SARANAC
PARTNERS

Investment Committee Update

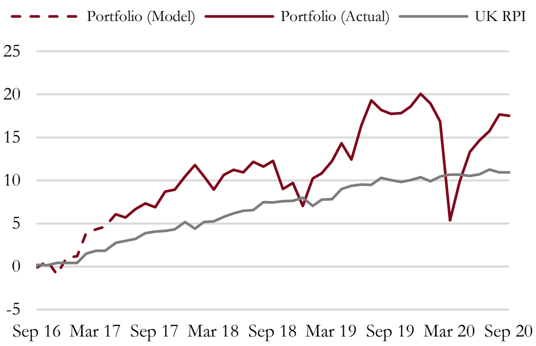
October 2020

AT A GLANCE

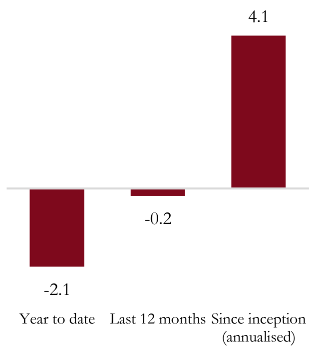
- During September, the multi-asset sterling moderate risk portfolio was broadly flat, leaving the portfolio return at -0.25% for the year.
- A negative contribution from developed market equities as markets corrected was balanced by positive returns in the fixed income portfolio.
- Furthermore, hedge funds and emerging market equities in general had a positive month.
- This month we have continued to add specific equity positions to the portfolio, with strong company specific stories. They include TJX (a pre-eminent off-price retailer), BMW (the European auto manufacturer) and Fanuc (a Japanese robot manufacturer).
- Further restructuring of the fixed income portfolio occurred in recent weeks as we shortened duration and raised the credit risk.
- We took profits in 10-year AA corporate bonds and rotated the proceeds into 5- to 7-year maturity BBB and BB+ securities. We also increased our exposure to subordinated financial debt.
- With respect to alternatives, we have now sold out of the remaining portion of the LFIS hedge fund and are investigating strategies focused on volatility and market-neutral equity exposure.

Figure 1: Multi-asset strategy (sterling moderate risk)

Performance (%)



Periodic returns (%)



Monthly returns (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2016									-0.1	0.7	-1.6	1.9	1.0
2017	0.2	2.6	0.4	0.3	1.4	-0.4	0.9	0.6	-0.4	1.7	0.2	1.4	9.4
2018	1.2	-1.2	-1.4	1.5	0.6	-0.3	1.1	-0.5	0.6	-2.9	0.6	-2.4	-3.1
2019	3.0	0.5	1.3	1.8	-1.7	3.5	2.5	-1.0	-0.4	0.1	0.7	1.2	12.2
2020	-1.0	-1.7	-9.8	4.3	3.2	1.2	0.9	1.7	-0.1				-2.1

Source: Saranac Partners.
Performance figures from inception (28 September 2016) are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees.

PORTFOLIO PERFORMANCE

During September, the multi-asset sterling moderate risk portfolio was broadly flat, leaving the portfolio return at -2% for the year.

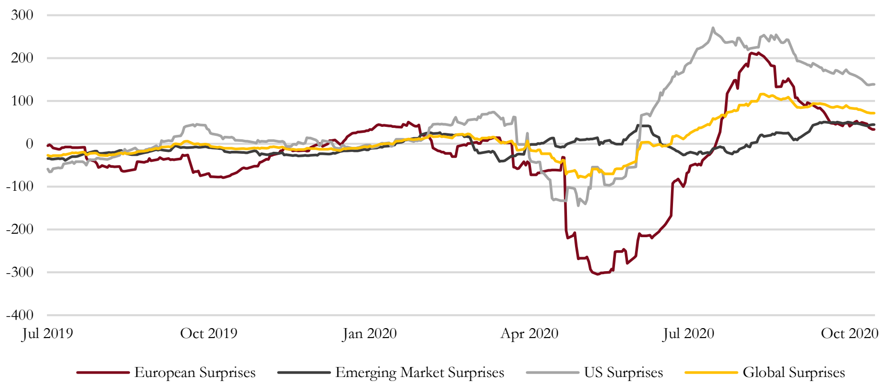
Equity markets experienced their first meaningful correction since June as the US, and to a lesser extent Europe, gave back some of the extraordinary gains of August.

This pullback relieved some of the more excessive sentiment and momentum indicators that had reached stretched levels by the end of August.

However, while equity positions were a negative contributor to performance during the month, our fixed income holdings benefited from a drop in government bond yields and generated positive returns to partially offset those equity losses.

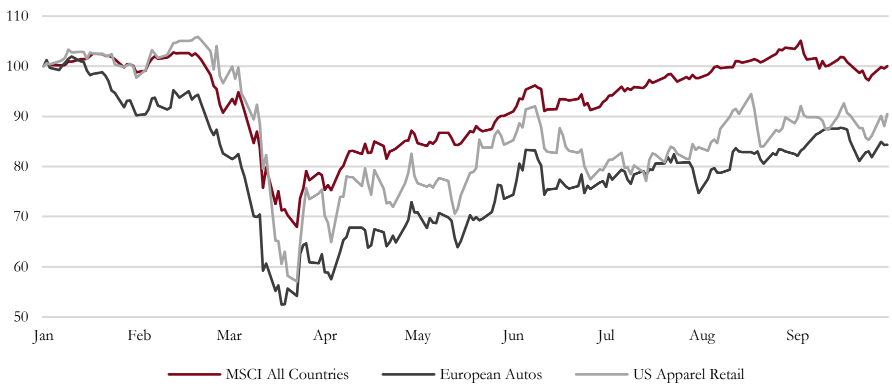
Hedge funds, in general, had a positive month, as did emerging market equities, such that the end result was a month in which returns were broadly balanced.

Figure 2: Citigroup economic surprise index
After a very strong rebound in economic activity and positive surprises from May, US and European economic data has now rolled over and lost momentum.



Source: Saranac Partners.

Figure 3: Relative performance vs global markets
The bounce back in European auto share prices and US retailers has lagged global markets this year. A broader economic recovery in 2021 should see these sectors play catch-up.



Source: Saranac Partners.

MARKET PERSPECTIVES

Macro environment

Last month, we noted that the surge in equity prices, which at the global level occurred predominantly in the second quarter, had levelled off, as some key supports for risk assets had faded. The rebound in global growth has clearly moderated and in the US and Europe there are signs that this recovery is stalling out.

Covid-19 cases are increasing across much of the developed world and lockdown restrictions are tightening across wider areas of Europe as governments struggle to contain the acceleration in cases. These restrictions on movement and social activity will inevitably diminish economic growth in Q4. Indeed, we are already seeing the PMI surveys show manufacturing level off in key European countries, while the services sector has slipped back into contraction territory.

Furthermore, it is seems unlikely that the US administration and Congress will be able to agree an extension to the CARES Act and provide further stimulus to the hardest-hit areas of the US economy, a failure that raises the risk of Q4 economic growth reversing again. The Citigroup Economic Surprise index has enjoyed a remarkably strong run since May, but these positive surprises have faded away since August, in both the US and Europe.

At the same time, some event risks are coming into view: the US election may be less disruptive in the event of a Biden victory compared to a close call, but the latter risk has not dissipated. A protracted legal battle as to who has secured the most votes, both popular and in terms of the Electoral College, would be unsettling for markets.

Second, Brexit looms – deadlines continue to come and go and markets seem to be sanguine as to some kind of deal being signed, but time is running out.

However, to the upside the potential for better news on a vaccine over the next six months is improving and could prove an important catalyst for a broadening out of positive market sentiment.

ASSET ALLOCATION

Equities

As we have made clear, in recent months we have felt that the equity weight was somewhat lower than where we wanted it to be. While we have increased this slightly through individual stock purchases (such as Las Vegas Sands and Crown Holdings), there is still a little way to go.

The current equity portfolio, which has performed well in recent months, includes a number of very strong performers, and we do not wish to rely solely on continuing strong outturns in these areas to sustain this outperformance.

The names we have added to the portfolio, listed below, have strong company-specific stories, which we would expect to perform even in an environment of subdued growth. But they also very much fit into the thesis that the ‘reopening’ of the global economy, most likely as a result of the wider availability of some kind of Covid-19 vaccine, will see some sectors of the market play ‘catch-up’ with the broader indices, having suffered more significant contractions this year. We continue to avoid the ‘value-trap’ sectors such as financials and energy, and also the very expensive momentum-driven elements in the IT sector and beyond.

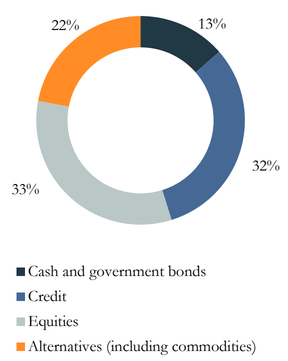
TJX – we know the company as TK Maxx over here, but it's called TJ Maxx in the US. This pre-eminent off-price retailer is a clear beneficiary of improved footfall and customer visits once social distancing restrictions ease and people are confident to get out and shop again. Given its low average price point, TJX would also be well placed to pick up additional sales from consumers looking to trade down in an economically challenged period.

BMW – no introduction necessary, the auto manufacturer has committed to dropping headcount from around 134,000 today to less than 120,000, the same level as 2014, which should drive meaningful operational margin expansion. The company is also planning to fully consolidate its China joint venture, which will be very accretive to both earnings and free cash flow. Higher-level arguments about our changing relationship with cars as people move out of cities and into the suburbs may also create a demand tailwind for the luxury end of the auto market. BMW is also better placed than all other European car makers (other than Peugeot) in terms of meeting emission standards.

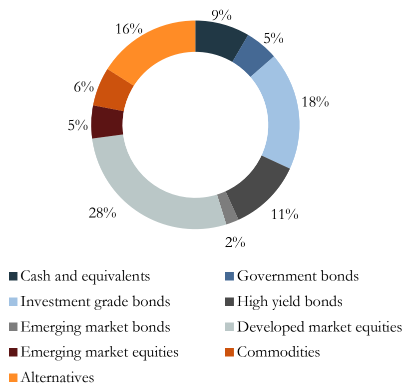
Fanuc – this Japanese robot manufacturer is best placed to take advantage of the increasing shift to the use of robotics and 'cobotics' (robots in tandem with human labour) in efforts to drive down costs. Much has been written about the possibility of more regional supply chains being built to reduce dependence on China as a result of this pandemic, as well as deteriorating US–Sino relations, and such a trend would be a major demand boost. After a period of above-average capital expenditure, investment should moderate and lift free cash flow generation and margins.

Figure 4: Multi-asset strategy (sterling moderate risk)

Asset allocation (%)



Detailed asset allocation (%)



Source: Saranac Partners.

Fixed income

We have been restructuring the fixed income portfolio in recent weeks, moving to lower the duration of the portfolio (reducing the sensitivity to inflation and long term interest rates) and raising the credit risk of our fixed income holdings. We see the additional yield offered by riskier credits within investment grade more attractive now.

We have cut the exposure to TIPS (inflation-linked US Treasuries) as inflation expectations look to have peaked in the near term and took profits in long-dated, AA-rated corporate bonds that had performed well this year.

We have reinvested the proceeds into a number of individual credits rated BBB or BB+, where yields are more attractive despite the maturities being shorter. In addition, we have initiated a position in an ETF that tracks deeply subordinated financial bonds, another area we think has value as bank balance sheets remain well capitalised.

Alternatives

We chose to sell out of the remaining portion of the LFIS hedge fund still held in portfolios after a modest recovery of some of the losses from Q1. We have also now exited from our pure CTA strategy. Having added a credit long/short fund earlier in the summer, we are now in discussions to add a niche market-neutral equity strategy to portfolios and continue to look for strategies to diversify returns that cannot be replicated anywhere in the portfolio.

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