News & Views

Q1 | 2018

Time flies

Our predictions for the year ahead

ALSO IN THIS ISSUE:

Our new confidence tracker

Jeremy Corbyn: menace or messiah?

Technology in emerging markets

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Welcome

2017 was an exciting year for Canaccord Genuity Wealth Management (CGWM) – particularly as we announced our acquisition of top independent wealth management company Hargreave Hale. Now we are focusing our efforts on a smooth integration, leveraging the expertise in both businesses to extend our services for our mutual clients' benefit. There is still much work to do, although I am pleased with the progress already made.

2017 also proved to be another year of solid investment returns across our client portfolios and largely as we predicted when we considered the key investment themes at the beginning of the year. Despite uncertainties at the end of 2016, we believed 2017 would prove to be a lucrative and stable year and this stood us in good stead, ensuring that our positioning was not overly defensive in what ultimately proved to be a supportive investment landscape. Justin Oliver, our Deputy Chief Investment Officer, Offshore, provides more details on page 8 in '2017 – the year of the expected'.

Will we get it right again in 2018? With their forecasting reputation intact, our Chief Investment Office (CIO) is now predicting the key investment themes for 2018. In contrast to many bearish commentators who are disconcerted by high valuations, our Chief Investment Officer, Michel Perera remains watchful but bullish – basing his outlook for markets on the fundamental economic indicators instead. He believes increasing volatility and lower asset class correlation in the year ahead will provide a number of investment opportunities for the clients of active investment managers like us at Canaccord Genuity Wealth Management.

With this in mind, our overriding message in this edition of News & Views is one of investment opportunity. Covering a wide range of important topics, from whether or not we should be invested in artificial intelligence to why it is important to have exposure to smaller companies, this year's key investment themes reflect our positive mood and are discussed fully in this edition. There will always be surprises and 'unknown unknowns' in any given year (see page 28) and it is our job to prepare for the unexpected and look for investment opportunities no matter what the economic backdrop.

Whilst thinking about the year ahead and your long-term wealth more broadly, you may be interested to try our new online tool and calculator (see page 4). By answering a series of questions about your current arrangements and future expectations you can see how well you are financially equipped for the future. It may motivate you to address some of those areas where you feel you could benefit from some expert advice to improve your long-term prosperity.

We hope you enjoy reading this edition of News & Views. As ever, if you have any feedback on the articles we have included or if there is a particular subject you would like us to cover in future editions, please let us know. From all of us at Canaccord Genuity Wealth Management, we wish you a very happy and prosperous New Year.

David Esfandi, Chief Executive Officer, CGWM

**Duncan Stratford,
Head of UK Front Office**

Confident and in control

Canaccord Genuity Wealth Management is now among the UK's top 10 independent wealth managers (measured by assets under management, administration and management contract). Duncan Stratford, Head of UK Front Office, looks at how this is helping to boost our clients' financial confidence.

At CGWM, our clients' needs are at the heart of everything we do. Becoming one of the UK's largest wealth managers has given us extra resources to support this, as it has enabled us to invest in new technology to meet your needs and exceed your expectations.

Building your financial confidence

We recently commissioned a YouGov 'wealth confidence tracker' study*. The results showed that most relatively well-off people feel confident they have the right wealth management strategy to meet their future needs, but are less confident about their standard of living in retirement and how the next generation will manage.

We believe it's vital for you to know where your own confidence is lacking, and get the extra power and knowledge you need to improve it. So, to help you gauge your confidence in your financial future, we've developed a completely new online tool. And to help you take control, we're upgrading Wealth Online, our client account management portal.

Introducing our unique wealth confidence builder

This free online tool poses simple questions about your current arrangements and future expectations – like how you'd like to live once you retire, how you might fund long-term care and how inheritance tax might affect your heirs.

Your answers generate your 'personal confidence score', showing how well you're financially equipped for the future. You can also ask for a personal wealth confidence report, giving you tailored insights and information. And of course, for further specialist advice, just contact your CGWM Investment Manager.

According to David Goodfellow, Head of UK Financial Planning, *"The wealth confidence builder shows clients where they still have concerns about their financial future. This knowledge often inspires them to rethink their arrangements. They can then call on our expertise to help restore their confidence."*

Try it for yourself at canaccordgenuity.com/wealth-management-uk/confidence-builder.

Our new, improved online portal

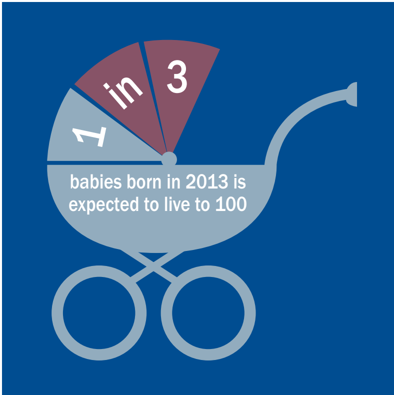
Our study* showed that feeling in control of their own wealth was one of the leading factors giving people confidence that their investments were being well managed. So we're doing all we can to help you stay in control and access the latest information about your portfolios.

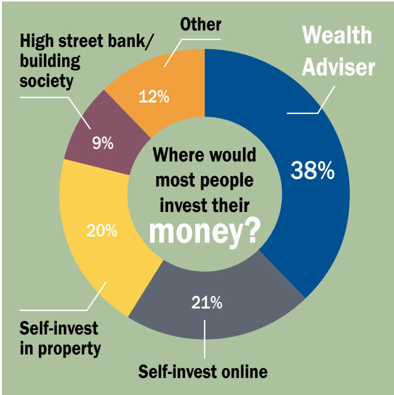
We're currently developing a more effective replacement for Wealth Online, where you and your financial adviser can monitor your account. The new facility will be available via an Apple or Google app as well as online, making it easy to access information whenever you want.

It will also provide much more detail. For example, you can check on individual holdings within your portfolio, or see how much exposure you have to a specific asset across all your investments. You can also view documents through a new portal that will be inherently more secure than email. It will collate all your documents in one place, so you won't need to request a copy from your Investment Manager.

As soon as you can register for this exciting new upgrade, we'll let you know.

*Total sample size was 1,035 adults, of which 541 have £750,000 or more in investable assets (HNWIs), 268 are workers with an income of £100,000 or more and investable assets of less than £750,000 (HENRYs) and 257 are aged 18-34 and earn £40,000 to £99,999 (millennials). Fieldwork was undertaken between 30 August – 8 September 2017. The survey was carried out online.





Generate your wealth confidence rating

To start with, please consider the five statements below. They're designed to help you think about your financial future and will generate your current wealth confidence rating. Then you'll need 5-10 minutes to complete the remaining 5 steps.

	Statement	Answer
1	Overall, how confident do you feel about your financial future?	Quite confident
2	Do you think you will have a better or worse standard of living when you're in retirement than you do now?	A slightly better standard of liv
3	Generally speaking, do you think future generations will enjoy a better standard of living than you have had or will it be roughly the same?	A slightly worse standard of liv
4	How confident are you that your wealth is being managed effectively to give you sustainable returns?	Quite confident
5	Thinking about the money you currently have invested through a bank, building society or wealth adviser, how confident are you that you could do a better job at managing your money?	Not very confident

You are: **Quite confident**

Now build on your confidence rating with our 5 steps

No matter how confident you feel about your financial future today, our research shows there are some areas of concern that almost everyone shares. The following steps look at each of these in turn so you can think about them more specifically.

Save and continue

Michel Perera,
Chief Investment Officer

Predicting the future

Key investment trends for 2018

Another year has passed and we are pleased to predict our new themes for 2018. First, though, we check on what we did in 2017: we go through last year's themes and give ourselves a scorecard.

As you can read in Justin Oliver's article on the following pages, we were pretty successful in our forecasts and how we implemented the ideas in our portfolios. Here we offer you our next set of themes, in the hope that they will be of interest to you.

Has the world changed much in one year? Well, there are some long-term themes that we need to dig into again, such as inflation. It is ultimately the key to many investment decisions in this world of low interest rates and we cannot be complacent about understanding its causes, path and impact. We look at the debate between the inflation hawks and doves and give you our balanced view.

The changes start to creep up on us when we look at UK politics and how investors may benefit or suffer from the effects. We try to be as dispassionate as possible, but it is undeniable that our clients' wealth will be affected by the final outcome of Brexit and the survival (or not) of the current government. We look at the likelihood of a Corbyn government and the impact on the markets.

More broadly, we look at how investment markets are evolving, and we pick up on three new themes. Disruption can affect every business and no trend is being viewed as more of a disruptor than artificial intelligence (AI). We analyse whether there is a difference between the industrial reality and the stock market returns. The disruptors may not always be in the countries where you expect them and we may surprise you by looking at technology pearls in emerging markets.

Closer to home, we revive the old 'small cap vs. large cap' debate, with the additional twist of the currency in the UK. Our conclusion? Having a good proportion of small cap stocks in your portfolio is generally good for your wealth.

Many individual and institutional investors have given up on stock picking altogether and embraced the passive route to equities. Does this really make sense? Are they throwing the baby out with the bathwater? We conclude that it is too early to read the obituary for active fund managers.

Undaunted by the prospect of forecasting the future, we go one step further and predict the surprises that this year might bring. One thing is certain: there will be surprises. The question is whether investors will be caught napping by them. We hope to prepare you for at least some of them. Interestingly, some are positive, but others could challenge your current lifestyle as well as your investments.

We look forward to another year of advising you on your investments and managing your money, and hope these thoughts will help you in your financial endeavours. Please let us know your reactions to our ideas and recommendations.

Justin Oliver,
Deputy Chief Investment Officer, Offshore

2017 – the year of the expected

As we look toward 2018, we re-examine the forecasts we made a year ago and assess their accuracy.

While there are many unknowns at the present time, the world at the end of 2016 seemed even more uncertain. Donald Trump had only recently secured a decisive election victory and it was unclear just how different Trump the president might prove to be compared with the brash, opinionated, Twitter-happy candidate Trump. The answer, we have since learnt, is not very different at all.

While the UK electorate had decided they preferred to be free from the shackles of the EU, formal exit negotiations had yet to begin. A year on, and we are no further forward on the terms of the UK's withdrawal, and the possibilities of a 'hard' or 'soft' Brexit remain open. So too, financial markets were beginning to focus on 2017's schedule of European elections. There were fears that extreme left- or right-wing factions could gain further power and destabilise the geopolitical landscape.

Amid these uncertainties our overriding message was one of confidence; we believed 2017 would prove to be a lucrative and stable year. This confidence has stood us in good stead and ensured that our positioning was not overly defensive in what ultimately proved to be a supportive investment landscape.

Our 2017 thoughts touched on a number of areas, both big picture issues and market specifics:

Monetary policy is dead; long live fiscal policy

Our central contention was that fiscal policy would become more important than unorthodox monetary policy in supporting global economic activity. While there has been some moderation in central bank support, it is difficult to argue that governments have taken up the baton in any meaningful way.

Reform of the US tax system may ultimately achieve this aim, but the impact is still unclear. The US Federal Reserve (Fed) has begun raising interest rates as well as taking the first steps in reducing the size of its US$4.5trn balance sheet. It will, however, be four or five years until it is reduced to a more 'acceptable' US$3trn.

The Bank of England has also initiated its first interest rate increase in 10 years, while the European Central Bank will cut its bond buying from €60bn a month to €30bn until at least September 2018. The Bank of Japan's monetary support is undiminished but overall it appears that 2017 marked a peak in central bank support. Governments have not been as forthcoming, although arguably this has not been necessary given the synchronised nature of the global economic recovery.

A year of political perils and possibilities

We highlighted that while elections in Italy, the Netherlands, France and Germany all had the potential to introduce greater political instability, these fears were likely being overplayed. As we concluded, *"There's life in the continent's old order yet."*

Aside from the Catalonia independence vote, the political landscape did not change as much as feared. The German election brought an increased support for the right-wing Alternative for Germany, while Emmanuel Macron resisted the challenge of the National Front. It took the Netherlands over 200 days to form a government in 2017, and Italy seems set to hold yet another parliamentary election in March 2018. All told, while European politics held the potential to act as a destabilising force, our sanguine view proved correct.

We're going on a bond bear hunt

As one of the more market specific themes, we felt that government bond yields would trend higher in a volatile fashion, but that any rise would be self limiting.

While longer-term yields have been underpinned, our broad expectation proved correct. We saw both volatility and a general upward trend in yields, particularly over the second half of the year.

The prices of short- and medium-dated UK Gilts fell as a less benign interest rate and inflation backdrop were extrapolated. Ten-year US Treasury yields traded in a relatively wide range of 2.04% - 2.63% and the yields of shorter dated maturities moved higher in response to Fed tightening. Euro sovereign issues also offered a higher yield at the end of 2017 than they did 12 months earlier. As we surmised, the bond bear market may have awakened from hibernation, but it is still early days.

Down but not out – why it makes sense to hold on to the bond proxies

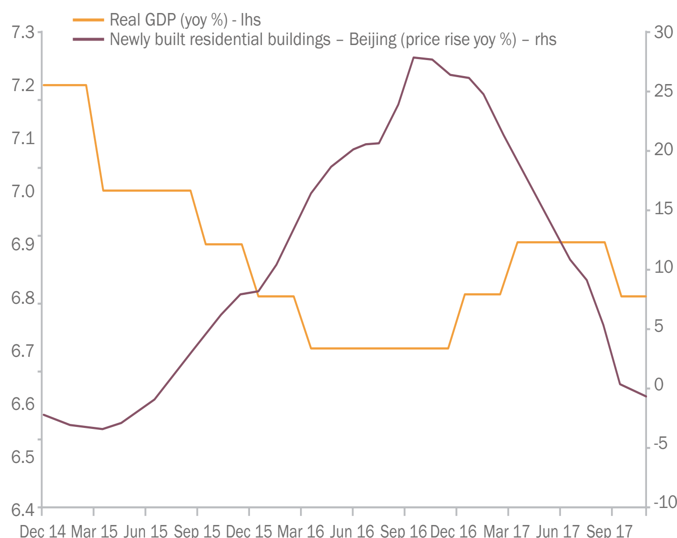
When referring to bond proxies and 'quality' stocks, we meant equities which offer bond-like characteristics in terms of sustainable and attractive dividend yields, or companies that evidence strong cash flow or low borrowing, or where the earnings are underpinned by high regulation. A significant exposure to emerging markets was also a potential characteristic. As shown by two of the stock examples used – WH Smith and Unilever – these companies were an astute investment during 2017.

While utilities underperformed over the year, other 'quality' stocks continued to demonstrate their worth. Companies such as BAT, Reckitt Benckiser and Compass all outperformed strongly in the first half of the year, although the second half proved more challenging given the rise in bond yields and certain stock specific issues.

Chinese year of the rooster – luck, romance and prosperity

"While there may be concerns about property prices, debt and growth within the Chinese economy during 2017, these fears are likely to be overplayed."

Chinese growth and property prices; now stabilising



Source: CGWM, Bloomberg

The predicted collapse in the Chinese economy did not materialise and the 19th Party Congress in October suggested that the leadership remains committed to doubling China's GDP between 2010 and 2020. This requires average growth of 6.3% per year between 2018 and 2020 – an achievable target.

Debt concerns persist but supply-side reforms remain in focus and the slowdown in the property market did not appear to have a significant impact on the wider economy.

Equity valuations – how to keep the party going in 2017

Our expectation that there was *"potential for reasonable returns from shares over the next 12 months"* may have been an understatement, given the subsequent performance of stock markets.

We felt that the expansion of price/earnings (p/e) multiples would likely be minimal and that stock market gains would need to be driven by profits growth. Using the S&P 500 as a proxy, this too proved correct, with the p/e of the market broadly unchanged over the year.

With Europe, Japan and emerging equity markets all performing extremely well, the party remained in full swing in 2017.

Where now?

While we are pleased with the accuracy of our 2017 forecasts, 2018 may prove to be more challenging on a number of fronts. We hope our forthcoming predictions will prove as accurate, and help us navigate markets successfully over the coming year.

Jeremy Corbyn: red menace?

> "To secure for the workers by hand or by brain the full fruits of their industry and the most equitable distribution thereof that may be possible upon the basis of the common ownership of the means of production, distribution and exchange, and the best obtainable system of popular administration and control of each industry or service."

Clause IV of the 1918 Constitution of the Labour Party, removed under the leadership of Tony Blair in 1995.

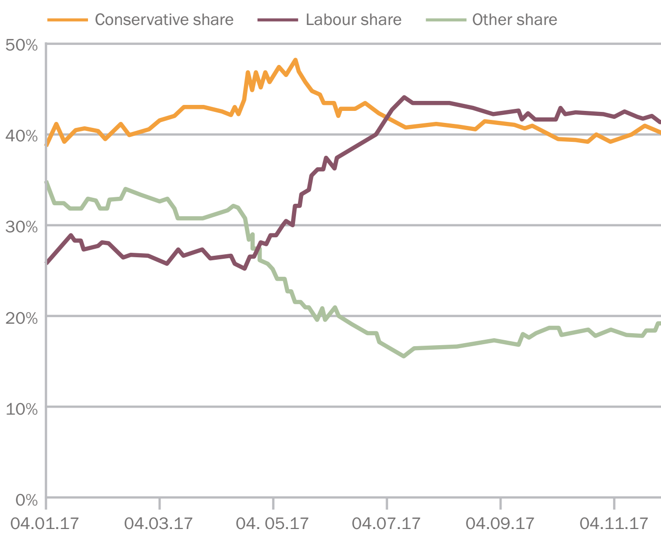
Richard Champion,
Deputy Chief Investment Officer, UK

For a while in 2017, it seemed as if the worldwide tide of populism, epitomised by Donald Trump, had reached its high-water mark. In a string of elections across Europe, the populist right and the left had failed to break through. Emmanuel Macron was elected President of France, and although not from any of the traditional mainstream parties, here clearly was a man of the centre. In the UK, Theresa May called a snap election while 20 points ahead in the opinion polls. Even days before the vote, senior Tory strategists were predicting a 90-100 seat majority.

The populist surge remains blunted in Europe, and Donald Trump may face a difficult mid-term election in a year's time in the US. But oh, how different things are here in the UK.

Despite losing the popular vote and lagging the Conservatives by 55 seats in the election, there is no doubt that Labour is in the ascendancy now, with a consistent opinion poll lead over the Tories of 2-3%. At the recent autumn Labour Party conference, we saw a level of self-confidence absent since Jeremy Corbyn was elected leader. Representatives of the party are now accorded a respectful ear in the halls of the Confederation of British Industry (CBI) and other business organisations.

UK opinion polls



Source: Wikipedia, reflecting underlying polls conducted by a wide array of polling organisations – accessed Dec 2017

The most successful populists, like Trump, have won largely by co-opting the machinery of an established party and building a rock-steady core base of support. Initially, it seemed Corbyn would fail to replicate this, and his chances were dismissed as risible.

But in the June election, he managed to pull precisely the same trick as Donald Trump. He secured the support of those who tribally could not vote for the other side, including many that had recently defected to UKIP in the run-up to the Brexit referendum, and at the same time seized the votes of the previously apathetic young as his core base. If he can repeat this, 'Jezza' seems electable, particularly faced with weakened opponents, even if we still don't think this likely.

The potential impact of Labour policies

Despite our scepticism, we're beginning to consider seriously what impact a Labour government might have. We suspect the topic is likely to be a recurring theme – or nightmare, depending on your politics – over the coming year. We're already seeing impacts in several sectors.

Although policies can change over time, there are certain general constants that are likely policies of a future Labour government. Under Corbyn, the Labour Party is committed to nationalising, or at least socialising, a range of sectors, including the railways, water companies, the electrical power grid and the Royal Mail, with restraints on the banking sector and special plans for RBS. They have also promised to bring Private Finance Initiative (PFI) contracts back under state control. The minimum wage would be raised, and zero hours contracts banned.

> There are several examples in history of left-wing governments that have been forced to change direction in the face of crumbling currencies.

There is a general commitment to more spending on infrastructure, health, social housing, education and sustainable energy, financed by higher taxation on companies and the top 5% of earners, and a clamp-down on tax evasion, as well as higher borrowing. Interestingly, there was also a commitment to balance the budget in the medium to longer term.

Of course, Corbyn still has to get himself elected, and his policies are likely to be put under sharper scrutiny by both the press and the Tories next time round.

But were he elected, what would these policies mean for markets? We think a mix of the following could occur as it became apparent Labour was going to win:

- Sterling would fall sharply – triggering a classic 'run on the pound'
- Government bond yields would rise
- Shares in banks, utilities, housebuilders, transport, support services, hotels and pubs, retailers and infrastructure trusts would fall
- Shares in overseas earners such as the energy companies, miners and pharmaceuticals would benefit from a lower pound and rise
- London house prices would come under pressure.

The effect of financial markets

Ultimately, markets are likely to constrain Prime Minister Corbyn's freedom of action. There are several examples in history of left-wing governments that have been forced to change direction in the face of crumbling currencies and rising bond yields.

Back in the early 1980s, François Mitterrand was elected President of France on a sweeping left-wing platform not dissimilar to Jeremy Corbyn's. It involved nationalising the banks, car makers and steel industry, higher taxation and higher spending. After 18 months he had to change tack, cut spending and embrace a more market-oriented set of policies, helping to kick-start a 15-year bull market.

More recently Alexis Tsipras was elected Prime Minister of Greece on a radical left-wing, anti-austerity agenda. Yet within months he had signed up to the package of austerity reforms forced upon him by the EU and the International Monetary Fund (IMF). Of course, in the meantime, the Athens stock exchange had fallen almost 50%, 10-year Greek government bond yields had shot up to over 19% (they're 5.4% today) and the banking system had been effectively decimated. Once he bowed to his creditors, the equity market rebounded, and is now up around 70% from its low.

Preparing for all eventualities

We remain significantly underweight UK equities, based on the poor economic and corporate fundamentals, even without the threat posed by a Corbyn victory. While we don't yet expect he'll turn his current poll strength into a majority-winning position, we will monitor his progress with care. Recent history has taught us not to write off the seeming improbable in politics. We would have to consider reducing still further our UK exposure if his momentum strengthened from here. In the meantime, we are finding plenty of opportunities in equities outside the UK, where fundamentals look much more attractive.

Inflation – mind the noise

Justin Oliver,
Deputy Chief Investment Officer, Offshore

Day by day, a plethora of official economic statistics are released, building into a vast data set. In just one month, from mid-October to mid-November, Bloomberg recorded 585 major data releases for G8 economies, with a further 175 revisions to previous data. Extending this to the G20 produces nearly 1,000 separate data points.

Crunching the inflation data

We believe that one specific sub-set will be by far the most important to monitor during 2018: inflation rates in the US, EU and UK. While other data may have a tangential impact on inflation and sometimes be used as a leading indicator, this relationship can vary. There is little substitute for the inflation numbers themselves, even if we accept that the statistics may not be a full reflection of price pressures in an economy. Their importance will be magnified during 2018.

Why we need to monitor inflation

Financial assets and equity markets have enjoyed strong performance primarily for two reasons. The first is the global economic recovery, which gathered strength during 2017. The second is that the world's leading central banks have continued to underwrite financial markets by extending emergency monetary support measures. As we outlined within our review of 2017, 'peak stimulus' has already been seen and the US, EU and UK are all reducing the scope of their support. Depending on how inflation responds moving forward, the support which many financial assets have enjoyed would be at risk if central banks feel the need to remove their policy support more quickly than expected.

Confusion

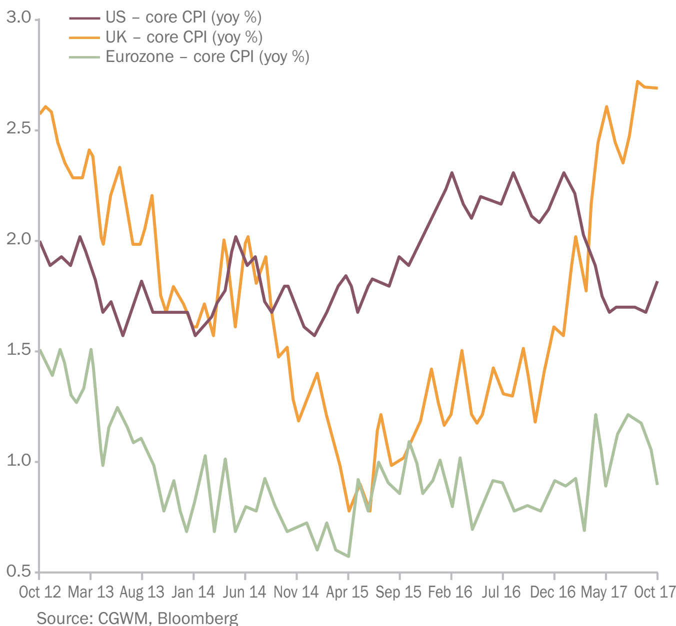
Policymakers are confused about why higher inflation has not already reared its head, given the underlying strength of the global economy and low levels of unemployment.

Some think that, like the bogeyman, it is waiting just around the corner, ready to pounce on the unsuspecting central banker. As Janet Yellen commented in September, *"we should be wary of moving too gradually (on raising interest rates) … potentially creating an inflationary problem down the road that might be difficult to overcome without triggering a recession."*

The reasons why inflation rates haven't already increased has been the subject of intense debate, with questions asked about whether the inflation-dampening forces are structural or cyclical. If structural, inflation could be expected to remain relatively subdued. However, if it's because of temporary forces, such as spare capacity in the economy (the under-utilisation of labour and capital that could be put to work to boost output), we may be set for a period of higher inflation as this slack has now been depleted. This mindset has implications for how quickly and aggressively central banks will feel they need to move.

It appears that Consumer Price Inflation (CPI) bottomed in 2015, although core-CPI (excluding food and energy) has flatlined in the US and EU over the past three years. Only the UK's core measure has registered any acceleration.

Core CPI readings remain generally moderate



Source: CGWM, Bloomberg

Schools of thought: the hawks

Those who believe that price pressures may increase, and that the inflation-dampening forces are temporary, often argue that the low jobless rate and steady increase in employment will feed through to wages which, in turn, will pressure inflation.

US unemployment stands at 4.1% – a rate not seen since 1999/2000 – and initial unemployment claims have been on a firm downtrend since the end of the global financial crisis. Meanwhile spare labour capacity has been cut, as shown by the diminishing number of people marginally attached to the labour force, or who are working part time but are available for full-time work.

Wage momentum is rising in most sectors and, with corporate profitability increasing, it is only a matter of time until average hourly earnings accelerate further. Companies are finding it hard to fill job openings, which is a precursor to higher wage growth. Proponents also argue that core inflation lags the economic cycle, so the subdued inflation readings in 2017 may still be a legacy of 2015/2016's deflation scare.

As far as the US is concerned, the impact of previous dollar strength and lower energy prices will also begin to diminish.

The doves

The opposing view centres on the impact of globalisation and technology, which has ensured that inflation is less sensitive to domestic macro conditions. It is the global output gap (the difference between actual economic activity and the maximum output if the economy were operating at peak capacity) which is of most importance and globally, significant slack remains. The IMF has highlighted technology as being the primary force behind a decline in wages as a percentage of costs; even at low levels of unemployment, firms may not need to increase wages. In the absence of wage inflation, broader price pressures will remain subdued.

The supposed closing of domestic output gaps is also viewed sceptically; these figures are notoriously inaccurate and consequently there is likely to be more slack in domestic economies than currently assumed. By way of evidence, US labour force participation is extremely low by historical standards and consequently there is potential for greater numbers to re-enter the workforce.

From an economic perspective, the Phillips curve, which plots the relationship between rates of unemployment and inflation within an economy, may also have changed. Low unemployment is no longer inflationary, due to factors such as outsourcing, global value chains and higher levels of automation. Demographic forces – the replacing of older, higher paid workers with younger, cheaper alternatives – may also be restraining wage growth and by extension inflation.

A balanced view of inflation

Our conclusion is that while there may be a temporary increase in inflationary pressures, structural forces will ensure they do not build significantly. Much as interest rates are unlikely to reach previous 'normal' peak levels, inflation will also remain subdued relative to history, ensuring that central banks can remove their unorthodox monetary support gradually.

However, there are many unknowns, and the potential for a central bank policy mistake has risen. We will watch inflation figures closely over the coming year. We feel that investors should do the same.

Professional sceptics

> The 9000 series is the most reliable computer ever made. No 9000 computer has ever made a mistake or distorted information. We are all, by any practical definition of the words, fool proof and incapable of error.

HAL – 2001: A Space Odyssey

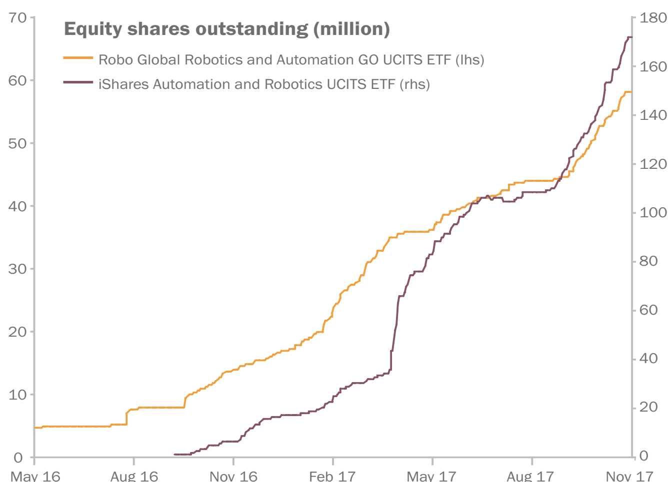
Justin Oliver,
Deputy Chief Investment Officer, Offshore

While we are still quite some way from true 'artificial intelligence' (AI) as science fiction writers might understand it, the term is being used with ever greater frequency. In investment terms, the concept stretches beyond laboratories of scientists trying to develop neural networks. It now includes machine learning (a field of computer science where computers learn without being programmed), deep data (looking for specific information to help predict trends or make calculations), natural language and autonomous vehicles. It also includes any company which could feasibly benefit from these technological advances. These areas are presented hand in hand with industrial automation and smart robotics to present a holistic investment universe.

To help investors capitalise on the march of technology, investment providers have developed several ways to access this theme. At least three actively managed funds have been launched in the UK in the past 12 months, which all have some degree of AI incorporated as a theme, while there are also exchange traded funds (ETFs) available which offer exposure to the specific areas of automation and robotics.

The London-listed Robo Global Robotics and Automation GO UCITS ETF share issuance has risen from just 4.4 million shares in May 2016 to 57.9 million by the middle of November 2017. iShares Automation & Robotics was launched in September 2016, but already has a market capitalisation of US$1.3bn.

Significant growth of robotic ETFs



Source: CGWM, Bloomberg

So should we, as investors, be seeking to capitalise on this trend?

A compelling investment opportunity

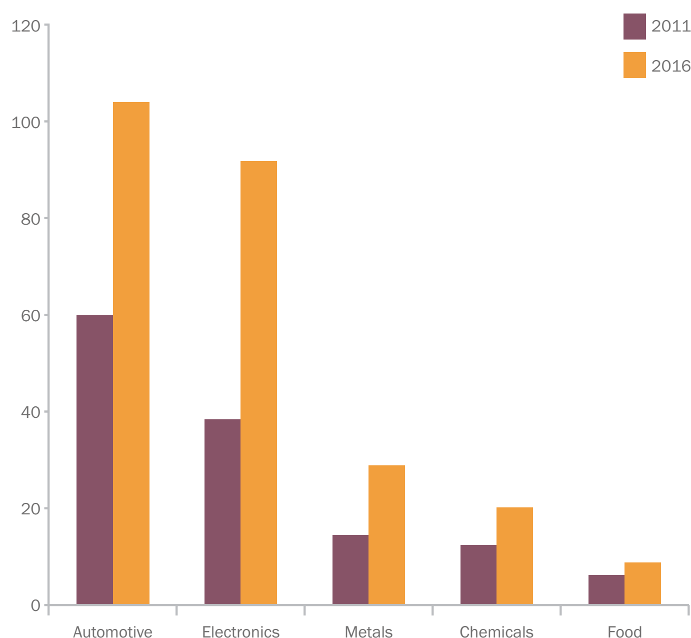
At first glance, the economics of the AI and robotics industry appear compelling. According to a prominent AI fund manager, *"we are at the start of the adoption of AI. Those positioned to benefit will enjoy a sustained period of growth."* Even more eye catchingly from an economic perspective, *"AI has the potential to double economic growth rates over the next 20 years."*

The corporate world seems to agree. CB Insights, which offers *"machine learning, algorithms and data visualisation to help replace the 3 Gs (Google searches, gut instinct and guys with MBAs)"* to predict future trends, estimates that US$1.5bn has been invested in AI companies in the last five years. Many of the largest companies in the world are investing in AI and machine learning, including Apple, Google, Amazon, IBM, Intel, Microsoft, Nvidia, Qualcomm and Tesla.

Research and Markets, an organisation with 1,700 research teams in 81 countries, expects the global AI market to reach US$36bn of revenue by 2025, growing at a compound annual growth rate of 57% between 2017 to 2025. Meanwhile, McKinsey estimates that 30% of tasks in 60% of occupations could be automated.

Robotics also appears to be a growth industry. The International Federation of Robotics highlights that in 2016 global sales of robots increased by 18%, to US$13.1bn, while robot supplies are expected to rise by 21% in Asia, 16% in the US and 8% in Europe.

Number of robot units worldwide by top sectors ('000)



Source: IFR World Robotics, FT

Unsurprisingly, the shares of companies involved in automation have responded favourably. Fanuc rose nearly 35% between mid-September and mid-November 2017, while Yaskawa and Kuka doubled within the year.

What's not to like?

At CGWM we prefer to avoid investing in fads and fashions. While AI may not prove to be a passing fad, it is certainly in fashion at present.

There is also a fallacy that faster growth automatically feeds through to higher investment returns. Unfortunately, there are flaws in this argument. For example, many of the growth statistics surrounding AI focus on revenues, as profitability within much of the industry is a scarce commodity. This is reminiscent of the late 1990s tech boom, and at this stage it is impossible to know which areas of AI, and which companies, are likely to survive and thrive. If history is any guide, there will be as many failures as successes.

We should beware of relying heavily on forecasts which look too far into the future, particularly from those who have a vested interest in the area. While economic growth may be boosted by the adoption of AI and deep-thinking algorithms, this is by no means certain. Just as today's world looks nothing like the one envisaged by sci-fi writers of the past, tomorrow's world may look vastly different from current predictions. The forecast 'winners' in certain scenarios may not be the existing incumbents; they may not even exist yet.

History also shows that the benefits of new technologies often take longer to materialise than first expected. For example, Paul David, the academic economist who has undertaken analysis of scientific progress and technological changes, found that when electricity was first adopted within factories, they became slightly more productive. It was only later, when the factories went further and began changing their configurations to capitalise on electricity, that the surge in productivity really began. Maybe humans will need to adapt their behaviour to deliver the true benefits of AI and automation.

Another issue is whether investors can truly allocate to or between the various AI sectors, or whether a wider technology exposure should prove sufficient. Would a broad technology fund, managed by experts in their field and who understand the fact and fiction of the AI investment universe, be a better investment route? The definitions of AI are so variable, and the investment universe so 'non-standard', that a compelling top-down view can quickly become blurred.

We always need to be sceptical of the claims made by the proponents of investment opportunities. The prospects offered by AI, robotics and automation certainly seem compelling. However, we don't take such claims at face value, or assume that they automatically guarantee a successful investment outcome. Instead, we will weigh the pros and cons of the investment rationale and suggest that investors also tread carefully before committing to this area.

Techie tiger, digital dragon

If you think emerging markets are just the home of mass production and low-skilled industry, think again

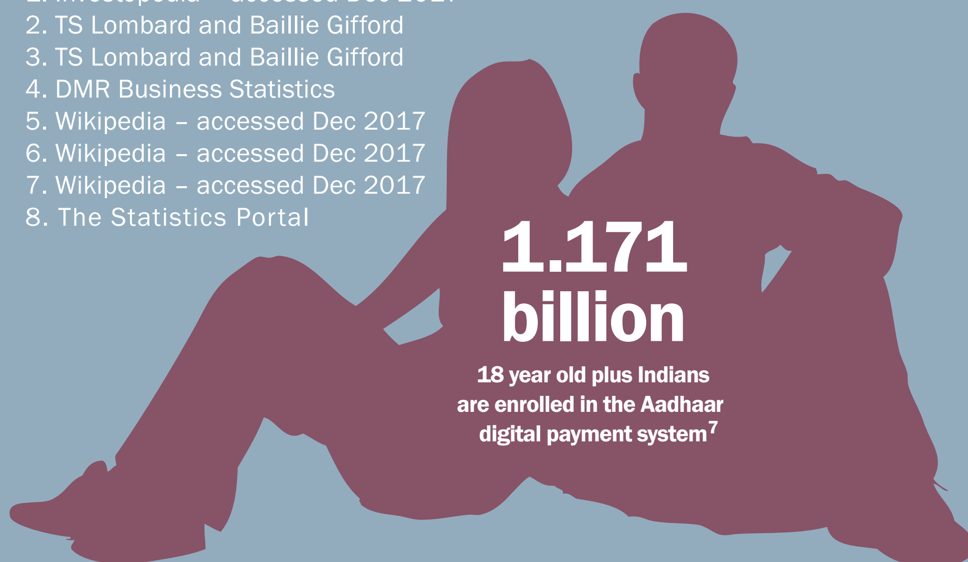
India has the largest

4G LTE telecommunications network in the world[3]

China has 3 times

as many smartphone users as the USA and the rest of North America combined[5]

1. Investopedia – accessed Dec 2017
2. TS Lombard and Baillie Gifford
3. TS Lombard and Baillie Gifford
4. DMR Business Statistics
5. Wikipedia – accessed Dec 2017
6. Wikipedia – accessed Dec 2017
7. Wikipedia – accessed Dec 2017
8. The Statistics Portal



Some might think 'emerging market technology' is an oxymoron, but investors should be wary of jumping to such facile conclusions. Today, the picture of emerging markets (EM) as commodity exporters and cheap factories is fast becoming outdated. This article reveals how EM have developed technologically beyond recognition, and explains why this should be reflected in investment portfolios.

Michel Perera,
Chief Investment Officer

To be fair, there are still some EM that fit the above stereotype, but they are fewer than before. There are also enough large EM countries with a technological footprint to make a difference in our daily developed market lives.

The obvious examples are South Korea and Taiwan, exporters of electronic components for decades. Today, companies like Samsung Electronics and Taiwan Semiconductor, which compete with the likes of Intel, are at the forefront of DRAM and NAND semiconductor technology, a US$400-billion industry.

This is not news for industry followers – but what may be news is the way countries like China and India have developed to challenge major US technology firms and change people's way of life beyond recognition.

Today, China has the highest rate of internet sales in the world (at 20%, ahead of the US and the UK). Its internet banking payment systems, Alipay and Tenpay, are used by 520 million and 360 million people respectively. Many Chinese today do not use cash or credit cards and pay exclusively through these platforms.

The social media mobile app WeChat has close to 1 billion subscribers. It is known in Asia as the 'App for Everything' and boasts an augmented reality platform and 3D appearance. China also has three times as many smartphone users as North America. Alibaba's Singles' Day in China dwarfs Black Friday in the US and is a digital shopping affair. Next year, China is slated to overtake the US in research and development spending.

China's technology drive started as a protectionist move to stop US firms moving into the country, but since then these businesses have expanded outside China, giving US internet giants a run for their money. Their growth and stock market performance have been every bit as stellar as those of the large US firms.

Today, some Chinese tech companies are the equivalent of their US counterparts in most sub-sectors of the technology world: Alibaba and JD.com are like Amazon, Baidu like Google, Sina Corp like Twitter, Ctrip like Expedia, Vipshop like Groupon and Tencent like Facebook. Indeed, the three large internet companies, Alibaba, Baidu and Tencent, are among the top 10 in the world.

In the recent Communist Party Congress, China set itself an ambitious plan to develop sectors like robotics, semiconductors, artificial intelligence, big data, electric vehicles and alternative power, as well as biotech, where it already has a large footprint. Whether they succeed or not is anybody's guess but the resolve, funding and government backing should not be underestimated.

Advances in India

India is also ahead of the developed world in various areas. The Indian software engineer may be a folk figure in most western countries, but the reality is that a country sorely lacking in basic infrastructure has leapfrogged western technology. Following the demonetisation reform last year, where 85% of the currency was removed without warning, India's merchants have been racing towards digital payment systems like Paytm. Crucially, the groundwork for the next step in payments has been laid.

The Aadhaar system is a 12-digit unique-identity number issued to all Indian residents, based on their biometric and demographic data. Over 1.171 billion people have had their fingerprint and iris scan registered, creating the largest digitalised database in the world and turning India into a digital economy, with the ability to bypass credit and debit cards altogether. This enables people to open a bank account in 10 minutes with a mobile phone and fingerprint reader. Soon this will lead to purchases without any credit card or phone. Over 99% of Indians aged 18 or over have been enrolled in Aadhaar.

In addition, India now has the world's largest dedicated 4G LTE network. Its data usage has already surpassed China and the US.

Most investors still believe that EM equities are driven by commodity prices and cheap labour in basic manufacturing. In fact, close to 30% of EM equity indices are technology. We think it won't take long before EM investment is finally seen for what it really is: the access to a new world that is not bound by the economic traditions of western countries.

This new world is the future of technology.

Richard Champion,
Deputy Chief Investment
Officer, UK

Small is beautiful – or is it?

Do you ever wonder why there are so many different approaches to managing equity portfolios?

Well, investing is a complicated business, particularly investing in equities, as there are just so many different moving parts. Whether an individual share turns out to be a good investment can depend on the performance of a company's business, economic fundamentals, valuation, geography, dividend policy, currency, politics, regulation, disruption, and many more variables. And in terms of risk, there is always the possibility that a company can go bust. (Naturally, we take the risk of permanent loss of capital very seriously.)

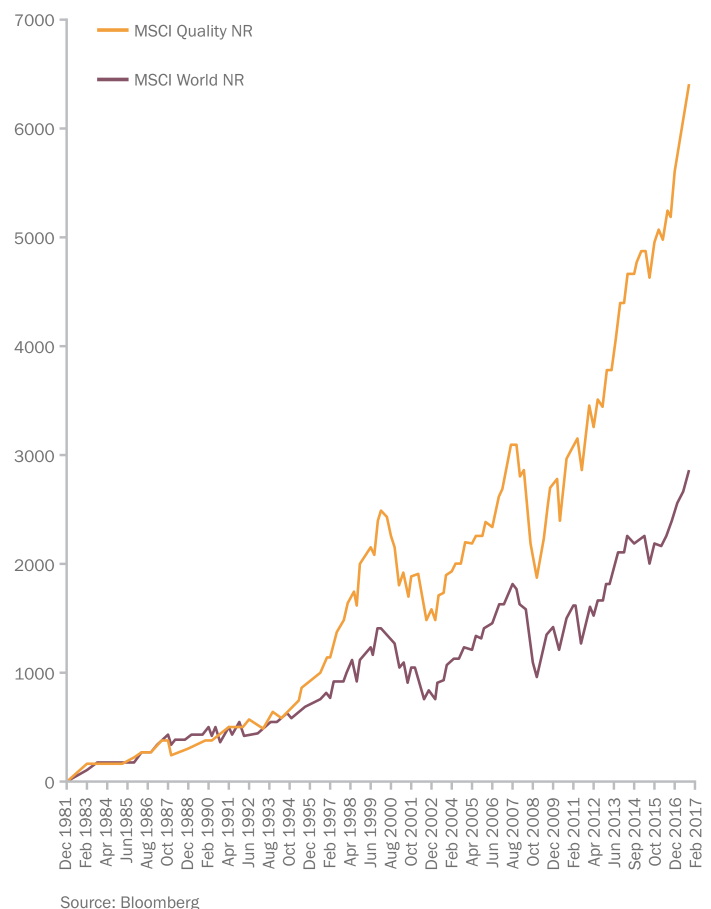
This complexity has led, over the years, to the emergence of many different approaches to managing equity portfolios, including:

- Active or passive (seeking to generate better returns than an index or simply to match them)
- Value or growth (buying shares based on low valuations or on underlying growth)
- Quality (buying companies based on the solidity and superiority of their financial structure and business model)
- Quantitative (using mathematical approaches)
- Technical (making investments based on share price charts).

Luckily, there are also ways to make things easier. If we can identify specific sectors or areas that systematically do better than the whole market over the long term, and if we can do so without adopting too much risk, it makes sense to have a bias towards them.

A visit to quality street

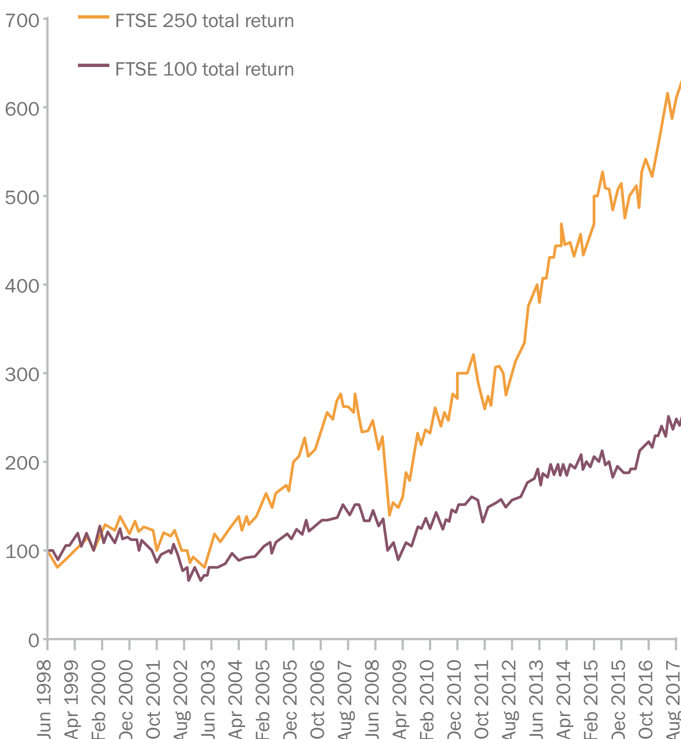
One often cited way to achieve this is the use of so-called 'quality' investing. The MSCI Quality Index, which aims to capture the performance of quality growth stocks as defined by high return on equity, stable earnings growth and low financial gearing, has a history stretching back to the end of 1981. Since inception, this index, including net dividends, has risen by an annualised equivalent of 12.3%, compared with 9.7% for the wider MSCI World Index on the same basis. This 2.6% annual difference may not sound much, but equates to a total return to date of some 6,265% compared with a more modest 2,680% for the world index.



Source: Bloomberg

Some of the highest profile global investors, such as Warren Buffett in the US and Terry Smith in the UK, adopt variants of this approach to try to benefit from this effect.

Another widely employed way of capturing the superior returns available from distinct sub-asset classes in equities is to use smaller companies. Within the FTSE All Share Index, the FTSE 100 (which comprises the top 100 of the index's 635 companies) makes up just over 80% of the total market capitalisation, with the balancing 20% made up of medium-sized and smaller companies.



Source: Bloomberg

Despite this split, JP Morgan has estimated that the average generalist UK equity fund has over 40% exposure to stocks outside the FTSE 100 – a very significant bet against the underlying index. However, it is also a very rational position to take. Since the end of 1985, when comparative records begin, the FTSE 250 Index (which is made up of the 250 largest companies after the FTSE 100) has risen at an annualised rate of 11.1%, compared with 8.3% for the FTSE 100. This has generated a return of just over 2,800%, compared with a little under 1,160% for the larger index.

The effect is equally marked in other countries as well. In each case, when you compare the Russell 2000 with the S&P 500 in the US, the MDAX with the DAX in Germany and the CAC Mid 60 with the CAC 40 in France over the last 15 years, the smaller company index has outperformed the larger. The stars of the show overall have been the French and German mid/smaller company indices.

Pros and cons of thinking small

What is it about smaller companies that enables them to generate such superior returns?

Firstly, they benefit relative to their bigger peers from the law of large numbers. It is easier to multiply the size of a company valued at £100m by ten than to grow a £100bn company to a £1trn company. At the very large end of the scale, the addressable market simply may not exist for the product the company makes. A related point is that large, sunset industries are more likely to be represented in the big indices, whereas smaller, innovative companies are more likely to form part of the smaller indices.

Secondly, smaller companies are more likely to be taken over; their size makes them more digestible to the acquirer.

Thirdly, the composition of the smaller index is very different from the larger. In the UK, for example, the FTSE 250, excluding investment trusts, has a 3% weighting to oil and 3% to banks. In the FTSE 100 the respective weightings are 15% and 13%. Perversely, even though smaller companies are seen as higher risk (and they do go bust more frequently) a higher sectoral concentration in the larger index can mean greater risk, as sectors tend to move together in the same direction.

Finally, small companies tend to be under-researched, and diligent investors can often discover hidden gems.

Of course, smaller companies do have their downsides:

- Just as with the quality style, there have been periods of as long as five years when they have underperformed their larger brethren
- They can be illiquid and tend to fall further than the wider market when equities suffer from serious corrections
- As noted above, in general they are more financially fragile
- They are more highly valued
- Particularly pertinent to the UK, they are more exposed to the domestic economy, which may prove a headwind in the event of a hard Brexit
- For the smallest companies, such as the AIM market in the UK, the performance track record has been much patchier.

Nonetheless, we still believe equity markets should have a solid year in 2018. In this case, having a meaningful exposure to smaller company equities continues to make good sense, and we try to ensure that well balanced portfolios have a proper allocation to them.

Form is temporary; class is permanent

Justin Oliver,
Deputy Chief Investment Officer, Offshore

Unfortunately, there is not a direct English equivalent of the German 'schadenfreude' – pleasure derived from someone else's misfortune – as shown within parts of the investment community when it was announced that the Manek Growth Fund would be closing its doors after nearly 20 years of largely unsuccessful performance.

Jayesh Manek is best known as the winner of the Sunday Times Fantasy Fund Manager competition in 1994 and 1995. This success led to the launch of the Manek Growth Trust in 1997. With a seeming talent for stock picking and the backing of investment luminaries such as Sir John Templeton, the fund grew to over £300m at its peak. Sadly, this was as good as it got.

Manek proved unable to match his previous stock picking success on a consistent basis and, following a sensational year of performance in 1999 at the peak of the technology bubble, the fund underperformed the FTSE All Share for the next four years. By October 2016 it had underperformed the FTSE All Share by over 280%, falling c.53% against an index return of nearly 230%.

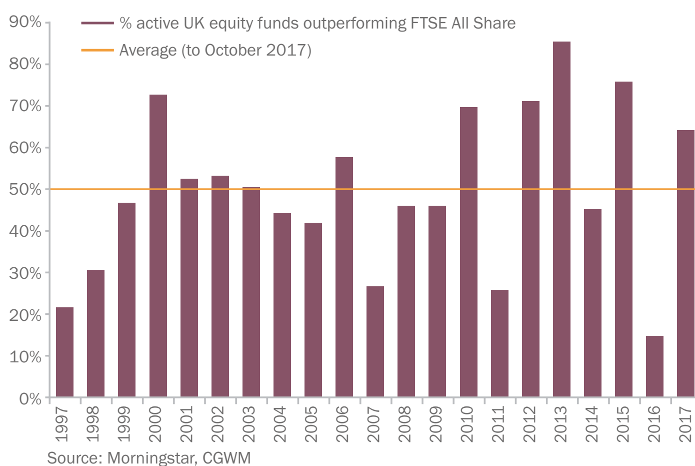
2018 – the year of the active fund manager

Sometimes it seems that the schadenfreude which greeted the closure of this fund is an extension of a serial pleasure at the perceived shortcomings of the active fund management industry as a whole. Commentators seem to revel in highlighting how few fund managers outperform their benchmarks over a certain period, or outlining why fund managers fail to justify the higher annual management fees they charge in comparison to their passive, index-replicating cousins. However, we believe the active fund management industry as a whole will prove its worth in 2018.

Just the facts ma'am

The performance of the active fund industry is not as abject as some would have you believe. Since 1997, an average of nearly 50% of managers investing in UK equities have outperformed the market in each calendar year.

UK equity – active manager outperformance per calendar year



Source: Morningstar, CGWM

Over a three-year rolling period, this figure rises to 52%. Over a five-year period, the percentage is 54%. Therefore, on average over the past 20 years, there is a 54% chance that over a five-year period a randomly chosen manager would have delivered outperformance.

At CGWM we don't allocate to fund managers randomly, but invest following extensive quantitative analysis and qualitative due diligence – so we would expect to meaningfully improve on this expected hit rate.

Not all funds were created equal

It's not always the same fund managers who outperform. Manager A may have outperformed in 2015, but underperformed in 2016. Manager B may have

underperformed in 2015 and outperformed in 2016. In a peer group of just these two managers, on average 50% outperformed each year, but neither outperformed in both periods.

This often underlies criticism of the active fund management industry. For example, analysis reveals that a particular manager outperformed in four of the last five calendar years. Because of the one year of underperformance, the fund manager is viewed as having 'failed' and seemingly cannot justify the higher management fees charged in comparison to passive vehicles.

This is a facile argument which fails to consider two things. First, no investment should be viewed as a success or failure when measured over just one year. Second, it takes no account of the margin of out or underperformance. If said manager outperforms by 1.5% each successful year on a net of fees basis, but underperforms by 4% in the more difficult year, over the five-year period as a whole, the fund would still have delivered outperformance of 2%.

The blame game

The number of fund managers who outperform in any period varies; the shorter the period, the greater the variability in the number of fund managers who beat the market. Reviewing the UK peer group again, the highest percentage of managers who outperformed in any one calendar year was 85%, in 2013. Over three years, the highest is 82% (June 2012 – June 2015) and over five years it stands at 76% (November 2011 – November 2016). On the other side of the equation, just 15% of fund managers outperformed in 2016, while the lowest percentages over three and five years stand at 27% and 28% respectively.

Is it any coincidence that the active fund management industry is subject to such schadenfreude following a year (2016) when 85% of funds failed to keep track with the market? Probably not.

How hard can it be?

What dictates how easy or hard it may be for active fund managers to outperform? Essentially it boils down to three things – efficiency, volatility and correlation.

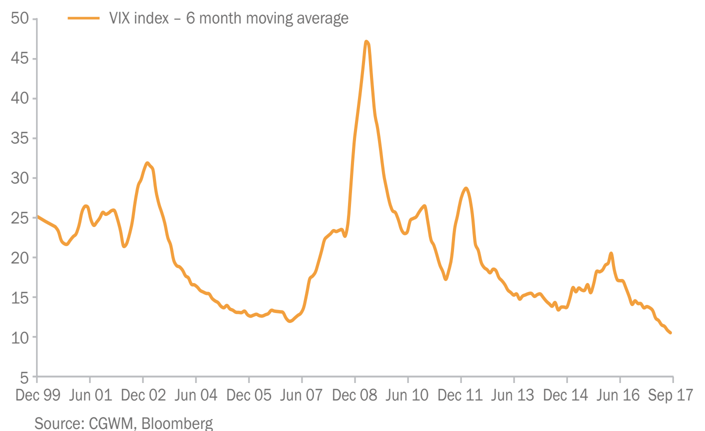
Stock market efficiency is the degree to which stock prices reflect all available, relevant information. The US is generally viewed as being the world's most efficient stock market and therefore, by definition, the most difficult to outperform as there are fewer inefficiencies upon which a fund manager can capitalise. Whereas, on average, 49%, 52% and 54% of UK funds outperform over one, three and five years, these figures drop to 43%, 44% and 45% when considering managers who invest in US equities relative to the S&P 500.

The latter two factors – volatility and correlation – stand behind our conviction that 2018 will be a year when active fund managers prove their worth. Both high volatility and low correlation provide tailwinds for outperformance; tailwinds which were lacking in 2016 but which we believe will re-emerge in 2018.

Volatility and correlation

Greater volatility allows active fund managers more opportunities to buy stocks when they have fallen significantly and/or sell assets which may have risen meaningfully. In a becalmed sea, the ability to add value by trading shares is limited.

Volatility to increase in 2018?



Source: CGWM, Bloomberg

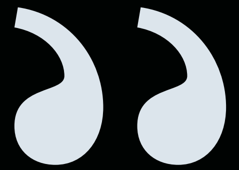
Similarly, if most stock prices are moving together, the potential to add value by identifying 'good' companies and avoiding 'bad' companies is also limited. The active fund manager does not want the price of everything to move in tandem – but that's what has been happening until recently.

There has been a welcome, sharp fall in stock correlations, which bodes well for the active fund industry. Volatility, as measured by the VIX Index, has been trending lower over the past few years. However, with central banks now beginning to remove policy accommodation and valuations elevated in many areas, we believe volatility may well break its downtrend.

Both developments look positive for active fund managers. The best, we believe, will justify their worth in 2018.

2018: a year of surprises?

There are known knowns. There are things we know that we know. There are known unknowns. That is to say, there are things that we now know we don't know. But there are also unknown unknowns. There are things we do not know we don't know.



Donald Rumsfeld

Markets are very good at pricing in ‘known knowns’. In fact, it is often not a good strategy to invest on the back of them, and known knowns by their nature provide very few surprises. Markets are less good at pricing in known unknowns; too often the speculation entailed in looking at them leads to extremes of valuation. Known unknowns often generate surprises but it is the unknown unknowns that provide the greatest scope for serious dislocation.

In this article we look at six possible surprises for 2018. All are known unknowns, because if we knew the unknown unknowns, they would be known.

Nice surprise one: Brexit works out

It is a highly consensus investment position (and one we happen to share) that the uncertainties surrounding the Brexit negotiations are bad for UK assets and for sterling. However, in this surprise, imagine coming to the end of 2018 and finding that the UK and the EU have reached a mutually beneficial agreement on Brexit, that:

- Entails minimal disruption to UK trade
- Allows the UK to retain access to the single market, but with much reduced financial contributions to European projects
- Gives the UK freedom to negotiate trade deals with the rest of the world
- Rekindles industrial and consumer confidence
- Leads to a spurt in growth, so the UK once again tops the G7 economic growth tables.

The results? A surge in sterling, a rally in Gilts, falling inflation, better real earnings, and for the stock market, modest growth, only constrained by the amount of overseas earnings in the FTSE 100. International investors flock back to UK stocks and bonds and UK assets are the strongest performers among all developed markets.

Nice surprise two: nothing goes wrong in the world economy – more Goldilocks

The bull market from the depths of 2009 is long in the tooth; including dividends, the S&P 500 Index in the US is up 18% so far in 2017, after rises of 12% in 2016, 1% in 2015, 14% in 2014, 32% in 2013 and 16% in 2012. Since the end of 2011, US equities have risen by 135% on this basis. In the UK, government bonds have returned 25% over the same period, and UK corporate bonds 55%. Except for gold, everything has gone up. It can’t last, can it?

In this surprise, that’s exactly what happens. Currently expected earnings growth of 12% in the US for 2018 expands significantly further with the benefits of tax reform; company profits increase strongly in Europe; central banks act extremely cautiously in raising interest rates and/or reducing Quantitative Easing (QE); global economic growth remains robust and inflation very tame.

This translates not into the measured, cautious optimism with which investors like us view the world at the moment, but an environment yet again of strong, double-digit returns in equities, solid mid-single digit returns from bonds and a further expansion of valuations. We may get scared where this leaves us by the end of the year, but the journey, though a white-knuckle ride at times, leaves us breathless and flushed with excitement by December 2018.

Nice surprise three: Trump gets stuff done

The first year of Donald Trump’s presidency has been a disappointment, even despite Congress finally approving his sweeping tax reforms at the end of 2017. Otherwise, his administration has been long on hot air and short of legislative action. Many now write off ‘the Donald’ as a loud-mouthed braggadocio, full of ill-considered and offensive bluster.

But in this surprise, things turn out very differently in 2018. The stock market loves the tax reform and the surge in investment, and rallies strongly, even as interest rates rise, and average hourly earnings begin to climb more quickly as well. North Korea suspends its nuclear arms programme and becomes more integrated into the world economy. A resurgent Trump propels his party to shock success in the mid-terms and lays the foundation for a second term presidency.

The world is seldom so pleasant, and to provide balance we’ve suggested three darker surprises on the next page.

Nasty surprise one: inflation comes back to haunt us

This surprise would see the depressing effects of technology on price levels dissipate in the face of very low unemployment and the emergence of significant skills shortages. As inflation moved past central bank tolerance levels, the current expectation of slow and gradual monetary tightening would be comprehensively broken. Authorities across the globe would remove QE and increase interest rates much more aggressively than markets expect. Bond prices would fall, and equity valuations, which are priced for a low inflation environment, would contract.

At the same time, company profits would come under pressure from rising wages and raw materials costs, creating lower valuations as well as lower profits on which to base the valuations. This would prompt a sharp contraction in shares across the world, rapidly denting confidence. The smug complacency of the Goldilocks economy is shattered, just as it was in 2008, only this time central banks don't have anything like the firepower they had then to combat it.

Nasty surprise two: populism comes back with a vengeance and bad things happen

Despite scoring his first (and only) major legislative victory in 2017 with the Tax Cuts and Jobs Act, President Trump continues to fall short on his other existing plans to reform healthcare, infrastructure, housing and welfare. As a result, faced by an electoral disaster in the mid-term elections, he withdraws from the North American Free Trade Agreement (NAFTA), starts building the wall to keep Mexico out and implements protectionist policies against China. At the same time, he ramps up tensions against North Korea, prompting significantly heightened geopolitical risk.

Russia takes advantage of a European Union distracted by Brexit and in its presidential election year tries to repeat the successful annexation of the Crimea by fomenting unrest and revolt in the Baltic states. The hope engendered by the election of President Macron evaporates in the face of a resurgent populist movement in Italy. In Britain, Theresa May's government collapses because of a compromise forced upon it by the EU during the Brexit negotiations on the border between Northern Ireland and the South, which results in the DUP withdrawing support. In the ensuing general election, Jeremy Corbyn wins on a mandate of uncosted promises.

In this nasty surprise, politics becomes the driving force to risk aversion. Risk assets would sell off aggressively, and safe havens, such as gold, the dollar, US Treasuries and the Swiss franc would rise on pure fear. The euro would fall and sterling plummet. Most equities would be crushed, although the collapse of sterling would mitigate the worst effects for UK investors. This would be scant consolation in the face of much higher personal taxation from the new Labour government.

Nasty surprise three: an attack on the new technological world order

We all now know that the wonderful utility that social network, search engine and internet media companies provide comes at a cost. The new economy giants evade taxation, facilitate fake news, corrupt the democratic process, invade the privacy of citizens and destroy countless thousands of jobs through unfair competition. Companies such as Facebook, Google/Alphabet, Netflix, Amazon and the like have been the primary drivers of the equity bull market, becoming the largest companies in the world in the process.

In this nasty surprise, the old-world order fights back. Google and Amazon are investigated by the US Department of Justice anti-trust authorities with a view to breaking them up. Facebook is caught up in investigations on its role in recent elections. Advertisers begin to leave the social networks, eroding their earnings.

Meanwhile, on the advice of Bill Gates amongst others, Congress implements legislation that taxes industrial robots as factors of production. Governments the world over find ways to tax internet retailing, damaging the ability of companies like Amazon to disrupt seemingly limitless areas of commerce. The use of artificial intelligence is strictly regulated. In China, the Communist Party takes effective control of the internet giants there, like Baidu, Tencent or Alibaba. Increasingly these companies become instruments of state control, just as in George Orwell's 1984.

The result is a collapse in the share prices of the FAANGs (Facebook, Amazon, Apple, Netflix and Google/Alphabet). With technology now 20% of the wider US market, this leads to a severe market correction.

Like most known unknowns and all unknown unknowns, the only certainty now is that whatever causes it, the correction, when it comes, will be a surprise. Indeed, we have had so long without a spike in volatility and a significant market downturn that in many ways the biggest surprise next year will be if we don't finally get one.

How can we help?

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