Learning outcomes: 1. How to invest for the long-term, despite short-term volatility and uncertainty 2. The factors that can give active managers a long-term advantage 3. The role of asset allocation in providing lower volatility returns to investors SIMON EVAN-COOK: Well there's a whole plethora of risks in life, but also in our financial services industry. There are so many, but the one we focus on really most of the time in our industry is volatility. And that to me brings with it a very short-term focus: you're worrying about what's going to happen over the next six months, over the next year quite often. But that I think brings with it its own set of risks. That in focusing very much on that short-term period you're forgetting to think about what could happen over the long term. So if you're saving for your retirement, which may be whatever, 20-25 years, or saving for your kids' university fees, very much long-term time horizons. If you're worrying about Brexit or you're worrying about Donald Trump, so therefore you're not putting your money in your market, that can go on for a long time and you end up potentially damaging your retirement by not investing today because of short-term concerns. So I've got a great chart that I think sums this up very well. It's from the Barclays Equity Gilt Study. It goes back over 100 years back to 1900. It's very full in terms of what it shows. It's worth explaining what this is first of all. So you've got the three asset classes on here shown as cash being orange, gilts being green and UK equities being blue. And what it shows is the range of outcomes you can get on an annualised basis over different periods. So if you take the bottom row, to start with here, it shows the range of outcomes you could expect from equities. The very worst you've ever had in any year has been a loss of nearly 60%. The very best outcome you've had in any calendar year has been again almost 100%. And obviously it's slightly smaller, less dramatic outcomes for gilts, then cash. MIKE HAMMOND: I assume when you're talking about returns Simon, I assume that you are talking about those returns, i.e. real returns after inflation. SIMON EVAN-COOK: Yes, it's very much real returns. So you can see there that cash has made a loss on this chart here. Obviously you can't do that in the real world with cash, unless you're talking about real returns, about inflation. So in a situation where inflation is higher than interest, then you can make a real loss from holding cash. So that's what this chart is showing. It shows after inflation returns. Now what the higher rows mean is that it's rolling periods. Again it's annualised returns within those, but if you go up the chart from five to 10 to 20, 23 years, so they're rolling periods. So the top row there is a rolling 23-year period, annualised returns again. So it goes from 1900 to 1923, from 1901 to 1924, so on and so forth all the way through to 1992 to 2015, so very comprehensive. But the most interesting thing about this chart is that you go from that one-year period up to the 23-year period at the top then, what you see is as your time horizon gets longer, what initially appeared to be the higher risk more volatile asset, because of the real features of that asset, it becomes the lower risk. So if you are investing for a 23-year period, actually you've never made a real loss from UK equities. You have from gilts and you have from cash. So on that basis when you've got that longer time horizon actually it becomes a lower risk prospect investing in equities than investing in something like cash or gilts. MIKE HAMMOND: So, on that basis then, what is your view in terms of why clients don't take sufficient risk? SIMON EVAN-COOK: Well I think what it comes down to is that we all have a mental quirk where we are always, we all say we're long-term investors. And I've put up a slide here saying Lord make me chaste - it's a famous quite from St Augustine - Lord make me chaste but not today. I think it's the same with long-term investing. That people say they're long-term investors, and they want to be long-term investors, but what their time horizon tends to look like is much more like the bottom line you see here. They're looking for what could happen over the long term, but they have that obstacle of the short term in the way first of all. So they think I'm going to be a long-term investor, I'm going to invest for my pension, but I just want to see how Brexit works out, or I just want to see what Donald Trump does. But the trouble is there's always something in the short term. There's always some reason not to invest today. It's just like we all have with our exercise plans or with our diets or whatever. There's always a reason not to go on the diet. We've just had Easter so that for me was a reason not to cut down on sugar because well there's no point doing it today, we've got Easter coming up. And I think people are the same when it comes to investing. They're just worrying too much about what's going to happen in the next very short period, and not enough about just getting invested today. MIKE HAMMOND: OK, so since 2009 we've been in a bull market, and arguably one of the most mistrusted bull markets of all time. Clearly there's a lot of political uncertainty around, so is now really a good time to invest? SIMON EVAN-COOK: I think it is if you have got a long-term perspective. Now I'll qualify that and say it's not the best time to invest for a generation. You really need to be at the bottom of a bear market when everyone's very fearful, so 2008/2009 were clearly amazing times to be invested. But I do think it is, if you've got a long-term time horizon, a good time to be investing. Now, I've put up a chart here, because I mentioned 23-year periods, and I wanted to show what's happened over the last of those 23-year periods just to give you an idea of what that experience was like. So if you start back here, you're looking at the end of 1993. Now you think back to what the conditions we had in those times. We had a terrorism threat, so you had a bomb being set off in the middle of Bishopsgate that year. You had, we were effectively in a recession. We'd had the ERM crisis. So there were lots of problems around this time. So it did not feel like a good time to invest. Certainly there were lots of short-term reasons to say I'm just going to hold back and see what happens. But then if you go through this chart all the way along here, you can see you've got 1997, you had the Asian crisis. You had the tech bubble bursting in 1999. You had a recession following that. Then the Iraq invasion in the early 2000s, 2003, then fast forward to the financial crisis in 2008, and the more recent dip you see at the end there being the Chinese FX crisis. And even now when you get to the top of this chart, you have Brexit, you have Trump. There's all sorts of reasons not to put your money into the market today. And yet had you ignored all of those scary reasons 23 years ago, you'd have had 7.3% per year return, and that's before inflation not after, but still a worthy return after inflation if you'd just invested and stayed with it. Now one of the risks that I hear people, when they look at this chart and think well that's all very well and good, I get the whole macro risk thing, but the reason I'm not investing today is because this chart goes from the bottom left up to the top right, so I don't like the fact that it's ending up at the top right. This looks like the top of the market type of thing. And again that's the kind of thing that as investment manager I worry about: are we buying at the top of a market? So I thought what I'd do is I'd look at the previous chart, the previous 23 years before this to see what happened in that 23-year period. Were you effectively buying at a trough and then this 23 period's just been a blip where you've been recovering from that? If you bring up the chart you can see no. It's the same shape chart, and you had exactly. If you were investing for this 23-year period you had the same considerations and concerns you did for the other chart. MIKE HAMMOND: It's quite interesting looking at that graph as well, because it clearly shows in the first four or five years you would have been struggling to make any money at all. SIMON EVAN-COOK: Absolutely, and that's what I mean by being a long-term investor. It is accepting that there might even be a four/five year period when not much happens. But staying invested for a 23-year period, for a long period, it means that you'll even out. So you talk about the '70s there, so you had oil crisis, international tensions. Going through to the '80s a couple of recessions early on there, you've got that sharp dip there for, and in 1987 the stock market crashed then, and then ending up as I mentioned before in that period in the early '90s in a period of recession. We'd just had a serious devaluation of the euro, and we'd also got economic problems and global concerns about what's happening in terms of international tensions. But you could describe the current day in exactly the same. We've got exactly the same concerns today, and the chart almost looks exactly the same as that. And yet at this period here if you got invested and stayed invested you've actually done well enough. So that's really what I'm trying to get at, is that I'm concerned that people are worrying too much about short-term considerations, and not enough about using the compounding power of equities and other good investments like that. MIKE HAMMOND: Thanks Simon. So, on the basis that you're looking to provide long-term capital growth for your clients, and you're also looking to do that with reduced volatility, how do you actually add value for clients when you compare that to the many low cost solutions that are now available in the marketplace? SIMON EVAN-COOK: Well I've been quite a passionate advocate of active investment since I've been running the fund. What I consider to be the strength of the passive argument is quite obviously the point they make about charges. And what I mean about that is that if you can get yourself a small advantage that works for you on a very regular basis and then leave that for a long time period, that compounds for you. And that's effectively the passive argument. Is that OK if you're going to be, if you can't do better than average, then you're better of reducing your charges and letting that not be a disadvantage by paying more charges and still being average. Now I get that, and that's a very powerful argument. But what I think it does is it forgets that there are all sorts of other advantages that you can get working for you rather than just stopping working against you. And get those powerfully compounding year-after-year, month-after-month in your favour. And they are more powerful, more dramatic than the small amount you can save from charges. I mean obviously we're trying to bring charges down as much as we can through negotiating with our fund providers. But if we can do other things that give us regular compoundable advantages, then I think we can way outweigh the advantages a low cost provider has over what we're offering. So I've called them, or I call them our six edges. And very broadly speaking these are areas where we think we can add a consistent compoundable advantage over markets, over our peers. And a lot of these advantages actually come from the type of fund manager we're picking, or the type of underlying vehicles that we're using. Well the first things we look at is, and the first edge we have is that we are very highly active. So we're looking primarily and starting with very active fund managers. Now this chart here comes from a study I did back in 2014. It was looking at how active UK equity managers are within the IA sector. So what I did was I took the UK equity income sector, I took the UK all company sector, which is effectively the two big UK equity sectors. Meshed them all together, and then re-split them based on how active they were, so using active shares. So if you had an active share of 100 being the highest, it means you're very highly active versus the FTSE all share. If you're a zero that means you're the perfect tracker, and then you obviously have a spectrum in between of how active you are. Now the blue part on the chart here shows how many funds in those two sectors are highly active, so that's 80% plus. You've got the green section here showing still active but not as active as the blue guys. And then the orange section here is closet index. Now what I mean by closet index is funds that are basically looking like the index, they're acting like the index, they don't look very different, but they're charging active fees for doing so. And when there's been a lot of anger directed at fund managers, I think it's directed at this part of the market where effectively you're paying a high fee for a produce that really isn't giving you a great advantage. And then you have the yellow part down here, which is genuine trackers, so they're openly tracking the market. Now what this shows I think is that really that's our pool. What we start looking at first and foremost is the blue part of that chart. So we can certainly discount the yellow part and the orange part. So we look at the blue part, and we'll have some that we look at in the green part as well. But those are the really genuinely active fund managers. Now there was another part to this study going back to 2014 that I looked at as well. I want to see am I mad doing this? Is it the wrong thing to be buying these highly active funds? Am I just taking more risk and not getting enough return back? But satisfyingly the numbers showed that even if you just picked the average highly active manager, so the average manager in that blue box. As you can see from this table here across almost all time periods, 10 years is quite a meaningful one but the peak as well as they were show that the highly active portion, even the average fund manager in there was outperforming its peers, being other active fund managers or trackers or particularly closet trackers by quite a long way. And that's without any selection from me. That wouldn't be me saying I think this guy's good or this guy isn't; that's just if you pick the average. So you give yourself a bit advantage just by starting in that point there. MIKE HAMMOND: And here you've just talked about the UK equity sectors, which is obviously our home market. Are you seeing similar numbers across other sectors? SIMON EVAN-COOK: You see in the UK, the most interesting thing I think about doing it on a global basis, which was another part of the study I did, was that within the UK sectors there are a lot more closet trackers, certainly by weight of assets and by number of funds as well. The reason for that I think is to do with home bias. There are a lot of fund managers out there, it's an easy sell to sell a UK person a UK equity fund. It's a natural demand that people feel like they're more comfortable being closer to home. So you don't find those closet indexers in a sector like Japan or emerging markets, because it tends to be, maybe it's more dominated by professional buyers who would not buy that type of fund anyway. So it is quite unique to the UK. I'd love to see a study that did the same thing on Japan funds for Japanese investors, because I'm sure you'd see the same thing there, a lot of closet indexers but in the Japan sector, and the opposite for UK if they were investing in the UK. MIKE HAMMOND: What is your general view on index-based management? SIMON EVAN-COOK: It's fair to say that I'm not a big fan of it. I think you can do a lot better than that again by using the edges I've mentioned there. You can do a lot better than investing in the index. And there are lots of ways to do that, which has been shown over time. And we use a lot of those ways again as our edges. I think they're dominated by large caps is the first thing to say. If you look at an index like the FTSE All Share, and that is, the vast majority of that is made up of the FTSE 100. Now I think that is a pretty poor place to start investing. You're anchoring yourself on something which has not done particularly well over time. So why do you need to do that? Unless you are a sovereign wealth fund investing £500bn, and let's face it most of us aren't, then you don't really need to invest in the same proportion in large caps as the market does. And we don't. So we're prepared to look elsewhere. So we look at small caps, that's another edge we look at, small and mid caps, we don't feel the need to be completely invested in large caps. Because if you look in the markets and see the extra you can get from investing in smaller parts of the market over time, it's huge. So I've got a chart here. One of the edges we have is we look beyond large cap, so we're quite happy, we think the opportunities are there to go and invest more in small caps. By no means all of the fund at all; we'll probably still have the majority of the fund in large caps, but we have much more in small caps. So this chart shows the difference you can get from investing in small caps versus large caps. The blue line - and this goes back to 1955, it's data from Numis - shows what happens if you invest £1 in small caps versus £1 in large caps over that time. The large cap £1 has grown to £805, so that's great. But the small cap £1 has grown to £5,400 almost. Now that's a huge difference, and that's again just by investing in the index, not from the actual, any selection. Now the other important thing to say here is that that is only a 3.4% difference per year. Now that sounds quite small, and that's the other point I'm trying to drill home here is that that small difference compounded up over a long time period turns into a massive difference in terms of the pot of wealth you're left at the end of it. So look beyond the large caps, look into small cap investing, because you can actually make much better returns from there. And just because the market says you need to be 80-90% large caps doesn't mean that you need to be 80-90% large caps. MIKE HAMMOND: OK. So we've talked about market cap and how you add value in that space. So what other characteristics do you look for? SIMON EVAN-COOK: Well we like to go with areas that have been proven to work over long periods of time. We don't like to go with fads that might be working for two years or the last three years, but haven't worked over time. One of the best ways to make money over long time periods is to invest in higher quality companies. So this is the Warren Buffett style effectively. So when we're looking at underlying managers, we like people who operate in that particular style. And what it basically means is you're looking at companies, you're trying to find companies that are cheating the market cycle. So typical company, an average company will be thrown about by the market cycle. What that means is they'll make profits for a while, competitors will come in from underneath, compete away those advantages, those profits, and then the share price will drop back down to the mean again. But there are certain companies who have certain advantages, be that through brands, be that through regulatory barriers stopping competitors getting in, that won't re-join that, will make extra profits and will grow at a nice steady rate over time. And that's really worked very well. So we like managers who operate that particular style, and we have quite a lot within the fund who do that. But if you look elsewhere what else we like, almost at the other end of the spectrum to that are value managers or deeper value managers. And they, what they do, they're not so bothered about quality, they'll look and understand how good a company is, but what they're really searching for are OK companies that are financially sound, but they're out of fashion with the market, everyone hates them. They think they're finished, they're going to go bust, and they're not going to go bust, they're just out of fashion for a little while. And if you actually invest when they're out of fashion, when everyone else hates them, eventually they'll rebound to the mean when everyone decides that they're not finished after all. And you can actually make a very good return from doing that. So they're almost mirror opposites of each other, but both have been shown to work over very long time periods, and we like managers who do that. The final thing that we look for is we like our managers quite often, not always but quite often to have an income discipline as well. That gives you a couple of things. It gives you a sort of defensiveness, because if a company's paying a dividend it gives you something to fall back on and have faith that actually in a bad time they can keep paying that dividend, eventually people will want to come back, because they'll want that dividend. But also it imposes a valuation discipline on the manager as well. Because if a company does too well the price rises too much, then the yield drops and they're forced to sell that stock and buy another lower yielding one. So it gives you that rotation into more attractively valued stocks as well. So we like income stocks. What I've got here is a chart showing exactly that. You've got the UK equity income sector versus the UK all companies sector, and it just shows that advantage over time. And then we also have a table here showing, and this time within the small cap sector in the UK showing that the high yielders there have done exceptionally well versus the lower yielders versus the market itself. And it comes from just that income discipline over time. That discipline for the companies as well as managers of paying a good dividend. So we like to have that. Even within out non-income funds we like fund managers to pay out on income, we like the strength and the defensiveness it gives us. MIKE HAMMOND: How do you go about actually blending all of those together? SIMON EVAN-COOK: Well like I say we like all of those styles, and what we like to do is have them in the funds at all times. It's very tempting to say we should be in a value fund now because we think a value fund is going to do the best for the next two years, so put 100% in value funds and then forget everything else. And then think well high quality is going to do well now, so 100% in that. And if you could get that right that would be incredible. But you can't get that right. Nobody can time those sort of factor moves as they're called that well. So we always have exposure to all of those different advantages within the fund. And what we'll tend to do is lean one way or the other. Now I've got an example here from our growth funds. This is our Japanese portfolio. And what you can see here, there's a number of different funds, just to talk you through this chart here. You've got the lighter blue line, that's a high quality fund, so that's a high quality Japanese equity fund. And you've got the yellow line here. That is our large cap value fund over that time period. So if you just concentrate on those two lines there, you can see that they move in very different directions. Now this is relative to the market, so when the line is dropping it's underperforming the market. When it's rising it's outperforming the market. And you can see high quality was doing extremely well up until about mid-2016, and we were taking the full advantage from that. And value likewise was struggling over that time period. And then you saw after Brexit, and then given an extra little boost after the Donald Trump election, value really started to win in a very big way. And so you saw that completely reverse. So if you're in one of those styles, if you were just in high quality for example, if you just chased and only bought that because you'd seen it do well over three years, your experience then is that you're buying just as the fund manager starts to underperform. And you get hacked off about that, and you wait whatever, another three years and you think this guy's finished, it never works anyway. And then you switch styles again. And we see investors doing this all the time. Typically they switch just at the wrong time. Now that is almost the opposite of what you should be doing. So you take the example of the yellow line here, our Japanese value fund. That was the biggest holding in our global growth fund at the point here you see just into summer 2016. That was because we're speaking to this manager. He's telling us that these stocks I'm buying are so cheap currently. This is almost the opportunity of a lifetime relative to everything else you could buy. We listened to that, we listen to our fund managers, and so we're putting more money into his fund and gradually taking it away from the high quality fund manager. Not completely but enough to tilt our own exposure more towards the value style, and give us a little advantage. So when that fund rebounded we're doing very well, getting ourselves an extra advantage. Now we have… MIKE HAMMOND: How do you actually use the inflows that you get on a daily basis to effectively rebalance within your Japanese portfolio? SIMON EVAN-COOK: Well they're very useful to us, because it gives us a natural discipline of if we're getting new money coming in, then we're looking at the funds which are still excellent fund managers, they're still very viable products, but we're putting the money more into those underperformers as the value of what they're doing gets stronger. So as money comes in we're again using that to help us tilt towards funds that we think, where the value's building up and hasn't been released yet. And that takes us away from the ones that have been doing very well. So it gives us a natural rebalancing mechanism that helps us to again lean to where we think the best value is in the market. Because we are effectively value managers within what we do. But there are another couple of funds. On there we've got a small cap value fund in there. That's the darker blue line. And then you've also, sorry the grey line there. And then you've also got there an income fund. That's the black line there. The important thing is they're all going to outperform over long time periods, but they're going to do it at different time spells. Now why this chart is useful, and if I grey out all the individual funds, that blue line you've got remaining on the chart there is simply what happens if you take the average of all four of those funds and put them together. So 25% each simply rebalanced every quarter, and we're doing a little bit more than that, but simply rebalanced every quarter. So all those four fund managers we think will win over time. But when you blend them all together, instead of having those roller coaster rides you see from one who's out on an extreme style in a different part of the market, you actually get something that looks a lot more like the market in the way it moves, and your outperformance becomes a lot smoother. And therefore it's much easier for you as a holder to hold on. And that's the important thing is to hold on and not panic because the fund you picked is suddenly doing quite badly when it had been doing spectacularly well before. MIKE HAMMOND: So in your view then there's lots of obviously reports about asset allocation is the biggest way that you add value to a portfolio. What's your general view on that? SIMON EVAN-COOK: I can see why people say that, but I think it's one of those almost myths within the industry that gets perpetuated so much that people just take it at face value. What that means is when people say that, clearly if you're trying to save for your retirement, and you're doing it only through cash, that's going to be a very different profile from doing it through equities. So your starting point is to get roughly the right asset allocation for what you want to achieve, and then to also take into account what risk you want to take. Now we know that, and we know financial advisers know that. So what we tend to do is offer funds that have a specific outcome that's tailored. If you want higher growth, and we've got growth funds that will achieve that, and they'll give you a certain level of risk. What those funds won't try and be is a Holy Grail fund. It won't try and be a high growth fund one day, and then will click and change it and it'll suddenly be a defensive absolute return fund because we can magically tell what's going to happen in the markets. We don't do that. We tend to have quite stable asset allocations. MIKE HAMMOND: OK Simon, so what's your view on the market as a whole in terms of asset allocation for you within your portfolios? SIMON EVAN-COOK: Well yes, I've just gone on about how we don't make big swinging bets. That doesn't mean we don't have some big positions versus or peers or versus the market within what we do. I think the big thing in terms of asset allocation is avoiding areas that look really expensive. Because if you can do that then I think you can do very well. So what we like to do is look at where the dangers are. And for us there are two areas that we don't like. One of those is government bonds, gilts, because we think they look really expensive. They look quite risky in terms of if you get an inflation kick-up what could actually happen to the yields there. Within our growth funds that's less of a concern anyway, because we're unlikely to be holding those types of assets. The other asset class that we don't like is US equities, because the valuations there look nose-bleedingly expensive on a long-term measure. So you look at the Schiller PE which averages the last 10 years of earnings. They've only been more expensive in 1999 and in 1929. So famous market peaks. So that, when a lot of people are bearish about the markets, they're looking at the valuations in US equities and thinking you don't want to be anywhere near equities currently. Now the good news is that actually outside of the US equities look perfectly reasonable value. They don't look the buying opportunity of a lifetime, but they look like the kind of level that if you invest now and stay invested for quite a long time you'll make perfectly acceptable returns that will help you grow your wealth. MIKE HAMMOND: Simon, we're out of time so thank you. SIMON EVAN-COOK: Thank you.