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Wealth

A monthly market outlook from the Wealthsmiths™

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Positioning portfolios for uncertain times ahead

When it comes to building a balanced and diversified portfolio, it seems 2020 has torn up the rulebook. Despite a global recession and a second wave of coronavirus, equities are riding high, making it hard for investors to find growth opportunities within acceptable risk parameters. Meanwhile government bonds – the risk diversifying stalwart of any portfolio – are offering practically no return at all.

A two-tier market

A high-level view of global equity performance tells a story of rising prices and returns of around 40% since the stock-market crash back in March. But when we dig beneath the surface, we find a two-tier market made up of a handful of large-capitalisation companies whose valuations have soared and small-to-medium-sized companies that are not faring so well. To illustrate this, a comparison of the year-to-date returns (as at end September) of the MSCI World Total Return Index (up 1.7%) and the MSCI World Equal Weighted Total Return Index (down 6.6%) shows an 8.3% difference. This is good news for investors since it means there are still growth opportunities to be found. But we must also be mindful that, while company earnings should improve, this will take time, and we will need to be patient.

Government bonds no longer worthwhile

Meanwhile, as we explain in more detail in the Investment View section, government bond yields have fallen to nearly zero, and investors have to look to corporate and high-yield bonds to find meaningful returns. While attractive yields of above 5% can be found on high-yield debt, there is an increased risk of those companies failing to pay out in the current climate. But if we do our homework and proceed with caution, they have their place. Although they are not a perfect replacement, short-dated investment-grade corporate bonds can take on the role of a diversifier with stable returns, a function that government bonds have historically performed.

A promising economic outlook, but work is still to be done

Despite a return to lockdown in several western economies, there are signs the economy is recovering. The purchasing managers' index, which measures economic trends in manufacturing, has risen from 37 in April to 53 in September – the highest it has been for over two years. Factories are running, and inventory levels are being restocked. Unusually for a global recession, recovery is being hindered by the services sector, and this is likely to be the case until a Covid-19 vaccine has been found and governments can confidently open public areas without restrictions.

The Sanlam view

The outlook for equities over the next three to five years is one of lower returns and increased volatility as some companies will do better than expected while others disappoint. With government bonds providing almost no scope for returns, investors will have to look elsewhere to fulfil the diversifying, low-risk function that those bonds previously performed. Valuations in many companies are high, making easy wins hard to come by; however, the market has repeatedly overlooked a number of quality businesses in favour of high-growth tech names. Although caution should be exercised, this provides opportunities for careful stock-pickers willing to do their homework.

[1]An average score across G20 countries that publish this data

Despite the second wave of lockdowns, the fog of uncertainty has thinned since March, however, the economic outlook remains weak, both in the short and long term. The cost to returns of protecting portfolios against short-term volatility has increased to the point where we will have to accept some volatility while waiting a little longer for decent returns.

Philip Smeaton
Chief Investment Officer

£32,000

The amount of UK debt per head of population. In the US, it stands at approximately $82,000.

Source: Bloomberg

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Investment view: why government bonds are no longer viable

Government bonds traditionally protect portfolios when equities fall, but current conditions mean they are offering zero return potential and can't provide the diversification we need. As a result, there is no longer a good rationale for holding these bonds, and we have decided to sell a large proportion of them.

The promise of a government bond

In normal economic conditions, government bonds (also known as sovereign debt) give investors the promise of a given return over time, with very little chance of that promise not being met since it is backed by the government. While the promised return is never huge, the fact there is a very low risk of default means that they play an important part in diversifying risk across a portfolio.

Why are government bonds out of favour?

But high levels of government debt, combined with persistently low interest rates, that means government bond yields have fallen close to zero. If interest rates remain low or become negative, and inflation doesn't rise, then you can still achieve a return on low-yield government bonds. But what if the economy recovers over the next three to five years? The longer-term opportunity cost of holding these assets for no return doesn't add up, and the risk of capital loss in the event the economy normalises is significant. It's simply not worth it.

What's the alternative?

To ride out this period of uncertainty, we are replacing a large proportion of our government bonds with short-term corporate credit, constructed in a bond ladder. That way, we can create a known positive return from companies that are highly unlikely to default on that credit in the next two years.

The chart shows an example of how a bond ladder might look. This example consists of five large global companies that offer an average return of 1.12% over an average of 1.4 years. While the return is not huge, it is better than we can achieve with government bonds and provides the risk diversification we need across the portfolio. Since the duration of these bonds is low, we can then liquidate and buy back into government bonds when they recover.

Bond ladder

Issuer	Expiration	Duration	Net yield
Co-operative Bank	November 2021	1.1	1.04%
Daimler	January 2022	1.3	0.78%
Deutsche Telekom	April 2022	1.5	0.42%
Scania	June 2022	1.7	1.42%
Phoenix Group	July 2022	1.8	1.88%
Average	**-**	**1.4**	**1.12%**

Source: Sanlam.
For illustrative purposes only.