FIVE YEARS AVOIDING THE STORM

With clouds gathering, do you stick or twist?

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The average client invests for the medium to long term.

Of course they'll experience ups and downs, but the aim is always to increase the value over time, right?

Clients don't necessarily expect to make money every single year but if they do lose money, it's crucial to provide them with the context around their loss.

Most clients will care more about the one time they lost money, than any of the preceding occasions they made money. A timely reminder of why they are invested in their portfolio will be appreciated by most:

Were they invested in a portfolio because it provided them with cheap exposure to global markets where there could be large moves up and large moves down?

Were they invested in a portfolio that targets a level of risk, rather than performance? (gains and losses could be smaller; however, the variance of these returns would likely be tighter and more in keeping with their risk profile).

Were they invested in a portfolio where currency risk was present, and their returns could be magnified (an unhedged portfolio)? or where it was removed and would have no impact on their returns (a hedged portfolio)?

Given the market moves this year, a look at the "big picture" is useful for clients.

This guide might help:

What has changed in the markets?

Market Performance Over the Last 5 Years:

Equities	Bonds	Sterling (GBP)	Volatility
↑	↑	↓	**Low**

Who would have benefitted from this?

Clients invested in a globally diversified portfolio, hedged or unhedged
who benefited from the equity, bond and volatility components.
Clients who had a unhedged portfolio
who benefited even further from the fall in Sterling.

What is the current scenario?

Equities	Bonds	Sterling (GBP)	Volatility
Approaching the end of a bull cycle?	**Bond bubble "bursting"?**	**Below 1, 5, 10 and 20 year averages!**	**High**

Given volatility and Brexit, what could the next couple of years look like for markets?

Equities	Bonds	Sterling (GBP)	Volatility
↓	↓	↑	**High**

What would this mean for clients?

Passive funds could be exposed

The equity, bond and volatility components become a challenge.

This is where a volatility target approach could be crucial for clients.

Unhedged portfolios become vulnerable

Additionally, a rally in Sterling could lead to significant losses in excess of a client's capacity for loss. An eventual rally in Sterling is widely predicted regardless of the Brexit outcome.

"**Boosted**" gains from years gone by could be **wiped out** in a heartbeat!

How could this happen?

A client's attitude to risk (**ATR**) profile is matched to a portfolio.
The portfolio risk **rating is a by-product** of the underlying asset classes it invests in.
Typically this includes a mix of equities, bonds, commodities, property and alternatives.

Volatility = Portfolio risk rating = client ATR
The "hidden danger" = the "currency effect".

Sterling movement after Brexit (expected to rally significantly over the next couple of years) will have a **large and significant impact on the returns of an unhedged portfolio**, even though it is not one of the asset classes a client sees or necessarily consents to when agreeing their ATR profile.

If Sterling falls, as it has done over the last five years, a client's unhedged portfolio returns will be boosted.

If it **strengthens**, *as it is widely expected to over the coming years*, a client's unhedged portfolio returns will be **significantly and detrimentally** impacted.

Over the past 5 years a weakening in Sterling has provided unhedged client's with boosted returns. This is because, within their globally diversified portfolio, they have owned assets denominated in other currencies, such as the USD, which have been rising in value as the USD has strengthened against a weak GBP.

This means a client's unhedged returns have come from growth in equity and bond markets, and these returns have been further "boosted" by the currency factor.

All of this in a low volatility environment has meant plain sailing for clients.

However, the landscape now looks very different!

Following the same approach over the next few years could be dangerous.

Equities and bonds may struggle and this would be bad enough (both asset classes are down year to date). Couple this with a widely anticipated rally in Sterling and clients invested in unhedged global portfolios could suffer extreme losses.

To make matters worse, these losses could be in excess of what they are expecting, as many clients may discover.

Conclusion

Some fortunate clients have made **unplanned gains** in global portfolios over the last five years.

These gains could be locked-in by switching to a cash fund or protected portfolio.

If already invested in a hedged portfolio, recent performance may have been lower, however switching back to unhedged now is **premature at best**, and **dangerous at worst.**

Stick or twist?

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