# Quarterly Commentary October 2023

# Pavis Verso DFM Portfolios & Pavis Premier Portfolios

## Investment Commentary

### Investment Markets

Q3 2023 has once again proven to be a challenging time for investors as both domestically and globally we face the challenges of high inflation, interest rates and, of course, geopolitical unrest. Despite this it is relatively pleasing to report modest gains across many of our portfolios. Of note is the performance of our income portfolios which benefit from a high level of dividend income and bond / fixed interest coupons. Over the quarter our Pavis Verso 75% Equity Income portfolio made a gain of 1.85% and the Pavis Verso 50% Equity Income portfolio was up 1.48%.

During tough market conditions investors will, quite understandably, look at the capital value of the portfolio and conclude that "if it's gone up that's good and if it's gone down that's bad". This is where behavioural science and financial education need to be blended.

For many, clients' investments are there to support their lifestyle, dreams and objectives and this is where we need some context. A portfolio valued at £500,000 in 2021 split between bonds and equities would have delivered an income / yield of c.£10,000 per annum. That same portfolio today might be worth c.£450,000 but would now be producing income / yield of more like £18,000 pa. Further, if invested in our Balanced / 50% Equity Income portfolios we would now expect the equity dividends and bond yields to be delivering over £22,500pa. Capital values have been tested but we must take into account the impact of higher interest rates. These things are inextricably linked and in the bond markets your money has not been working this hard since before 2008.

### Equities

The stand-up performance thus far in 2023 has been the global tech giants and their current valuations are beginning to look extremely stretched. If you invested in 493 of the USA's largest 500 companies (but not the 7 tech giants) your year-to-date investment return would have been negative. If you had been invested in all 500 companies, you would have made a gain. With £GBP weakness against the $USD over the last month or so we are now taking advantage of these market conditions to bank some profits and reduce weightings to the sector. The North American equity markets generally delivered a return of c.0.94% for the quarter.

UK Equities made modest gains during the quarter of around 0.7% but both Europe and the Far East suffered falls of -2.1% and -1.1% respectively.

### Fixed Interest

For many investors it is difficult for us to adequately explain what a complete game changer the increases in interest rates will mean to long term performance. If we go back to the autumn of 2021 investment grade bonds were yielding around 2% pa. That has now increased to circa 6.25% pa. For clients that require even more predictable returns we are seeing cash deposit rates in the region of 5% p.a. for instant access and similar for 1-3yr term deposits. UK Gilts offer fixed returns over the next 12-48 months of between 4.5% and 5.0% pa.

## Outlook

The consensus coming from the central banks and economic forecasters is that in the face of stubborn inflation, interest rates are going to stay higher for longer. The bond markets have already factored this in and once markets start to see some downward pressure on rates this should increase the capital value of bonds. Trying to explain this concept can be challenging but, generally speaking, if the average term of an investment grade bond is 7 years and the markets expectation on interest rates falls by 1.5% p.a. then we would normally expect the value of the bond to increase by 10.5% (1.5% x 7). A shorter term bond would increase less in value and longer term would increase more.

In many parts of the world, equity markets look to be fairly valued but with some huge discrepancies. Many parts of the North American markets actually look good value but large tech is exceedingly expensive. The UK looks particularly good value with undemanding price / earning ratios and a relatively high and predictable stream of dividend income. Of note in the UK is smaller companies which seem to offer exceptional value. Take the FTSE 250 index for example, these are the largest UK companies by market value that sit outside the FTSE 100 index. For many years these were viewed as higher growth stocks but over the last 8 years the market has stalled. With the index at c.17,600 its exactly where it was in 2015.

Short term predictions about market movements aren't worth the paper they are written on. The blunt but honest truth is that nobody knows and those that pretend they do are a danger to themselves and those that believe them. What we can say with more certainty is that higher interest rates give investors the opportunity to earn more in the deposit and bond markets that until very recently would have felt like a pipe dream.

# Rebalance

Regularly rebalancing investment portfolios helps to ensure that they remain aligned to the level of risk and return that investors expect. It also will also have the effect of reducing the holdings where prices have performed most strongly and buying those which have become more attractively priced.

Both our Pavis Premier Portfolios and Pavis Verso Portfolios will be rebalanced on the 31st October 2023 and you will receive contract notes reflecting the sales and purchases that result.

All our portfolios contain an element of flexibility whereby asset weightings can be altered from their normal weighting (within a prescribed range) to reflect market conditions and expectations. The following adjustments will be applied this quarter:

## Pavis Verso Discretionary Managed Portfolios Equity and Bond Weightings

The Pavis Verso Discretionary portfolios asset weightings are reviewed and adjusted on a discretionary basis. This quarter the discretionary manager is making adjustments to the following areas:

| Region/Asset | Adjustment | Reason |
|---|---|---|
| UK Equity | No Significant Change | Neutral Outlook |
| North America Equity | No Significant Change | Neutral Outlook |
| Europe excl. UK Equity | No Significant Change | Neutral Outlook |
| Japan Equity | No Significant Change | Neutral Outlook |
| Pacific (ex. Japan) Equity | No Significant Change | Neutral Outlook |
| Emerging Markets Equity | No Significant Change | Neutral Outlook |
| Global Equity | No Significant Change | Neutral Outlook |

| | | |
|---|---|---|
| Global Technology | Significant Change | Removed this strategy after a strong run this year, largely driven by a re-rating, pushing valuations into uncomfortable territory. |
| Global Health | Significant change | Added as a replacement for Global Technology position given more attractive valuations, defensive characteristics, robust earnings growth, and tendency to perform well in periods where interest rate hikes have peaked. |
| Global Small Cap | No Significant Change | Neutral Outlook |
| Property | 7% Underweight | Defensive outlook due to market conditions |
| Bonds | No Significant Change | Switched high yield exposure into short dated high yield fund which has a very strong track record of avoiding defaults. Very little, if any, yield sacrificed for lower credit and duration risk.<br>We also added some UK government bond exposure to reduce the credit risk across portfolios as economies show evidence of slowing. The risk reward in UK government debt has improved substantially now that bond yields have risen so high in the last couple of years. |
| Cash (Growth Portfolios) | Slightly Overweight | To take advantage of current Market conditions. |
| Cash (Income Portfolios) | Slightly Underweight | To bring levels more in line with Growth Portfolios. |

*Please note that the above percentages are approximations and are based on the normal asset weighting.

The reasons for the above positions are as follows:

**Growth Portfolios**

- Equities
  - Switch Technology fund into Healthcare and Pharma Fund for defensive reasons.
  - Other assets remain as current positioning, which keeps us modestly underweight equities.
- Fixed Income
  - Switch Vanguard Global Aggregate Bond ETF into Vanguard Global Bond Fund – rationale is move away from ETFs into equivalent mutual fund, weighting to remain as current, which is a slight move down from before to address desired reduction in credit risk.
  - Switch iShares Core Global Aggregate Bond into Royal London UK Government Bond – rationale is to move away from credit risk and US treasuries into UK government debt, which is underrepresented in the portfolios.
  - Switch JPM Global High Yield into Royal London Short Duration Global High Yield – rationale is to reduce duration in the High Yield component of the fund, the Royal London fund has exceptional default track record and still yields nearly 8%.
  - Cash slightly up from normal to take advantage of current interest rates.

**Income Portfolios**

- Equities
    - ➢ No changes from current positioning
- Fixed Income
    - ➢ Switch from Schroder All Maturities Corp Bond to Royal London Government Bond – rationale is to reduce credit risk and increase UK Government debt exposure which is underrepresented.
    - ➢ Switch position sizes between Royal London Short Duration High Yield and iShares Global High Yield – rationale similar to High Yield trade in growth portfolios, reducing credit and duration risk with little impact on yield.
    - ➢ Cash reduced slightly, so now more in line with growth models.

## Pavis Premier Portfolios Equity Weightings

Within our Premier Portfolios we reduce our weighting to equity markets that appear expensive. We use a rules-based approach to measure markets based on the ratio of price to average earnings. This is known as the "Cyclically Adjusted Price Earnings" (CAPE) ratio.

Below is a summary of the resulting positions for the next quarter:

| Region | Move this Quarter | Current Position |
|---|---|---|
| UK | No Change | In line with long-term weighting |
| North America | No Change | 20% below long-term weighting |
| Europe excl. UK | No Change | 10% below long-term weighting |
| Japan | No Change | 10% below long-term weighting |
| Developed Pacific (ex. Japan) | No Change | In line with long-term weighting |
| Emerging Markets | No Change | In line with long-term weighting |
| Developed World (i.e. Global) | No Change | 20% below long-term weighting |

The CAPE ratios have generally changed very little since the end of the last quarter. A few regions saw falls in CAPE but not enough to increase our weightings. Therefore, weightings remain unchanged as above.

The CAPE ratio is a comparison of a stock or index price to its total earnings, which is used to tell whether its's over or undervalued. It's an extension of the traditional price-to-earnings ratio (P/E) that monitors a ten-year period to account for variations in profitability due to economic cycles.