



Director Questions - 18th October 2022

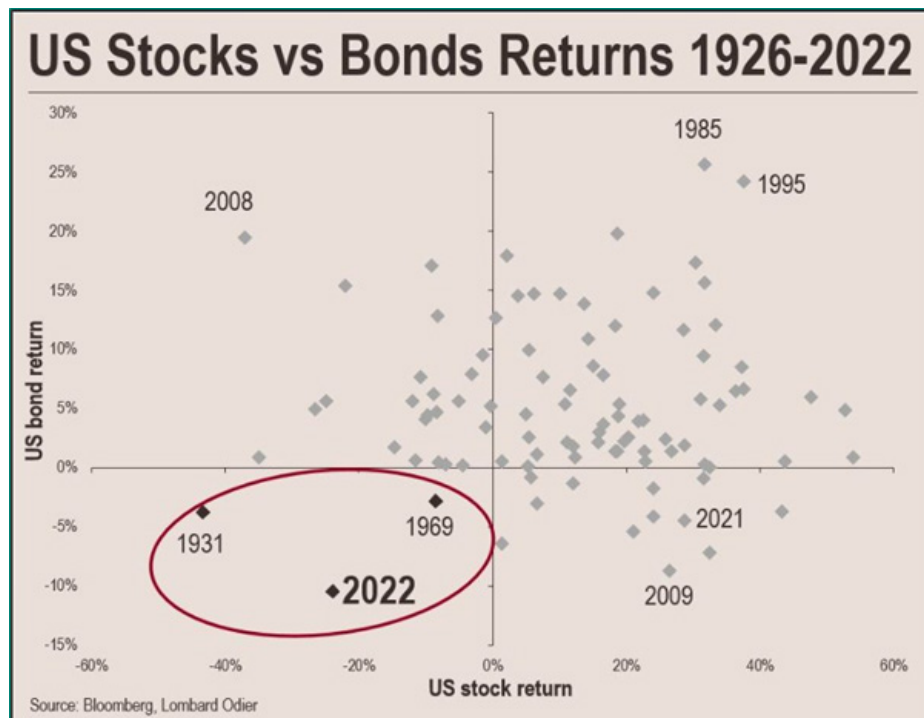
Frequently asked questions regarding markets and portfolios.

2022 Performance

In the last three decades that the Directors of Burley Fox have been Advisers, there is no doubt that 2022 has been one of the worst years for investments across all asset classes. We have been speaking to a number of our Investment Clients over recent months, and as well as our Technical Bulletins on the markets we thought we would also publish some of the most popular (if that's the right word!) questions that have been asked.

As ever, if you do have any questions or concerns, please contact your Investment Director at Burley Fox, but in the meantime the following may be of interest.

U.S. Stocks V Bonds Returns 1926 - 2022



What is Fixed Interest?

Traditionally a moderate or medium risk portfolio would have around 60%-75% of the portfolio invested in Shares which are companies listed on the Stockmarket and the rest in Fixed Interest. Usually the lower the risk, the more Fixed Interest you would see in a portfolio as generally, Fixed Interest has lower volatility (moving in price up and down) than shares.

Fixed Interest is debt or loans, issued by two main entities, Governments (UK Government Debt is called a Gilt) and Companies (Corporate Bonds). Gilts and Bonds are issued usually for a fixed interest rate and term, so if you hold them from issue to maturity you would receive interest and your money back at the end of the term.

Generally a country is more secure than a company, so generally a Bond will pay more interest than a Gilt. During the term though the open market price of a Gilt or Bond can vary.

What is happening in the market?

The overwhelming issue affecting markets is rising inflation and Central Banks raising interest rates to reduce demand and hence inflation. Raising interest rates means mortgages are more expensive and so demand falls, but also so do asset prices.

Inflation has been historically very low since the 2008 Global Financial Crisis and so have interest rates, and this has encouraged all Governments to borrow substantial amounts of money.

In the UK for example, whilst we have one of the lowest debt to national income ratios, successive Governments have been borrowing when it was cheap to do so. Labour, Conservative / Liberal Democrat Coalition, and latterly Conservatives have added over £2 Trillion of unfunded Government Spending over the last 14 years to the National Debt. This is not sustainable, particularly when interest rates and the cost of the debt begins to rise.

This has been exacerbated by the Covid 19 Pandemic and the War in Ukraine, sparking huge rises in Energy prices, and Governments have tried to protect their populations from the financial impact of these by borrowing ever increasing amounts of money.

Markets are concerned that if Central Banks raise interest rates too much, especially when inflation has started to fall, that they could push economies into recession. At the moment, one glimmer of good news is that unemployment remains at record low levels, which is not something that you would usually associate with a recession.

How will this affect Shares & Fixed Interest?

As we said earlier, 2022 has been a perfect storm for investments with all asset classes down. In terms of Fixed Interest, let us imagine that you brought a 10-year Gilt or Bond for £1, a few years ago, which is paying 2% per annum. If interest rates go up to say 4%, then no one will pay you a £1 for that bond as they can get more interest in the bank. Similarly if inflation is 9%, again no one will pay £1 for your Bond, as they will need to earn more than 2% on their money or it is eroded by inflation.

So in this case, Fixed Interest capital values will fall, and this is what we have seen in 2022. Recently the UK Government offered for sale a 10-year gilt with an interest rate of 1% pa. This was too low, so they could not sell them for £1, but ended up selling the Gilt for around 83 pence.

For the buyer they would earn 1% interest each year, plus the Government in 10 years time will pay then £1 for the Gilt which they brought for 83 pence. The combination of the interest rate and the capital appreciation give an overall return of just over 3% per annum.

A company is usually valued on a multiple of its profits or earnings. For shares rising inflation and interest rates mainly means reduced profits. High inflation and interest rates may mean higher production costs and lower profit margins. Also consumers will have less money to spend as demand is reduced. Finally in very simple terms the lower the interest rate, the higher the valuation multiple of a company, so rising interest rates by reducing profits and valuation multiples leads to falls in the price of a company and hence their share value. All of this has happened in 2022.

Annuities

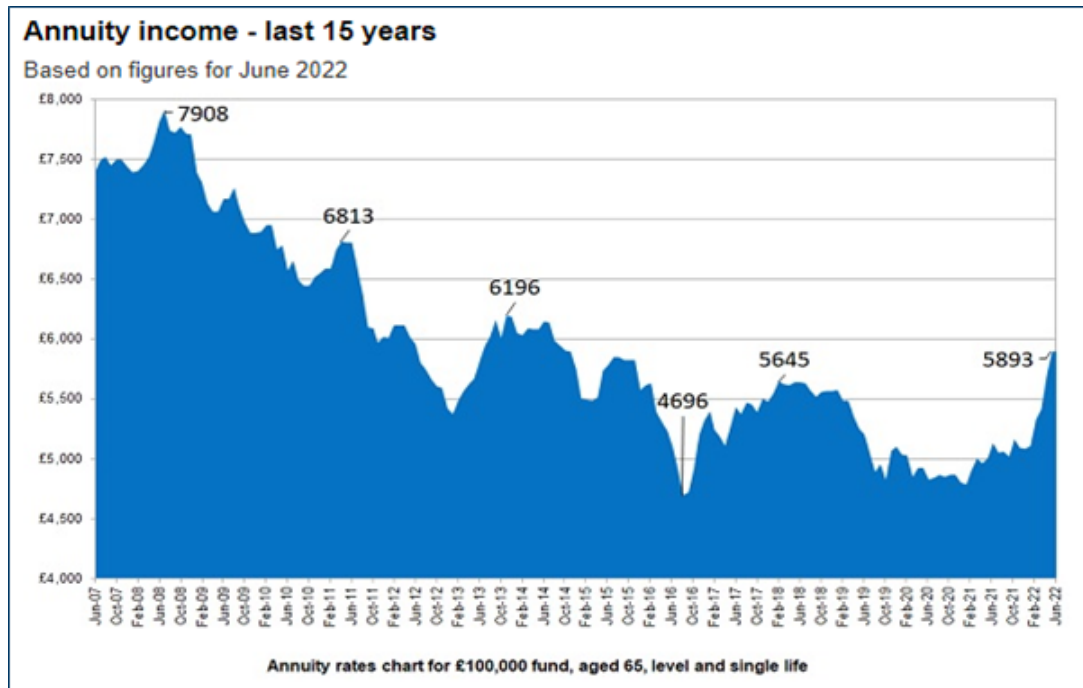
One bright light in 2022 has been the performance of annuities. Annuities are usually used in Pension Funds to provide a secure income in retirement. The downside of an annuity is that generally you and your beneficiaries lose access to the pension fund.

Annuities are based upon long term Gilt Yields and life expectancy. If the price of a Gilt falls, then its yield usually increases, and so we have seen annuities increase dramatically in 2022, as detailed in the graph overleaf.

Annuity rates have been falling for over 15 years + and so most people tend to draw their retirement income via Income Drawdown, where you keep the fund invested and draw money directly from this. Whilst annuities are not suitable for all, their recent increase in value may make them attractive for someone looking to exchange their pension fund for a secure income.



Annuity Income Chart - As at June 2022



Have we seen this all before?

Yes, we have. Both in 2008 and 2020, we saw markets and portfolios fall by over 20%. In both cases markets recovered soon after these severe falls, although the following recessions lasted longer.

The following graphs shows the performance of an example medium risk portfolio (blue) and the FTSE 100 (red), during and after the falls in 2008 and 2020.

2008 Market Falls & Recovery



01/05/2008 - 01/04/2010 Data from FE fundinfo2022



2020 Market Falls & Recovery



28/02/2020 - 01/07/2020 Data from FE fundinfo2022

Past performance is only a guide and future yields cannot be guaranteed. Unit prices can fall as well as rise.

When will markets recover?

At the moment, no one can say, but we believe we are looking at a 2008 scenario rather than 2020, so our view is that we will not see a recovery in markets and portfolios until we start to see inflation come down, and Central Banks stop increasing interest rates. This we believe will not be until at least towards the end of Quarter 2 2023. We cannot of course discount the possibility of further falls in valuations in the future, but investing is for the long term.

The actual total return for this client's actual portfolio, from 1 January 2013 to 14 October 2022 net of all fees and charges using the internal rate of return was 66.23%. This takes into account all of the turmoil of the last 2 years with the Covid 19 pandemic and 2022 Cost of Living crisis.

Overall Performance

The long-term performance of our portfolios remains competitive as can be seen in the table below, which details year by year performance over the last 10 years. The top line is an actual APS medium risk portfolio, net of all fees and charges, whilst the second line is the AFI Balanced Index, the benchmark we use for a medium risk portfolio.

2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
-20.82	11.80	7.18	17.88	-6.98	13.82	9.24	6.48	4.40	16.23
-15.77	9.88	7.15	14.29	-5.98	11.47	9.64	4.91	5.53	12.09

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What should I do?

This will vary on each individual client's circumstances and should be discussed with your Investment Director, so the following is very broad brush.

If you think that you may need cash / withdrawals from your portfolio in the next 12 months, then it may be appropriate to consider moving these funds into cash now, given that we cannot discount further falls. What is happening in 2022 is very upsetting and we can understand the desire to stop further unpleasant falls in valuations.

We have mentioned annuities previously and for those who have pension income needs and have previously discounted annuities, now may be the time to revisit your annuity options.

A number of clients have raised moving into cash to stem falls, and whilst it will do this in the short term, if you are investing for the longer term, then there is the risk that you will be in cash when the market recovers. We have seen this before with investors understandably reluctant to re-enter the market after suffering losses, and missing out on the recovery and crystallising their losses.

Investors have often tried to "time" the market – essentially selling to avoid falls in investment prices and investing to capture the upside. Selling assets crystallises your investment position. Losses or gains may have been made, but de-risking or moving to cash eliminates the prospects for future investment returns. Market volatility can result in drops in value, but it can also see similar movements in the opposite direction over time. Usually, periods of sharp falls and sharp rises, the best and worst days in markets, occur in close proximity.

Between 2001 and 2020, seven of the 10 best days of the S&P 500 index occurred within two weeks of the 10 worst days, and 6 of the 7 best days occurred the day after the worst of that year. The second worst day of 2020 - 12th March – was immediately followed by the 2nd best day of the year.

These data tell a story: remaining invested avoids decision making errors in the short term that can critically undermine the most robust of financial plans. Sometimes taking no action, is the action.

Will my Pension go Bust?

A lot of media attention has been focused on the Bank of England intervening to prevent Pension Funds going bust. Firstly these relates to Defined Benefit Schemes, which Burley Fox does not deal with. Our pension plans are investment or savings based, so will be affected by markets as we have detailed in this bulletin.

In simple terms the issue with Defined Benefit schemes is that they promise to provide a certain level of benefits for the members. Many such schemes have effectively taken out insurance to protect the fund against severe market volatility, and this is known as LDI or Liability Driven Investment.

However, these plans had not anticipated such volatility in Gilts, and it is a bit like car insurance, where the Insurers claims have gone up so they then ask the policyholder for more premiums. The policyholder, in this case the Defined Benefit scheme, has to raise cash to cover this, but most hold Gilts, so when they sell Gilts it lowers the price and exacerbates their problem. This is why the Bank of England stepped in with an offer to buy gilts.

Outlook

The outlook does remain difficult, but as we have seen before market turbulence is part and parcel of long term investing. This is why we recommend holding cash outside of portfolios to provide funds, when markets are depressed in value, so that you do not need to crystallise any losses.

Markets will recover in time, but we cannot discount further falls in value before the recovery. If you have any concerns please contact your Investment Director. In the meantime we continue to monitor the markets, portfolios and will be in contact if any changes are required.

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<https://www.burleyfox.com/documents/BFL-Privacy-Notice-2018-V1.pdf>

