INVESTMENT THEMES 2020

Twenty-twenty vision

Our balanced view of the year ahead

Canaccord Genuity Wealth Management

Contents

How can we help?

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Welcome

Perfectly poised investment expertise

Each year, we develop our investment themes to share what we believe are the most important considerations for our clients and investors in the coming year.

While we don't have a crystal ball, we do have the substantial resources and tools of a global company to analyse today's economic fundamentals and key investment trends. We consider opposing views and weigh all the possibilities, to ensure we provide you with a totally balanced and unbiased view of the year ahead.

Our investment themes for 2020

We believe there are four important themes for investors in 2020: politics, interest rates, technology and an approach known as factor investing.

World economies and markets are undoubtedly being influenced by today's politics, so with 2020 set to be another highly political year, it's vital for investors to understand what's happening in order to make the right investment decisions.

On page 15, I look at whether there will be any respite for markets and how investors can best navigate this political labyrinth, while on page 5 Jordan Sriharan looks at the influence of politics on the direction of interest rates. Having been low for so long in the UK, investors could be forgiven for thinking they'll never go up again. Jordan, Head of our Managed Portfolio and Passive Services, explains how this could change and why it's so important to consider interest rates when investing in multi-asset portfolios.

Technology is never going away – we are all too emotionally invested in its benefits. But are we overlooking its dangers, and the way it changes our lives? Should we be scared? Maybe just a little. We should also be wary of the way we invest in technology, as Richard Champion, our Deputy Chief Investment Officer (CIO) UK, explains in his article on page 17. As we become a more socially conscious and caring society, investing in tech and picking the sustainable 'winners' is becoming more complicated.

We also discuss the pros and cons of 'factor investing'. While it may sound academic, Justin Oliver, our Deputy CIO International, provides a straightforward explanation and his rationale for why there could be an interesting shift between different factors in 2020.

This publication is the distillation of our most important ideas, so we hope you find them informative and thought provoking. Whichever way it goes, 2020 could provide exciting opportunities for investors.

If you would like more details of any of these ideas or our investment process at Canaccord, we would be delighted to hear from you.

Michel Perera, Chief Investment Officer,
Canaccord Genuity Wealth Management

Jordan Sriharan
Head of Managed Portfolio and Passive Services

Will UK interest rates ever go up?

Interest rates in the UK have been at extreme lows in the post financial crisis era, and sometimes it's hard to believe they will ever go up again.

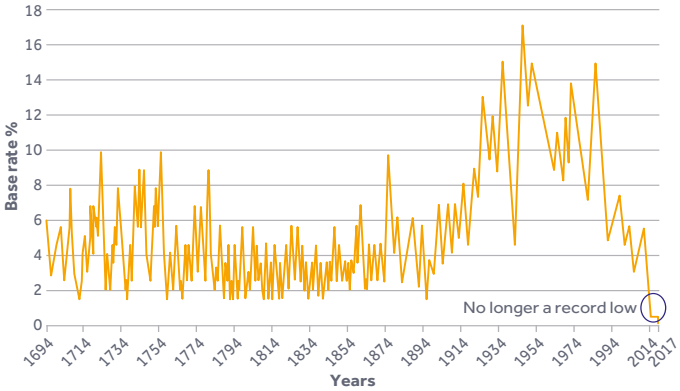
Nonetheless, it is still important to consider their future direction when choosing between different asset classes. Are interest rates likely to rise soon? What could possibly make this happen?

To find out what could make them rise, we need to look at what has kept them so low for so long.

Background

On 5 March 2009 the Bank of England cut UK interest rates to 0.5% – the lowest level since it formed in 1694. The base rate fell to 0.25% after the EU referendum and has since risen to just 0.75%. These have been intentional moves from the Bank to force savers to spend money.

Bank of England base rate 1694-2017



Source: Bank of England

However, a decade after March 2009, we might have expected rates to have moved a little higher. We can't constantly keep spending, surely?

In fact, a number of structural forces are keeping interest rates low. To start with, while we still live in a world of volatile commodity prices, technical advances in the extraction of raw materials have created a price ceiling.

Secondly, in the 1980s the Conservative government limited the power of the unions and this is still helping to control increases in earnings.

While those two factors are important for suppressing inflation and therefore interest rates, two other factors are helping to keep rates low: demographic changes and technological advances.

Blame it on the boomers

The retiring baby-boomer generation and declining fertility rates have changed the shape of the working population. Those approaching retirement typically need a pension to replace their income in old age and the most common way to generate income for a pension is through purchasing a blend of government and corporate bonds (often referred to as an annuity). Bonds are used because they pay a fixed level of interest per annum, and this forms the building blocks of a portfolio that delivers a set target income.

As more people retire, the demand for bonds increases. Higher demand leads to higher prices for bonds (bond yields have an inverse relationship, so higher prices mean lower yields and vice-versa), which has contributed to the low yield/low interest rate environment.

Technology – the transparent truth

The extraordinary advances in technology over the past 25 years have completely changed the way we do business. This has helped to reduce inflation, keeping interest rates down.

Because we now do so much shopping around online, and can compare prices in seconds, the price we pay for goods and services has become far more transparent. This has driven prices down over time. Lower prices lead to lower inflation.

Old academic textbooks used to tell us that lower prices reflect lower demand and a weakening economy. Today – aided by the power of technology – we can have lower prices, robust demand and a strengthening economy.

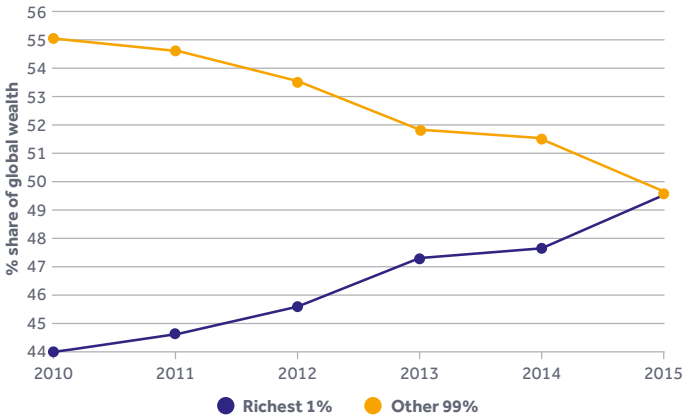
The power of politics

During the 30 years before 2009, interest rate policy reflected structural changes in the economy: as inflation fell, interest rates fell in sync. Yet monetary policy since 2009 has been more aggressive, with interest rate cuts being greater than the fall in inflation, forcing investors away from cash and bonds and into riskier asset classes like property and equities.

Since then, global economic growth has been robust, for which central bank policy makers cannot be faulted. However, growth has been unequal and the dispersion of wealth has widened. The huge uplift in both property and equity prices has benefited homeowners and investors, while those at the lower end of the financial spectrum have struggled.

The concept of 'trickle-down economics' suggests that the wealthiest in society spend the most and contribute the most in taxes. As long as their wealth increases this should trickle down to the poorer members of society. However, the evidence suggests that this has not, in fact, occurred.

Share of global wealth 2010-2015



Source: Oxfam

As a result, there has been a growth in the popularity of left-leaning political leaders, represented by Jeremy Corbyn in the UK and Elizabeth Warren in the US. Both want to reverse growing levels of inequality, and this means moving away from loose monetary policy and towards more egalitarian fiscal policy (i.e. taxing the rich, spending on the poor). The most significant consequences of more socialist policy-making could be the elimination of subsidies to asset owners (through low interest rates) and an attempt to redistribute towards the financially disadvantaged and disenfranchised (through more fiscal stimulus).

The election of Corbyn and/or Warren could force markets to rethink. Raising an excessive amount of government debt to inject a large dose of fiscal stimulus may play well to the electorate but could raise concerns over their ability to repay the debt. This can cause international capital to flow out of a country, possibly – finally – triggering higher interest rates.

In conclusion

The structural drivers in play in the global economy suggest that low interest rates are likely to be here for some time. However, in today's polarised political environment, this may provide the catalyst for higher interest rates in the short term.

We don't manage our discretionary portfolios through political forecasting, but it is critical to focus on both the short- and long-term drivers of interest rates. As the economic cycle gets longer and investor uncertainty rises, asset prices become more volatile. We believe the most important way to manage volatility in portfolios is by understanding the direction of travel for interest rates.

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Justin Oliver,
Deputy Chief
Investment Officer,
International

Factor or fiction? The truth about factor investing

During the coming year, we expect an approach known as 'factor investing' to play an even more important role in determining investment returns.

What is factor investing?

It is an approach that identifies and targets investments which exhibit certain 'factors' that drive investment risk and return. It is most widely applied to company selection within stock markets, although it can be extended to other asset classes. By either capturing or avoiding certain factors in an objective way, the aim is to improve portfolio returns, reduce risk and/or enhance diversification. Consequently, it's seen as a third approach to investing, sitting between full passive investing (whereby an investor seeks to match the return of a market capitalisation-based index) and traditional active management (where a fund manager will aim to outperform a stock market or index based on their subjective assessment of a particular stock's investment potential).

Factor-based investing is rooted in the world of academia, and academics have now identified over 600 factors which may influence risk and return. In reality however, many of these will simply have been used as marketing justification for the launch of a new investment product. There are five style factors commonly accepted as being the most important:

Value

This is the tendency for stocks that trade at a discount to similar companies based on fundamental valuation measures, such as cash flow or book value[1], to outperform more expensive assets. Purchasing securities at lower prices could lead to higher returns.

Quality

High quality stocks, defined by reference to metrics such as strong cash flow or high profitability, will generally outperform lower quality companies.

Size

Smaller companies in aggregate will, over time, have a tendency to offer a higher return than larger companies.

Momentum

Stocks which have recently outperformed an index will tend to continue outperforming and vice versa; the winners will keep winning, the losers will keep losing.

Volatility

This describes the propensity for low-volatility stocks to outperform high-volatility stocks on a risk-adjusted basis.

[1]The book value is the value of a business according to its books (accounts) that is reflected through its financial statements.

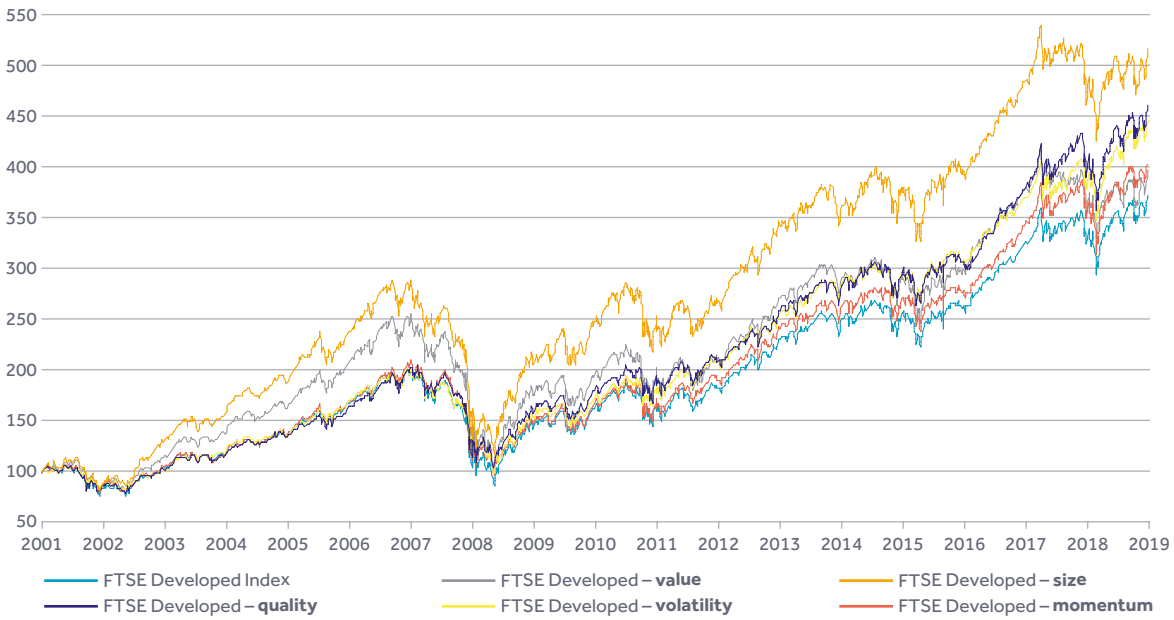
What are the implications for investors?

The factor approach has gained popularity because indices constructed using the factors of **value**, **quality**, **size**, **momentum** or **volatility** have outperformed traditional equity indices constructed by reference to market cap over the long term.

The chart below shows the returns of indices comprising companies that fit each of the five factors, relative to the market cap alternative. Each factor has outperformed over time.

Value, quality, size, momentum, volatility relative to market cap

Long-term factor returns rebased to 100

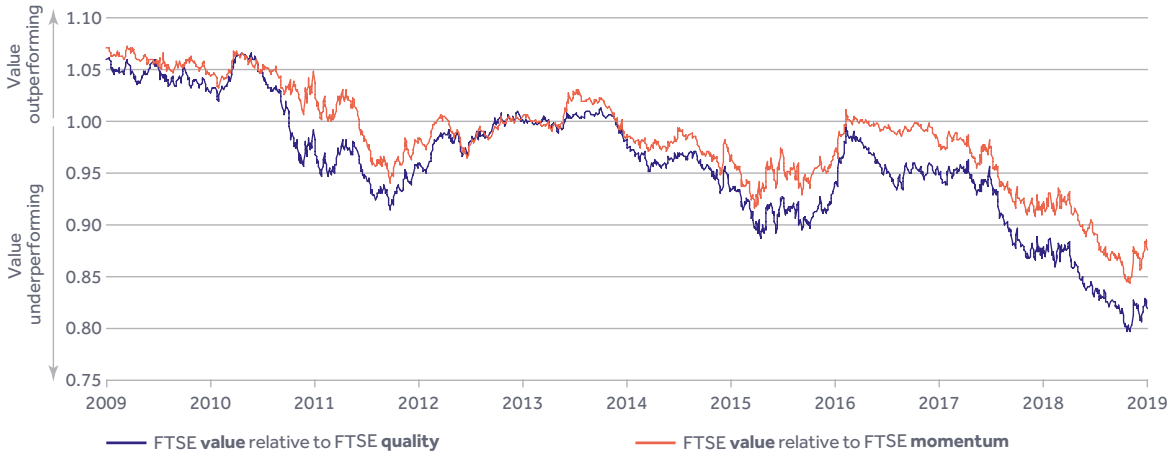


Source: FTSE

Over 20 years, these factors have added value. However, the outperformance of a factor in one year does not guarantee outperformance in the next, and it may be better to combine exposure to different factors, rather than relying on one single characteristic. For example, over the past few years, **value** stocks have consistently underperformed growth (where one is paying a high price for future growth prospects; the opposite of **value**), **quality** and **momentum** factors, but over the long term **value** has delivered outperformance of the broad market.

Given the significant underperformance of **value** and outperformance of **quality** and **momentum** as factors, it is reasonable to expect that 2020 may bring with it a reversal, with **value** set to outperform. The underperformance of **value** is currently at its most pronounced since the 1930s. To use an analogy, if we were to imagine an elastic band with **value** at one end, and growth (non-value) at the other, then **value** is becoming cheaper at one end (so stretching one way) and at the same time growth is becoming more expensive at the other end (stretching the other way). Therefore the relative valuation difference between the two is getting bigger because one is moving one way and the other is going in the opposite direction. At some stage, there will be a snap back and **value** will significantly outperform.

Value factor relative to quality and momentum



Source: FTSE

How could the performance of value stocks affect my investment strategy?

This has two implications for investors. First, they may wish to consider incorporating a dedicated exposure to **value** stocks.

Second, some strategies and funds have benefited from a focus on **quality**. These companies have also displayed **momentum**; they keep on outperforming. At some stage, this style will fall out of favour and these companies, and the funds which have a heavy weighting to them, will underperform. Investors therefore may wish to consider reducing their exposure.

Do factor strategies perform consistently during an economic cycle?

No. During periods of economic recovery, smaller and more flexible companies (the **size** factor) tend to perform better, as do **value** stocks. If growth is strong and/or stable but decelerating (as in 2019), **quality** stocks lead the way.

Quality and low **volatility** factors also work particularly well during periods of stress – and clearly, the current environment with trade wars and Brexit is a period of heightened uncertainty.

Since July 2009, movements in the yield curve (which plots bond yields for various maturities of debt) have significantly affected factor performance. A flattening yield curve aids **quality** and **momentum** factors, while a steepening curve assists the **value** and **size** factors.

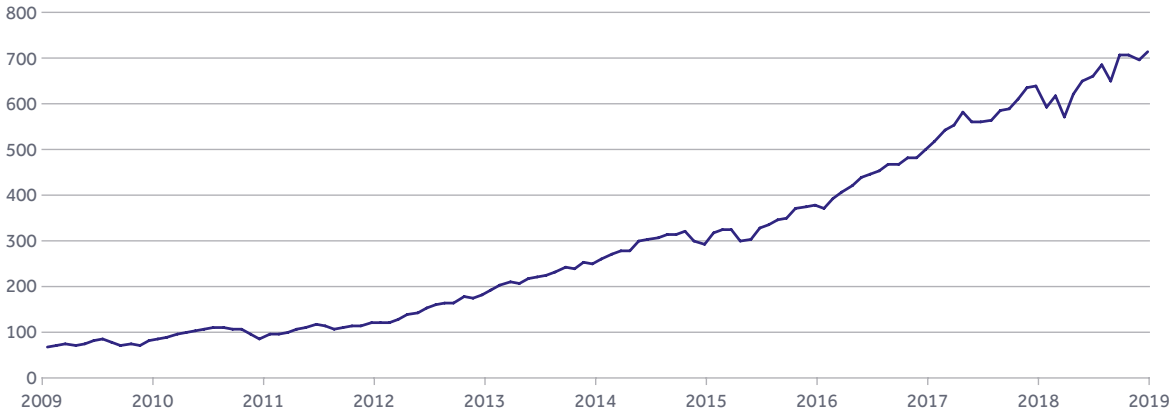
Over 20 years, these factors have added value. However, the outperformance of a factor in one year does not guarantee outperformance in the next, and it may be better to combine exposure to different factors, rather than relying on one single characteristic.

Is it easy to trade in and out of individual factors?

Actively increasing or reducing exposure to individual factors on perceived shifts in the performance drivers of stock markets is extremely difficult. Yet the explosion in the number of exchange traded funds (ETFs) which are based on factor investing has made it easier. According to ETFGI, the independent research and consulting provider on ETFs, at the end of December 2018, there were 1,298 factor exchange traded vehicles and 159 providers of such funds. These were listed on 40 exchanges in 32 countries, and accounted for assets under management (AUM) of US$617.65bn.

This could mean that it is much easier for certain style factors to become overcrowded and that, when reversals do occur, they are likely to correct more sharply and much more quickly than previously.

AUM of factor strategies (US$bn)



Source: Morningstar Direct

What conclusions can we draw?

Our job, as investment managers, is to understand what is driving performance, how much risk we are taking and whether we could generate better returns, or reduce risk, by changing the allocation to certain factors. This could become even more important in 2020.

Given the divergence in factor performance over the past few years, we would expect value to lead the way in 2020. However, it would be foolhardy to commit too much to one factor. The rewards for being right could be significant, but so could the cost of being wrong.

Politics and investing in 2020 – a primer for investors

Michel Perera,
Chief Investment Officer

Since January 2018, when President Trump began putting tariffs on imports from various countries, market returns have diverged massively. The best returning asset class has been developed market government bonds. It shows that if investors had been able to predict the course of the politically motivated trade war, they could have eked out greater returns and perhaps even avoided most of the Q4 2018 market bloodbath.

With 2020 set to be defined by significant political events (including a US presidential election), investors need to take a closer look at how politics affects markets and investments. What could happen? What's the best way to prepare for it? What is priced into the markets? Which events could be concerns or opportunities?

In this article, we look at the political and geopolitical considerations for investors in 2020.

Populism

The recent renaissance of populism appears to be inspired by the huge difference in income growth between the bottom 90% of the population in western countries and the top 1%. At the same time, emerging countries have come out of poverty and done better than the average western person.

Traditional left-wing politicians blame the rich for these income discrepancies, but more recently right-wing politicians have blamed foreigners, through immigration or globalisation. However, populism hasn't really affected markets, and is unlikely to matter to investors in 2020.

Socialism

On the other hand, what would happen if the populist wave were replaced by socialist politicians?

Markets dislike high taxes, unbridled social spending, nationalisation and government intervention. However, if a left-wing politician gets elected, they need a majority big enough to thwart opposition and pass their proposed socialist legislation.

- In the US, the president would need a majority in both houses of Congress, which is rare
- In the UK, the Labour party would need an outright majority.

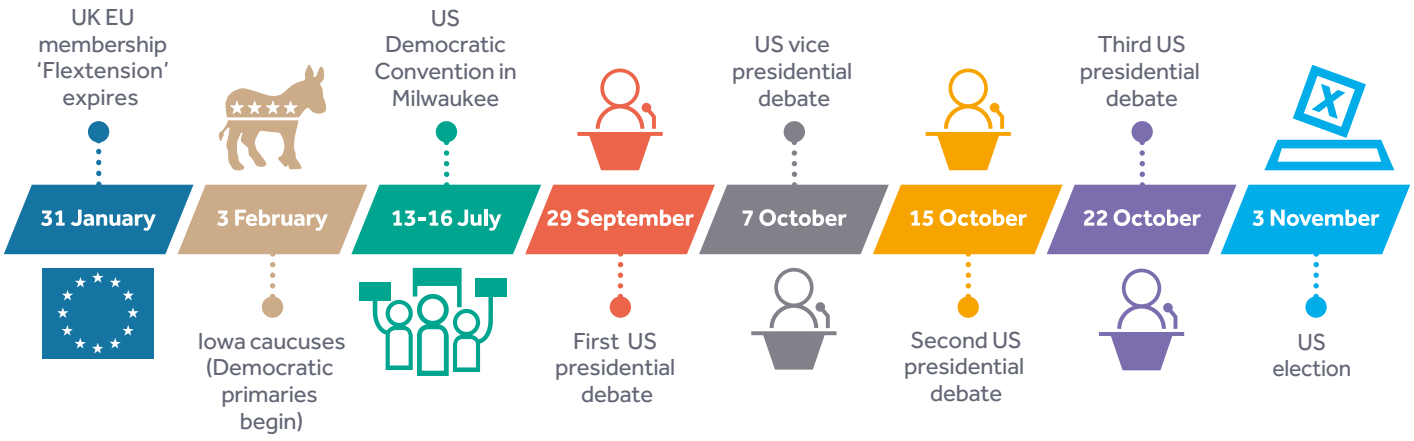
Without these majorities, the legislative programme could be severely weakened and have less effect on markets than feared.

The 2020 US presidential election

Historically, the differences between what Democrats and Republicans represented were minimal. Now, with clear differences between both parties, the outcome of the US presidential election matters more. President Trump's fixation with trade deficits is a clear example.

However, US presidents have limited legislative power and need to work with both branches of Congress to pass laws. Where one party runs the House and the other the Senate, little legislation normally gets through.

2020 political events timeline



President Trump has broadened his powers, but his potential impeachment could disrupt trade negotiations and exacerbate tensions.

Regardless of the outcome, the run-up to the election will create risks and opportunities for investors.

Geopolitical tensions – a new cold war between the US and China?

In the previous cold war between the two superpowers, the Soviets were hardly economic rivals to the US. Today, China is arguably less of a military competitor yet a stronger economic challenger (see table below), having built state-of-the-art infrastructure and turned into a manufacturing powerhouse. China has thrown down the gauntlet and the US has picked it up. This has led to trade tariffs, technology bans, intellectual property fights and tensions in the South China Seas.

In principle, investors could remain unconcerned. However, a massively escalated trade and technology war would affect everyone, reduce world growth and cause a huge slump in equities.

US vs China cold war: who can win?

US		CHINA	
+	−	+	−
Silicon Valley	Physical infrastucture	Nationalistic fervour	Control impacts creativity
Agriculture	Fractious politics	Government comprised of 'most competent' individuals, rather than most popular	Still a copycat
Entertainment	Manufacturing lags	Top-down allocation by government to investment sectors, rather than by markets	Ageing de-mographic nightmare
Financing for companies	Inefficiency at lower levels of economy due to majority of population being poorly educated/ skilled	Manufacturing powerhouse	Ruthless verdict of the market is missing due to investment sector allocation by government
Creativity	Not-invented-here syndrome	Infrastructure	Another Tiananmen?
Two oceans	Will golden goose of immigration be killed?	Education system	Could the Chinese consumer bug cause economic problems if people aren't saving enough?
Natural resources	Short-termism	Made in China 2025: a plan	
Military strength and technology		Belt and Road initiative	
Capital allocation by markets		Can make long-term investments	
Has been written off before		High savings	

Globalisation could morph into regionalisation, where a country dominates the continent within which it trades: e.g. China in Asia and the US in the Americas. Alternatively, the US and China might agree a truce with a limited trade deal, which would give markets a fillip before the US election.

Investing abroad

Diversified portfolios often invest in countries without western democratic traditions. Although these regions offer potentially higher growth, there are dangers. Portfolios may be affected by poor corporate governance, partially state-owned firms, opaque financial statements, meddling governments, corruption, or even expropriation.

Ecological issues

ESG investing (environmental, social and governance) can outstrip the performance of conventional portfolios. On the other hand, if governments are pressured into causing deep cuts to industry through environmental regulation, it could have a growth-dampening effect and hurt investor sentiment. Witness the slump in European auto sales triggered by the change in emissions standards in 2018.

Brexit

Reduced commerce between the UK and the EU will affect growth. Trade agreements take years, if not decades, to be signed, so relief for exporters may be slow to arrive, even after the UK finally leaves the EU.

Individual firms could still carve out a profitable trading position; it's a matter of finding the right investments. Careful 'bottom-up' stock picking will matter enormously. The currency aspect will also need thorough analysis, as sterling could fluctuate.

How can investors navigate the political landscape?

Given how deep seated some of these issues are, it seems politics will continue to be an important factor for investors in the foreseeable future. The clash of societal views between populism and liberalism could morph into a clash between political and economic extremes, with consequences for investors' wealth. Political events like Brexit can be either a risk or an opportunity, depending on how prepared you are.

The good news is that there will always be investment opportunities. However, investors may need to become more tactical and look at investments which could prosper under varying scenarios.

Investing in technology – a battle between good and evil

Richard Champion, Deputy Chief Investment Officer, UK

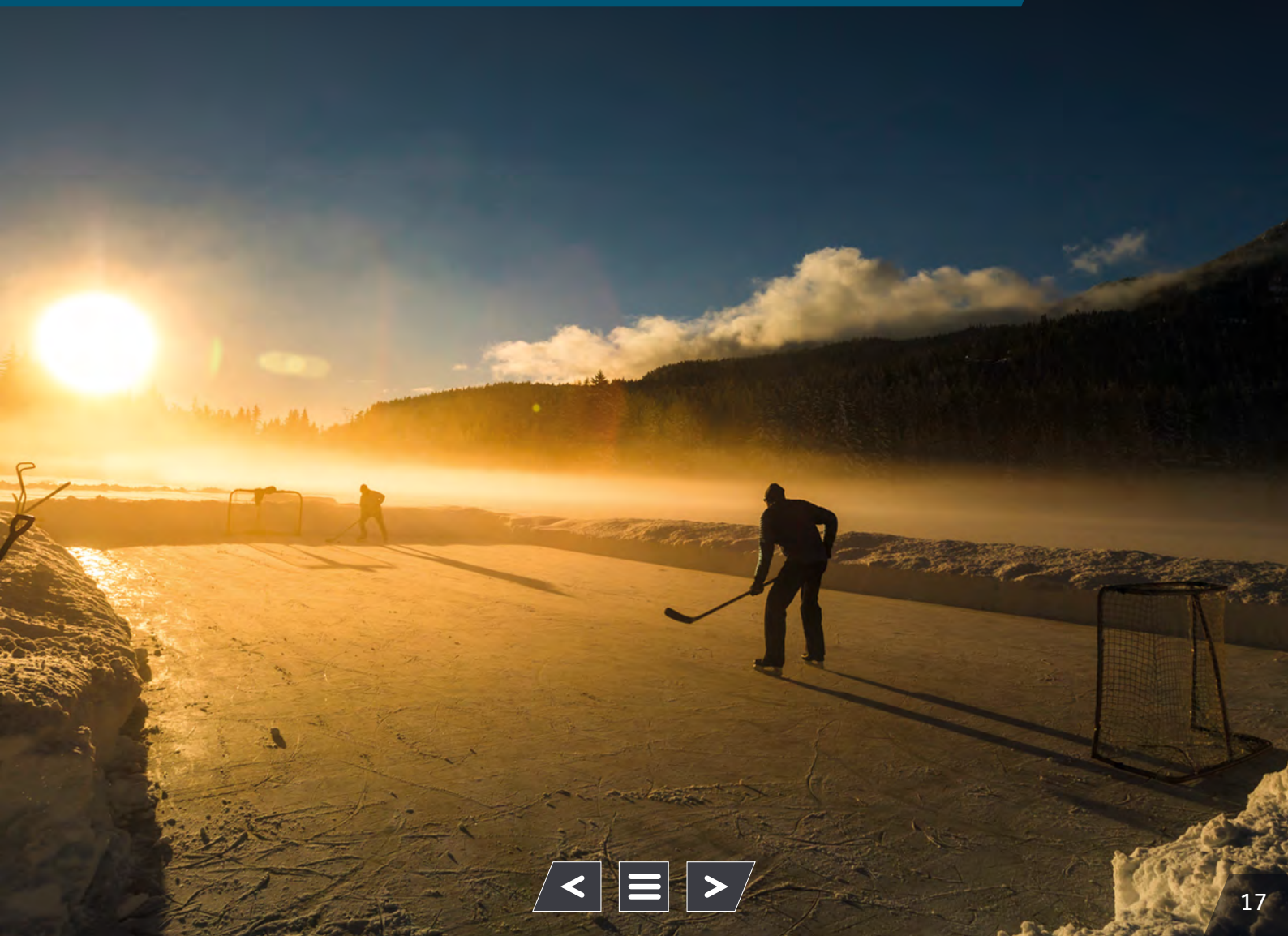
Investing in technology today is rather like the 'Star Wars' saga. While it has the redemptive potential of the Light Side, there is also a Dark Side. So, how do investors identify the 'good' tech companies and those that are not only ethical, but that will be successful in the long term?

The good and bad sides of technology

The benefits and utility of all the gadgets we live with today are obvious: looking up the weather forecast on the go, booking travel and restaurants, streaming films, email, social media, keeping in touch with the news, gaming for relaxation. We take all these things and many others for granted.

However, from the moment these online functions were created, they began to leave digital traces. So, unless we are exceptionally careful, we leave an echo behind of what we have searched for, bought, downloaded, uploaded, shared, written, and even what we have said.

And with advances in computing power and artificial intelligence (AI), it has become increasingly possible for companies and governments to delve into this deep mine of information. Over the last few years, the assumption that the data we create will only be used for the purposes we'd like has become naïve and simplistic. The Cambridge Analytica scandal was a clear example of this.



Our digital world

67%
of the world's population use a mobile device[1]

57%
of the world's population use the internet[1]

90%
of the world's data has been created in the last two years[2]

45%
of the world's population use social media[1]

42%
of the world's population access social media on a mobile device[1]

[1]wearesocial.com/blog/2019/01/digital-2019-global-internet-use-accelerates
[2]forbes.com/sites/bernardmarr/2018/05/21/how-much-data-do-we-create-every-day-the-mind-blowing-stats-everyone-should-read/#29dcf63b60ba

Investment opportunity or phantom menace?

When analysing technology as an investment theme in a world more and more focused on ESG (environmental, social and governance) factors, it's important to consider what has driven the more sinister turn of events recently and recognise the potential opportunities and threats for investment returns.

There are two factors at work. Firstly, there is the extraordinary facility of consumers to generate and hand over vast amounts of personal data. This is mirrored by the poor quality of personal, corporate and government internet and computer security throughout the world, such as multiple US municipalities falling victim to so-called 'ransomware' attacks.

The second factor is the rapid development of new technologies that allow for the creation and gathering of truly prodigious amounts of data. AI systems and machine learning allow previously hidden patterns to be discerned, while advances in optics allow greater precision in everything from recycling to agriculture. Facial recognition increasingly enables individual faces to be identified in large crowds, while voice recognition now means people talking on the street may be picked up and attributed to the speaker. Meanwhile, home devices routinely record conversations. Refinements to satellite positioning systems make our locations less a thing that belongs to us – and more just information that paints an intricate picture of who we are.

The shape of things to come

Beyond analysing our personal data for targeted advertising, the Internet of Things (IoT) means that ever more devices are now internet enabled, from domestic fridges to thermostats in the smart home and from agriculture to industry. Further, the rapid expansion of cloud-based data storage also means that there is now an almost infinitely scalable way to store the gigantic volumes of data.

In the western world, the potential abuses of this data explosion are being met with more intrusive regulation, with companies like Google, Facebook, Apple and Amazon under threat of being broken up.

In the eastern developing world, however, these threats go largely untrammelled. Indeed, in China, the rise of so-called 'social scoring' means access to housing, healthcare and education, the number of permitted children and even the ability to live in certain areas is determined by how well the citizen has 'behaved'. It is similar to how access to credit in the UK is determined by one's credit score, but has a sinister Orwellian overtone.

In China, the potential for new technologies to corral the masses and mould them in a certain direction isn't seen as a bad thing. Quite the reverse: it's the object of state policy.

Balancing the benefits against the downsides of investing in technology

Can it be acceptable to invest in companies that engage in or facilitate the dissemination of 'fake news', or that surreptitiously collect and exploit data from their users? Is it acceptable to invest in companies that make high-end semi-conductors used in gaming computers, which also happen to be key in enabling facial recognition, when that is used for racial or cultural repression? Does the nature of technology itself, with its propensity for creating giant quasi-monopolies, lend itself to sustainable investing?

Over the next 50 years, our western way of life, based on democracy and respect for individual human rights, is going to be challenged by a different world view. As China begins to flex its economic muscles, it would only be natural for a Chinese view to take precedence over the western tradition.

How these questions affect our decisions about investing in technology

Technology remains a key driver of economic growth, global development and equity market valuations; it has provided good returns for many investors and continues to present opportunities in terms of capital appreciation. Although we recently reduced our tech exposure in discretionary portfolios, partly on valuation grounds, it therefore means we are likely to add back to it at some point.

However, in a world more focused on ESG factors, we will have to ensure we're making the right decisions, and by providing capital to the 'good' technology companies, we can all build a better future.

The acceptable face of tech investing

There are certain areas of technology where we believe that, currently and ethically, the good outweighs the bad.

Health

Technology that helps people to improve their health or fitness can be an ethically acceptable investment. For example, devices or apps that measure activity or record heart rate, quality of sleep and other personal data.

Water

Access to drinkable water is a basic human right. Water technology providers are enabling people to transport, treat, test and use water efficiently. This can help poorer countries and communities to improve water quality.

Communications

Mobile phone technology can help people in poor countries with low-density populations to access education and banking services which would not otherwise be available to them.

Education

Apps and other technology are enabling people all over the world to benefit from distance learning and home tutorials, studying languages and attaining qualifications and practical skills.

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