A Bird's Eye View
Sparrows Newsletter

November 2017

Protecting assets through turbulent times

Lessons from Sparrows Capital's Brexit experience to date

"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February."

Mark Twain

Investing is a risky endeavour. Anyone who tells you otherwise is being disingenuous. Even if you opt to keep your assets as cash under your mattress, you are still choosing between risks. Not only might you be robbed, but you are also likely to see your purchasing power eroded over time.

When investing there are two key risk categories: those you have identified, and those you have yet to identify. The latter pose the biggest threat to your nest egg. Because no one has a crystal ball, you and your investment portfolio will always be exposed to unforeseeable events. Even scenario analysis is of little value, as reality seldom respects our projections and expectations. The best an investor can do is to apply a healthy dose of common sense and rely on a handful of proven principles.

Take Brexit – the UK's withdrawal from the EU – for example. On 23rd June 2016, the British people voted in a referendum by 51.9% to 48.1% to leave the European Union. The result came as a complete surprise, as most polls and other preliminary indicators had predicted the opposite outcome. Around the world, such unpredictable events occur with surprising consistency. Some, such as the election of President Trump in the US, have significant effects on markets. Some less so. The question I try to address in this paper is simple: what should an investor do to protect assets through turbulent times?

Some investors have understood the futility of trying to predict the future, but others have yet to acknowledge it. Working with this latter group can be challenging. In most cases, only a combination of painful experience and deep self-reflection will eventually enlighten them. Many investment managers genuinely believe that they possess forward-looking skills. Real estate funds run by Standard Life, Aviva and M&G totaling circa £15 billion[1] were caught offside by the Brexit outcome and were forced to suspend trading, trapping investors' money and underlining the very real *liquidity risk* that investors have unknowingly accepted.

Currency is another portfolio element heavily affected by Brexit. In the months following the referendum, the British pound fell sharply against the US dollar; from 1.49 dollars to the pound on 23rd June 2016, by 23rd October sterling had fallen by 11.4% to trade at 1.32, having touched 1.20 along the way.

Chart 1: GBP to USD

Source: Bloomberg.com

Any UK based investor running a bias towards sterling denominated assets saw these assets fall in value relative to major global currencies. Such *home bias* is another risk that many investors run, often unintentionally, believing that they are safer investing in assets in their own countries. There are numerous well-researched psychological explanations for this[1], but focusing on one's home market may in fact bring negative effects.

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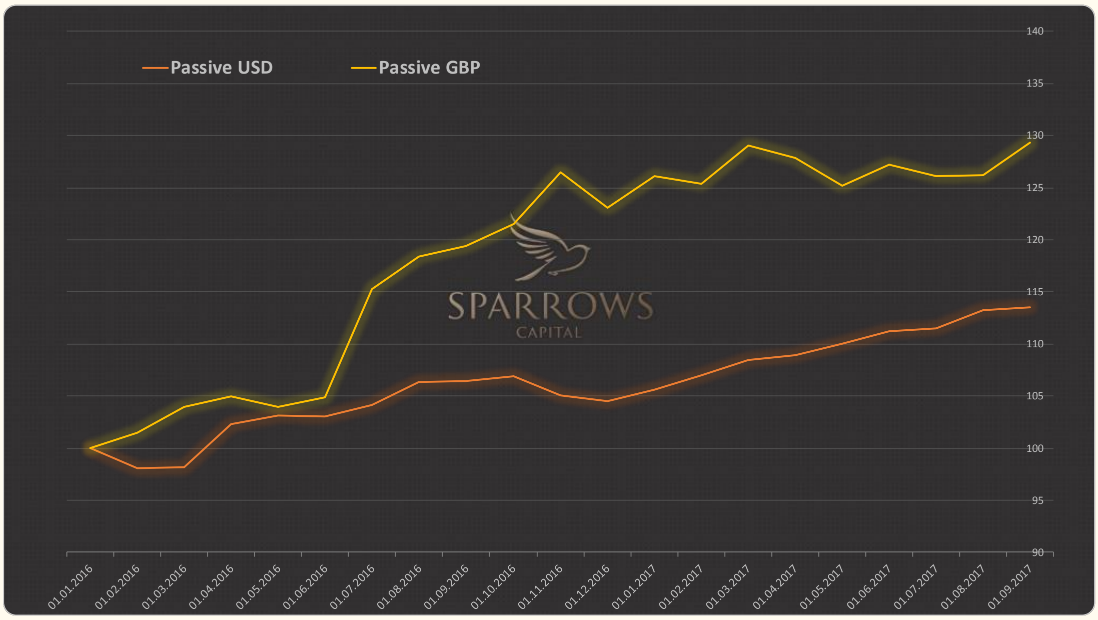
[1] Source: https://www.ft.com/content/5c1be46c-4456-11e6-b22f-79eb4891c97d
[1] To read more, see: *Information Immobility and the Home Bias Puzzle* by Stijn Van Nieuwerburgh and Laura Veldkamp, 2005

Against this backdrop, how has Brexit affected Sparrows Capital's clients, and why?

Chart 2 below depicts the performance of a live example of a global multi asset portfolio between January 1 2016 and April 30th 2017.

Chart 2: Sparrows Net Portfolio Performance



Derived from the performance of a live client portfolio between 1st January 2016 and 31st September 2017. Performance in USD and GBP, net of all fees and costs. Balances provided by the custodian, Goldman Sachs AM. ***Past performance is not a reliable indicator of future performance. Returns may increase or decrease as a result of currency fluctuations***

The portfolio returned 13.5% over the reported period in USD. That equates to 7.9% per annum, a great result for a portfolio primarily aimed at preserving capital. A UK-based investor, assessing his portfolio performance in sterling, has enjoyed an even more spectacular 29.3% return over the reported period (16.7% per annum) in his home currency.

What are the key lessons we can take from the Brexit experience so far?

1. Diversification works.

   Home bias is avoided by globally diversifying the portfolio. Whilst the beneficiary of the assets in the above example is a UK-based individual, avoiding the temptation to skew the investment portfolio toward UK denominated assets has proved to be helpful.

   In this particular case there were no sterling denominated liabilities restraining the portfolio. This will not always be the case, and portfolios should always reflect their objectives. It is also important to note that a reversal effect may occur; nobody has a crystal ball.

2. Shifting assets tactically seldom works.

   Sparrows Capital does not apply 'tactical asset allocation' in our managed portfolios. We argue that tactical asset allocation is another euphemism for a strategy that attempts to extract outperformance ("*alpha*") through market timing (see FAQ on our website: http://www.sparrowscapital.com/resources/). Long-term investors are better off accepting the collective wisdom and knowledge of the market than trying to outsmart or second-guess it.

   Our approach enables our investors to capture the underlying performance of the markets, without the need (or indeed, the belief) that they should try to preempt an unpredictable future.

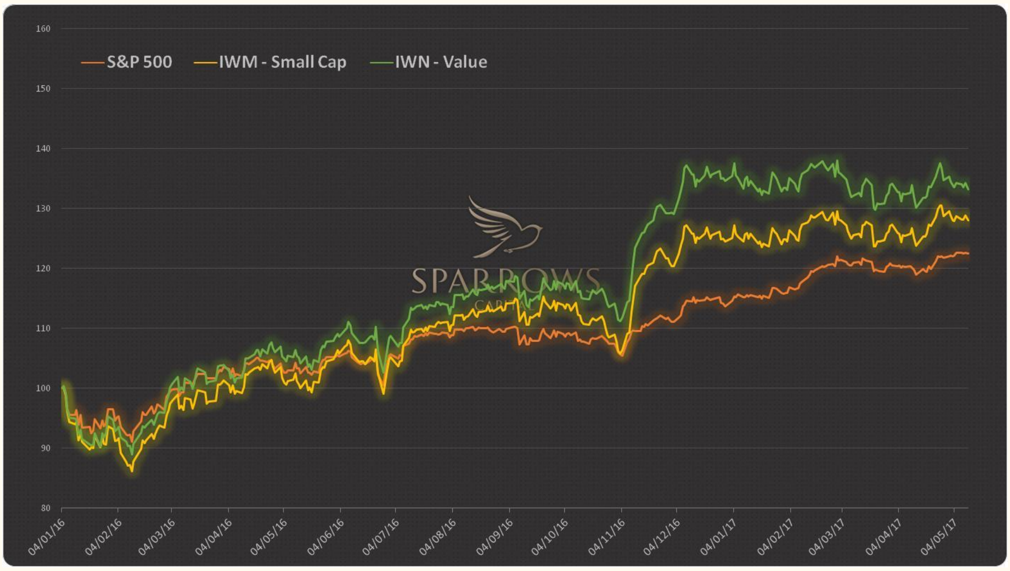
3. Managing ETFs (or any other portfolio building blocks) is crucial.

   As investors in commercial property funds learnt (see footnote #1), it is vital to screen and to understand fully the instruments that make up your investment portfolio. Sparrows Capital's clients have not (so far) experienced any liquidity issue whatsoever. We employ a rigorous screening process to ensure that our clients only hold carefully selected 'trackers' that provide the desired exposure to liquid asset classes.

4. Factor tilts can enhance risk / reward.

We often advise clients with risk capacity to skew their investments toward persistently rewarded risk factors. The portfolio shown above contains tilts toward two risk factors: size and value. In the chart below, you can see how these factors have performed against a broad market index (S&P500) over time.

Chart 3: Risk Factors vs S&P 500



Source: Bloomberg. Performance in USD, Total Return. The Index is not an investable fund. ETF performance figures are net of OCF costs.

Past performance is not a reliable indicator of future performance. Returns may increase or decrease as a result of currency fluctuations

The factors have outperformed the broader equity market, contributing positively to portfolio performance. The positive effect that Trump's election (in November 2016) had on small-capped firms and on value companies is evident in the graph. However, the introduction of risk factors can have complex effects, and investors should be prepared to weather prolonged periods during which a factor-based portfolio will underperform the broader market.

5. My final observation is somewhat counter intuitive: the strong performance this portfolio has delivered makes me feel nervous. Naturally, I am pleased to see our clients' portfolios do well; but I am conscious that a conservative portfolio such as this (35% equity, 55% fixed income) was not designed to do **this** well, nor should it be expected to do so over the medium to long term. Performance like this is not sustainable.

Even so, I do not let my *feelings* interfere in the investment process. I accept that my emotional and psychological biases can only negatively affect my clients' portfolios, and that they are far better served by following a disciplined, evidence-based strategy than by being influenced by my subjective opinions.

Inevitably, the market will eventually turn. When it does, we should expect to be surprised by the catalyst, by the timing and by market events as they unfold.

Yariv Haim
Founder and CEO

For more information on our philosophy, process or if you just want to challenge these observations, please get in touch.

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