Economic and Investment Update Conference Call Transcript – 13 January 2022

Presenters

- **Nick Fletcher**, Senior Partner of LWP and Chairman of the Investment Committee;
- **Ian McCafferty**, CBE, former member of the Bank of England's Monetary Policy Committee and member of the LWP Investment Committee; and
- **Stuart Fowler**, Investment Director of LWP.

Nick: Good morning, everyone, and I'd like to wish all of you a very happy and fruitful New Year. This is the latest in our series of what have become regular, quarterly client calls in which we discuss the outlook for the economy and issues pertaining to our investment strategy. This we hope to do over the next forty minutes or so before answering some of the questions you've kindly submitted, for which, many thanks. We aim to finish the call at, or before, 12 noon. Before we begin, regulatory requirements oblige me to inform you that London Wall Partners is authorised and regulated by the Financial Conduct Authority and the views expressed in this call do not constitute formal investment advice or recommendations, which can of course be provided separately and individually as appropriate. Also, the content of this call is the property and copyright of London Wall Partners and none of the comments should be used or taken out of context without prior permission. A recording will be made available and full details about our investment performance can be found on our website www.londonwallpartners.com. So, many of you will know my two colleagues on the call this morning, but for newer listeners, let me briefly introduce Stuart and Ian.

Ian McCafferty is one of the UK's leading economists and from 2012 to 2018, he was a member of the Monetary Policy Committee at the Bank of England. Before that, his career spanned the city, the CBI and BP, amongst others. He joined London Wall Partners as a member of the investment committee and senior adviser in the spring of 2019. As well as working with us, he is a visiting professor at King's College London, a member of the government's Senior Salaries Review Body, and a senior advisor to Oxford Economics. Stuart is the investment director at London Wall Partners. He joined the firm in 2015, following his role as head of global equities and fund manager selection at the in-house fund manager of the National Grid Pension Fund. He has been a city stalwart for many years, having also worked at HSBC, Morgan Grenfell, AXA and Kleinwort Benson. Good morning to both of you, and welcome to the call.

Ian: Good morning, Nick

Stuart: Good morning.

Nick: Good morning. Well, as ever, there is a lot to talk about this morning, at the start of the New Year. It is a time-honoured tradition to look forward and identify some of the key events, issues and drivers that will mark the year ahead. So, we're going to start this morning with an overview of some of the key factors influencing the economy and markets in the coming year. We also hope to focus on some of the longer-term performance of the types of businesses that we invest in. That long-term focus might sound a little optimistic, given that Omicron cases are currently surging and that the pandemic will continue to buffet the short-term outlook. But epidemiologists are already suggesting that the characteristics of Omicron are such that this current wave might mark the last in the Omicron phase of the virus. If this is indeed the case, and I pray it will be, it could mean that as 2022 progresses, we can start to return to something a little more like normal. But let's start with Omicron, which has rapidly emerged in recent weeks, and appears to be much more contagious than previous variants. Case numbers in the UK and elsewhere have soared, but what might this imply for the economic recovery which had been looking positive for 2022? Ian, what's your take on how Omicron might influence the economic outlook?

Ian: Well, Omicron emerged so quickly that we're only now beginning to see data of any real use in interpreting its impact. But after the initial alarm at its appearance, I do think some encouraging news is starting to emerge. The Omicron variant appears, from the early data, to have a number of critical characteristics that will determine how the wave of disease progresses. First, it seems to be much more infectious than previous variants with an R rate (the number each infected person will go on to infect themselves) some three times that of the previous dominant strain, the Delta variant. And this appears to be because its incubation period in the body is shorter, making infected individuals infectious that much more quickly. It also appears to be better able to evade previous immunity, either from previous infection or through vaccination, and the chances of catching COVID for a second time are estimated as five times higher than it had been with Delta.

So, those two characteristics mean that Omicron has spread really rapidly. It was first identified in South Africa only on the 24 November of last year. But by mid-December, it had been reported in over 60 countries, and by early January, the World Health Organisation was reporting some 10 million new cases a week, with the numbers roughly doubling every week. Not all of these will have been Omicron, but in South Africa, 80 per cent of the new cases were caused by Omicron, so it's not unreasonable to assume that it's a heavy contributor to that wave. But its other characteristics give us cause for hope. First, it looks to be far less virulent than previous variants, with rates of serious disease, hospitalisation and death lower than in previous waves. Now, this may be due to an inherent characteristic of the virus itself, as early studies suggested it does less damage to the lungs, or because of the protection afforded by vaccines, as a third vaccine recently delivered, dose of the mRNA vaccine, such as that produced by Pfizer or Moderna or some other newer alternatives, does appear to provide good protection against infection and serious disease.

As well, the very speed of its transmission means that it's likely to peak and then fade relatively quickly. There are only so many people it can infect, and the faster it spreads, the quicker some level of herd immunity and hence the peak of the wave will be reached.

And these characteristics mean that the need for economic restrictions, which were imposed in the early phases of the pandemic primarily to reduce pressure on public health services, are less likely to be needed. Of course, even with the reduced rate of serious disease, if the number of cases is high enough, it could still pose problems for the health services. A small percentage of a large number is still a large number when it comes to counting hospital beds. So, some restrictions have proven necessary, and many countries have reintroduced restrictions on international travel. Some countries such as Germany, India, South Korea and the Netherlands and Austria have imposed short-term lockdowns, or closure of certain types of business. But for most countries, restrictions have focussed on the isolation and testing of those infected, rather than widespread economic shut-downs.

But even if the direct economic impact from lockdowns remains limited, the emergence of Omicron has caused a widespread softening in consumer confidence and some spontaneous changes in personal behaviour so that many people are practicing voluntary social distancing and are going out and spending a little bit less. So, I think this wave is going to hamper economic activity through the early part of 2022 and we will see GDP growth weakening over the course of the first quarter, and that interrupts the recovery underway since last summer. But the current period of weakness is driven less by enforced business closure and more by those changes in personal behaviour and patterns of demand, as well, as by labour shortages, as the available workforce is reduced by the high numbers of people isolating.

But if the early data about the nature of Omicron is borne out, then there's every hope, I think, that the economic impact of this wave will prove relatively short, allowing much of the first quarter shortfall to be made up by the summer. So, essentially, the Omicron wave should represent no more than a pause before the global economy resumes its recovery path into the second half of the year.

And that means, I think, that economic forecasters have not had to alter their projections much as a result of Omicron. For 2022 as a whole, world GDP growth is now expected to increase by just over 4%, and that's down from about 4½% that had been expected before the new variant emerged. It's still the case that the advanced economies will provide much of that growth impetus for 2022.

Nick: So, you're saying the impact on growth may not be that much, which would be good news. But how about inflation, Ian?

Ian: Well, the impact on inflation of the emergence of Omicron itself is less clear. You'd think that slightly slower growth would alleviate inflation pressures, but this, I think, is unlikely to be the case. The sheer number of cases now appearing, and hence the number of workers being forced to isolate, is likely to exacerbate the supply-side issues that have characterised the recovery so far; disruptions to both production and transportation of raw materials, components and other goods, which have added to inflation pressures.

And I think Omicron will add to inflation pressures in other ways, too. Throughout the pandemic, demand for goods has risen sharply, while demand for services has fallen. It had been expected that as the pandemic waned, more normal patterns of demand would remerge, with a switch in demand away from goods back to services as the world opened up. But if continued social distancing and reduced consumer confidence were to delay that predicted shift back from goods to services, that too would intensify current inflation pressures. Already, global inflation forecasts are being revised higher with forecasts for CPI inflation around the world now exceeding 4¼% this year, up from under 4% as recently as November.

Nick: Yes. So, the global economy could be facing another difficult year then.

Ian: Well, I think compared with some of the concerns that emerged at the outset of the Omicron wave and the sharp correction in markets that we saw in early December, things now look a little bit more positive, though I have to say that the outlook remains clouded in uncertainty. Prospects for the advanced economies remain promising with growth of some 4% or so, but for many emerging economies, the recovery's going to take longer to get going. So, on a central scenario, the economic recovery looks set to continue in 2022, giving us a second year of healthy growth. But, and it is a big "but", that recovery remains volatile, regionally uneven and more prone to disruption than we've seen for a long time. And that's why I stress that uncertainty levels remain very high.

And it looks likely that even for those countries and regions enjoying a healthy post-COVID recovery, the disruptions in supply chains and shortages of raw materials will take some time to clear, constraining the pace of growth and generating inflation over the first half of the year. But by the second half, both the transportation disruptions with shipping and shipping containers in the wrong locations for current trade flows, and many of the shortages of key components and imports, including microchips and construction materials, are likely to ease.

But as these supply-side problems ease, the global economy will start to face other headwinds. So, from here on, the global economy is starting to face what you might want to call the "hard yards". Over the course of 2022 and 2023, the unprecedented amount of fiscal and monetary support for the economy that we've enjoyed over the past two years is set to diminish, and this will act as a drag on growth.

Both the monetary policy actions that provided broad economic support and the more targeted fiscal mechanisms which helped minimise the short-term damage to business viability and levels of employment during the pandemic are both coming to an end. So, while the central scenario is that the global recovery continues, there are a number of potential pitfalls which might await us, and a good deal of uncertainty.

Nick: We talked, Ian, in some detail on our last client call in October about the prospects for higher inflation, as well as the shifts in both monetary and fiscal policy that are likely. Higher inflation has for some time now been one of the key risks to both the economy and markets identified by our investment committee. Is there anything much new to report, and how are those risks playing out, do you think?

Ian: Well, on the inflation front, there is a bit of a pattern emerging. For several months now, each month's inflation figures for each of the major economies have come in somewhat higher than had been anticipated by the central banks. In the jargon, the central banks have been a bit behind the curve. To give one example, it was only a few months ago that the Bank of England thought that inflation would peak in the Spring of 2022 at about 4%, but following the Autumn surge, it's now quite possible that inflation could hit 7% by then. In the United States, a similar experience has driven consumer price inflation to 7% already.

And the big concern, I think, for both central banks and for financial markets is that the sharp upsurge in inflation or the monetary response to it, causes a repeat of the 2013 taper tantrum, a four-month period back then of serious instability in global bond markets in which yields spiked sharply higher.

So, to counter this, central banks have upped their communications and are now providing forward guidance on how and when monetary policy will be tightened.

In November, the Fed chairman, Jerome Powell, announced that the Fed would start reducing its monthly bond purchases by $15 billion a month from December 2021 with the aim of ending the monthly purchase programme by the middle of 2022. Even before this reduction programme had started, this message had been updated because of the faster inflation, with the monthly reductions doubled to $30 billion a month, so that the QE programme in the United States would cease in March. And this paves the way for rising US interest rates by as early as the second half of this year.

The Bank of England has also begun to tighten monetary policy. It was the first central bank to do so. Its communications were somewhat less clear, as it failed to raise bank rate at its November meeting, as widely expected, but then confounded market expectations again by raising the bank rate by 15 basis points in its December meeting.

But I think for investors the important point is that so far financial markets seem to have taken these shifts in monetary policy essentially to a much more hawkish stance than they had expected later last year. And the prospect of interest rates rising slightly faster in 2022 than had been previously expected, they've taken those moves firmly in their stride. Most company share markets began 2022 at close to record highs, and they seemed to have absorbed both the higher inflation and the monetary policy consequences without undue concern.

Now, I do think that the current bout of inflation will last a bit longer than central banks continue to believe, as higher energy and raw material prices already seem to be having some impact on wages and hence broader inflation. So, we're not out of the woods quite yet.

But inflation is an annual calculation, so unless prices keep rising, or more accurately, accelerating, inflation will eventually start to decline as the year-on-year calculations work through. So, by 2023, I do think we'll be seeing inflation easing back towards the 2% targets set by the central banks. So, unless we get a further big surprise pushing inflation materially higher than currently expected, I think the risks of a severe market reaction driven by fears of inflation have actually lessened in recent months.

Nick: But economics is the dismal science, and economists are always worrying about something. So, what are you particularly concerned about as you look into 2022?

Ian: Well, as I mentioned, this year both monetary and fiscal policy will start to go into reverse. We've already seen the early moves on monetary policy, and by mid-year, a good deal of the lavish fiscal spending that characterised 2021 will have been cut back. So, policy is shifting from a tailwind to a headwind, putting pressure on what is still really a fragile recovery. And this is particularly true if, as looks likely, that President Biden is forced to rein in his Build Back Better agenda, that is the $1.75 trillion plan for increasing spending on social and climate programmes, which is currently stuck in the senate.

But while the economic risks for 2022 are real, I think they actually take second place to those in the geopolitical sphere.

Nick: Okay. And what concerns you on that front?

Ian: Well, a number of countries with interests, I think best described as antithetical to the West, have started to flex their muscles recently and further escalation could easily provoke serious trade embargos and sanctions, or even limited armed conflict in 2022.

Emboldened by the isolationism that we saw of the Trump era, and the poorly executed withdrawal from Afghanistan, and the weak showing of President Biden in the polls, leaders in China, Russian, Iran and North Korea are all expanding their political and territorial ambitions.

In China, the ruling Communist Party under President Xi has become less tolerant of dissent and Chinese external relations have become more assertive, particularly with regard to Taiwan. Already we're seeing trade disputes and security-driven embargos on high-tech commerce, and they're increasing, but would be escalated much, much further in the event of further threats to Taiwan's self-governance.

At the same time, in Russia, as we know, President Putin is using what he sees as a moment of Western weakness, with a new government in Germany, elections in France, and the initial equivocation of America, to rewrite Europe's post-Cold War security order by limiting the influence of NATO, as well as fulfilling his ambitions to retake control of Ukraine. Escalation here would lead to sanctions that would be economically damaging for both sides, especially at a time when gas prices are already at record levels.

In Iran, there are ambitions to develop nuclear weapons. The stalled nuclear deal between the US and Iran is close to collapse and Iran is ramping up its uranium enrichment programme. A collapse of that deal would also involve economic sanctions, but would probably increase hostilities in the Middle East as well, as Israel attempted to prevent further Iranian progress towards weapons capability.

If any of these were to flare up badly, they would have significant negative consequences for both the economic outlook and for financial markets.

Nick: Okay, so with tensions rising, we're going to need from leadership and skilled diplomacy in 2022, that's for sure. But I'd now like to look a little further ahead, if we may. With so much uncertainty about the short-term, it's a brave man who predicts more than a short time ahead. Nevertheless, I do know you have been giving some thought to some of the longer-term changes that the pandemic might have brought in. In previous client calls, we've talked about the changing role of government - how the pandemic has cemented the expansion of government into new roles and is ending the low tax, small state consensus of the past 30 years. But from conversations I've had with you, I know that you also foresee some other strategic changes that will affect business more directly. Can you tell us more, please, Ian?

Ian: Yes. It's not only governments that are changing as a result of the pressures of the pandemic, business will be changing too. There's a lot of talk about new hybrid models of work or employees and of the adoption of new technologies to increase productivity. But I think these are relatively small scale in relation to the shift now underway to the dominant business model of the past 40 years.

Since the 1980s, globalisation has been the most important story for the world economy. Rapid growth in world trade flows, the development of services trade, and the growing interconnections and inter-linkages between national economies, as supply chains have globalised, have been the main contributor to world prosperity and poverty reduction.

But the legacies of the pandemic have tested this model of globalisation to its limits. As the pandemic hit, many countries abandoned their liberal trade outlook and banned the export of key goods and components, including drugs and medical equipment. And more recently, the lockdowns have put unprecedented strain on complex multi-stage supply chains, with serious shortages of key raw materials and components and disruption to transportation. And this is prompting many multinational companies to move from a "just in time", model with lengthy and complicated globalised supply chains, to what you might call a "just in case" model, and, in the jargon, on-shoring more of their production close to the final market. They're also multiplying the number of suppliers that they rely on and relying on single long-term supply chains rather less.

Environmental issues are also testing those limits to globalisation and trade as well. Behind the headlines emerging from COP26 about whether we can limit warming to 1.5 degrees, were the very interesting discussions – at least I found them interesting – about how such ambitions would be monitored and policed, including:

- pressure on banks and to take greater account of environmental progress when granting finance to global industries;
- business responsibility for supply chains in climate reporting; and
- the use of trade rules and sanctions to punish non-performers and provide a level playing field.

So, I think over the coming decade the pace of globalisation will slow and some of the integration and the co-dependency of the world economy of recent years will, I think, be unravelled. Firms will shorten their supply chains, widen the number of suppliers and invest to produce more closer to their home markets.

And after 40 years, or nearly 40 years, in which international businesses have reduced costs and enhanced margins through broadening and extending their supply chains, and by concentrating their production in low-cost areas, I think this will come as quite a change.

Nick: Well, thank you, Ian, for your, as ever, fascinating overview of both what 2022 might bring and your thoughts about the longer-term. Will you stay on? There are a couple of questions for you later on inflation and debt levels. So, what I take most from your comments are two messages. The first is the high level of uncertainty we continue to face across politics, the economy and financial markets, and the second is that we're in a period of rapid and fundamental change which will continue to reshape the landscape in which we all do business. Ever more important, therefore, is our investment approach at London Wall Partners to continue to focus on the long-term, and avoid being distracted by the day-to-day sound and fury with which we are bombarded. I'd like now to turn to Stuart. In recent calls, Stuart has covered different aspects of our fund selection strategy and the characteristics of some of the key companies to be found in our model portfolio. Stuart, over to you.

Stuart: When I was on a call three months ago, I discussed many of the UK companies in our model funds, while noting that I didn't then have time to mention some of the interesting life sciences stocks that are held in them. I promised to cover them in this call - and today I'm going to be addressing a number of our model fund holdings in the healthcare sector. Healthcare businesses represent about 20% by value of our company share model funds, which is the second biggest sector weighting after technology; the IT etc. accounts for about one third of our allocation to stock markets in our company share funds. In addition to recommending the investment trust simply called the Worldwide Healthcare Trust, all of our other model funds except one have some healthcare businesses in their portfolios, and the one that doesn't owns four software companies which serve parts of the medical world.

Our notable allocation to healthcare is somewhat justified by the strong historic investment performance of the sector. At its recent results of the 30th September 2021 the Worldwide Healthcare Trust, despite a dull patch recently, were able to say that they had made shareholders 15.4% per annum since they floated in 1995, which is a handsome absolute return and better that the 12.2% return of the Health Care Index over the same timeframe.

You may have seen Nick use a page from the Berkshire Hathaway accounts to illustrate number of points about investing over the long term, including the notable impact of strong, compound outperformance over multiple years. But to spare your mental arithmetic this morning, I'll confirm that those annualised returns have delivered 4,282% to shareholders over the 26 plus years of the trust's life, while the Index has returned 1,991% over the same timeframe.

It is, of course, more important to look forwards than back, and the future still seems to offer a strong demand tailwind for the healthcare industry, with probably the most important driver being an ageing population in the developed world. For instance, people over 55 years old make up just 30% of the US population, but account for 56% of the medical spending there. As the populace ages in the Americas, Europe, China and Japan, more of each area's economic output is likely to be devoted to healthcare expenditure. Increasing wealth in emerging economies is also likely to be a positive, as medical expenditure tends to rise with improving prosperity.

However, the key attributes in the healthcare sector that our fund managers seek out are the prospect of successful innovation, as this is the best means of generating sales growth and achieving attractive profit margins. Innovation also helps companies deal with the inevitable patent expiries, which eventually subdue the profits of most established medical products.

But innovation is not without risk, particularly in the healthcare sector. So, our fund managers in aggregate maintain a broad spread of companies to mitigate the impact of any new product disappointment, and we currently calculate that around 150 of the near 430 individual holdings in our company share model funds are healthcare names – i.e. 35% by number of the whole, as opposed to 20% by value – so, on

average the position size in each healthcare holding is smaller than the names in other sectors, which should limit the adverse impact on returns if anything goes wrong with any of the individual businesses. Another way in which we seek to build appropriately diversified portfolios is by ensuring that our mix of model funds has a broad spread across different segments of the healthcare sector, so in addition to mainstream pharmaceuticals and biotech stocks, our recommended funds also own medical device and joint replacement manufacturers, health insurance companies, robotic surgery machine makers, diagnostic businesses and medical research tool makers.

The largest individual healthcare stock position in our model is the US company Illumina, which is held in two recommended funds. I mentioned this business on a call two years ago, as this is the company whose equipment was used for sequencing the genome of the original COVID-19 virus found in China in early 2020, which enabled the vaccine research programmes to begin around the world. Illumina is the global leader in genomic analysis, supplying government and academic research laboratories, hospitals and pharmaceutical companies with its instruments, as well as the reagents that these machines use. The investment appeal of Illumina arises partly because there's increasing demand for genetic analysis, but also for the financial model of the business – with around 70% of revenues arising from the sale of consumables which are used in the analytical process, the company has the recurring revenue attractions which are sometimes described as the razor and razorblade model (i.e. where the initial purchase of a particular brand of razor leads to regular repeat purchases of the associated razorblades). Since Illumina launched its first research product in 2007, the cost of sequencing a gene has fallen by a factor of 10,000 and this change in economics is spurring on the use of genetic research in many areas of medicine.

While Illumina is generally regarded as the gold standard for genomic analysis, it isn't without competition, and one of our model funds made an investment in rival Oxford Nanopore before the UK company listed on the London Stock Exchange in September of last year. Oxford Nanopore uses a different approach to gene sequencing, which is currently broadly less accurate, but faster and cheaper. However, Illumina must presumably respect the science as they were trying to buy a business using similar technology a year ago. As it turned out, the US's Federal Trade Commission, or FTC, blocked the deal as they feared it would reduce competition. And now Illumina is having another run-in with the competition authorities, this time on both sides of the Atlantic, as it has acquired a company called Grail, which used liquid biopsies (i.e. effectively blood samples) to detect cancers at a very early stage. Both the FTC in America and the EU want the purchase of Grail by Illumina unwound as they fear it could stifle the prospect of new entrants into this market, as it is likely such businesses would need to use Illumina's gene sequencing technology – but this legal battle will probably run and run. Illumina asserts the regulators only have a theoretical concern, as the market for Grail's services don't yet exist and Illumina doesn't believe the EU has a case as Grail doesn't do any business in the bloc.

However, I should point out that Grail is active in the UK, as last year it started a pilot study on 165,000 patients in conjunction with the NHS, in the expectation it can demonstrate that its Galleri blood tests really do work and thereby enable the UK to make a step change in improving its treatment record in oncology.

The second largest healthcare holding in our model portfolios is the Danish company, Novo Nordisk, which is best known for being the world's leading manufacturer of insulin, and it's particularly appropriate to highlight that company today as on Tuesday, just two days ago, it was the 100 year anniversary of the first human diabetic to be treated with insulin. I should also point out Novo Nordisk is active in other areas as well, such as research into obesity and chronic conditions like haemophilia, and some cardiovascular and Alzheimer's diseases, as it's got a 600-strong team of research scientists working in those areas. Novo Nordisk is particularly highly regarded for its development of new formulations of insulin; with over the years its long-acting insulin being of particular benefit to managing the more severe type 1 diabetes, especially during sleep, and the introduction in 2019 of an insulin tablet – rather than an injectable – form for some type 2 diabetics, was also a notable breakthrough.

With the number of people in the world living with diabetes expected to grow from about 460 million in 2020 to 700 million in about 25 years' time, particularly due to the impact of diet and lifestyle issues, which can cause the onset of type 2 diabetes, it's not surprising there are a number of other companies held in our modern funds, which also help address this growing market.

Other successful investments have included two US listed businesses. The first being Dexcom, who produce devices which enable diabetics to monitor their blood sugar levels via a sensor on their skin, which in turn sends signals to their mobile phone. And the second is Tandem Diabetes Care, who make insulin pumps which take the readings from Dexcom sensors and automatically adjust insulin levels to keep patient's blood sugars within the appropriate range.

The third largest aggregate healthcare holding is the US company UnitedHealth, which has two divisions. The first uses the UnitedHealth name and is the largest US health insurance and benefit programme provider, serving public and private sector employees, as well an individuals. However, the more interesting division from an investment standpoint is its Optum division. Optum is effectively a healthcare technology operation which uses data to help drive improvements in the US healthcare system, seeking to reduce cost and enhance patient outcomes. In the UK, we're used to this type of activity being the preserve of the NHS, but the US healthcare world is structured differently, and Optum has a lead in using its analysis and insights to help improve the overall US medical system. Optum works closely with care providers, healthcare insurance companies and life sciences businesses with whom they have long standing relationships.

For example, Optum provides information data analytics to biotech companies to support the discovery of new treatments in more cost-effective ways, and UnitedHealth has continued to invest in methods to collect, manage and analyse data more effectively, such as with the use of AI or artificial intelligence. They're also seeking to acquire another US healthcare company, Change Healthcare, whose revenues are increasingly derived from its software and analytics business, and this should strengthen Optum's overall market position.

The fourth and last healthcare holding, which accounts for more than 1% of our look-through model company share allocations, is Moderna. Obviously Moderna is now well-known for its success in developing an mRNA COVID vaccine, but its investment attractions are much deeper than that. The company was built to develop and produce a broad range of RNA-based therapies and in some ways, Moderna is almost more like a software company than a medical business, given it effectively writes RNA code to programme human cells. Its ambitions to be able to develop treatments for flu, Zika, HIV and cancer, for example, have been boosted by the credibility and funds generated by the successful development of the coronavirus vaccine, and the company looks likely to be generating headlines for many years to come.

I started by saying I was going to discuss a number of the interesting UK life sciences businesses which are held in our model fund, and given the UK's strong position in this industry, it's not surprising there are several to mention. The strong medical academic traditions in Britain's leading universities, together with the unique structure of the NHS and support provided by research organisations like the Wellcome Trust and Cancer Research UK, mean that Britain is likely to continue to produce a number of interesting new healthcare businesses in the years ahead. Indeed, I probably should have mentioned earlier than Illumina's gene sequencing capabilities came about because of the acquisition of a UK business called Solexa, which had been founded by academics in the University of Cambridge.

Among the smaller UK life science companies held in our model funds are **PureTech Health**, a FTSE 250 drug development company focussed on underserved and serious diseases, with a particular focus on immunology, **Adaptimmune Therapeutics**, a UK-based Nasdaq listed company which develops therapies to encourage the immune system to target tumours, and **Avacta Group**, which produces diagnostic products, including a COVID test and it also sells products which help chemotherapy drugs be targeted more accurately in the body. And the final two I was going to mention today are **4D Pharma**, which is a biotherapeutics company which seeks to use the human microbiome (which is the polite way of saying bacteria which live in our digestive system) to treat a number of conditions, and **Tissue Regenix**, which develops products which help the body to regenerate bone and soft tissue to help address orthopaedic, dental and cardiac conditions.

Given the somewhat niche focus of these companies, they're probably unlikely to become household names, and as is often the way in the medical world, conspicuous success would most probably attract the takeover attentions of larger healthcare companies who could roll out their products worldwide at a faster pace.

Such bid activities are a normal part of the healthcare industry, with smaller startups effectively providing third-party R&D that bigger businesses subsequently acquire. However, while overall merger and acquisition activity in world markets was strong in 2021, it was somewhat subdued in healthcare for several reasons, and not just because some research programmes were disrupted by the pandemic. In March 2021, competition authorities in the US, Canada, EU and UK started a joint working party to update their approach to analysing the impact of mergers in the pharmaceutical sector and there's also been some uncertainty on US drug pricing, as President Biden's Build Back Better Bill included some proposals to control prescription drug prices for both Medicare and private individuals. While this Bill passed the House of Representatives, it didn't pass the Senate, with one Democratic Senator holding out against the whole package. And whilst the resulting uncertainty is likely to linger on for at least a few months, there was a modest pick-up in healthcare corporate activity towards the end of the year, with most notably Pfizer buying the immuno-inflammatory specialist, Arena Pharmaceuticals, for nearly $7 billion. I think if this upturn in M&A activity continues, this should boost the healthcare sector in the short-term, but the longer-term picture remains as strong as ever, in our opinion. And that really concludes everything I was going to say about the healthcare sector today, so back to you, Nick.

Nick: Thank you, Stuart. Honestly, your deep research and knowledge is hugely reassuring, and thank you very much indeed. Your expertise is excellent. The piece of paper that I was referring to in the Berkshire Hathaway report, it's page two of the Berkshire Hathaway report of 2018, which was the last time the chairman issued it. And it shows a difference between how the market values Berkshire Hathaway and the value of Berkshire Hathaway itself, in terms of its earnings. And it just demonstrates the huge difference and the differential between how the market values something and the business itself and the value, and that's why we don't get too hung up on short-term market movements. So, perhaps I can now turn to some of the questions we have received, and again, many thanks for sending them to us. We're keen to ensure that these calls really meet your needs, so letting us know of any issues or queries you may have already really does help. And the first question for Ian, and we'll come on to one for you in a minute, Stuart, but what is the likelihood of a deliberate increase in inflation to mitigate government debt levels, and what might be the consequences on post-COVID growth expectations? I appreciate there are two questions there. So, the first is, what is the likelihood of a deliberate increase in inflation to mitigate government debt levels?

Ian: I think the chances of that are pretty low for two reasons, and the first reason is what you might call legal and institutional. The current legal framework for delivering low and stable inflation is designed to prevent government from manipulating it for political ends. In the UK, for example, under the Bank of England Act of 1998, the Bank of England is charged with delivering the inflation target and is operationally independent in its decisions and actions – and that operational independence is also true in the US and in the Euro zone.

So, if government were to try and stimulate higher inflation through higher spending or lower taxes, any inflationary pressure created would be addressed by the Bank through raising interest rates, over which the government has no control. Short of repealing the Bank of England Act all together, the only way that the government could encourage higher inflation would be to change the inflation target that it requires of the Bank from the current 2% that has prevailed since the Act was passed in 1998. If that were raised to say 4 or 5%, that would obviously change the inflation outlook, but such a move by the government would have immediate financial market consequences with government bond yields and commercial interest rates rising to reflect the expected higher inflation, and that would be problematic for the government.

And that links to my second reason, which is that the economics that are involved dictate against simply raising inflation to mitigate debt. Using inflation to depreciate the value of outstanding debt can only work if the rate of interest levied on that debt (that's the debt service cost) remains below the rate of inflation itself. Otherwise, what you gain in terms of depreciated debt capital is more than offset by the higher cost of the interest payments. Now, in the 1970s, when interest rates were controlled by the government itself, when inflation rose as high as 25%, interest rates were never higher than 17%, so, the erosion in the value of the debt capital was not fully compensated by higher interest payments, and the real value of the government debt then fell.

But I don't think this would happen again. It's an example of what economists call “money illusion” when people view their wealth and income only in nominal terms, rather than in real terms. And it can occur when there are low levels of financial understanding and when you have a tightly repressed financial system. But in an economy such as the UK today with sophisticated free capital markets and a memory of what inflation can do, any expectation of higher inflation would be met by demands from the holders of government securities for higher interest payments to compensate. So, from the government’s perspective, the cost of serving the national debt would rise, wiping out any gains from the depreciation of the debt itself. The Office for Budget Responsibility calculated that the current debt level of some £2.2 trillion, a rise in bank rate of 1% would increase government debt service costs by about £10 billion a year, and if this were accompanied by equivalent rises in inflation and gilt yields alongside, the full annual debt service cost would rise by closer to £25 billion. And this is a scenario the Chancellor is known to be worried about, as it would jeopardise his own fiscal plans, because he would have to spend so much more on debt service, so there would be less money available for all of his other ambitions, including that ambition to cut taxes later in the parliament.

Nick: This also answers another of the questions sent in. Is this a good time to borrow money as inflation takes off?

Ian: Well, I think any rise in inflation is likely to be met by an at least concomitant rise in the interest rate you're paying to borrow, and in an efficient financial market, those two should roughly cancel each other out. Only if inflation surprises and interest rates did not follow would there be any gain. So, in my view, decisions on borrowing should continue to be made on the basis of affordability, rather than on movements in inflation.

Nick: Thank you, Ian. Stuart, you normally highlight ESG issues in part of your talk when you're on these calls, but I notice you didn't cover that topic today. Was there a good reason?

Stuart: Well, you're absolutely right. My feeling is the best way of reminding clients that the managers of our model funds naturally take ESG matters into account when researching stocks is to mention the subject in every call – and I'd originally intended to discuss ESG when talking about Novo Nordisk, the insulin manufacturer. However, I decided it was a bit complex and might have side-tracked me. In essence, the subject I was going to raise was Novo Nordisk's response to the controversy of high insulin prices in the US, which is a sufficiently contentious matter for it to be actually addressed in President Biden's Build Back Better Bill, which I mentioned earlier. Novo Nordisk has always been aware of its social responsibilities – with the "S", of course, in ESG, being social – and their US patients assistance programme and four other related measures have helped over a million Americans access affordable insulin last year. And Novo Nordisk also supplies cheap insulin to vulnerable patients in countries elsewhere, particularly those which have inefficient healthcare systems.

The second thing to highlight on ESG is the governance structure of Novo Nordisk, which is slightly unusual. I know corporate governance box-tickers in the UK wouldn't like their dual capital voting structure, but it does mean that the controlling shareholder, who is called the Novo Nordisk Foundation, which controls 76% of the votes with just 28% of the capital, to meet its objective of supporting humanitarian purposes by backing Novo Nordisk's corporate ambition of defeating diabetes, which is somewhat of an unusual objective for a commercial insulin producer.

Nick: It is indeed. I mean, the next natural question then is, what happens to our investment when Novo Nordisk has fulfilled their corporate ambition?

Stuart: Novo Nordisk don't make a secret of the idea that they want to defeat diabetes, so I know our fund managers are well aware of it, and they should be looking for signs and if necessary, sell the shares beforehand. But also, that's a reason why Novo Nordisk also developed expertise in other areas, such as haemophilia, obesity, Alzheimer's and other chronic conditions. I think we also have to bear in mind that there are other medical companies which have shown that they've been able to completely address individual conditions. I mean, the example comes to mind of the American company Gilead, which in essence developed a product which has completely addressed Hepatitis C, so that it is no longer a problem. It does their reputation no end of good, because it seemed to work. It certainly makes them a lot of money.

Nick: Right. Well, thank you, Stuart. We've got a couple of other questions which are on financial planning really, which I'll deal with. The first question is, if all is so uncertain for the coming year, what's the right amount of cash to hold in any portfolio?

Well, the answer is a strategic financial planning one, and as ever, depends on the individual circumstances of each individual and family. The relationship between cash inflows (that's income), and outflow (expenditure) and the assets and any liabilities is critical in determining the risk management criteria and therefore the asset allocation to cash. There are numerous factors to consider, such as forthcoming capital expenditures, whatever they may be for, gifts in relation to succession planning, potential inheritances and ongoing annual requirements, among other things. So, no two families are the same, therefore it's essential to measure up these factors to achieve the right answer as to how much cash to set aside. And this is where the financial planning advice is critical to asset allocation, and potentially more fruitful outcomes, by investing higher amounts in more productive, top-quality assets where it is appropriate.

The final question we have for today is, will there ever be any appeal to having corporate bonds in a portfolio, and if not, what would have to change for there to be so?

Well, in short, the answer is no, to having corporate bonds in the portfolio, and there is little that would change our view. There are several reasons for this. Firstly, why would we want to give away the potential of the equity upside, relative to a likely lower fixed return while retaining corporate risk? Secondly, we achieve the low volatility element of your portfolios where needed, with the highest quality UK or US sovereign debt, which is lower risk than corporate debt. And this enables us to hopefully increase returns by investing higher amounts in the equity of top quality businesses while still being prudent. Thirdly, we don't invest for the income element, because we already have set aside cash, if we've done our financial planning properly, for ongoing requirements. So, corporate debt doesn't form part of our portfolios.

Well, that's all we have time for today. So, I'd like to thank both Stuart and Ian for their interesting contributions, which are very much appreciated indeed. Of course, if you have any other questions that you would like them to answer or me, we would be delighted to hear from you, whether you're listening live or to a recording which will be sent out afterwards. Please just send me an email and we'll revert to you appropriately. Now, as most of our listeners are aware, our over-arching mission at London Wall Partners is to assist individuals and families to appreciate their capital – and by that I mean enjoying the fruits of their labour while also hopefully growing it – by providing sensible advice on the three main disciplines, being proper financial planning, appropriate asset allocation and quality investing. And these disciplines are inextricably linked, in that thoughtful goal-oriented planning leads to appropriate asset allocation, and good judgement and analysis enables quality investing.

It's incredible how many times we see often under-investment in quality assets, and much over-diversification. So, appropriate asset allocation is key, as is quality investing. A joined-up approach is essential really in producing fruitful returns in the context of the economic and investment environment into which Stuart and Ian have been speaking.

We're very grateful for the introductions and referrals we continue to receive from clients, and we would love to meet any of your friends and colleagues who you think may benefit from a confidential discussions with us. So, thank you to everyone who dialled into our call this morning, and thank you again to you, Ian, and Stuart. We plan to hold our next quarterly call on economic and investment issues on Tuesday, 12 April at 11.00 a.m. There will be communications being sent out before that, and I do hope you'll be able to join us then. In the meantime, enjoy the rest of your day. Thank you so much.