

As I step into my new role as Chief Executive Officer of Kleinwort Hambros, my final CIO Blog looks back at key themes and lessons learnt from a decade of managing client assets in turbulent times. Over the years, the investment team and I have poured heart and soul into trying to understand the world as it unfolded. No matter how unprecedented or complex the subject – from negative interest rates and oil prices to Brexit and COVID-19 - our goal has been to filter out the 'noise' and focus relentlessly on the evidence.

A quick canter through some of the titles of my past blogs points to the turbulence of the last decade: *Forward Misguidance (Oct 2014); Inequality bubble (Nov 2016); [Theresa] May in June (Apr 2017); Laboured breathing (Mar 2018); Brexhausted (Mar 2019).* While there were many twists and turns in markets, my tenure as CIO was punctuated by three overarching macro themes: unprecedented levels of monetary stimulus, tectonic geopolitical shifts and conspicuous inequality, all of which we navigated with our investment process, VaMoS.

VaMoS

Having opinions on every matter under the sun is easy; *some even think that constitutes an investment process.* But it is the antithesis of the culture at Kleinwort Hambros. When it comes to making investment decisions on behalf of our clients we let the data guide us. It's in our DNA.

There is much data out there, but our empirical work led us to devise the VaMoS framework (Valuations, Momentum and Sentiment) to analyse the data in a meaningful way. In a nutshell, investment returns are compelling when valuations are low, momentum is positive and sentiment or the prevailing mood is overly negative (it is a contrarian indicator). The opposite is also true. Returns are poor when valuations are high, momentum is negative and sentiment is overly positive. When combined with measures of the economic climate this provides a robust dashboard of data to navigate financial markets. Ignore the noise and emotions and focus on the data. That is our investment process in a nutshell.

To illustrate our approach, let's consider the biggest macro themes of the past decade.

1. Quantitative "Sneezing"

With torrential levels of monetary stimulus ("quantitative easing") in the face of mountains of debt and low growth across advanced economies, many were expecting the last decade to experience high levels of inflation and poor asset class returns. Many notable strategists and investors proclaimed that the answer to these ills lay within emerging markets, anchored by a rising China on track to become the world's

biggest economy. Many believed that the weaknesses in advanced economies were mirrored by strengths in emerging markets, which would enjoy much higher structural growth rates and lower debt partly due to younger populations with growing disposable income. A structural shift from a 'unipolar' to a 'multi-polar' world was occurring, and huge emerging market demand would propel a voracious appetite for commodities.

It was a great story, not least because it was built on seemingly solid pillars of logic. But the proponents of this worldview were completely wrong. The supposedly weak advanced economies would go on to experience a long and riotous bull market delivering strong investor returns across nearly every asset class. In contrast, the returns from emerging market assets as well as commodities would prove largely disappointing.

With the benefit of evidenced-based approach, it was clear to us why the outcome would be different to what the 'logic' dictated. In the early part of the last decade, valuations for advanced country risk assets were relatively cheap and market momentum had turned positive (two signals suggesting an attractive environment for investors). Yet with most investors still scarred from the global financial crisis and on edge over the Eurozone's debt crisis, sentiment remained pessimistic (another signal suggesting markets were attractive for investors prepared to be contrarian).

And whilst the real economy was undoubtedly weak (as evidenced by anaemic annual GDP figures), a dispassionate study of history suggests that risk assets still tend to enjoy a healthy premium over safe-assets so long as a full-blown recession is avoided (i.e. weak growth is still okay).

In line with our process, this made it a compelling time for us to invest.

Emerging market economies did indeed have higher structural growth rates, fuelling the "logical" (and flawed) argument that they were a better place to invest. But their financial markets were much more volatile and subject to repeated shifts in momentum. Sentiment toward emerging markets was perennially optimistic, but it was built more on hopeful narratives than on fundamentals.

2. Politically Savvy

Advanced country electoral politics are another great source of theorising. Many investors scrutinise every Western democratic election in detail, positioning themselves for one outcome or the other.

UK elections are no exception. Only five years ago, the 2015 election returned the Conservative party with an overall majority and put to rest the strained Conservative Lib Dem coalition. Led by Chancellor George Osborne, we were hurtling towards becoming a "low tax, low welfare" state. It seemed nothing could stop him.

And yet something did. Within the proverbial blink of an eye, the outcome of the UK's 2016 EU referendum upended the political establishment and unleashed waves of uncertainty. Not to be outdone, the US swiftly raised the stakes by selecting Donald Trump as the Republican nominee for the 2016 presidential election. Financial markets looked on with dread.

There were numerous other examples of seemingly world-changing electoral contests and results, not least Emmanuel Macron's shattering of the French political paradigm in 2017.

But poring over the data, it becomes clear that – in the long run - it doesn't really matter who wins elections in the Western world. Our analysis of the UK over 120 years found very little long-term difference between the Labour or Conservative parties in terms of GDP growth or equity market returns (even when including left-leaning leaders such as James Callaghan). *History clearly shows that the party in power – or elections in general – are a poor guide to making investment decisions in developed democracies, probably because of the presence of deep-seated, established institutions.*

In a paper we published on Brexit in February 2016, we wrote:

> "Perhaps the closest proxy of what may happen comes from the 'Black Wednesday' events in the UK in 1992… market volatility shot up. However, in the six months that followed, UK equities rallied by 25%. UK government bonds also performed well with 10-year Gilt yields dropping from 9.3% to 7.7%. Sterling – the central lever from where pressure was released – weakened by 12% against the US dollar."

Referring to the historical proxy of Black Wednesday turned out to be more salient than the prognoses of doom and gloom proliferating around the referendum. More widely, our evidence-based approach guided us to participate in the 2010s bull market, despite all sorts of "good" political reasons not to. An objective assessment of the prevailing economic regime, valuations, momentum and sentiment remained a far better guide than any attempts to discern the unknowable from the tea-leaves of politics.

3. Equal to the task

The third major theme over the last decade has been conspicuous inequality.

In advanced economies, we are fortunate to have seen a long era of relative peace, stability and growth marked by great reductions in disease and absolute poverty. As this era was born from the ashes of the Second World War, it is perhaps easy to think that the biggest threat to continued prosperity is external – e.g., from foreigners and foreign nations. But, domestic angst may be the biggest threat, fuelled more by the strains of a 'two-speed' economy than by net immigration or geopolitical activity. The structural inequalities – in areas such as income, housing or health - have been further highlighted during the COVID-19 pandemic.

Such inequalities are likely to be exacerbated by environmental degradation which is further concentrating issues around the distribution of resources and exposure to the harmful effects of climate change and associated problems like air pollution.

On such important social and environmental considerations, the stance of the Kleinwort Hambros investment team has been very clear. As discussed in our November 2019 CIO Blog *Having your Cake and Eating It:*

> "…returns cannot be measured solely in pounds and pence. It would be myopic in the extreme to consider just the bottom line on a valuation statement but not also the air that our children – and our children's children – breathe. It would be short-sighted to only uphold the law and norms of today, and not strive to channel capital to companies which are setting the standards of tomorrow. At some point in history, brave companies first opened the door to women executives, to the LGBT+ community, to minorities – they set the standards which are now considered normal."

It not only right to tilt towards investing in companies with higher socially responsible and sustainability credentials – in terms of their Environmental, Social and Governance (ESG) performance - but our research shows that it is also good for returns. Our equity selection process – which screens thousands of companies on quality and value factors – leans naturally to such companies. Consequently, our discretionary mandates have less exposure to businesses that derive more than 10% of their turnover from the sale of alcohol, fossil fuels, tobacco products or weapons (i.e., less when compared to the exposure within the MSCI All Countries World Index of global equities). We continue to improve our approach in an effort to improve returns as well as the world around us.

Bottom line

Nearly all of my CIO Blogs have ended with a bottom line and this one will be no different.

First, I want to thank the investment team – the stewards of our "VaMoS" investment process. They have spent many early mornings and late nights building the foundations of our investment engine, constructing a 'star process and not a star manager' approach which will continue to guide our investment decisions going forward. We continue to strive for improvement and greater learnings, and I am confident the team will continue to raise the bar. *Over the past decade, the industry has recognised the team's achievements with investment excellence and performance awards across all strategies on many occasions. My proudest moment, and one that I will forever treasure, is the Investment Team of the Year award, which recognised the contribution of the team as a whole. They remain in place, and you can rest assured that your investments will continue to be made in line with our robust process, supported by the full weight of evidence.*

In my new role as CEO I expect to bring the same evidence-based approach to serving our clients and I plan to engage all stakeholders to help our business thrive in a rapidly changing world. While the nature of problems is different, the problem-solving techniques will not be. Before I speak, I wish to listen. Before I act, I wish to learn.

There have been many changes over the years within our business and our operating markets. *Kleinwort Hambros has been in business for over 200 years, and as CEO, my obligations stretch back in time to the original founders – and stretch forward to all the future employees, clients, families and shareholders we have yet to serve.*

I am privileged to be supported by an exceptional 750-strong staff, each one of whom I will rely on to help Kleinwort Hambros reach ever-new heights, building on its venerable foundations.

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