NESTOR

# The 7IM Personal Injury Fund

## August 2016 - Comment

# The 7IM Personal Injury Fund – Objectives

The objective of the 7IM Personal Injury Fund is:-

> *"To provide a long-term total return from investment in a range of asset classes. There may be moderate risk to capital, but the fund will be managed with the intention of limiting volatility to relatively low levels in normal circumstances. However, as a consequence, long-term return expectations may be lower than for higher-risk portfolios. The sub-fund invests predominantly in a range of collective investment vehicles and securities, which may give exposure to a range of asset classes. While bonds and other income generating assets are likely to represent a significant part of the portfolio, the portfolio may also include assets with scope for capital growth in real terms, and assets with scope for greater volatility"*

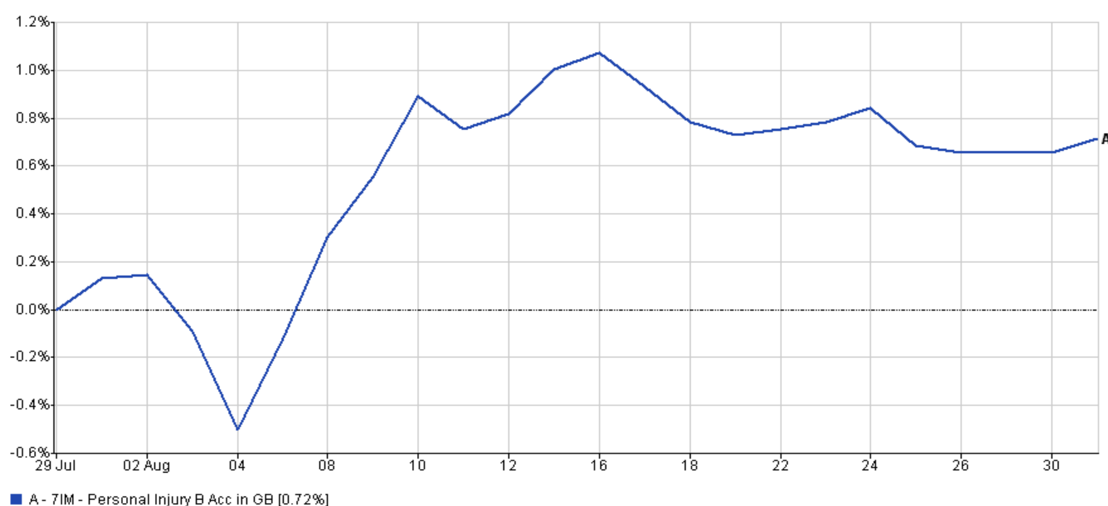
> *"Investment may also be made in warrants, deposits, cash and near cash, money market instruments, other transferable securities, derivatives and forward transactions and other investments to the extent that each is permitted by the regulations. This may include instruments held to reduce volatility of downside potential for the portfolio as a whole".*

# The 7IM Personal Injury Fund – August 2016 Comment

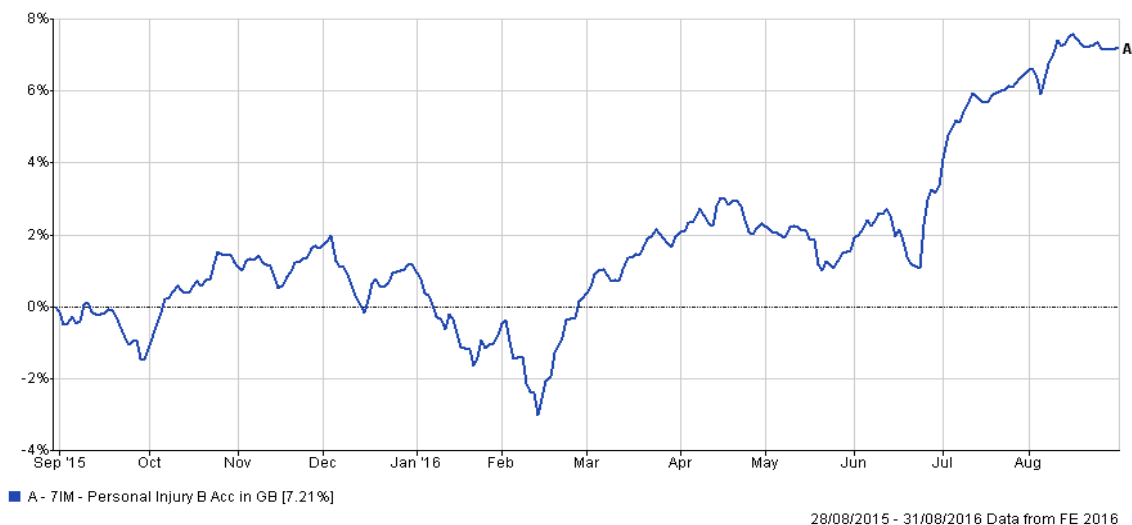
Markets continued to make progress through August, extending a long period of unusually low volatility. This might be put down to weak trading volumes in the summer period, but perhaps also to investors' relatively cautious positioning: surveys revealed unusually high cash balances held by fund managers in their funds, keeping dry powder on the sidelines.

Stock markets generally rallied, led by Asia (with MSCI Asia ex Japan gaining 3.3%) and China in particular, with the HSCE index of Chinese shares listed in Hong Kong rising over 6%. While global bonds saw yields rise a little, gilts continued to rally, with the ten year gilt yield falling to around 0.6%. Gold weakened, down 3% as fears over the immediate post-referendum world continued to subside.

The 7IM Personal Injury Fund delivered further gains in August, returning **0.72%** (B Acc) for the month:



As a result, realised returns now stand at 6.0% year-to-date and **7.21%** (B Acc) over the last 12 months, well ahead of 7IM's long-term projections:




On a rolling five year basis, 7IM Personal Injury Fund fund has now delivered 4.9% annualised returns, slightly ahead of 7IM's long-term projections (B Acc = **26.42%**):

While markets remained unusually calm through August, trending higher on thin volumes, 7IM remain conscious of the risks investors face, and prepared for the period of calm to end. After a strong run-up, 7IM took profits on the fund's Asian equity positions (taking overall equity weightings below 20% for the 7IM Personal Injury Fund). 7IM still see good prospects for Asian equities in the medium-term, but stand aside temporarily after the recent upsurge.

Elsewhere, 7IM also took some profits on the US Treasury holdings, reducing holdings by around 3%. With ten-year Treasury yields as low as 1.5% in early August, the bond market may not be adequately pricing the risks of future interest rate rises in the US. At such low yields, 7IM's other diversifying and protective holdings (for example, gold and the S&P 500 put position) may offer better risk buffers in any period of market volatility. 7IM will continue monitoring opportunities in US Treasuries and are prepared to buy back if valuations improve.

7IM have taken advantage of interesting opportunities in some less liquid segments of credit markets, with purchases over the past few months in senior secured loans (e.g. NB Global Floating Rate Income) and a strong rally in August in the holdings of structured credit funds (such as Carador and Fair Oaks Income). 7IM have added to this allocation, with a small initial position in Alcentra European Floating Rate Income: this listed investment company holds a diverse portfolio of senior secured loans from UK and European companies and was added to the fund at a substantial discount to net asset value (7IM subsequently added more in early September).

As a result, the holding of cash and short-term bonds in the fund is again up to around 20%, providing a significant risk buffer in the event of market wobbles, and substantial firepower to purchase assets if pricing improves.

The strong market rally since the end of June has taken many investors to an uncomfortable place: many missed it altogether (the average hedge fund has made less than 1% year-to-date, and the average Targeted Absolute Return fund in the IA sector classification has made barely zero). Even for those who have benefited from the rise in asset prices this year, the current situation in both bonds and equities puts them in a difficult spot. Congratulations to those investors who have held long-dated bonds and ridden them to new record low yields, recording sharp capital gains; but what now? Yields hardly looked interesting at 2% for a ten year gilt at the beginning of the year; despite a Bank of England rate cut and the prospect of more Quantative Easing (QE). Across the global, ten-year gilts look dangerous priced to yield just 0.65% at the end of August (far short of core inflation at around 1.3%). The experience of the last few years shows that nothing is unthinkable in a world driven by infinite QE: zero yields or even negative yields for long-dated bonds. But even if yields fall to zero on the 10 year Gilt, further returns are mathematically constrained – scope for no more than a modest capital gain, against scope for significant capital losses if yields rise. With an annual yield of just 0.65% on offer for 10yr gilts, it would take a rise of just 7bp to wipe out a year's income. So what could possibly justify holding government bonds at such low yields? Expectations of recession and deflation certainly would, driving yields even lower and well into negative territory; but that sort of scenario is a long way from consensus, which anticipates subdued but steady growth and some upward inflation pressures. Expectations that bonds bought now could be sold at a profit to central banks undertaking ever more QE might justify holding gilts, Bunds or Japanese Govt Bonds; but central bankers are becoming aware of the negative impacts of QE, and 7IM cannot take for granted that government bond purchases will expand forever. Relative value across different bond markets might justify some positions (US Treasuries, for example, yield almost 1% more than Gilts and still offer some return potential in plausible scenarios). Regulatory directives or risk management pressures force some investors to hold low yielding government bonds – those not forced to do so might struggle to explain their actions if yields do rise, causing capital losses.

What about equities, where investors have also seen explosive gains? Investors must be careful not to fall into "money illusion" when looking at UK equities – the FTSE 100 is up 12% this year, but the Pound has fallen 13% against a basket of its trading partners: the market's rise, particularly in the period since BREXIT, partly reflects the impact of weak currency driving a repricing of companies which derive the vast majority of their revenues from overseas. Equally, the global investor looking at the FTSE 100 in US Dollar or Euro terms, will see an index that has gone nowhere this year. In local currency terms, global equities have gained about 5% so far this year (with the US and Emerging Markets doing better, Europe and especially Japan doing much worse). However, this has taken place against the backdrop of falling earnings expectations - stocks have generally become more expensive relative to earnings. This is perfectly justifiable if 7IM expect earnings to accelerate in the years ahead, and it might reasonably be argued that sector specific problems (in the energy sector in particular) are fading; but it's harder to justify when economic growth expectations are subdued. The sense of equities as a default investment choice, selected reluctantly by investors because cash offers no return and bonds offer no return with the prospect of volatility and capital losses, becomes hard to shake off, unless 7IM start to see hard evidence that companies are able to convert economic growth into much more robust earnings growth.

7IM are left with an uninspiring but relatively unthreatening economic outlook: the deep growth scares of the last year or so look misplaced and they see low probability of a major global slowdown in the next 12 months (the UK, of course, faces more uncertainty, particularly in the area of capital investment and the prospects for higher inflation thanks to expensive imports). But nor do they see strong drivers for a major acceleration in global growth. Consumers have capacity to increase spending, but confidence may not be strong enough; wages can rise, but the pace of US job creation seems to be slowing; corporate capex is recovering from the oil sector shock of the last year or two, but is not yet buoyant enough to drive a broader recovery. Central bankers and economic commentators have been calling for governments to provide a meaningful fiscal boost – borrowing at historic low cost to fund infrastructure programmes and other spending programmes, which could boost growth – but the political appetite to do so is limited. There will be periodic scares and thrills, but 7IM see little to drive a major shift in the growth outlook yet.

7IM think markets' focus will shift increasingly to policy over the next year – particularly monetary policy. While their expectations for the path of economic growth over the next year have narrowed, the range of possible courses that could be followed by central banks and national exchequers seems wider. Headline inflation is likely to rise in the US and UK, as energy prices have stopped falling and currency moves will feed through to consumer prices: that's a direct opportunity that 7IM will look to exploit through inflation protection certificates in their funds, but it also reduces the flexibility for central banks to act. In the US, the Federal Reserve is still looking to increase interest rates, but the loose policies pursued by other central banks, and the risk of a much stronger Dollar or a volatile equity market reaction still seem to be constraints. In Europe and Japan, central banks have broken taboos by moving to negative interest rates and buying an ever-expanding range of financial assets: it's unclear how much further these policies can be taken, or how markets would react to ever larger asset purchases. The risks of a policy misstep – or an adverse market reaction to central bank communications – seem higher than usual.

So this is the challenge investors face, particularly those with a desire to manage shorter-term volatility, yet still achieve medium-term returns ahead of inflation: a subdued economic outlook, modest corporate earnings growth, policy uncertainty and relatively expensive assets. There is value to be found, but sometimes it comes with other baggage, such as illiquidity, complexity or political risk. This is an environment where asset prices can be much more volatile than seems justified by an economic environment that is rather stable; where traditional portfolio protectors (government bonds) no longer play their stabilising role and indeed introduce risks of their own. In such a world, 7IM need to be nimble, investing where they see value emerge, but not afraid to take a profit, and holding diverse sources of protection in their funds for an uncertain world.

Twelve months volatility of the 7IM Personal Injury Fund, as measured by standard deviation is currently 4.51(1), which is well below the long-term maximum target of 7.1 and similar to the IA Mixed Investment (0%-35% shares benchmark) of 3.91(1).

*(1): Source: Analytic: Twelve Months to 20 September 2016*

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We have developed an enviable reputation as financial and investment advisers for personal injury survivors and their families. From pre-settlement expertise including periodical payments, through to the use of trusts and investment planning, our skills and experience within this highly specialised area of financial planning is unrivalled.

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