INVESTMENT CYCLES AND FACTOR BASED INVESTING

The correct asset allocation of a client's investment portfolio is the bedrock of the Swallow Financial Planning investment process. This note is designed to explain how we use investment cycles and factor based principles to enhance the investment process.

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1. INTRODUCTION

When constructing a client portfolio we start from the bedrock of a market-cap-weighted index as the best representation of an asset class. Over this basic premise, however, we have the considerations of risk tolerance, the investment objectives and the cyclical nature of investment returns. This is where factor based investment options come into play.

2. INVESTMENT CYCLES

If proof is needed of economic cycles one only has to look at the ill-fated Gordon Brown's comments that "Boom and Bust" was at an end.

There are quite a few different recorded investment cycles, some of which are listed below:

2.1 Seasonal Fluctuations

Statistics are always suspect, however, Robin Griffiths suggested that if you invested £1 into the UK FTSE 30 (as it was then) Index when the Queen was crowned then by November 2006 it would be worth £760. If you could have got out of the market for the May to October period your £1 would be worth £4,750.

The old adage of "sell in May and go away" has for many proved to be a good policy. The end of this comment is "come back St Ledger Day", but nowadays it is felt that Halloween is probably the most consistent time.

Had you tried this technique in 2009 you would have lost 23% return on the FTSE 100. It was a similar picture in 2012 so it is "pot luck" whether this works for you.

2.2 The Political Cycle or Kitchen Wave

This was first suggested by Joseph Schumpeter an Austrian economist. Nowadays it is primarily linked to the US presidential period and is believed to create a 32 month cycle of growth followed by a 12 month average down cycle. The down cycle would, of course, usually be at the beginning of a new term when the incumbent had a further 3 years thereafter to get things "hunky dory" for re-election!

2.3 The Economic Cycle

The economic cycle (sometimes called the business cycle) is the natural fluctuation of the economy between periods of expansion (growth) and contraction (recession). Factors such as gross domestic product (GDP), interest rates, levels of employment and consumer spending can help to determine the current stage of the economic cycle.

The economic cycle is usually considered to have 4 stages:

- Expansion (the rapid growth period after a trough).
- Peak (the economy is overheating creating inflation).
- Contraction (growth slows, unemployment increases, inflation subsides).
- Trough (the end of contraction and the beginning of expansion).

Economic cycles tend to be measured between peaks and troughs. Since about 1950 US peaks have come on average at about 5 1/2 year intervals, however, this does hide a very wide range of variations from 2 years to 10.

In the UK a recession is defined as two successive periods of negative growth, i.e. gross domestic product (GDP) goes down for two successive quarters. Some say these are every 7 years others 10 years.

Description	From	To	Length
Post WW1	1919	1922	3
Great Depression	1930	1932	2
Post WW2	1956	1956	0.5
Knock On From US	1961	1961	0.5
Double Dip Stagnation	1973	1975	2
Inflationary Peak	1980	1981	1
Fixed Exchange Rate	1990	1991	1
Banking Crisis	2008	2009	1

The banking crisis was the worst recession since WW2. Whilst the technical recession only lasted 5 quarters, the stagnation thereafter showed single quarters of negative growth once in 2010 and 2011 and twice in 2012.

2.4 The Juglar 10 Year Cycle

Again, this is open to interpretation, however, it suggests that the first 2-3 years of every decade tend towards negative growth whilst the remaining 7 are positive.

2.5 Kondratiev Waves

From the Russian economist Nikolai Kondratiev in the 1920s. His theory suggests that economies have 40 to 60 year cycles of growth and stagnation with 4 seasons. An article in Investors Chronicle (December 2009) suggested we were then in "Winter". In the subsequent 10 years asset values did very well. The Kondratiev wave suggests periods of over performance by different asset classes:

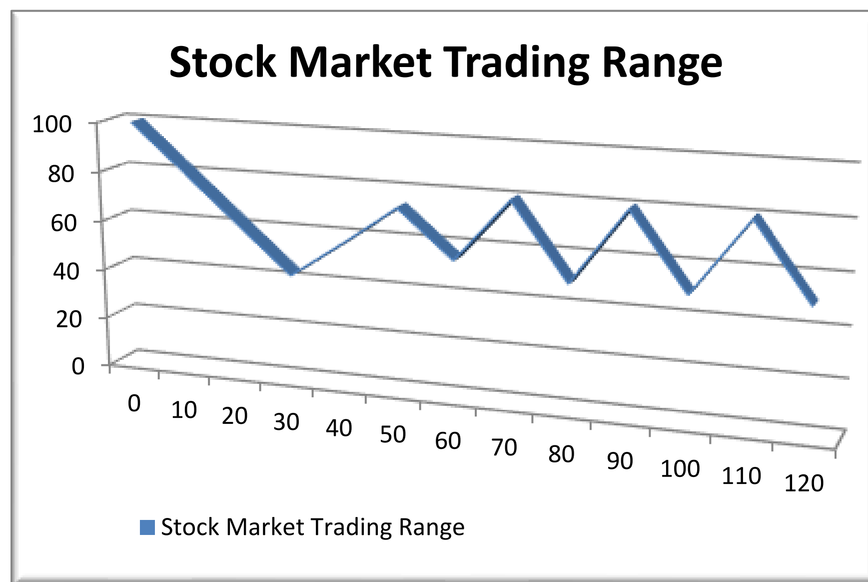
SEASON	MARKET EXPECTATION	EQUITIES	BONDS	CASH	COMMODITIES	PROPERTY
Spring	Gentle Inflation	Positive	Negative	Negative	Positive	Positive
Summer	Rampant Inflation	Positive	Negative	Negative	Neutral	Positive
Autumn	Falling Inflation	Positive	Positive	Neutral	Negative	Negative
Winter	Low Inflation	Negative	Positive	Positive	Negative	Neutral

In other words, buy assets when you have inflation, bonds and cash when you have not. Right now we would say we are in spring (COVID has rather messed up everything!).

2.6 Reinhart, Reinhart & Rogoff - The Effect of Excessive Government Debt

This is a more recent piece of research. In essence Reinhart, Reinhart and Rogoff looked at the aftermath of equity performance in the period after a market crash ***where previously there had been excessive government borrowing not linked to armed conflict***.

The upshot of the research is that there tends to be a prolonged period of stagnant equity markets (up to 20 years).



As can be seen from the above, you have the initial fall followed by a prolonged period of equity trading within a defined range (their stats showed the range to be 25% +- i.e. 52%).

We have certainly seen this affect post 2008 with the upper ceiling to the FTSE 100 being 7,700 and the lower trough perhaps 5,500. Right now (August 2021) this looks a very plausible thesis which suggests we will retain the stagnant share prices for another 7 or 8 years yet.

2.7 Investing Within The Economic Cycles

In the 1990s Legal and General were promoting the idea that market timing could be used to influence the asset allocation to good effect. The following is a simplified representation of their suggested bias at different times of the economic cycle:

MARKET EXPECTATION	EQUITIES	BONDS	CASH	COMMODITIES	PROPERTY
Dividend expectations up Inflation projection up	Neutral	Negative	Negative	Positive	Positive
Dividend expectations down Inflation projection up	Negative	Negative	Positive	Neutral	Positive
Dividend expectations down Inflation projection down	Negative	Positive	Positive	Negative	Neutral
Dividend expectations up Inflation projection down	Positive	Positive	Neutral	Negative	Negative

Again, the above is based on 2 aspects only, i.e. inflation and equity market sentiment. Other practical common sense attitudes can affect market timing views, such as the position of the residential or commercial property markets, oil prices, BREXIT, COVID or global terrorism.

3. WHAT IS FACTOR INVESTING

Factor based investing is a strategy that identifies and targets investments which exhibit certain ‘factors’ that drive investment risk and return.

By tilting towards, or avoiding particular factors in an objective way, portfolio returns can potentially be maximised.

4. FACTOR TYPES

There are 4 basic factor types.

4.1 Value Stock

I.e. stock which has a high asset value compared with it's market value. Investors tend to buy based on success and ignore short term under performance hence providing an opportunity for over performance when the share recovers favour.

This has been a noticeable underperformer in recent years when the potential for tech in particular has left these shares in the doldrums.

4.2 Size

The return on any investment is a direct correlation to the risk involved. Smaller companies fail more often than larger companies, however, they grow much quicker. Put succinctly, they offer higher proportionate returns but with correspondingly greater risks.

4.3 Momentum

Investors make behavioural systematic errors (sometimes called the "lemming" effect) and these affect market prices. This type of behaviour is usually attributable to momentum stock (i.e. the tech boom of recent years) where investors ignored logic to push prices of some stock way beyond any possible future return curve.

4.4 Minimum Volatility

These are investments which have a lower level of peaks and troughs to their share price. They tend to be the staples of our lives, i.e. Proctor and Gamble, Heinz, Supermarkets, i.e. the necessities of life. This factor can be very useful in a nervous or falling market.

5. HISTORIC RETURNS

We all know the mantra "past performance is no guide to future returns" however what has happened in the past is the only certain information we ever have.

At different times in the investment Cycle each of the above factors has outperformed.

- Value Stock has returned more than expensive stock
- Small Stocks have returned more than larger Stock
- Stocks with strong recent performance have outperformed stocks with a weak recent performance
- Stocks with lower volatility have earned greater returns than stocks with high volatility.

By predicting which Factor will outperform in the coming months we aim to add value to your investment process.

6. TARGET BASED ASSET ALLOCATION

If your objectives require your investments to generate above inflation returns then regardless of your personal preferences the asset allocation needs to reflect the type of assets needed to generate the required returns in the longer term (or your objectives need to be adjusted accordingly).

Other factors that affect the generic asset allocation model would be:

- Your investment timescales
- The need for income from a portfolio
- The need for liquidity

7. STRATEGIC ASSET ALLOCATION

Having looked at the building blocks of asset selection (i.e. based around your risk tolerance and objective needs) we can then "add value" by trying to tilt your portfolio towards assets we consider will out or under perform. For instance, in recent years interest rates have effectively been at zero. If you invest at a time when interest rates are at zero it seems a reasonable assumption that the interest rates are more likely to rise than fall in the years ahead.

Despite the preference for fixed interest holdings as a hedge against risk, therefore, it seemed unlikely that fixed interest holdings represent a good investment. This has led us to hold very little fixed interest stock within our portfolios. We tend to stick to cash or (for the more risk tolerant) commercial property.

8. OTHER CONSIDERATIONS

8.1 Pension Income

If you receive pension income you are in the "draw-down" stage of your life. In essence the draw down stage of life is when the purpose of your investments is to generate an income for you when you are no longer able to generate same from working.

If you accept this concept then in our view you should capitalise pension income back to a capital value and add that in to the Asset Allocation equation as a secure asset.

At this stage we are using very generous standard assumptions for pension income as follows:

Pension Type	Gross Annual Pension	Assumed Annuity Rate	Equivalent Capital Value
Level annual pensions	£10,000	4.17%	£239,684
Escalating annual pensions	£10,000	2.18%	£458,912

The current rate for a joint life level pension with both spouses being aged 65 and the survivor having a pension of 2/3rds the main annuitant is 4.17%. Better terms can be obtained if the individuals are in ill health.

Add escalation by the Retail Price Index (RPI) to the quotation and the rate drops to 2.18% (September 2021).

The rate doesn't alter hugely for single life due to the new unisex annuity rates.

We would always take into account pensions when considering your asset and factor allocation. However, this is not the industry norm so within your presentation we usually include two sets of recommendations, i.e. one assuming we take account of guaranteed pensions and one ignoring them.

8.2 The Economic Outlook

Whilst we try not to meddle with good basic asset allocation, where we see fundamental risks to an asset or factor class we will make allowance for this within our investment recommendations. You will find our latest views on asset and factor allocation on our website under bulletins.

9. KEEPING YOUR ASSET ALLOCATION UP TO DATE

It is fair to say that at different times in the market cycle the different asset classes are likely to perform better than their counterparts. This being the case ***it is essential*** that we regularly review your asset allocation to ensure it still matches your risk profile. By asset allocating properly we are trying to insulate you (to some extent) from market fluctuations. For instance, if a cautious portfolio has not been reviewed during an equity boom, it will be far too heavily invested in equities when the inevitable market correction occurs. On the other hand, if a high risk portfolio is not reviewed after market falls it will not be sufficiently geared to growth assets to generate the rewards the high risk investor wishes.

We recommend a minimum review of your asset allocations once a year or when you are considering additional investments or asset sales. Put simply, it is a waste of time undertaking asset allocation if you are not then going to review and realign the assets regularly thereafter.

Another good reason to review your asset allocation is stock risk, i.e. where a particular fund has performed well and now represents too high a proportion of your overall holdings. Finally, of course, it is worth using your annual capital gains tax (CGT) allowance to achieve tax free growth.

10. SUMMARY

We do not advocate dipping in and out of the market, nor would we try and Market Time the market, however we do feel that there is some justification in using appropriate Factor funds to reflect the current state of the world markets, economies and outlook.

Many of the cycle theories offer common sense solutions to different economic conditions.

We believe that getting the asset mix right has far more effect on your long term returns than choosing the right equity fund. If we can achieve "constancy of purpose" over the longer term then we are certain we can add substantial value to your affairs.

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 08.2021 Investor Cycles And Factor Investing and was last updated in August 2021. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

Investments are subject to market risk, including the possible loss of the money you invest. Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. Diversification does not ensure a profit or protect against a loss in a declining market. Performance data shown represent past performance, which is not a guarantee of future results. Note that hypothetical illustrations are not exact representations of any particular investment, as you cannot invest directly in an index or fund-group average.

E.&.O.E.