FACING UP TO REALITY

April 2024

ARC RESEARCH

THE PURSUIT OF BETTER INVESTMENT PERFORMANCE

FACING UP TO REALITY

"You take the blue pill, the story ends. You wake up in your bed and believe whatever you want to believe.

You take the red pill... and I show you how deep the rabbit hole goes."

MORPHEUS, THE MATRIX (1999)

For many investors the first few years of the 2020's will have felt both unstable and unsettling. Private clients have watched the value of their portfolios oscillate alarmingly as financial markets have been on a rollercoaster ride.

The latest downturn, which commenced towards the end of 2021, has proven particularly pernicious after taking account for inflation. However, arguably investor reactions to COVID followed by the invasion of Ukraine have been metaphorically akin to investors swallowing the "blue pill" and refusing to face up to reality.

Investors should not be surprised that fiscal and monetary policy profligacy across the globe has ended up being inflationary.

As early as February 2009, in the immediate aftermath of the Global Financial Crisis, Warren Buffet wrote:

"In poker terms, the Treasury and the Fed have gone **all in.** Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel.

These once-unthinkable dosages will almost certainly bring on unwelcome after effects.

Their precise nature is anyone's guess, though one likely consequence is an onslaught of inflation."

WARREN BUFFETT

FACING UP TO REALITY

Of course, there is nothing modern about a government spending wildly beyond its means and then searching for an easy way out.

In 1455, Henry VI granted patents to alchemists for "*enabling the king to pay all the debts of the crown in real gold and silver*".

Some 555 years later, President Obama turned to the quantitative easing alchemists at the Federal Reserve to solve the same problem. Other central banks were swift to follow.

What investors have every right to be surprised about is the length of time it took for inflation to take hold, thereby forcing a normalisation of interest rates and ending a QE-created illusion. In retrospect, 2010 to 2020 was a golden period for equity investment, with outsized equity market returns at a time when bonds, commodities and hedge funds struggled.

As the decade progressed, with inflation remaining quiescent and economies robust, multi-asset class investing increasingly became viewed as archaic and pointless. The optimal portfolio now consisted solely of equities, a viewpoint encapsulated in the acronym TINA, There Is No Alternative, as equities were driven ever higher by excess liquidity and bond yields moved to ultra-low or even negative levels.

But whilst TINA might have been the doyenne of the 2010s, the 2020s are surely going to be the decade when TARA once again comes to the fore. Coined by Goldman Sachs, TARA is the acronym for There Are Reasonable Alternatives. Investment strategists are seemingly united in the view that the return of positive real interest rates in bond markets means that there are now multi-asset class investment solutions available offering attractive return characteristics across all risk appetites.

So, looking ahead, what lessons can investors glean from the Wonderland decade and the subsequent harsh return to reality?

- With equity markets reaching new highs and bond yields stabilising, it is tempting for investors to believe that all is well in the investment Wonderland.
- However, adjusting for inflation, most private client portfolios are back to 2016 levels.
- If financial market returns revert to typical historical averages, the typical sterling private client investor needs to accept that their real wealth has fallen by around 15 per cent from its 2021 peak.

The return of TARA means that now is the perfect time for investors to ensure that their portfolio asset allocation is in harmony with their risk appetite. The siren call of TINA into equities has been muted.

A NUMBERS GAME

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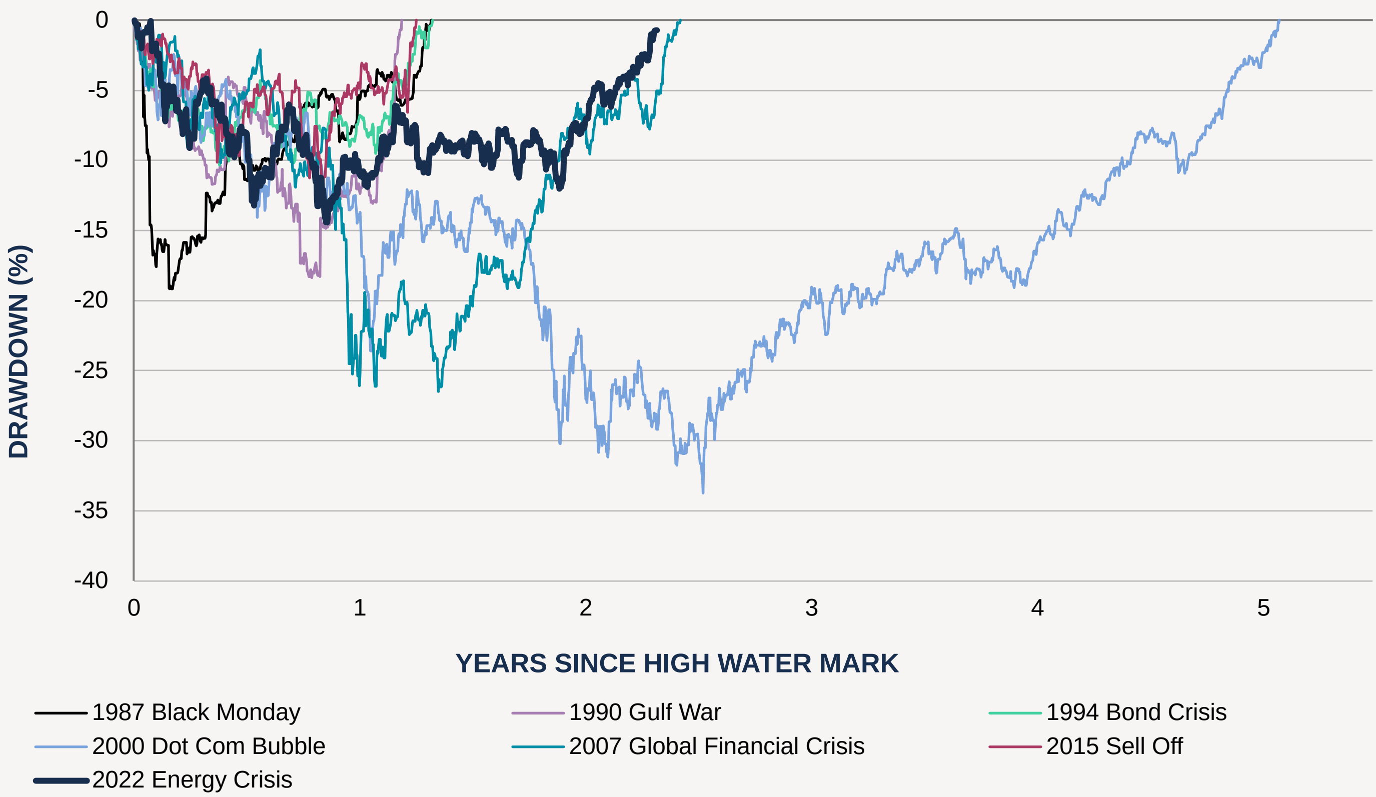
The chart below plots the time the average ARC Sterling Steady Growth private client portfolio would have taken to recover from a financial market shock.

Since the flash crash of 1987, there have been 10 occasions when such an investor might have experienced a drawdown of over 10 percentage points. Of those, on seven occasions nominal recovery took longer than a year.

NOMINAL RECOVERY TIMES



Way out in front, with a recovery period of five years, is the drawdown caused by the bursting of the Dot Com Bubble at the turn of the Millennium.

The next longest nominal drawdowns were after the Global Financial Crisis (GFC) in 2008 and the recent energy-driven inflation pulse precipitated by the Russian invasion of Ukraine.

In both these cases, nominal losses were broadly recovered in just over two years.

NOMINAL VS REAL RETURNS

Nominal returns are simply an expression of the numerical returns of an investment, i.e. the change in price and any income received.

Real returns adjust the nominal returns for inflation (as measured by the UK Consumer Price Index), or how much the cost of goods and services has increased, providing a clearer picture of the change in purchasing power.

THE REAL STORY

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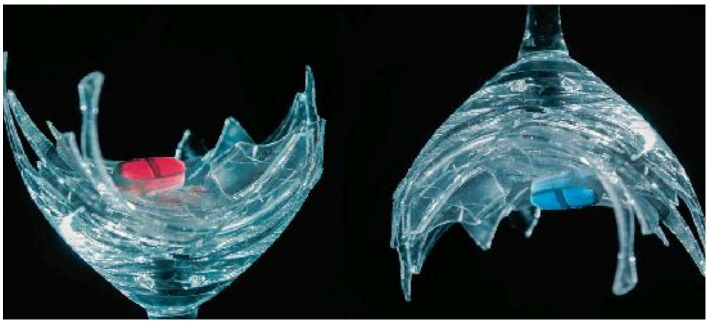


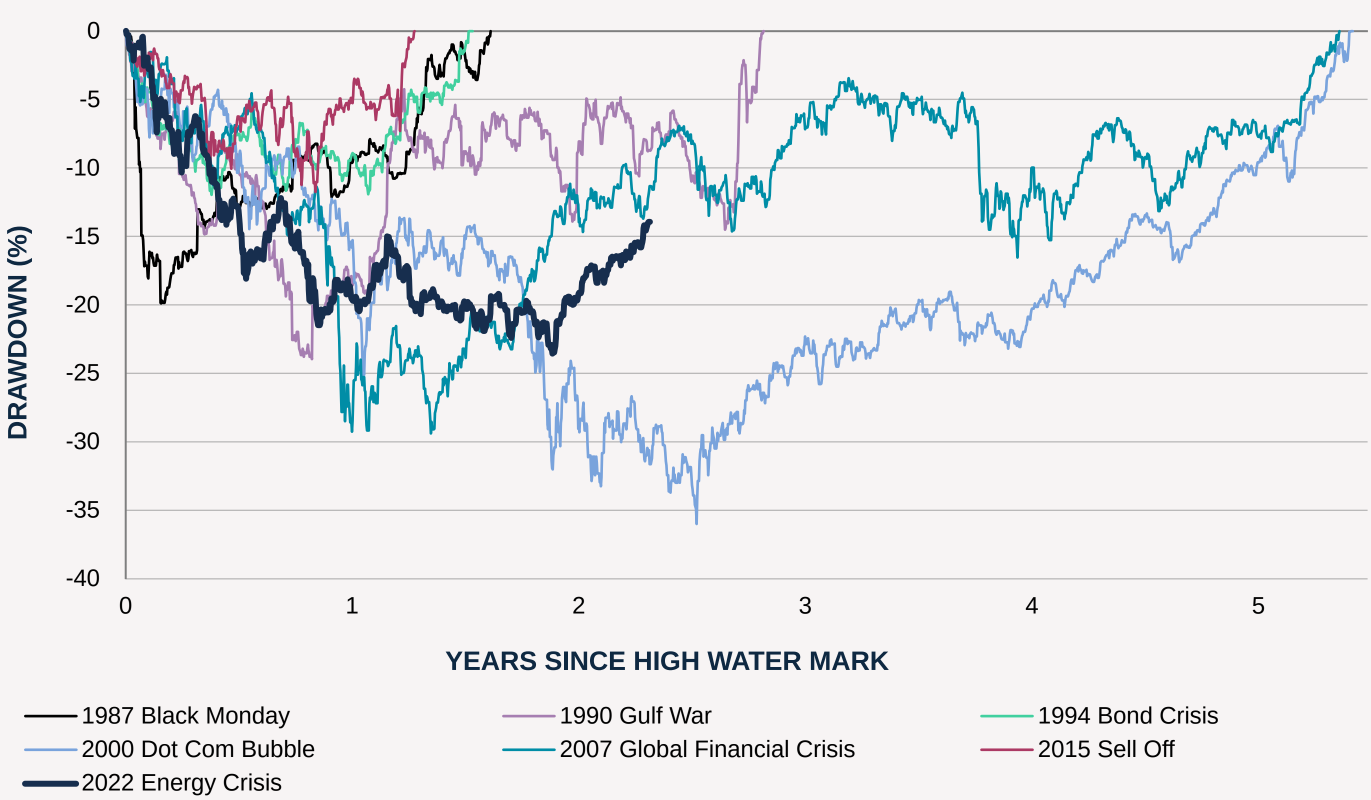
The return of inflation means that investors need to face up to reality.

Thinking that recovery in nominal terms means their portfolio is back on track is rather like swallowing the 'blue pill' and accepting an illusion.

Thus, whilst money illusion might make an investor feel more comfortable when their portfolio recovers to a previous numerical high, the 'real' question is at what point previous purchasing power recovers.

Once adjusted for inflation, drawdown periods for the GFC and Dot Com Bubble converge at just shy of six years; and after two years the current drawdown is still around 15 percentage points away from real recovery.

REAL RECOVERY TIMES



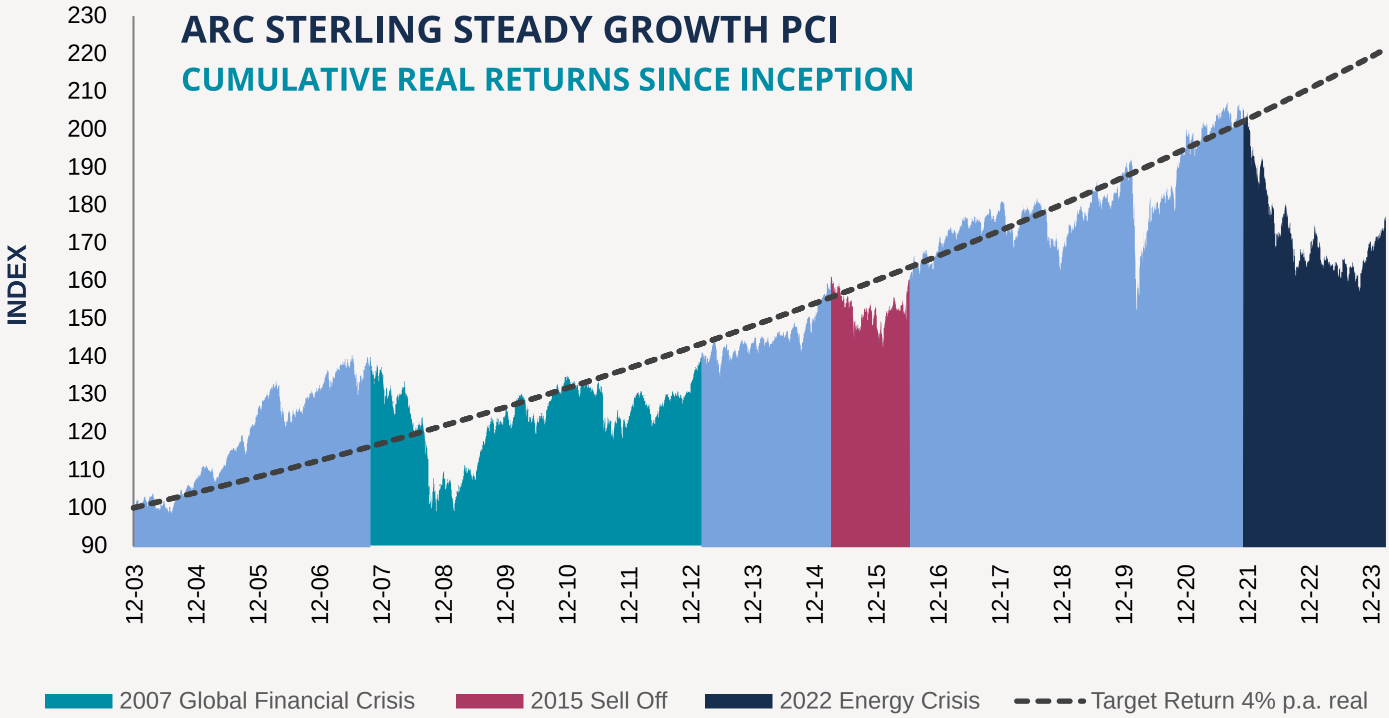
The current drawdown is still around 15 percentage points away from real recovery

THE REALITY GAP

Every investor with an inflation-based performance yardstick will be acutely aware of the reality gap that has opened up.

As time ticks by and a real recovery in portfolio value still looks distant, those who rely on regular withdrawals from their investment portfolios should be wondering whether belts need to be tightened.

The chart below plots the ARC Sterling Steady Growth Private Client Index since inception against a trend line of inflation plus 4 percentage points per annum. That target is a common expectation for a multi-asset class portfolio with equity exposure of around 70 per cent and suggests that an investor in such a strategy should be able to sustain a withdrawal rate of up to 4 per cent per annum over the long term.

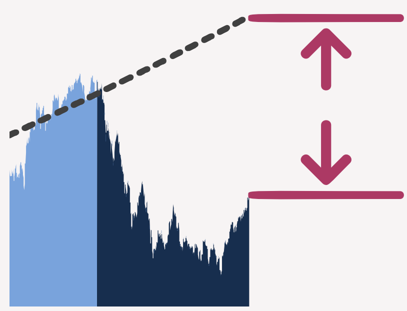


The light blue shaded periods are punctuated by recovery periods from three market drawdown events: the 2008 GFC; the 2015 sell-off; and the 2022 energy crisis.

Note that up until 2021, the ARC Sterling Steady Growth PCI was delivering real returns of circa 4 per cent per annum.

However, the most recent drawdown has caused a very significant gap to appear.

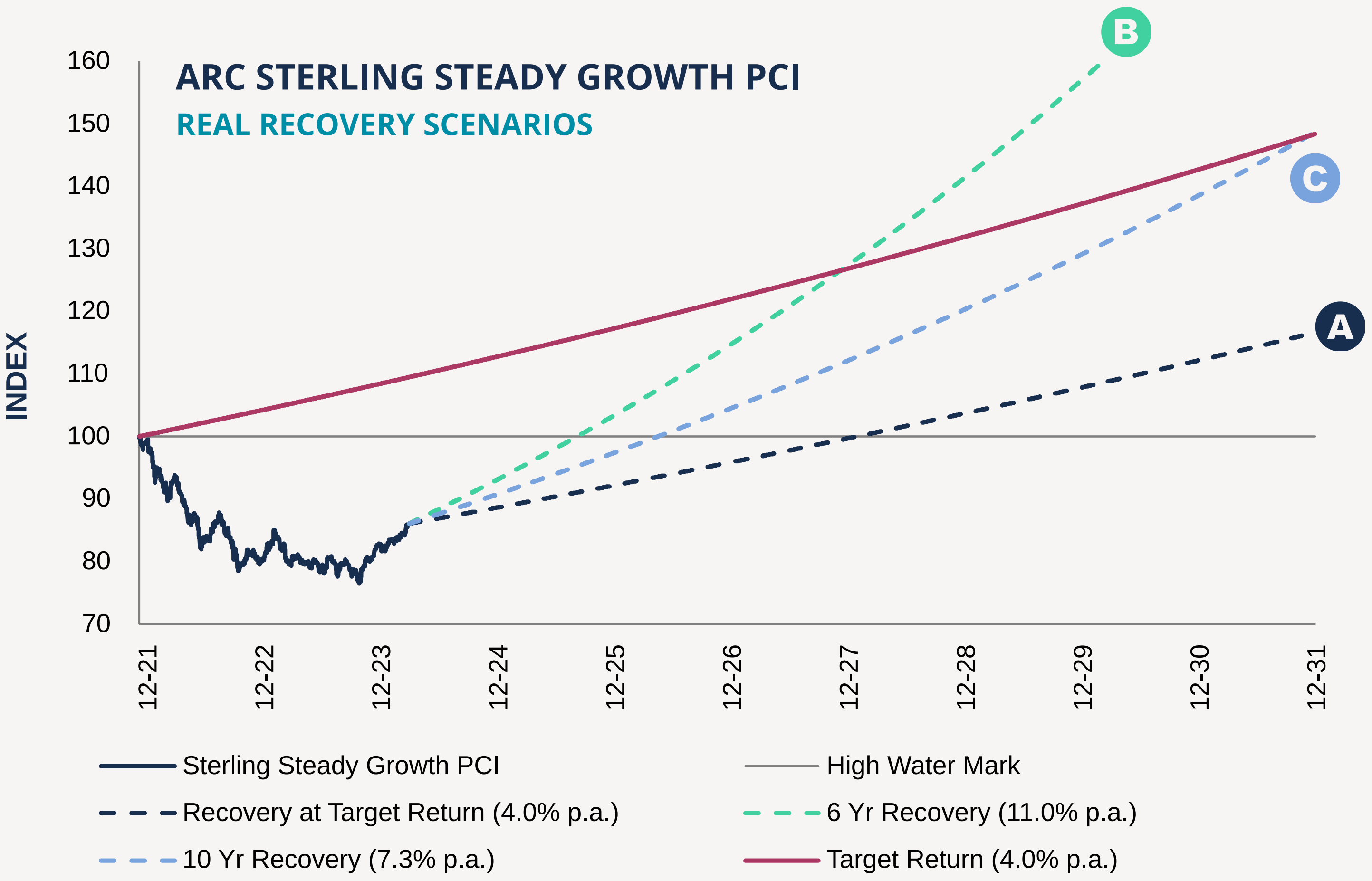
To restore real wealth to the long term Target Return in 6 years will require real returns to average 11% pa from here.



REBASING EXPECTATIONS

It is tempting for investors to place their trust in long-term averages and try to look beyond market cycles. However, it seems increasingly certain that the re-adjustment of bond yields in 2022 has resulted in a one-time downward shift in the wealth of investors.

The thick blue line shows that the reduction in real wealth from December 2021 to March 2024 has been around 15 per cent. In the meantime, the red target 4 per cent per annum real return line has moved upwards meaning the performance gap is currently around 20 per cent.



A If steady growth portfolios deliver average real returns going forward of 4 per cent per annum, real recovery will take six years, similar to the two previous worst real drawdown periods during the last twenty years, those precipitated by the dotcom bubble and the GFC. Perhaps more importantly, the "average" steady growth portfolio will never bridge the gap back to the Target Return of 4% per annum in real terms.

B To restore real wealth to the long term Target Return in 6 years will require real returns to average 11% pa from here. That feels unlikely!

C To restore real wealth to the long term Target Return within 10 years will require real returns to average 7.3 per cent from here.

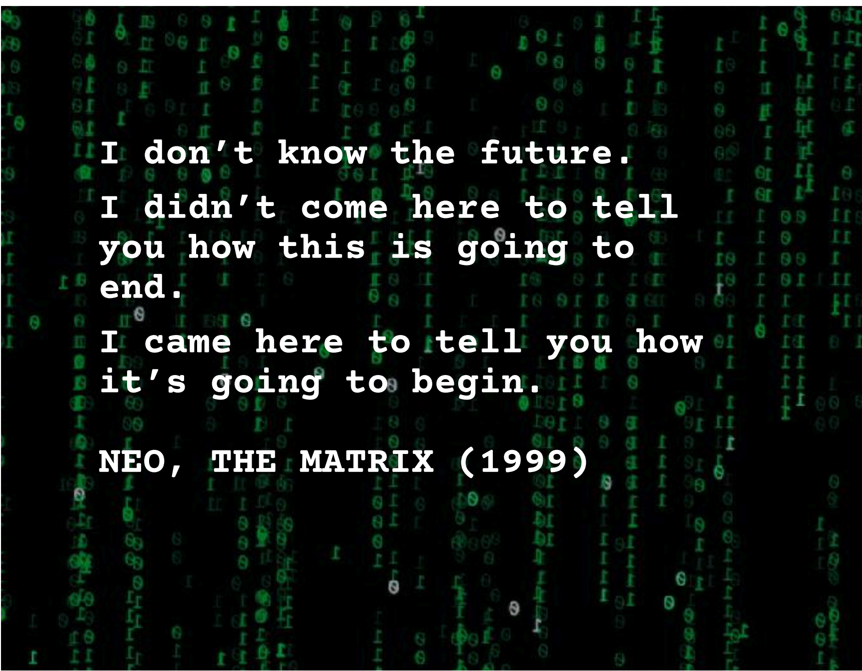
CONCLUSIONS

- Whilst steady growth multi-asset class private client portfolios have, on average, recovered in nominal terms, once adjusted for the impact of inflation it is apparent that the real value of portfolios is still significantly below its 2021 peak and akin to those first seen in 2016.
- A recovery in real wealth will require a sustained strong performance by both bond and equity markets. If the current drawdown is only going to match the longevity of the dotcom bubble and GFC, real returns over the next three years will need to average 4 per cent a year.
- If real performance reverts to its historical norm from here, it will be necessary for investors to begin adjusting their future withdrawal plans accordingly. The sustainable level is probably around 20 per cent lower today than it was at the start of the decade.
- Investors should also be thinking about their investment risk appetite and asset allocation mix. TINA has given way to TARA. Multi-asset class investing should once again offer both risk diversification and positive real returns.

Sir John Templeton, described by Forbes magazine as one of the most successful money managers in history, had ten investment maxims. The first two were “Invest For Real Returns” and “Keep An Open Mind”.

In an ever-changing world, it is too easy to get caught up in the crowd and chase yesterday’s winners.

Financial market behaviour today may be analogous to 1999 when the first Matrix film was released and the dotcom bubble was at its peak. But as Neo famously said at the end of that film “*I don’t know the future. I didn’t come here to tell you how this is going to end. I came here to tell you how it’s going to begin.*”



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