AJBell

WORLD INVESTMENT OUTLOOK 2021

Your comprehensive guide to the coming financial year

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AJBell

FOREWORD

Andy Bell
Chief Executive Officer

2020 has been dominated by the coronavirus pandemic and the havoc it continues to cause across the globe. I certainly do not envy those in power, who find themselves having to make impossible decisions on an almost daily basis. So much is unknown at the moment, but what we can be certain of is that the pandemic, and the measures introduced to control it, will have far-reaching implications for some time to come.

Compared to all this, the vexed issue of Brexit has become almost a side note but, as I write, a trade deal has still yet to be agreed. The consequences of this, too, are potentially enormous. And then there's the US Presidential Election. Perhaps the most divisive and bitterly fought campaign in living memory has played out against a backdrop of mass COVID-19 fatalities, the Me Too movement, Black Lives Matter protests and the escalation of tensions with China to a level that many agree now constitutes a new Cold War.

Little wonder that the markets are almost impossible to second guess. As we attempt to navigate the multiplicity of challenges currently facing us in this mad world, the views of leading fund managers and investment experts are in greater demand than ever before. And so, despite the many virus-related obstacles in our path, we forged ahead with Investival 2020.

Hopefully for one year only, this unique festival of information and music is available online, uniting advisers with a line-up of returning speakers and Investival neophytes in the COVID-free safety of cyberspace. As ever, all the recordings from the event are available for you to view on our Infocentre. If you would like to register for Investival 2021, you can do so now at Investcentre.co.uk/support/events. I sincerely hope I will be able to meet you there in person!

Of course, the pandemic threw up many other challenges for our company than just the logistics of Investival. Clients rely on us to keep their investments safe and their money flowing, so we had to ensure that we could maintain a business as usual approach despite the pressure of social distancing and mass home-working.

Judging by the remarkable response to our most recent adviser survey, it looks like we passed the test with flying colours. The lessons learned, and the need to adapt rapidly, have even given rise to some positive permanent developments, such as the move to accepting electronic signatures on many documents. Constantly striving to adapt and improve our offering also led to the new Retirement Investment Account and our third-party MPS option. According to the survey, it seems that both have hit the desired spot.

Turning back to the markets and the possible global trends that will emerge in the coming year, I now hand you over to our Investment Director, Russ Mould. I am sure he will find the task of making predictions almost as difficult as I found it to congratulate my Liverpool-F.C.-supporting son on his team's recent success in the Premiership.

INTRODUCTION

Russ Mould
Investment Director, AJ Bell

Oil-man, racehorse-owner, cattle-rancher and real-estate magnate Nelson Bunker Hunt may be best known for 1980's spectacular fall from grace which followed his attempt, alongside brothers Lamar and William, to corner the silver market. He failed, not least because industrial users of silver rebelled; the Federal Reserve was in the process of jacking up interest rates, which made the borrowing used to hoard the metal much more expensive and, ultimately, the silver market just proved too strong to buck.

The Bunker Hunt brothers' rationale for trying to buy as much silver as they could afford – and then some – lay with the galloping inflation which had come to characterise the late 1970s, thanks to what they saw as unduly loose monetary policy from the US Federal Reserve and a lax fiscal policy and lavish spending by Government. As Nelson Bunker Hunt put it: "Almost anything is better than paper money. Any fool can run a printing press."

Bunker mentality

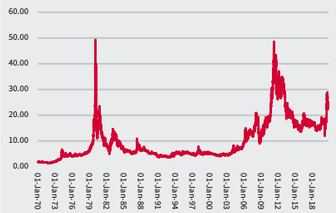
No wonder so many advisers and clients warm to the old adage about how history continues to rhyme, even if it may not repeat itself exactly. They will be well aware of what could look like some uncomfortable historical parallels as central banks further loosen monetary policy and Governments add to aggregate sovereign deficits, both from already once-unthinkable levels, as they seek to provide support to economies that are laid low owing to the pandemic.

Yet a return to the inflation of the 1970s is not guaranteed. An oil price shock in the wake of 1973's Yom Kippur War initially helped to stoke inflation. This time around, we have an oil price shock of a different kind, since crude has gone through the floor, owing to oversupply and a plunge in demand thanks to both the recession and efforts across the board to reduce consumption of hydrocarbons.

Beyond the role of oil, there are two clear schools of thought.

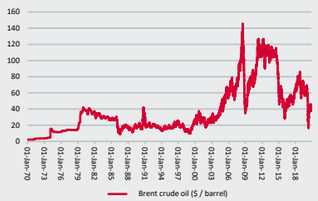
- The pandemic provides further ammunition for the case against inflation and fuel for the case for ongoing disinflation, or even deflation. Increases in unemployment will destroy demand, so the argument goes, and pressure prices as companies scramble for share, especially if they face an onslaught from lower-cost, online-only rivals. Platform propositions across a range of industries continue to drive out inefficiencies and costs, helping users to achieve what they wish more easily and cheaply. Central bank efforts and Government efforts to support the economy are merely pulling forward demand and leaving corporations and consumers alike with debts to repay in the future – a process that will weigh on consumption and capital investment further down the road, to the detriment of growth.
- Adherents of the 'inflation-is-coming' camp assert that governments and central banks are providing support to consumers where it is needed, with the result that demand will hold up fairly well. Instead, the theory goes, it is supply that is being destroyed, through the need to rearrange and onshore global supply chains and the failure of certain companies, or indeed the hollowing out of entire business models. The result is that the same or higher levels of demand will outstrip supply.

The Bunker Hunts came unstuck when they tried to use silver to combat inflation



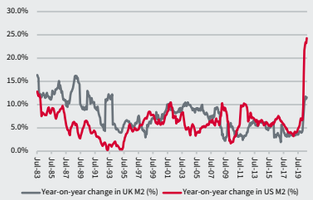
Source: Refinitiv data

Oil is currently helping the case for disinflation, unlike during the 1970s



Source: Refinitiv data

Money supply is surging on both sides of the Atlantic



Source: FRED – St. Louis Federal Reserve database, Refinitiv data

Even if the inflation camp prevails, it is not certain what type of inflation will result. Some measure it simply by price rises, as crudely measured by consumer price indices for selected baskets of goods. Others take the Austrian school approach, which sees inflation as a monetary phenomenon and one where zero-and-negative interest-rate policies, quantitative easing and loose fiscal policy combine to unleash a wave of newly-created money and erode its value.

Time will tell

Only time will tell which thesis prevails, although the deflation camp will just shrug when confronted with the arguments for inflation, noting they have been tried frequently over the past decade, without any great success. That in turn explains why long-duration assets – such as bonds and growth stocks like the FAAANM sextet of Facebook, Alphabet, Amazon, Apple, Netflix and Microsoft – have done so well.

But the corollary of that is that any return of inflation would challenge the dominance of these asset or sub-asset classes. Disinflation's dominance dates back pretty much to the Volcker Fed's move to squash inflation back in the early 1980s. Its retreat in the face of inflation would therefore logically require a totally different strategic portfolio allocation and a move away from fixed income, growth and 'paper' assets to the 'harder' alternatives, such as commodities, precious metals and real estate – a return to the 1970s and the situation which so frightened even the fabulously wealthy Bunker Hunt boys.

It can be argued that the touch paper for inflation is already on show, in the form of galloping money supply growth. But the light is still not evident, for that is velocity of money, not just its supply.

Perhaps, then, a full embrace of Modern Monetary Theory, or universal basic income, or central bank digital currencies (whereby monetary or fiscal largesse are not distributed indirectly through banks and their reserves and loans but directly to consumers or public infrastructure projects and employment) will provide the spark. Advisers and clients must therefore keep an eye on politics as well as economics, and that is what the World Investment Outlook and the AJ Bell Investval are here to help them do, each and every year, even in a different format owing to this year's highly unusual backdrop.

CORPORATE BONDS MAY HELP YOU REDUCE ESG RISKS

Paul Syms, CFA
Head of EMEA ETF Fixed Income Product Management, Invesco

Until quite recently, it was primarily through equities that investors could align their portfolios with their views on environmental, social and governance (ESG) issues. Fortunately for today's investors, the funds industry has evolved to offer a variety of asset class exposures and different approaches, including exchange-traded funds (ETFs) designed to passively follow a growing range of ESG indices. Many of these indices – and therefore the ETFs that track them – combine exclusions with positive screens, with the aim of increasing exposure to companies that are successfully reducing ESG risks.

55%

anticipate the majority of their ESG investments to be in passive funds within the next five years.[1]

ETFs with an ESG-based methodology have seen consistently strong growth over the past two years, with positive inflows even during the most volatile period earlier this year. Thus far, equities have taken the lion's share, but this could start to balance out as fixed income strategies evolve. This could be significant especially for ESG investors who may have 20% or more of their assets invested in bonds. We believe ETFs offer investors an effective way to incorporate these strategies in client portfolios.

Cost is one of the main reasons why many investors choose ETFs over other investment vehicles, while the transparency of the ETF structure means nothing is hidden and the full list of holdings is published daily. That last point can be critical for investors in an ESG product, as it enables them to see precisely what is – and isn't – being invested in, to make sure it doesn't stray from the stated objectives.

Another way to look at transparency is in terms of performance. We all know past performance is no guarantee for future returns, but an ETF provides a clear, easy-to-measure performance objective. Most ETFs are designed with the aim of delivering the performance of a named benchmark.

We recently commissioned a survey[1] of professional investors and discovered that 71% expected to have more invested in ESG funds in the next two years, while 45% said they expected to increase their investments in passive ESG ETFs over this time period. Looking further out, 55% anticipate the majority of their ESG investments to be in passive funds within the next five years.

One of the key requirements highlighted in the survey was for a passive ESG fund to perform similarly to a standard, non-ESG benchmark, especially if they are considering replacing an existing holding to improve the ESG characteristics in their client portfolio. And this is precisely what some, but not all, ESG indices aim to do. The task for bond index houses is made somewhat more difficult by the complexity of those markets, with companies often issuing a variety of bonds, each with a different maturity date, coupon and possibly other features.

While the development process may take longer to complete, the results are often worth the wait. For instance, Bloomberg Barclays created a series of corporate bond ESG indices that aim to deliver similar performance as the standard indices from which they were created, but with significantly improved ESG characteristics. They start out by removing bonds issued by companies involved in tobacco, civilian or military weapons, thermal coal or oil sands, and then reweight the remainder according to their MSCI ESG scores. Those with the highest scores are rewarded with higher weightings in the index, while those with below-average scores have their weightings penalised.

If you are looking to incorporate ESG more completely into your client portfolios, fixed income ETFs can now provide you with the tools to do so – and without having to pay extra.

[1] Survey conducted by Pollright, the research arm of Citigate Dewe Rogerson, from May to July 2020.

VOLATILITY, VALUE VS GROWTH AND THE VIRTUES OF A HEALTHY-MIX PORTFOLIO

Richard Buxton
Head of Strategy, UK Alpha, Jupiter Asset Management

It is not unusual to run into choppy markets in the fourth quarter, and I have to say I am not at all averse to a bit of volatility.

After the dramatic moves we saw in March as COVID-19 took hold, there followed a period of almost one-way travel -- very upward momentum on Wall Street through August. Admittedly, the UK lagged the US and remains out of favour with global investors.

In the US, the tech-heavy NASDAQ, in particular, was overdue for the setback in September after the smooth run since spring, particularly given the mixed economic picture, increasing COVID-19 lockdowns and political manoeuvring here and in the US.

I will not say much about the US election cycle -- given that I am writing this in mid-October, you know more than I do. On Brexit, I am expecting that cooler heads will prevail, and we will get an agreement that avoids the UK leaving on WTO terms.

The other cause of late-year market oscillations in recent years has less to do with current events. Investment banks cut the size of their trading books to get their balance sheets in pristine condition ahead of the end-of-the-year stress tests. It is a little bit like cleaning house before the fastidious in-laws arrive.

As I said, I do not mind a bit of volatility. As a long-term investor you can use it to your advantage. There are stocks we are looking at that if they came down in price sufficiently,

we would consider starting a position, and others we hold where we would look to increase our position.

I am very comfortable with the spread of businesses – the healthy mix of stocks -- that we have in the Merian UK Alpha Fund. It is a high-conviction portfolio of 30-40 large-cap companies, including those that are focused on the domestic market, global businesses, and a mix of growth stocks and value-oriented shares.

We made some changes to the portfolio in April, but it was more nip and tuck than radical surgery. It is not for want of internal and external debate.

I do not feel now is time to abandon value-driven businesses in favour of chasing pure growth stocks. You cannot immediately identify a catalyst for changing the growth-value spread. I am not expecting an early rise in interest rates and bond yields to provide it, but values can get too extreme and can unravel simply because of the eternal dynamics within markets.

The outperformance of growth stocks has not helped the UK, with its heavy exposure to perceived value sectors such as oil, financials and domestic cyclicals, and scarcity of genuine growth stocks or a large technology sector.

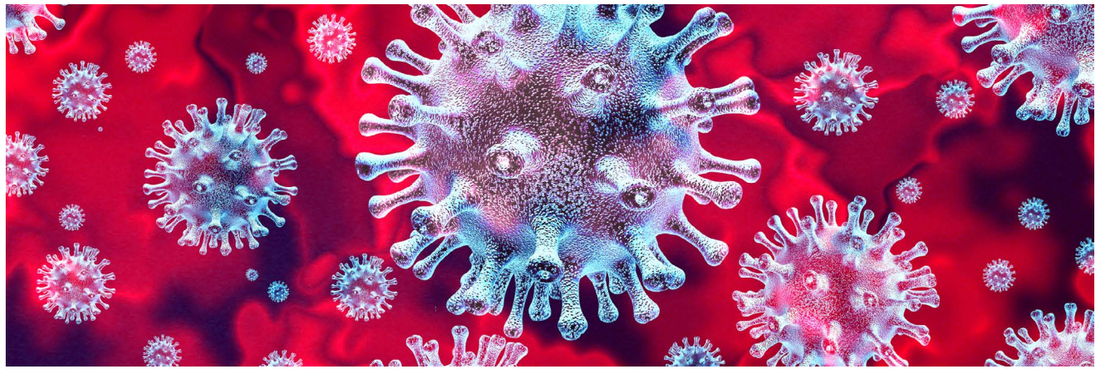
I continue to believe bank shares are viewed too gloomily. Barclays trades at a fraction of its book value, and yet the mood music from banks is quite constructive. Mortgage business margins have been expanding and the heavy provisions they have made reflect economic scenarios that are an awful lot worse than the evidence today would suggest is necessary.

Exposure to some travel-related shares has hindered returns this year but many companies have done the difficult work of adjusting capacity and cutting costs so that they can reach previous levels of margin at much lower levels of revenue. We are closer to a COVID-19 vaccine that would have the potential to provide a big boost.

In lieu of a vaccine, I believe the next best thing for patient, long-term investors is a healthy mix of stocks that can withstand periods of volatility, economic uncertainty and growth-value conundrums.

UK EQUITIES IN NEED OF A VACCINE

Richard Colwell
Head of UK Equities and Portfolio Manager,
Columbia Threadneedle Investments



We have seen something of a recovery in global markets since the pandemic struck,[1] which was unsurprising given the magnitude and speed of action taken by central banks and governments, led by the Federal Reserve. It has been shock and awe, with all records being broken, both fiscal and monetary stimulus – the Fed stimulus alone has reached more than $3 trillion, equalled by US government fiscal stimulus.

But what does all this mean for UK equities? It helps to put the UK market in context. The S&P, led by the mega tech stocks, has clearly rocketed, exhibiting the very pronounced growth versus value trend we have seen in recent years. The surge of mega tech indicates that investors have become fixated on "visions" and growth in pursuit of future-proofing their investments.

This pursuit of future-proofing investments has led to bubble characteristics in the tech sector, which could be kick-started by anything from exogenous-led investor jitters to regulation or anti-trust legislation targeted at the seemingly all-powerful tech entities.

Contrast that with the UK which, as an asset class, has been beleaguered for quite some time. PE yields, price-to-book and performance have returned to levels lower than they have been since the 1970s against the MSCI World index. We are very cheap, even when you strip out energy and banks, and this reflects 20 years of divestment out of the UK asset class, led by pension funds.

We would argue that UK equities are poised to recover strongly – and sooner rather than later. As a value asset class it currently offers some of the best opportunities in distressed shares for a decade. It clearly has many stocks disrupted by Brexit, as well as those sectors impacted by COVID, such as leisure, travel and retail. But going forward we do not want to disregard these troubled areas, we want that optionality in our portfolios alongside the resilience that served us well and kept us out of trouble since the pandemic hit – sectors such as pharmaceuticals and food retail.

On the income front all the focus is on dividends. The dividend cuts we have seen were more brutal than in the last downturn, but we always get a dividend rebasing at the end of each cycle, and we are trying to smooth that through the cycle as we did following the global financial crisis in 2008-09. We are confident that we will be able to mitigate the expected 40-50% drop in UK market dividends and still offer an attractive yield.

The UK market might be the land that time forgot, but the best time to invest can be when it feels most uncomfortable.

[1] 11-week recovery began 23 March to 2 September, as measured by the S&P 500, Bloomberg, 3 September 2020.

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GLOBAL INCOME AND THE CASE FOR INVESTMENT TRUSTS

James Harries
Senior Fund Manager, Troy Asset Management

Troy Asset Management was established by Lord Weinstock of GEC renown, and Sebastian Lyon in 2000 to protect and grow investors' capital - in that order. Troy, having seen the GEC business destroyed in the technology boom, recognised that times of heightened speculation can be catastrophic to wealth preservation if one loses perspective, patience and discipline. At the core of this is to invest without reference to benchmarks but with reference to the underlying quality of the businesses in which you invest and have an absolute return mind set. Capital allocation is a function of seeking to balance quality, growth and income while ensuring adequate diversification and no notion of being "overweight" or "underweight" in any particular sector or company. Once a portfolio is established, turnover should be kept low, recognising that the real money is made in the patient compounding in a settled, quality portfolio and not in the continuous buying and selling of shares. Finally this inherently conservative but quality-focused approach should deliver above average returns with below average volatility over a full market cycle. This is especially important for those with irreplaceable capital and in need of income – two things which often coincide in retirement.

In these disquieting times this approach is more relevant today than ever. Even before COVID-19 appeared, the backdrop was laden with risk to the unwary investor. After years of structurally declining interest rates and rising asset markets we are left with an opportunity set across capital markets (bonds, equity, credit, property and so on) that is fully valued by many historical measures and which implies low returns. This is at a time when several other underlying factors are also reaching historical extremes. These include levels of indebtedness, declines in working age populations owing to demographics and the pace of technological disruption, which are making economic growth and inflation hard to achieve. And now we have COVID-19 which has exacerbated many of these existing trends.

So what are we to do? We believe that investing globally in a portfolio of high quality income bearing equities remains a compelling prospect for investors to meet their needs. But it must be done in a way that recognises and accommodates these distortions and challenges. As a result we are highly selective about the businesses in which we invest in, concentrating on those that demonstrate their quality by having a high return on capital employed. This is derived from identifiable and durable competitive advantages and a business model that does not require large amounts of capital to grow and enables them to both invest adequately in the business to grow as well as pay an income. We want businesses that are well financed and sensibly managed. Such a portfolio should generate consistently growing free cash flow which is what funds both income and capital growth in a predictable way.

The number of businesses that meet these criteria are few which results in a relatively concentrated portfolio. It follows that one should have the widest opportunity set possible which means a global approach makes sense.

We have constructed a resilient portfolio that generates an approximately 6% free cash flow yield funding a 3% income yield which we expect to grow next year and beyond. In this way we are able to meet the needs of our investors and face the future with confidence despite the uncertain outlook.

Having recently been appointed as investment manager of the Securities Trust of Scotland, we will also be discussing the advantages of a closed-ended structure. By following the above approach we aim to re-establish the investment trust as the leading quality global income trust in the UK.

BUSTING THE MYTHS IN FIXED INCOME

Sajiv Vaid
Portfolio Manager, Fidelity International

Myth 1: Negative yields = negative returns

The stock of negative yielding assets has risen aggressively over the last five years and today totals over $14 trillion. Investors are not necessarily buying these bonds for income, but rather capital appreciation. Negative yielding bonds can offer crucial downside protection during risk-off periods and can offer surprisingly positive returns over the longer term.

Myth 2: The only way is up (for yields)

Commentators often suggest that yields can only move higher from here and have cited this repeatedly - and incorrectly - over the last 10 years. We are firm believers in the "lower for longer" view with powerful structural forces keeping rates low and rangebound, namely: ageing populations and rising debt-levels. Moving to an older population drives interest rates lower for two reasons, firstly, with fewer workers available the labour force declines and economic output falls, secondly, as we age, we tend to save more and this excess saving drives the equilibrium interest rate lower. Rising debt-levels make the financial system increasingly sensitive to rises in interest rates and this is apparent when looking at each time central banks have looked to normalise monetary policy over the last 30 years. The coronavirus crisis has only exacerbated these debt issues as governments have piled on record levels of debt to try and stimulate their economies. The implications of this are long term and profound and we see rates remaining firmly low and rangebound.

Myth 3: Fiscal + monetary policy = inflation

Expansionary fiscal and monetary policies have concerned investors about the prospects for rising inflation. We would caution this and point to the last 10 years as evidence that expansionary policy does not translate to rising inflation and that government spending in response to COVID-19 has only plugged a low-demand-driven gap and done little to shift economies into "heating-up" mode associated with rising price-levels. Rather than filtering into the real economy and lifting goods' and services' prices, QE inflated asset prices and we think this time will be similar. Fiscal policy, on the other hand, has a much clearer transmission into real economy, through jobs schemes or direct payments to households, which might prompt investors to think inflation will return via this policy tool. Here, though, additional government spending has simply offset a record fall in demand. Output gaps have widened, and the fiscal response has helped to close these gaps but done little more and economies are still running firmly below full capacity.

Myth 4: Bonds offer little diversification away from risk assets

As bond yields have moved lower commentators have questioned whether fixed income can still offer diversification away from stocks. In response, we know the lower boundary for yields is not zero and one only need to look to the three negative yielding bonds markets we illustrated earlier for evidence that low yields do not translate to lack of diversification away from stocks. We would highlight that bonds proved themselves once again during the latest sell-off period. During Q1 2020, long-dated UK Gilts delivered a total return in excess of 10% (the 7-10 year UK Gilt Index delivered just under 4%), while the FTSE 100 was down almost 24% over the equivalent period. Bonds continue to offer diversification away from stocks and lower yields do not mean this benefit is compromised.

Investment grade sits in the sweet spot

To summarise, negative yielding bonds do not translate to negative returns, bond yields can continue to move lower, inflation is unlikely to return, and bonds continue to offer diversification benefits. With this knowledge, it seems quite clear that bonds are, and will continue to be, an essential tool in a well-diversified portfolio. Bonds offer income, modest volatility and diversification away from stocks. Within the fixed income sphere, high-quality investment grade corporate bonds is where we see the opportunity. Not only do high-quality corporate bonds offer additional yield over government bonds (spread) and cash, but they also offer a more modest risk-profile relative to lower-quality high yields bonds. For income-seeking investors, we see investment grade bonds in the sweet-spot.

This information is for investment professionals only and should not be relied upon by private investors. Past performance is not a reliable indicator of future returns. Investors should note that the views expressed may no longer be current and may have already been acted upon. Changes in currency exchange rates may affect the value of an investment in overseas markets. The value of bonds is influenced by movements in interest rates and bond yields. If interest rates and so bond yields rise, bond prices tend to fall, and vice versa. The price of bonds with a longer lifetime until maturity is generally more sensitive to interest rate movements than those with a shorter lifetime to maturity. The risk of default is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may therefore vary between different government issuers as well as between different corporate issuers. Issued by Financial Administration Services Limited and FIL Pensions Management, authorised and regulated by the Financial Conduct Authority. Fidelity, Fidelity International, the Fidelity International logo and F symbol are trademarks of FIL Limited. UKM1020/32488/SSO/NA

EVOLVING DEVELOPMENTS AND NEXT STEPS IN ARTIFICIAL INTELLIGENCE

Ben Rogoff
Fund Manager, Polar Capital

In the years ahead, we expect artificial intelligence (AI) to increasingly take on the baton from the cloud and smartphone, driving innovation and disruption across multiple industries. AI growth is demonstrated by another record year for M&A and fundraising, with 231 AI-related deals consummated while 2,235 transactions raised $26.6 billion for AI start-ups.

AI continues to advance at an astonishing pace with a major milestone reached in natural language understanding (NLU) when a model from the Google AI Brain team achieved 'superhuman' performance in June 2019. Since then, other teams from the likes of Baidu, Alibaba, Microsoft and Facebook have done the same. In natural language processing (NLP), Microsoft has been working on a transformer-based generative language model (T-NLG) aiming to let machines generate words to complete unfinished sentences based on context, respond to a question with direct answers and summarise an article precisely like humans. To achieve this, its model features 17 billion parameters – to essentially learn from all the text published on the internet – compared to around 26 million used in a typical image-recognition model.

Microsoft's model has already surpassed human performance, achieving 98% grammatical correctness and 96% factual correctness. The implications are profound: today, the relative scarcity and cost of collecting data required to train machines is preventing wider adoption of real-time analytics. However, transformer-based models have the potential to transform multiple industries.

Significant progress has also been made using AI to solve complex games building on DeepMind's AlphaGo victory over Lee Sodol in 2016. Playing poker, Plurius, an AI engine designed by Carnegie Mellon and Facebook, beat 12 professional players over more than 10,000 hands. By playing millions of hands of poker against copies of itself, Plurius was able to use a limited look-ahead algorithm, rather than playing to the end through decision trees. This allowed it to 'solve' for poker in just eight days using a single 64-core server and just 28 cores during live play – remarkable when you consider DeepMind's AlphaGo victory used 1,920 CPUs and 280 GPUs. In October, Google-owned DeepMind's StarCraft 2 AI reached grandmaster status in a real-time strategy game, besting 99.8% of humans. It was trained by watching videos of professionals, then from simulated gameplay against itself over 44 days, equivalent to 200 human years playing the game.

More recently, NVIDIA has used a generative adversarial network (GAN) to recreate PAC-MAN without an underlying game engine. Rather than relying on actual gameplay, two competing neural networks instead created 50,000 episodes of content convincing enough to pass for the original, allowing the AI to learn the rules of the game.

However, there is still much work to do. In the case of PAC-MAN, the neutral networks trained themselves incorrectly, with ghosts closely trailing, rather than making contact with, the titular protagonist. More worryingly, GANs have been exploited to create 'deepfakes' seen on social media where faces have been transposed or voices transformed to give the impression that someone did or said something they did not. Last year, Nancy Pelosi was the target of a deepfake with her speech appearing slow and slurred in a video shown on Facebook, leading Rudy Guiliani to question her mental state. This issue is so serious that several US states have passed laws banning the use of deepfakes to interfere with elections.

Despite these – and other – challenges, we are comforted by the fact that controversy often accompanies the rapid diffusion of new technologies and that, in time, appropriate governance will be established to facilitate the rapid and healthy development of AI, one of the most powerful technologies in decades.

FINDING THE FAANGS OF THE FUTURE

Robin Geffen
Head of Liontrust Global Equity, Liontrust

Everyone's reliance on technology has become even greater during the COVID-19 pandemic this year, especially during the periods of lockdown. Whether it is communicating for work or in our personal lives, securing deliveries, paying for shopping or for home entertainment, technology has become even more essential.

It is not surprising, therefore, that technology has been one sector that in aggregate has not only withstood the economic downturn since March but has thrived. The famous FAANG stocks – Facebook, Amazon, Apple, Netflix and Alphabet (Google) – have been the biggest drivers of stock markets both in the US and globally in recent years.

The question facing investors is how much of an allocation do they continue to make to these mega caps and whether now is the time to also focus on global small caps and trying to find the next FAANG; can investors discover the 2020 equivalent of Amazon in 2000 when one of its shares was worth $2 or less? We believe there are a number of reasons why investors should consider global small caps.

The first is because of the growing valuation gap between large and small caps, which has left the latter relatively cheap in our view. This is because global small caps have underperformed large and mid caps in 2018, 2019 and since the start of 2020. Over the past four years, the MSCI Large Cap World Index has returned 51.70% whereas the MSCI Small Cap Index is only up 28.89% to 30 September 2020. The current calendar year has so far been the worst relative performance for global small caps since 2004.

This is counter to the trend of the past 20 years, however. Since the start of 2001, the MSCI World Small Cap Index has returned 460.63% against 230.68% by the MSCI AC World Index. We believe the underperformance of the past three and a half years has presented buying opportunities among global smaller companies on valuation grounds. This is enhanced by the fact that global small caps have relatively few followers among brokers and therefore are often underappreciated.

Another attraction is the fact that smaller companies lead economic recoveries, including following the Global Financial Crisis, and we have no reason to believe it will be different this time when the world finally moves beyond COVID-19. The unprecedented technological change we have been experiencing during the pandemic creates the chance for investors to find the future FAANGs.

Software is a favoured sub-sector for us. Software products have been uniquely positioned in the pandemic in that they have served mission critical functions for businesses to continue to operate.

A great example of this in the communications software sub-sector is one of the long-time holdings in our Liontrust Global Smaller Companies Fund – RingCentral. The company has been thriving off a trend to shift processes to the cloud and avoid unnecessary equipment capex by allowing employees to use their own, more familiar, devices for work purposes. The outlook for the company pre-COVID-19 was significantly boosted after the company announced a partnership deal with Avaya.

Another long-term holding is Twilio, which provides a communications API platform for software developers. If you've received a text, call or email from a company through an app or webpage, it is likely that it used a Twilio plug-in solution. With the rising need for an online/virtual presence for all businesses, Twilio stands to benefit by providing the necessary tools that developers need to be able to provide this service.

We believe global small caps are also worth considering now because of their relatively cheap valuations, the fact that far fewer brokers follow them than mid and large caps and their potential for economic growth as we come out of this crisis.

COMBATTING CLIMATE CHANGE - ACTIVELY INVESTING IN THE TRANSITION TO A LOW CARBON ECONOMY

Ben Constable-Maxwell
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Whether it's the rising number and intensity of hurricanes or floods, forest fires or droughts, it is increasingly untenable to ignore the causes and consequences of climate change.

Arguably there is no more critical challenge facing global society. The effects of global temperatures rising to 1.5 degrees Celsius above pre-industrial levels, as projected by the International Panel on Climate Change, are severe. At two degrees, the impact looks grave.

It is not only the health of our planet at risk from rising carbon emissions, but also our financial wellbeing. Despite the scale of the challenge, I am buoyed by the contribution that investors can make.

The power of persuasion

Active investors like M&G have long held company management to account on corporate strategy and governance. In the same way, we can hold feet to the fire on climate change.

Companies need to properly understand the risks, and I believe it is the role of responsible investors to persuade their management to make positive changes. Frank discussion about the risks that climate change poses to a company – for instance, if rising sea levels might inundate its coastal assets – can shape opinions and strategy.

Disclosure of climate risks is important. The Taskforce for Climate-related Financial Disclosures (TCFD) has developed a framework for consistent climate-related financial risk disclosures, upgrading the importance of climate reporting by requiring its integration within financial accounts.

Ambitious targets and metrics can help ensure companies make tangible progress towards mitigating risks. Another vital step is linking executive remuneration to climate-related goals. Rewarding progress and aligning incentives makes them more likely to be achieved.

Shaping a sustainable transition

I believe the transition to a lower carbon economy will be more effective if incumbent companies are coaxed into playing an active part.

Their scale means they are well-placed to deliver a positive impact. For instance, if a global car maker can halve carbon emitted from the 10 million vehicles it makes a year, its environmental benefits could far outweigh those of a manufacturer of 1,000 zero-emission cars a year.

Leading companies which spearhead and mainstream sustainability in their sectors can deliver terrific impact. Take Ørsted, for example. The Danish energy company is at the forefront of society's transformation towards renewables, having once been a fossil fuel-focused business. Today, Ørsted has built more offshore wind farms than any company worldwide and has committed to being coal-free by 2023, when it will have reduced its carbon emissions by 96% compared to a decade ago.

Keeping up the pressure

While the shift away from a carbon-intensive economy may appear incremental, I am confident that we are on the cusp of companies accelerating their progress, spurred by legislative, normative and economic pressure.

Investors are right to support companies that take steps towards combatting climate change, but it is also right to expect material progress.

The threat of divestment can be an effective one, but it is no panacea. Exerting pressure alongside other shareholders on companies to decarbonise can be a more powerful tool.

Investors with more than US $34 trillion in assets under management have signed up to the Climate Action 100+ initiative to ensure the world's largest corporate greenhouse gas emitters take action on climate change.

The environmental risks of climate inaction are evident. Where companies do not act, they will not only expose themselves – and their investors – to financial losses, but they will miss opportunities for success that lie in tackling this challenge.

CH-CH-CH-CH-CHANGES… ASSET MANAGERS, IT'S TIME TO FACE THE CHANGE

Ryan Hughes
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As the famous quote goes, "Timing is everything", and with everything happening in the world right now, I'm acutely aware that making predictions about financial markets is about as reliable as an election poll. I'm writing this the day after Pfizer announced a breakthrough in the hunt for a COVID-19 vaccine and it's fair to say things feel remarkably different to how they did just a few days ago. So, rather than make some big predictions about what's going to happen in financial markets and look horribly wrong as events change in the short term, instead I'll look at some of the big issues facing the asset management industry and how these might pan out into 2021 and beyond.

In the world of asset management, 2020 has definitely been one of consolidation, with active managers seeking refuge in each other's arms as cost pressures continue to squeeze their margins. The purchase of Eaton Vance by Morgan Stanley to create a $1.2 trillion asset manager and Franklin's purchase of Legg Mason to create a $1.5 trillion rival are certainly eye-catching but, closer to home, Jupiter has bought Merian, Liontrust has bought Neptune and Architas while Premier has merged with Miton, plus there have been many more. According to the Investment Association, the last 12 months has seen the highest amount of asset management M&A for a decade but it feels like there is further to go, as the main reasons why this is happening haven't gone away. The reality is that passive investing has seen significant growth in popularity and has eaten into the high profit margins of asset managers, and the response has been to try and take costs out of the businesses through consolidation.

With a wave of consolidation of asset managers should hopefully come a wave of consolidation of funds, but there has been little sign of that so far. It's now just about 12 months since the introduction of the Value Assessments, which the FCA hopes will prompt better outcomes for investors and encourage asset managers to more proactively manage their fund ranges. Perhaps unsurprisingly, the first year of these new documents has seen little change, but then that was always likely to be the case. In reality, it will be much harder for asset managers to claim their funds represent value for money in years two and three if they are persistent underperformers against a style-appropriate benchmark. At that point, the FCA will be expecting to see a clear action plan and will rightly question the new independent directors about how they will drive value for investors. So 2021 could be an interesting year when we finally start seeing poorly-performing funds and those that have been sub-scale for a number of years being put out of their misery.

Some of those funds that have been struggling from a performance perspective have been those with a heavy bias towards value investing and, in some cases, the fund managers have paid with their jobs. In a world where investors and the media seemingly want a straightforward narrative that outperformance must mean you are a good manager and underperformance must mean you are bad, the nuances of what drives investment performance often gets lost. I'm a strong believer in style biases and see it as vital to understanding the inherent style of any active manager, as without that you don't have a suitable frame of reference to understand what 'good' and 'bad' performance genuinely looks like. As I write this piece, 'value' stocks have just had one of their best days ever on news of a potential vaccine, having lagged growth companies for the last few years. If we look back in history, we have seen periods when value investing has been winning and growth has lagged. The market is never static, and understanding the relationship between style and market performance remains as important today as it ever has been. While I'm not using this piece to call the end of the underperformance of value investing, it's clear that valuations have reached extreme levels and those funds that win in 2021 could be very different to those that won in 2020.

One of those losing strategies in 2020 has been property, with the open-ended physical funds being suspended in March and only a few reopening at the time of writing. As a result, much of 2020 has been focused on liquidity, not least with the FCA proposing that open-ended property funds should have a notice period for redemptions of between 90 and 180 days. Understandably, this has caused much consternation among

the property asset managers who observe that this will potentially make open-ended physical property funds uninvestable. While this may be the case, there can be no getting away from the fact that telling investors they can't have their own money back when they want it for their own protection fundamentally undermines investor confidence in the asset management industry. I've spoken about this issue for much of 2020 and agree with the FCA's approach; should these rules come into place in 2021, it will represent a significant move away from the notion that daily dealing is the default option for every asset class. While it may not be popular, among asset managers at least, the FCA is taking decisive action and maybe it won't just be property funds that look at moving away from daily dealing over the next 12 months.

The final area to address for 2021 is the exponential rise of ESG as a theme. Not a presentation now goes by without an asset manager talking about their commitment to ESG and it's great to see this concept that has been around for many years becoming mainstream. I think we'd like to hope that the governance element of this has been firmly embedded in investment processes for many years but the environmental and social elements have further to go. The COVID-19 crisis has shown that companies in almost any industry can and do have an impact on society and it was encouraging to see so many companies try and do their bit for society in how they responded to the global pandemic. In many respects, it feels like this has accelerated the trend that was already happening and we should all welcome a world where companies are more aware on the impact they have on the world they operate in. The vast majority of asset managers are only at the very start of their journey when it comes to ESG and I'm sure this will continue to develop at pace in 2021.

In summary, 2020 has been a year of change for asset managers but many of the major trends we have seen this year will persist in the 12 months ahead. Consolidation, value assessments, liquidity, ESG and numerous other factors are reshaping the asset management landscape, and only those asset managers prepared to embrace these changes will survive to tell the tale.

THE LAST WORD

Kevin Doran
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Congratulations! You made it this far and all the way to the end. In a year like 2020, that's no mean feat and so you're either bored or have a thirst for investment content from a wide range of sources. Either way, we hope you've enjoyed this year's World Investment Outlook (WIO).

When we were penning this 12 months ago, words like 'COVID', 'lockdown' and 'furlough' didn't exist in our lexicon, whereas today they're thrown around like confetti. It goes to show just how unpredictable the world can be, especially in a short space of time.

As investors, to get through years like 2020, it's often useful to have some sound maxims to fall back on in uncertain times. 'Keep your portfolio diverse' is a great one to have and – more than ever – 'be sure you're investing for the long term'.

That's why this year, the WIO covers everything from equity to bonds; open- to closed-ended funds; UK to international; and technology to base metals. Keep it diverse, invest for the long term and make sure you're beating inflation by a bit, and the laws of compounding and monetary policy will do the heavy lifting for you.

Or will they? Another phrase that's slipped into the phrasebook this year is 'the new normal' – shorthand for contrasting now with a pre-2020 world that we'll never see again post-pandemic. But does this apply to the world of investing?

The advocates of a new normal for investors will talk of negative interest rates, modern monetary theories and long-term global declines. It's certainly the world that bond investors see ahead of us, as yields on Government bonds are practically zero for as far as the eye can see, but is it consistent with equity markets?

Not at all, and this is where it gets tricky, since for equity markets to justify their valuations (even after the declines of 2020), there has to be a future where revenues, profits and hence shareholder returns all head on a higher trajectory. So who's got it right?

Well, let's start with the basics. Any economy, no matter where you are in the world, grows due to two things, and two things only. Population growth and productivity gains. Or, in other words, production increases because there's more of us and/or we get better at producing 'stuff'.

Right now, there's a touch under 8 billion people on the planet. According to UN estimates, we'll be closing in on 10 billion by the time 2050 comes around, which equates to roughly 1% growth year on year (despite a global pandemic). So, population growth is a given.

And if there's one thing you can say about humans, we're one hell of a resourceful species. Take the response to the COVID-threat as a great example. Unknown novel virus? Pah! We see your virus and raise you a vaccine. Thanks to the advances of science and technology Ben talked about in his article, you can take productivity growth as a given for the future as well.

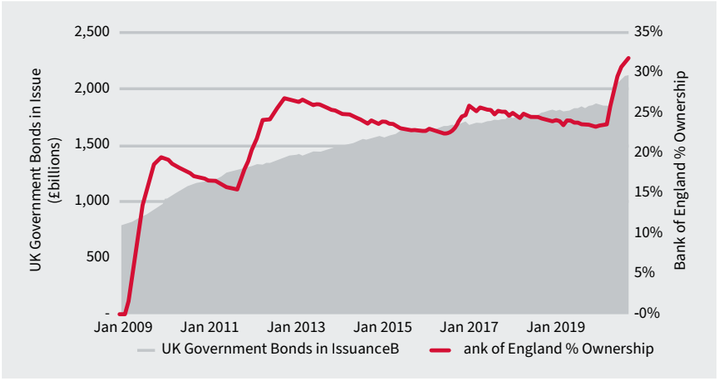
And so, what is it that explains the difference between the outlooks of bond and equity investors? The answer lies not in this crisis, but the last, when the world faced a financial virus that threatened to contaminate the banking system, to which the central bankers rolled out their own medicine in the form of quantitative easing (or QE).

The results of that vaccination have been stark, and not without their consequences. Just as Russ talked about the infamous Bunker Hunt brothers who attempted to corner the silver market in the 1980s by buying up all the shiny metal they could lay their hands on, central banks have effectively cornered the Government bond markets since 2010 through the printing of money and the purchasing of Government debt.

Ultimately, the Bunker Hunt failed in their ploy to push silver prices to unsustainable levels, declaring themselves bankrupt in 1988, and being convicted of market manipulation a year later. The only flaw in their plan was they didn't have a state sponsor and access to a printing press, unlike the central banks of today.

And so, as we look into the future, it's always best to do these things with an eye on history. For all the talk of 'new normals' and 'unprecedented' situations, a wander through early

18th century France tells us the story of John Laws, who convinced the French Regent, the Duke of Orleans, to switch the nation to paper money, provide Government assurances that the new money would be backed by future taxation, form a central bank to administer the process and turn on the printing presses. The result? A booming French economy, a rise in stock markets (the Mississippi Stock Company went up 20x) and the funding of state projects in both France and the newly-colonised territories of what is now Canada and the US.



Of course, that didn't last forever, and eventually the inflationary effects of the ploy caught up with the French, but for a period from 1716–1720, France was awash with riches, the people were happy and the Duke of Orleans repaid the National debt.

Which brings us to today. Back in 2015, during the Labour Party leadership campaign, the relatively unknown Mr Jeremy Corbyn and his economic sidekick, John McDonnell, proposed a policy known as 'People's QE', which involved the printing of money to fund Government projects such as housebuilding, railway extensions and hospital rollouts via a newly formed National Investment Bank. Sound familiar?

Five years ago, the world wasn't ready for that plan, but five years ago the world wasn't recovering from a global pandemic and wasn't led by populist governments with an arsenal of three-word slogans. Five years ago, central banks still had a modicum of independence. Be sure to watch this space.

No matter what the future holds, what we can be sure of is this: as populations and productivity grow, so too will economies. With money printing comes inflation (either in asset prices or shop prices) and thinking long term, being diverse and keeping your costs down when investing will still be a winning strategy. Be sure to check out the AJ Bell range of funds if you like the sound of that.

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