Economic and Investment Update Conference Call Transcript – 14 July 2022

Presenters

- **Nick Fletcher**, Senior Partner of LWP and Chairman of the Investment Committee (**NF**); and

- **Ian McCafferty**, CBE, former member of the Bank of England's Monetary Policy Committee and member of the LWP Investment Committee (**IM**).

NF: **Thank you very much Suzanne. Good morning, everyone. This is the latest in our regular quarterly 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 50 minutes or so, before answering some of the questions we've received, for which very many thanks. We aim to finish the call at around 12 noon.**

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So, joining me on the call this morning is Ian McCafferty, a Senior Advisor to London Wall Partners and a member of our Investment Committee, who many of you will know, but for newer listeners, let me briefly introduce Ian. Ian is one of the UK's leading economists with over 40 years of professional experience. He joined us in 2019 having stood down, after six years, as a member of the Monetary Policy Committee at the Bank of England. That's two terms' limit. Before the Bank, his career spanned the City, the CBI and BP, amongst others. And as well as working with us, he is visiting professor at King's College London, a member of the Government's Senior Salaries Review Body and a Senior Adviser to Oxford Economics. Good morning, Ian!

IM: Good morning, Nick. And Good morning to everyone listening.

NF: **Well, it's sobering to reflect on what's been happening since our last call. Stock markets have continued to decline, making the first half of 2022 the worst performance since the early 1970s, and that market volatility is unlikely to be over. The conflict in Ukraine drove energy and commodity prices to new highs recently, albeit that they have edged lower in recent days. And, together with the physical embargoes on strategic goods and services that both sides have**

deployed, the stresses placed on the world economy are considerable. Nor have we seen the last of Covid, with the new waves around the world threatening trade flows and supply chains. Not surprisingly, policymakers across the world are struggling to deal with the fallout. Inflation has risen to levels not seen since the early 1980s. Companies are reporting significant problems with workforce shortages and forecasts for economic growth are now being revised down amid fears, in some countries at least, of the possibility of a recession in the offing.

In our last call, soon after the war started, we talked of the significant supply shock to the global economy that the war in Ukraine represented and, Ian, you described the channels by which that shock would feed through into the world economy, that is, oil and commodity prices, trade restrictions, financial flows and supply disruptions, through constraints in key raw materials and components. Back in the spring, many thought that the war would be brief such that the shock might not be long-lasting. Though we did talk about the possibility that the conflict could become long and protracted. Well, we're now almost 150 days in, with little sign that the war will soon end. So, Ian, how is that supply shock playing out, and have you had to change your assessment of its impact on the world economy?

IM: Well, it is clear Nick that the world economy is paying a hefty price for the war in Ukraine. Though it's remained a local conflict and has not been allowed to escalate more widely into other parts of Europe, the economic consequences are spreading globally. Those channels we identified, through which the shock would feed into the world economy - commodity prices, financial flows and trade - have proven, by and large, correct. But although I suggested then that the negative supply shock would be sizeable, it is turning out to be even larger than I thought, with greater consequences for both inflation and economic growth.

Now, there are several reasons why the shock is turning out to be bigger than we'd anticipated. The first is the way in which the war has played out on the ground, which has intensified the amount of disruption to supplies of some key raw materials and commodities. One example is that Ukrainian grain exports have been drastically reduced, not only as a result of disruption to the sowing and harvesting of this year's crop, but also because of a Russian naval blockade of the Black Sea, which has prevented the export of existing stocks. Now, with grain widely used as a feedstock in many agricultural processes, including feeding chickens, for example, the impact on food prices across the board has been marked. But there are other geopolitical factors that are also making the supply shock worse than we initially expected.

First, there are some non-aligned countries, such as India, that have resisted calls to join Western sanctions on Russia and have continued to purchase cut price Russian oil and gas in bilateral deals. This has allowed the Kremlin to be more aggressive in physically restricting supplies of energy to Western Europe, without damaging Russian revenues, and that's put further upward pressure on global crude oil and European natural gas prices. Last month, Brent crude prices, again, exceeded $120 a barrel, close to their peak of the spring. And European gas prices,

at last week's price of over €160 / megawatt hour, are now double the level of the start of 2022.

Second, oil prices have been higher than expected because OPEC has proven less willing than we'd thought to increase its own production of crude oil to offset the loss of Russian oil supplies. OPEC claims that this is because production capacity is limited and cannot be boosted in the short term, but, in reality, it appears to be more the result of an unwillingness to upset Russia, which is not a member of OPEC but is a member of the OPEC Plus Alliance, and, in addition, a cooling in the diplomatic relationship between Saudi Arabia and the US which has followed the change in Saudi leadership and the US criticism of Saudi human rights, following the murder of the Saudi journalist, Jamal Khashoggi.

This means that OPEC is not playing its more usual role of swing producer to offset the loss of Russian crude from the market. So global energy and commodity prices have risen even further than expected at the outset of the war and that's added to inflation pressures across the board.

But, in my view, it would be wrong, I think, to describe all of the economic problems we now face as stemming directly from the conflict in Ukraine. That conflict has placed severe stress on the world economy and in doing so has exposed some underlying weaknesses that are more legacies from the pandemic. Those underlying weaknesses have turned the recent events into something of a perfect storm. Now, we've talked already about some of the legacies from the pandemic in our previous conversations, and one example is how the vulnerability of long, complex, just-in-time supply chains was exposed by the lockdowns. And that problem is still evident, given that we've had recent lockdowns in China.

But another problem for the way our economies are operating post-pandemic (and it's a legacy of the pandemic itself) is now becoming apparent. And this is also making it more difficult for the Western economies and, in particular, the US and the UK, to adjust to the shock stemming from the war in Ukraine.

This new legacy involves the labour market and changes in worker behaviour across a number of Western economies. Now it's becoming clear that the pandemic has caused a structural shift in labour supply in the willingness and ability of people to offer themselves for work. Now, in all economic downturns, including those caused by the pandemic lockdown, it's normal for people to withdraw from the labour force as job opportunities dry up. And normally as the economy picks up, or in the case of the pandemic, opens up, they return to the labour market and thus restore an increased labour supply.

But this time it appears that many have withdrawn from the labour market somewhat more permanently, and this has caused serious labour shortages as economic activity is recovering.

This changing behaviour has come as a bit of a surprise indeed. If you think back, as lockdowns were lifted, policymakers and economists were more concerned that, as job support schemes were phased out, there was going to be a sharp rise in unemployment, which clearly didn't happen. Part of this change in labour supply can be explained by the incidence of long Covid. The numbers unable to work due to, in the data, an unspecified long-term sickness, have risen sharply over the past two years. Also, the numbers assessed as having long Covid have also gone up and, putting these two pieces of information together, it appears that the virus is having longer-term effects on labour supply and economic activity than was originally expected. But this is not the whole story, other factors are also at work. It appears that the reduction in labour supply in a number of economies is most concentrated in two age groups: those under 25 and those approaching retirement. So, the best explanation for the labour shortfall that we're now seeing, that is not explained by long-term sickness, is that first, the young, discouraged from looking for a job during the pandemic, have stayed on in further education and that enhances their eventual employment prospects, so that aspect should fade in time. But as well, older workers seem to be bringing forward their retirement plans, having re-thought and re-assessed their economic and lifestyle goals during the pandemic years.

NF: This is globally, not just in the UK.

IM: Yes, you've seen this commentary in the UK papers but it's also happening in Europe and, to a large extent, as well in the States. And this means that labour supply, in a number of Western countries, is struggling to keep pace with demand. Staff shortages in some sectors are widespread and wages are becoming, therefore, more responsive to rising inflation. So, the war-induced inflationary shock from higher energy and commodity prices has also started to spread a bit into the wider economy as firms start offering higher wages to compete for scarce staff and that's added to inflationary pressures over the course of the summer.

NF: What you've said Ian has led many commentators to draw parallels with the 1970s - the last time we had such a severe inflationary shock. Do you think that that is a fair parallel? And where does that leave us in terms of where inflation peaks? And how persistent it is? There are three questions there!

IM: Well, I do think, if I'm honest, that the comparisons with the 1970s (and I happened to start my professional career in the 1970s) are a bit alarmist, and I think they fail to recognise some of the differences that exist between now and then.

NF: Which are?

IM: Well, the first big difference is that the architecture for macro-economic policy is very different. Back then, there was little by way of a policy framework for dealing with rising inflation and no inflation targets backed up by legal statute. Central banks were subservient to their finance ministries and monetary policy was in the

hands of politicians, who, in turn, were beholden to powerful economic interest groups, such as the trade unions. As a result, once inflation had started to take off, there was little to prevent it worsening until the development in the 80s, and then the 90s, of dedicated inflation policy frameworks, and the creation of independent central banks charged, legally charged, with controlling inflation.

Now, older listeners may remember the emergence of those such as Paul Volke, who was Chairman of the Federal Reserve in the United States in the 1980s, and, slightly more recently, Eddie George, the first Governor of the Independent Bank of England, who both made their reputations as inflation fighters. And although the main central banks can be criticised for being somewhat behind the curve, as inflation pressures began to mount late last year, the policy response to rising inflation is now well underway. The Fed in particular is now undertaking one of the most aggressive policy tightenings in recent history, having raised its policy rate by 175 basis points since March with further increases expected in the coming months. So, I think the chances of a persistent inflationary spiral of the sort that we saw for almost a decade back in the 1970s are very unlikely. And I think there are already early signs that the old economic adage about inflation, that 'the best cure for high prices is high prices', is again about to be proven true. Already that elevated level of inflation and the squeeze on purchasing power that it represents is causing growth to slow quite markedly in the Eurozone and in the UK and to a somewhat lesser extent so far in the US.

And that prospect of much slower economic growth is already having an effect on commodity prices, with oil, copper, and wheat, falling back in very recent days. So, the slower growth in itself is reducing the risks of a prolonged bout of inflation. Overall, although this bout of inflation that we're undergoing now is likely to be a little more prolonged than the central bankers originally thought, I think we can project with some confidence that by the end of this year inflation will be starting to come down again, although it's unlikely to be closing on the 2% central bank targets much before the end of 2023.

NF: Okay. So, if we're not going back to the 1970s, how high do you think inflation will get and how long before it falls back to the 2% that the main central banks have as their target?

IM: Well, I think to answer that question, we need first to recognise that the key drivers of the current inflation in the United States, the Eurozone, and the UK, are somewhat different. So, both the peak and the duration of that high inflation will differ for each area. Now, there are two causes of the high inflation at present: one, the sharp rises in energy and commodity prices, largely driven by the war; and two, domestically-generated inflation in those economies that were over-stimulated by expansionary fiscal and monetary policy through the pandemic.

While both factors have some part to play in each area, the balance between them does differ. Everywhere has suffered from the global rise in crude oil prices, but because natural gas prices are determined regionally and have risen significantly

more in Europe, as a result of the restrictions by Russia on pipeline exports to Germany, the Eurozone and the UK have suffered more from rising energy inflation than has the US.

In the US, by contrast, more of the inflation has been caused by the enormous fiscal expansion from the Biden administration and the tight labour market and the excess demand that this has caused. Unfortunately, on this analysis, the UK is undergoing the worst of both worlds. The UK is getting the worst of the energy price inflation but is also somewhat overheated…and this derives partly from the pandemic stimulus package of 2020…but has been made worse by Brexit which has reduced the available supply of labour further. In the UK, unemployment is now at its lowest for 40 years and laborious shortages are widespread, adding to those inflationary pressures. And this has been further compounded for the UK by the weakness of the sterling which has pushed up the prices of all imported goods.

So, the inflation outlooks differ slightly area by area. In the US most forecasters expect inflation to peak over the summer at around 8.5% and to fall back to close to the Fed's 2% target by next summer. In the Eurozone similar peaks are expected, but with a weaker economy, the fall-back next year should be slightly earlier and faster. In the UK meanwhile, inflation is expected to peak later in the autumn at over 10%, possibly nearly 11%, and is unlikely to fall back to target until at least the end of next year. Now, of course, all of those forecasts are heavily dependent on what happens to energy prices. In recent weeks, as economic activity has softened, crude oil prices have fallen back from the $123 a barrel of early June to closer to $100 - $110 now.

US natural gas prices have also slipped back from a peak of over $9 to $6 now. But fears that Russia might impose further physical restrictions on gas into Western Europe, as we move towards the winter, have driven Eurozone gas prices sharply higher from under €100 in early June to closer to €170 recently. So, further to this significant risk disruption to European gas supplies, if Russia closes a pipeline or fails to reopen the pipeline that's currently closed for maintenance, would not only push peak inflation in Europe and the UK yet higher but would also delay the decline in inflation over the course of 2023.

NF: Well, one of the key concerns for markets in recent months is how central banks will react to such high inflation and what that means for interest rates. So how aggressive do you think the Fed, the Bank of England and the ECB will be in fact?

IM: Well, to some extent, all of the central banks are playing catch up. They started with a view that inflation would be only modest and temporary and then were caught out by the sharp pickup caused by the conflict in Ukraine, and they're now having to tighten policy slightly more aggressively as a result. But they also face two serious dilemmas, which make their decisions on how far and how fast to tighten policy more difficult. The first is that, faced with the type of inflation we have now, monetary policy is not particularly effective. I know that sounds like a weak excuse (the type that British Rail used to use when it blamed train delays on

the wrong sort of snow) but when much of the inflation is caused by problems on the supply side of the economy (energy and commodity shortages and raised prices) changes in monetary policy can do little directly to solve the problem. Monetary policy influences inflation by affecting the level of demand by speeding up or slowing down the pace of demand growth in the economy and hence domestically driven inflation pressures. But monetary policy can do little to conjur up more oil or reduce grain shortages. So faced with supply-side inflation pressures, all that a central bank can really do is to ensure that the economy is growing at a slow enough pace and with enough slack in the labour market to ensure that rising prices do not translate into constantly rising wages, which would trigger a wage price spiral.

So, for the US economy, where more of the inflation is the result of excess demand and an overheating economy, the path for the Fed is clearer. They need to slow the economy enough to squeeze out wage and margin inflation, and since March they've been raising rates rapidly. The policy rate rose by 50 basis points in both the March and May meetings and by 75 basis points in the June meeting. That makes this the most aggressive tightening since 1994, and markets currently expect a further 175 basis points by the end of the year, taking the Fed's funds' rate to over 3%.

At the other end of that spectrum though is the Eurozone, where growth was already weak and more of the inflation is supply-side driven. Under these conditions aggressive tightening of monetary policy risks driving the economy into recession without doing that much to reduce inflation. That's why the ECB has been much more cautious. It has ceased its asset purchase program which started in mid-2014 and has announced that a gradual but sustained path of interest rate rises will start in July, but it would be the first increase in 11 years.

In the middle of that spectrum is the Bank of England which, in the words of its Governor, Andrew Bailey, *"is treading a fine line between controlling inflation and triggering recession"* and as such I think the MPC is likely to continue to move rates higher at a steady, but probably cautious pace, from the current one and a quarter percent to a likely peak of somewhere just over 2% by early next year.

NF: **So, you're still expecting interest rates to remain quite low by historical standards? In the 20 years up to the global financial crisis official interest rates averaged close to 5%, well above where you see them going even with inflation peaking at 8% or more. So, surely rates will have to go much higher if inflation is to be controlled, won't they?**

IM: Well, I think there are a number of reasons why I think interest rates will remain well below those that prevailed before the global financial crisis before 2008 / 2009**.** First, the structure of the world economy has changed since then, shifting demographics and changes to savings and investment flows, mean that the equilibrium interest rate (that is, the interest rate that balances the world's economy) has fallen over the past 20 to 30 years and those fundamental drivers of

financial conditions are not going significantly into reverse**.** So, the secular era of low-interest rates is not over even, as cyclical factors have recently driven rates higher. Second, when rates start from such a low point, the leverage that they have on the economy, in any policy tightening, is much greater.

I think I better explain that with a numerical example. If you borrow a hundred pounds at 5% and then interest rates rise to 6% your debt service cost, the amount you're paying in interest rises from five pounds to six pounds, but that's an increase of 20% in your monthly payments. But if your starting interest rate is 1% and it moves to 2%, your monthly payment also rises by a pound, but that's a doubling in your monthly outlay. So the impact on your other spending is likely to be greater. So, when interest rates start from such low levels and spending patterns have adjusted to those low levels, the impact on borrowing and spending of a change in rates, of say, 1% tends to be larger than if interest rates were already higher. In the current circumstances, it doesn't take a big change in rates to have a noticeable effect on the economy.

I think the third reason is one I cited earlier with that old adage that 'the best cure for high prices is high prices'. What that means is that unless governments accommodate the high inflation by continuing to expand fiscal and monetary policy, which is what they did in the 1970s, the very existence of the high inflation squeezes real consumer incomes such that the economy slows sharply of its own accord, thus removing much of the inflationary pressure over time. My former colleague, Sir Charlie Bean, the former Deputy Governor of the Bank of England, has come up with a good term for that process, he calls it 'Immaculate Disinflation', and that's what we're starting to see at present. So I don't believe that central banks will have to tighten that much further to slow their economies as the high inflation is doing a good deal of the work for them.

NF: So, from what you are saying, we should expect economic growth to slow sharply over the next year or so. Does that mean we should be concerned about recession as well as inflation, Ian?

IM: It's already becoming clear, I'm afraid Nick, that the outlook is changing rapidly and key forecasters who have updated their forecast recently such as the OECD who have signalled the marked change compared with what they'd expected at the start of the year. I mean relative to the forecast in January, the OECD has doubled its projection for inflation in 2022 to reflect much higher energy prices, but it's cut its growth forecast significantly. For both, the US and the Eurozone growth in 2023 is now expected to be only 1.5% down from the 2.5% projected in their previous forecast earlier in the year. As yet few forecasters are prepared to predict recession as their central case, but I think there's a risk that at least one of the US, the Eurozone, and the UK, experiences a shallow recession at some point over the course of the next 12 to 18 months. In the Eurozone and the UK, in particular, the most topical data show that activity has lost a good deal of momentum recently and the squeeze on real incomes from the high inflation is likely to persist through the winter leaving consumer spending vulnerable to quite a nasty downturn.

The US has got a bit more momentum, though consumer spending and housing are slowing. So I think the risk of recession is less imminent there, though with the Fed tightening more aggressively, the chances of recession later, perhaps in 2023, can't be ruled out. But I think before we get carried away with the pessimism about recession, any dip into recession over the next year or so is likely to be much shallower and much shorter than those of recent experience. I mean the lockdowns in 2020 provoked the sharpest decline in GDP in almost 100 years, while the 2009 recession, after the global financial crisis, was made worse by the dislocation of the financial system. This time downturns are likely to be less synchronised with some recovery in China in prospect for next year, which means that at a global level growth is likely to continue, albeit at a very modest pace.

NF: Well Ian, that's been a very comprehensive, if sobering analysis of what is going on. One final question for you for the moment, it is clear that the global economy faces some daunting challenges in coming months. So our investment committee will have its work cut out monitoring developments, but in such volatile times, I think it would be remiss not to ask you about some of the, what I call, left field risk that might further disrupt what is already a difficult environment for markets. How do you see that?

IM: Well, I think the scenario for the next year that I've described (elevated levels of inflation, central banks raising interest rates, combined with, at best, poor growth for the world economy, and governments attempting to limit the economic pain amongst their electorates) is clearly not a comfortable one. What we do know from history is that such conditions severely test the resilience of individual economies, individual markets, companies and governments. So, if there are any underlying weaknesses anywhere in the system, they're likely to be exposed. When we think about where those weaknesses might be, many commentators simply look to previous crises and assume that the faults will appear in similar places. But this time I don't think the banking system or mainstream finance are likely to prove key fault lines. The work of regulators in boosting central bank capital and controlling risk since the financial crisis means that a banking or property crisis is much less likely than 10 years ago. But I do think there are some underlying weaknesses clearly on the geopolitical front: China and Taiwan are big risks. I won't talk about that in detail, but clearly having seen what's happened in Ukraine with Russian expansionism, if China decides to have a pop at Taiwan, that would be clearly very, very, serious. On an economic front, I think the main danger that I foresee is that governments are pressed by political reasons to try and support their economies through the crisis caused by the supply-side shock from Ukraine and that would leave us more in a position of towards the 1970s where we are accommodating that economic shock and that would lead to longer inflation and ultimately probably less growth.

NF: Thank you, Ian. Of course, the current economic cocktail elevated inflation, rising interest rates, slowing growth, the uncertainty of a war that could escalate and the slew of bad news has seriously depressed confidence, and short-term financial market performance has been poor as a result. I mean, so far, we've

seen two phases earlier in the year as fears of inflation began to mount and bond markets sold off in response. We saw a strong market rotation away from growth and technology-driven stocks in favour of those benefiting from the short-term cyclical environment: energy and mining companies and banks, for example. This has been a headwind to our portfolios in the short term, given the absence of value sectors like commodities in most of our recommended funds. More recently as a shock from the war in Ukraine hit home, that growth value rotation (so-called) mutated into more widespread weakness across the board. In the six months to the 30 June 2022, the US Stock Market experienced its sharpest fall in the first half since 1970, going down by 20.6%. And in the very short term, it is quite possible that that volatility and weakness might continue. And as we progress through the summer months market liquidity, of course, tends to reduce due to seasonal factors, as traders and other market participants go on vacation. During this period markets tend to be more sensitive to changes in macro-economic news and sentiment, I'm sure you'll agree. Also, as the global economy slows, concerns about recession are likely to take over from those about inflation. So, we may have to prepare for a further bumpy ride over the coming months.

IM: Over the six months that you've talked about (the first half of this year) we have maintained our strategy to plan personal finances carefully, invest in quality stocks, and not attempt to react to the short-term uncertainties. I mean, given the very volatile outlook that we still see, are you continuing to recommend that approach?

NF: Well, even when things are very uncertain, an investment strategy that relies on predictions of short-term market movements is, I believe, inherently dangerous. Let me give you an example, in 1970 when markets last fell this much in the first half of the year, the following 12 months saw the S&P 500 rebound by 37.1%. This was strongly illustrated in the note we send inviting clients to this call. So, the short answer, Ian, is yes.

While markets can be volatile, quality companies can continue to perform, that is why we stress the importance of patience as a long-term investor, preferring to focus on allocating capital to investments with the quality to out-perform over the long term. That dichotomy between markets and companies is well summed up in the 2021 annual letter to shareholders from Smithson, which is one of our recommended investment trusts, and this is how it goes which says*: "imagine a dog walker crossing a field, their dog wildly zigzagging around them. We would relate the companies we own to the walker, clear in direction and making steady progress across the field while the daily market price is like the dog moving back and forth quite randomly. Now the current economic storm may well send the dog cowering for cover but given enough time, we know that the price and value will eventually meet again, just as the dog and the walker will ultimately leave the field together. We are also confident that as well as making constant progress, a high-quality company, if it trips up during the storm, will rise again and keep going. Low-*

quality value companies on the other hand may never get back up". That's the end of the quote.

IM: But, given the uncertainties that we do face, how can we really focus on the long term at the moment?

NF: Well, I've always been slightly wary of the phrase, the long term, as it can be used as one of those excuses that some in our industry make to paper over mistakes rather than providing an honest assessment of the reality of the situation. But the fact is that a long-term investment approach is important for several reasons, however, it does need to be based on solid underlying fundamentals, all of which of course are based on judgement calls about the future with limited information and are by no means guaranteed or certain.

We believe in investing in predominantly quality growth companies alongside some smaller to medium-sized businesses that have an opportunity to make a huge difference to society. But we would not want growth without value or value without growth which does put some light on this growth value argument. You've got to have growth and value. Growth at a reasonable price would therefore be an appropriate description of the type of companies that we want to invest in, focusing on high-quality companies with sustainable growth prospects is a winning strategy over the long term and has been shown to work through several economic cycles by our recommended fund managers.

Now normally at this point, I'd bring in our Investment Director, Stuart Fowler, but he's been off sick recently and is only now working his way back in. The good news is that we have good bench strength at London Wall Partners and the investment team has been assisting me and my fellow partners, as I've assumed Stuart's responsibilities. Over the seven years that Stuart has been heading the Investment Strategy team, I have remained closely involved in investment matters as Chair of our Investment Committee, but given the current environment, it's been very good to meet with our fund managers and dive into the weeds, as it were, as we have rigorously appraised and re-appraised all of the funds we recommend.

As we know, risk management is about maximising the likelihood of return while minimising the chance of a permanent loss of capital. If there are investments within our portfolio that are down and likely to stay down, no amount of talk about the long term will improve matters and we need to be realistic about this. Our fund managers are paid to use their discretion over their holdings day by day. But in the event that they don't do a good job, we need to challenge them and if they don't pass muster we must weed them out. Now, we hope our judgement calls are sufficiently sound that we rarely have to do this but, like life, investment is not a perfect science. And likewise, we hope our selected fund managers will select such great companies that they rarely have to change much.

I thought it might be helpful and somewhat reassuring to report back to you some facts and observations from our recent travels. In doing so, I hope to provide a

frank and earnest assessment of how we and our selected external fund managers have done and what that looks like for our portfolios so far.

Let's start with Fundsmith, Lindsell Train, and GuardCap, which together represent 38% of our adventurous portfolio. Throughout I'm going to use our adventurous portfolio when talking about fund weightings - the numbers will, of course, differ for those in other models. These three funds each invest in a focused portfolio of no more than 30 high-quality resilient businesses in areas with strong structural trends that should support future growth - trends such as the increasing digitisation of the global economy, the need for increasing healthcare as people live longer and the expansion of the consumer classes across the world. The high-quality nature of the companies in these funds is demonstrated by their superior financial characteristics. For instance, as Fundsmith highlighted, they have gross profit margins of around 60% in their portfolio compared to the 45% typical of the S&P 500 and FTSE 100. Their operating profit margins are also higher. They are also conservatively financed and then high returns on capital employed as at the end of 2021: Fundsmith's portfolio had interest cover of 23 times and a return on capital of 28%, again markedly higher than the indices averages. These funds invest in companies that have been in existence for a good time and which have experienced both good and bad market conditions, including periods of high inflation.

We have spoken directly to the management teams in the last three months and their confidence of the ability of their companies to withstand future challenges. To give you some examples:

- London Stock Exchange publicly listed in 2001, since when its shares have produced a total annual return in sterling terms of 19%;
- Unilever founded in 1929, since 2000 has produced a total annual return in sterling terms of 9.8%;
- Pepsico, founded in 1965, with a total annual sterling return of 11.3% since 2000;
- Diagio formed in 1997, which since 2000 has produced a sterling return of 12.6%; and
- L'Oreal, founded in 1909, and introduced on the Paris Stock Exchange in 1963, since 2000, its shares have returned 9.7% annually in sterling terms.

This is to name but a few. And I'm sure you'll agree, they're all pretty well-known names.

So far this year, Lindsell Train, GuardCap and Fundsmith have not been immune to the market downturn, falling by between 6.9% and 16.5%, and this compares to a year-to-date decline of 8.9% in the FTSE All World Index and their longer-term performance remains strong. Since December 2014, they've each returned between 13% and 15% annually compared to the FTSE All Worlds 10.8% per annum.

We also recommend two specialist theme funds: Worldwide Healthcare Trust and ClearBridge Infrastructure, which make up a further 19% of our adventurous

portfolio and both funds are managed by highly specialist and well-resourced teams who've been investing in companies in their sectors around 30 years, and I do think it's worth going into a bit of detail here just to understand them.

Worldwide Healthcare Trust is run by OrbiMed, a US-based business and one of the largest dedicated healthcare investment companies in the world, managing over $18,000,000,000 in investments. The team includes several investment professionals (80 in total) and 30 individuals with scientific and medical backgrounds. And that expertise, we believe, has contributed to the trust's strong long-term performance, which has been 14% per annum, compared with 8% percent per annum for the World Index since the trust launched in 1995. OrbiMed is particularly excited about the long-term opportunities within innovative biotech technology companies, which are driving progress in areas such as Oncology and Alzheimers. Currently the trust's largest holding is AstraZeneca whose share price has risen nearly 30% this year after nearly a decade of declining revenues as it turned itself around under CEO Pascal Soriot.

AstraZeneca has recently co-developed a highly effective treatment for breast cancer called 'Enhertu' which has been approved for the US by the US regulators and OrbiMed believes that Enhertu could potentially generate sales in excess of $15,000,000,000, which given that AstraZeneca's total revenues in 2021 were $37,400,000,000, is quite significant. Over the last year, Worldwide Healthcare's allocations to innovative biotech companies and to Asia have been headwinds to performance. But last week I met the lead manager of the trust, Sven Borho, who's been investing in healthcare companies for over 30 years. He believes that recent market sentiment has resulted in the largest under-performance of Biotech companies that he's seen in his entire career with about one third of all biotech companies now trading at market valuations, below the net cash on their balance sheets, which should represent tremendous long-term investment opportunities.

And the manager believes there are signs that recent negative sentiment may have begun to reverse in June. So, while the trust declined 17.3% between the start of the year and the 1 June, it's actually risen by 9.8% since that date, and by 6% last week. So it's rising back. The sector is also seeing increased acquisition activity as larger companies seek to strengthen their drugs pipelines and access innovative technologies. And this should re-focus investor attention and help narrow the trust's 8% current share price discount to the net asset value. So with the threat of drug price reforms in the US receding, Worldwide Healthcare should continue to be an attractive long-term investment managed by an excellent team.

The other specialist team fund, the ClearBridge Global Infrastructure Income Fund, has produced useful diversification in our portfolios having risen in value by 11.7% this year to date. The fund is managed by a specialist infrastructure team based in Australia undertaking deep fundamental research on high-quality infrastructure companies globally. We received an update from the lead manager, Nick Langley, in June and it only served to further reinforce our confidence in their expertise and the fund's long-term prospects, which is run with a high conviction approach of

only 38 holdings. A key attraction of investing in infrastructure businesses is that cash flows tend to be underpinned by long-term contracts and regulation and / or regulation providing greater certainty of growth. Over half of the ClearBridge Fund is invested in regulated utilities such as electricity and gas distribution networks, whose rates of return, set by regulators, benefit from higher inflation and bond yields and has, therefore, provided useful protection in an inflationary and rising interest rate environment.

Despite the strong performance of infrastructure assets, this year ClearBridge still see opportunities at reasonable valuations, given their understanding of regulatory regimes globally. The team is very well placed to take advantage of these opportunities. For instance, in the US each of the 50 states has its own regulations requiring the sort of specialist in-depth knowledge that Clearbridge possesses to keep abreast of events.

Over the next decade high-quality infrastructure companies offer attractive growth prospects as the energy transition towards 'Net Zero' gets underway. I mean the United Nations estimates that $4,000,000,000,000 a year needs to be invested in renewable energy until 2030 if the Net Zero target is to be hit by 2050. So there's tail in there. Many of the Clearbridge fund's holding should benefit from increased investment in new generation capacity in Europe, among them is the British company SSE, which used to be known as Scottish and Southern Energy, which plans to triple its renewable energy output by 2030 as well as Clearway Energy, a US developer and operator of wind solar and energy storage facilities and Spain's Iberdrola, the world's largest wind power producer which owns Scottish Power in the UK. So it's not all bad.

We continue to believe that shares enlisting infrastructure companies should deliver returns above inflation over the medium and long-term as well as providing appropriate portfolio diversification.

IM: So the five funds you've talked about, they represent close to 60% of the holdings in our adventurous model. So that's essentially the core of the portfolio. They provide reasonable downside, I think, with plenty of upside potential, but what are the other holdings that we recommend (that is, the rest of the portfolio)?

NF: Our next two funds invest in somewhat smaller businesses offering the opportunity of rather higher returns over a longer horizon. They invest in companies that are established but which have the potential to become much bigger companies, hopefully. These are Smithson and HG Capital Trust, which together represent a further 12% of our adventurous portfolio.

Smithson is run by the Fundsmith team and adopts a very similar strategy to the Fundsmith Equity Fund, but with a focus on less large businesses. Now sentiment towards the shares of medium-sized companies has been weak during the year to date and Smithson's share price has decreased by about 38% since the start of the year. But a good deal of that is due to the emergence of a 12% discount to net

asset value as market sentiment has turned negative. We believe this discount is unlikely to endure in the medium term. I recently had a phone call with Smithson's lead manager, Simon Barnard, which reinforced my confidence in the long-term growth prospects of the businesses held in the portfolio. They're reasonably valued, seemingly cash check generative, enjoy strong gross profit margins and returns on capital. Simon believes many of the portfolio companies are not only retaining a strong market position, but in fact are increasing market share. The managers at Smithson find attractive investment opportunities in the IT sector but also other sectors too. In fact, there are cyber security businesses in there. In addition, they also invest in consumer goods companies with strong brands such as Fever Tree and Domino's Pizza - and don't we all need a tonic and some cheap food right now!

HG Capital also focuses on the software sector and invests in private non-quoted businesses. The share price has fallen by 21.8% in the year to date. But based on the net asset value data for March 2022, it's now trading at a 25% discount to that net asset value. Even if the net asset value is reduced when the new data appears for June, we believe this material discount is disproportionate and again a reflection of short-term negative market sentiments and should not be long-lasting.

We attended HG's Annual Investor Day at the end of March 2022 and met with the manager for a follow-up meeting in Mary and I'm meeting with the Chairman in a couple of weeks to gain a deeper understanding of how the portfolio is faring in the current environment. HG's portfolio companies continue to grow strongly with revenues and profits growing at broadly 30%. HG Capital are actively involved with their investee businesses and work to drive operational improvements. Many of the companies in the portfolio offer mission-critical software to businesses such as tax accounting and payroll.

With high levels of recurring revenues and cash generation. The manager is able to take a patient approach and, given HG's strong balance sheet, is well placed to take advantage of opportunistic deals should valuations become more attractive.

Our eighth selected fund is Sands Global Leaders. This fund focuses on businesses with strong financial characteristics. A couple of examples are: Microsoft shares have returned 29.9% over the last 10 years; and Visa shares have returned 24.9% per annum. So over the short term this fund has been negatively impacted by its focus on global growth businesses, it's fallen 19.2% in the year to date but since inception in 2018, it's produced a total return of 9.7% annually. And while this particular fund is relatively new, as a manager, Sands has a strong track record of out-performance. Their Global Growth Fund has delivered a return of 12.2% since its launch in 2008, which has out-performed the FTSE All World of 11.7% over the same period So, there's a little bit about performance.

The remaining 11% of the allocation to company shares in our adventurous portfolios is invested in two investment trusts run by Baillie Gifford in Edinburgh: Scottish Mortgage and Edinburgh Worldwide. Scottish Mortgage makes up 9% of our

adventurous model and Edinburgh Worldwide, a rather smaller allocation of 2½%. Compared with our other funds these have particularly distinctive investment approaches, focusing on high-growth disruptive businesses of an earlier stage in nature, across both public and private markets. Scottish Mortgage focuses on somewhat larger, more established, businesses like Amazon, Google and Tesla. Edinburgh Worldwide on somewhat smaller younger businesses. In recent years, they've both delivered significant returns. Even after the recent fall, Scottish Mortgage in the last 10 years has returned 20.2% and Edinburgh Worldwide 13.1% per annum, compared to the FTSE All World return of 11.8% per annum. But these two funds have been hit hard by the re-rating of growth stocks earlier in the year. The rise in bond yields as inflation fears mounted has re-rated the net present value of future earnings of high-growth businesses such as those held in the trust.

So, after a stellar rise during the pandemic, Scottish Mortgage has fallen by 42.4% this year to date and Edinburgh Worldwide by 37.6%. Now, although it could be argued that Edinburgh Worldwide is only a small proportion of our portfolios and that the fund that it replaced in our model has also fallen, I have to say that this does not make me feel any better about how this fund has performed. But as with Smithson and our other closed-ended investment trusts, a good part of the fall in the share prices of both Scottish Mortgage and Edinburgh Worldwide has been due to the widening of the share price discounts to net asset value driven by, again, that market sentiment, Scottish Mortgage and Edinburgh Worldwide have both widened around about 15% year to date. These widening discounts have had an impact on our overall performance. So overall, of the close to 16% decline in our adventurous model in the year to date about 5% is due to these widening discounts. Now were these discounts to have remained at historical levels, our adventurous model would be down some 11%, closer to the 9% fall in the FTSE All World index. For both Scottish Mortgage and Edinburgh Worldwide, we've been speaking to the managers of both trusts in recent weeks to closely scrutinise and challenge them on recent performance and portfolio activity. We continue to keep matters under constant review with the retirement in 2021 of James Anderson, lead manager for Scottish Mortgage, questions about the long-term direction of the fund and I've also severely questioned one of their decisions, that is, the retention in the fund of a business called Shopify which, while it might have tremendous business characteristics, was in my view significantly overvalued at $200,000,000,000 as at November 2021. As yet, I'm not entirely satisfied with their answer, so we will probe further. But with both of these trusts, we believe they are down but not out actually, and we are watching the prices carefully as well as the discounts to net asset value, but we do not expect their double-digit discounts to the net asset value to persist and, as with Sands, we believe this is, therefore, not the right time to dispose of these funds. We have though temporarily ceased new investment in all three for the time being.

IM: Those company funds therefore make up about 90% of the portfolio. What's in the other 10%?

NF: So, alongside our company share funds, where appropriate for a client's financial circumstances, we recommend two Sovereign Bond Holdings: a US TIPS ETF and a

UK gilt. The TIPS stands for Treasury Inflation Protected securities, which are the US equivalent of the UK index-linked gilt. And the purpose of these two investments is to provide portfolio diversification and an element of protection during adverse events. In addition, these holdings provide useful currency diversification with a mix of US dollar and sterling denominated funds. So, the protection and diversification comes from the fact that historically Government bond prices have been negatively correlated with equities: when equity prices are declining bond prices rise. So high quality government bonds can be a place of safety during economic and market turmoil, although in the past year, this normal relationship has been challenged, as both bond and equity prices have declined in tandem as fears of both inflation and rising interest rates intensify. Nevertheless, the 13% appreciation of the US dollar this year has helped our investment in the TIPS, when in sterling terms, this has risen by 2.9% in the year to date. The US dollar typically, as you know, strengthens during times of economic stress and the diversified currency mix in our portfolios help provide an element of protection in the portfolios.

Now, I'm just conscious of time here. We're coming to the end of our time but we have a few minutes for questions for our listeners. And I think one of them is what is the outlook for the dollar and sterling, Ian.

IM: Well, the dollar is traditionally seen as a safe haven in times of uncertainty. So with so much going on it's not surprising that it has benefited. As of yesterday, we reached parity, at least temporarily between the dollar and the Euro and the pound has weakened to about $1.18, and that's the weakest since its historic low back in 1985. Given that economic outlook that we talked about earlier, I think it's hard to see that trend going into reverse anytime soon. The US economy is more robust than that in Europe so that the Fed is likely to be more aggressive in its tightening of interest rates than either the Bank of England or the ECB and that, in itself, would favour the dollar. But in addition, the vulnerability to events in gas markets is much greater in Europe where there's a risk that Russia cuts off supplies to Germany later in the year. So the likelihood of recession next winter is much greater in Europe than it is in the US. If you add to that the political uncertainty in the UK, until we get a new Prime Minister then both the euro and the pound continue to look vulnerable and to be honest within the Eurozone, I also have some concerns about whether we're going to see strains within the euro itself in coming months because of these economic difficulties.

NF: Just one quick one, on the prospects for the Eurozone and the euro over the coming years Ian.

IM: Well, I think the problem for the Eurozone at the moment is that the economic stresses are not shared equally amongst the countries. Dependence on Russian gas is much higher in Germany and Eastern Europe than it is in say France or Spain and inflation's much higher in some countries than in others: inflation in Poland is 15% and in Austria it's only 9%. This divergence makes it much more difficult for the ECB to set a single monetary policy that's optimal for all countries in the euro and that

raises questions about whether, as a currency and a currency area, the euro will hold together in such difficult economic times. We've already seen bond yield spreads between Germany and the periphery widen recently and that's a sign of growing tensions. I think in the coming months, we may see a bit of a re-run of the euro crisis of 2012 where the spreads widen further. But I still believe that the ECB will, as it said last time, do whatever it takes to hold the euro together. So I think euro markets may be in a bumpy ride, but I think we will get through this.

NF: **Many of you will know that I'm a very keen golfer - as some of you are - and today is the start of the 150th Open at St. Andrews. In preparing for today and thinking about economics and the markets, it struck me that golf, a bit like investment, is a series of ups and downs to get to the final score over 72 holes. True professionals who end up with the lowest winning score keep grinding it out, no matter how bad a run they might have had trying their best, doing their research on the course and looking to minimise risk while maximising reward. Every top golfer will tell you that it is important to stay patient, stay focused and stay the course, but winning does rely on having a sound swing and great ball striking capabilities, as well as a strong and resilient psychological state when it really matters, including when things don't look so rosy and despite the elements, whether wind rain or shine.**

Well, isn't that a bit like what we need when investing our money in the context of the uncertain environment in which we do so. Though, there is no 72-hole finish line as such, similar characteristics are required. The good swing and great shot-making being the equivalent of being invested in good underlying companies where the fundamentals matter and having fund managers that know how to select them. Not every shot will be perfect. But it is the overall series of collective shots that will count over time and should produce satisfactory results.

On that note, we've come to the end of our time. I hope you enjoy the rest of the summer and we look forward to hosting our next quarterly call at 11:00 a.m. on Thursday, 13 October, 2022. We hope you'll be able to join us then.

In the meantime, have a good summer and thanks very much for listening.