WAVERTON

INVESTMENT MANAGEMENT

WAVERTON CAUTIOUS INCOME FUND

Knowing what we don't know

So, Trump trumped the polls, equity markets responded with an all-time high (in the end) and bond markets are selling off across the developed world. In December, the UK Supreme Court will hear the Brexit case on appeal the same day (the 4th) that Italy votes in Prime Minister Renzi's referendum on constitutional reform, on which he has staked his political career. Should he lose, which is eminently possible given the very high proportion of "undecideds" (56%, according to EMG Acqua), the Eurosceptic Five Star Movement will likely run for office on a "referendum on Europe" mandate and, if the Brexit and Trump shocks are anything to go by, could win. If that weren't enough political risk, both France and Germany go to the polls in 2017 in the face of continued limp economic growth in the former and a refugee crisis in the latter.

I said in a recent podcast interview that the thread that ties the global political "backlash" together is a fatigue with the status quo; from Argentina's election of Mr. Macri through Greece's election of Tsipras to the recent Brexit and Trump votes, there is a global demand for change, a demand which transcends political ideology, geography, class and any other subset of our global society one can think of.

What does this mean for portfolio managers? It means that knowing how to position is extremely difficult: even if we had perfect foresight as to who would win by what margin, it wouldn't be clear how to position the portfolio. For example, in the run-up to the US Presidential election, markets were behaving positively on any indication of a Clinton win and poorly where Trump looked as though he had an edge. Then, in the immediate aftermath of the vote, equity markets sold off precipitously, gold bounced and bond yields fell, but only until c.6am London time; by the end of the day, the Dow Jones Industrial Average was at an all-time high. Howard Marks, principal of investment house Oaktree Capital, writes well on this here.

So what are we doing? Knowing what we don't know is a crucial part of what we do. When we know we don't have an edge in predicting political outcomes, let alone the second and third order effects as regards markets, our best policy is to diversify the portfolio. In the case that the electorate vote for the status quo, portfolios will rise with the market (a rising tide lifts all boats); however where the market reacts negatively, we stand a better chance of protecting the portfolio from capital loss.

Today the Cautious Income Fund is carrying 49% equity, 21.5% fixed income and 23% alternatives exposures, with the remainder in cash. The portfolio's allocation to European equity is just 4.4%, while the cross-asset class exposure is 6.5%. The fund retains positions in hedging strategies, gold and non-Euro currencies also, further diversifying the capital base. The pro-forma yield is 3.62%.*

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*As at 18.11.16