tavistock WEALTH
REVOLUTIONARY THINKING

PIVOT TO ESG

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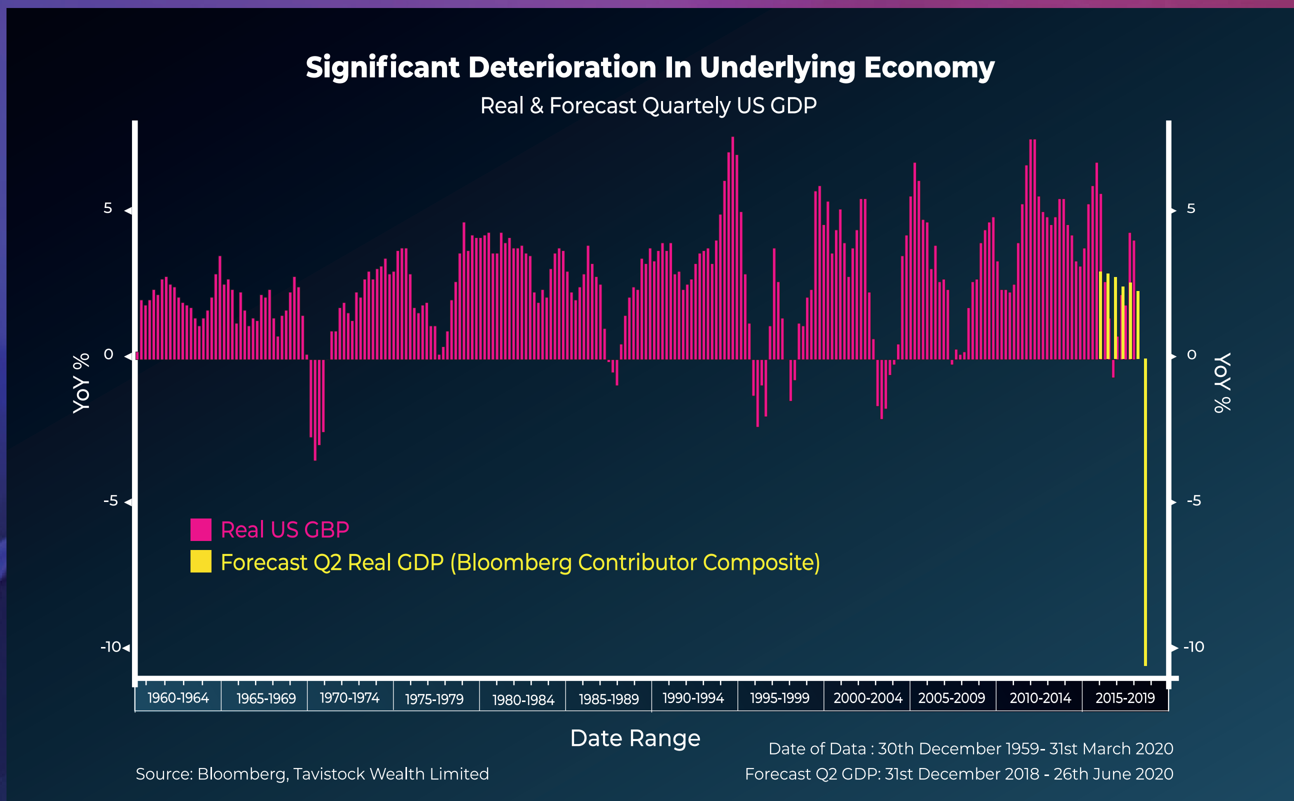
26th June 2020

The recovery in US equity prices, from the corona crisis, has been one of the most rapid in history.

Whilst the fall broadly matched the one in 1987, in blue, the S&P 500 now sits approximately 10% below all-time highs. In the late 80s, it took almost two years to recover and the subprime mortgage crisis and dot-com bubble took even longer.

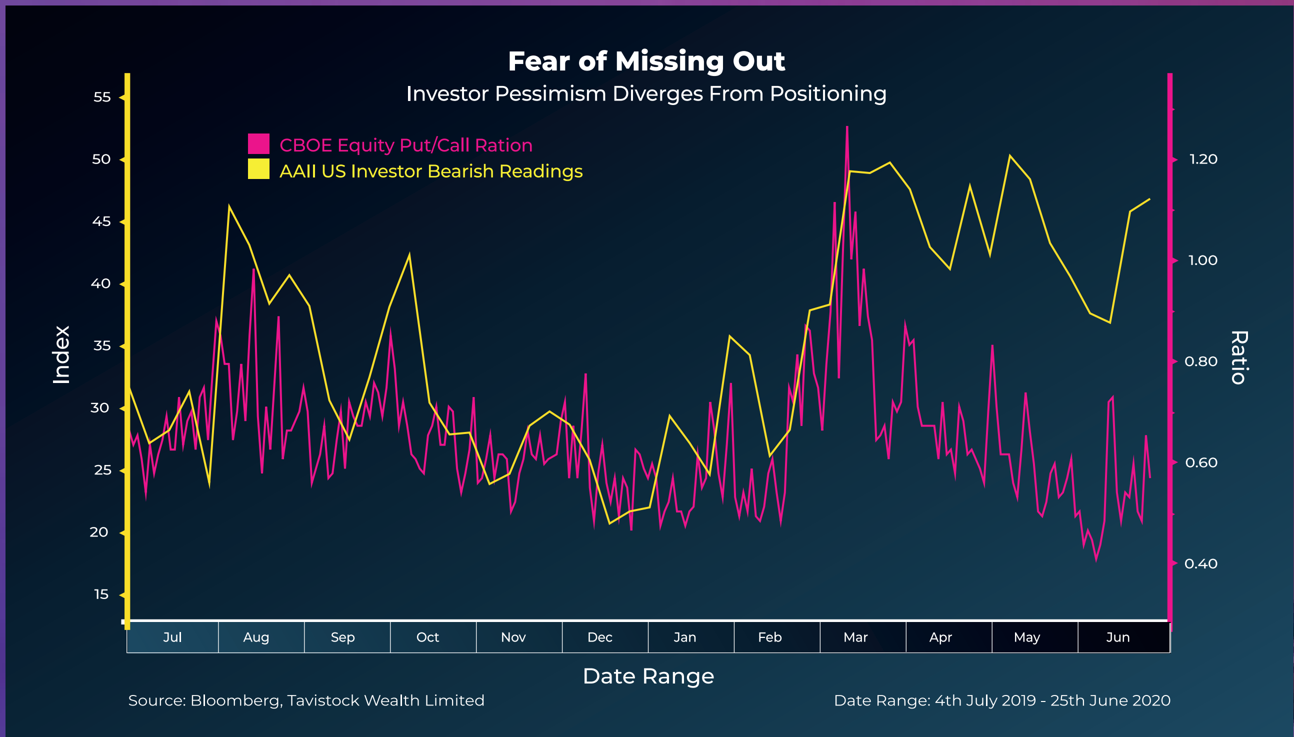
The rationale for the market recovery is based on the overwhelming faith investors have placed in the ability of global central banks, and governments, to deliver economic recovery. Further, as time progressed, the coronavirus seemed to follow a pattern, as the number of new cases started to fall and the curve flattened across countries. As people's worst fears failed to manifest a wave of optimism fuelled a rally in global risk assets.

Due to human psychology, markets tend to overshoot, to the upside and the downside. To that extent, the recovery from the March low made sense. However, we are concerned prices have now overshot to the upside and by doing so, become entirely detached from the fundamentals. This is evident from the chart below which shows the sharp decline in forecast Q2 GDP, in yellow. If realised it would be the worst decline in over 60 years. Earlier this week the International Monetary Fund slashed its economic forecasts for 2020 and now predicts global GDP will fall -4.9%, down from -3% in April.

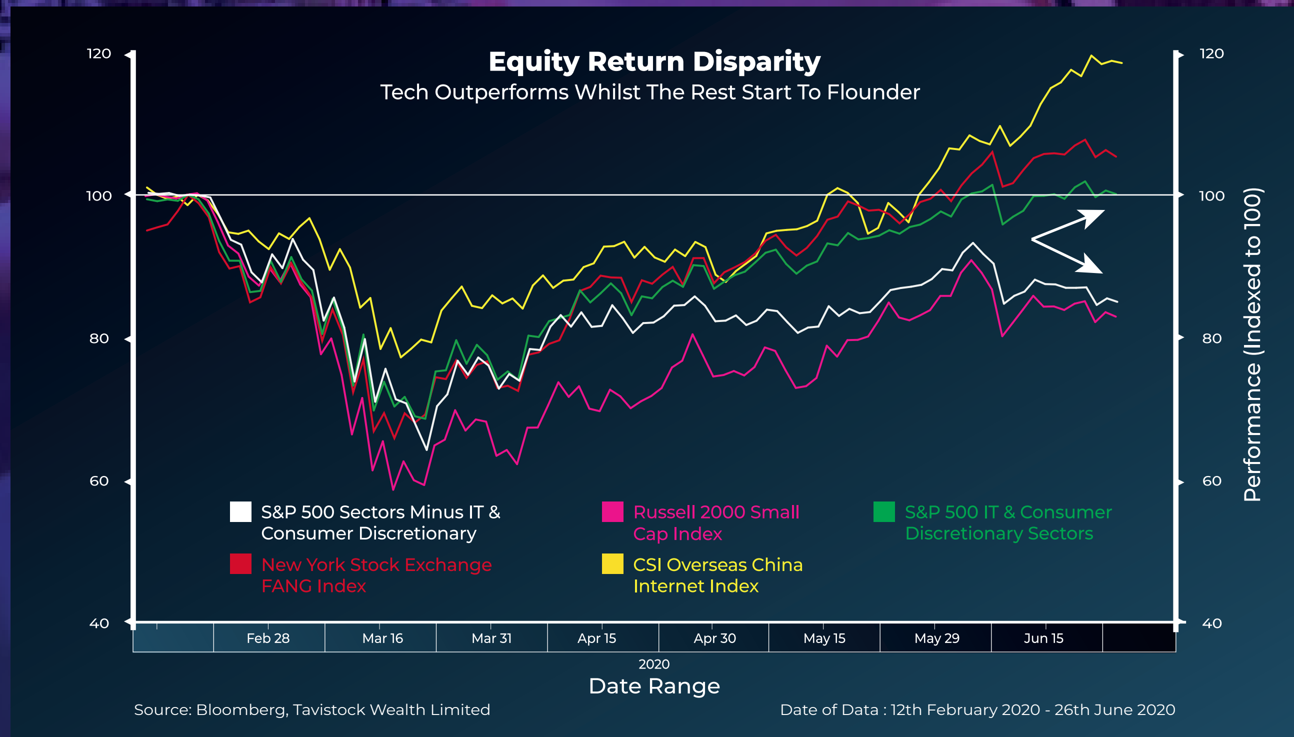


We are not alone in this belief. According to the latest Bank of America Merrill Lynch Fund Manager survey, 78% of fund managers believe the stock market is "overvalued", its highest level since 1998.

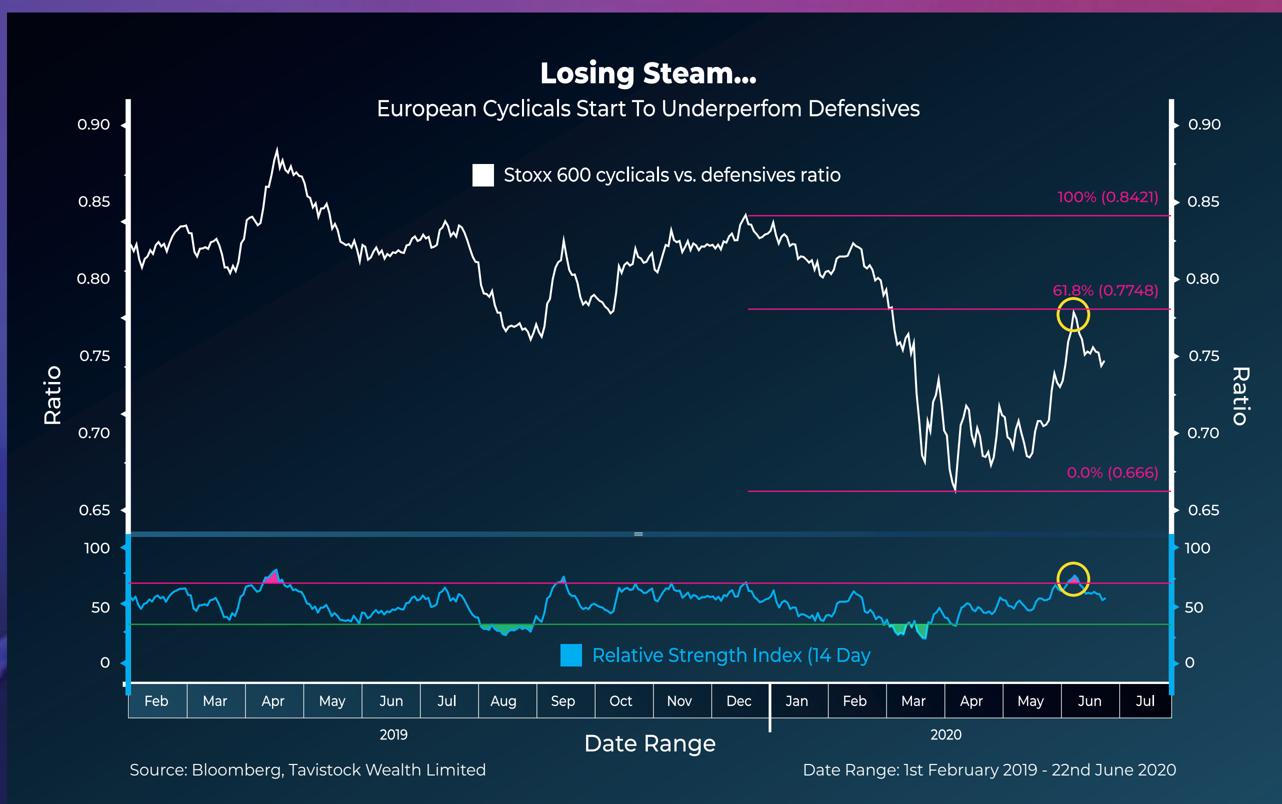
Somewhere along the way, the prior fear of losing money gave way to FOMO, the fear of missing out. This is evident from the chart below which shows investor sentiment towards the stock market over the next 6 months, in yellow, remains pessimistic even as the ratio between puts and calls, in pink, reflects increasing, and begrudging, market participation. Anecdotally, stories in the press about retail investors piling into Hertz, a bankrupt car rental company, via Robinhood.com, a commission free retail trading platform also points to potential euphoria which is typically bearish stocks.



Technology stocks have performed incredibly well over the last few months, as evidenced by the CSI Overseas China Internet Index. In the US, equity markets have also been supported by the persistent outperformance of the FAANGs, namely Facebook, Amazon, Apple, Netflix and Alphabet – formerly Google. These companies sit within the technology and consumer discretionary sectors which are now back above prior highs. However, the remaining sectors of the S&P 500 have stalled and started to decline, alongside small caps. This kind of disparity can last for some time but is always resolved the same way. Either the market leaders fail to generate sufficient earnings to justify their lofty valuations, causing them to catch-down to the rest of the pack, or the economic recovery leads to a rise in investor optimism causing the laggards to catch-up. The fact the laggards are starting to falter is a potential concern.



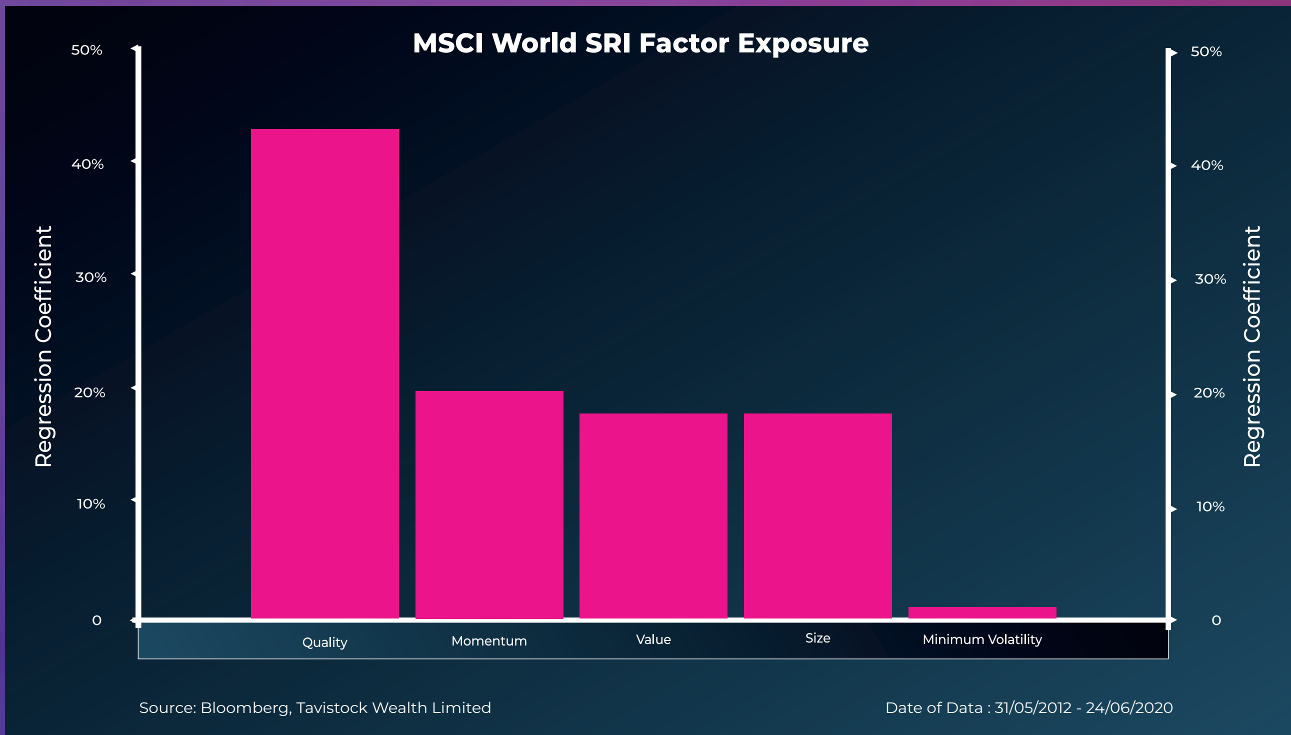
This is also evident from the chart below which shows the STOXX Europe 600 equity index. Since the market low, cyclical stocks have outperformed defensives. However, since early June this is no longer the case.



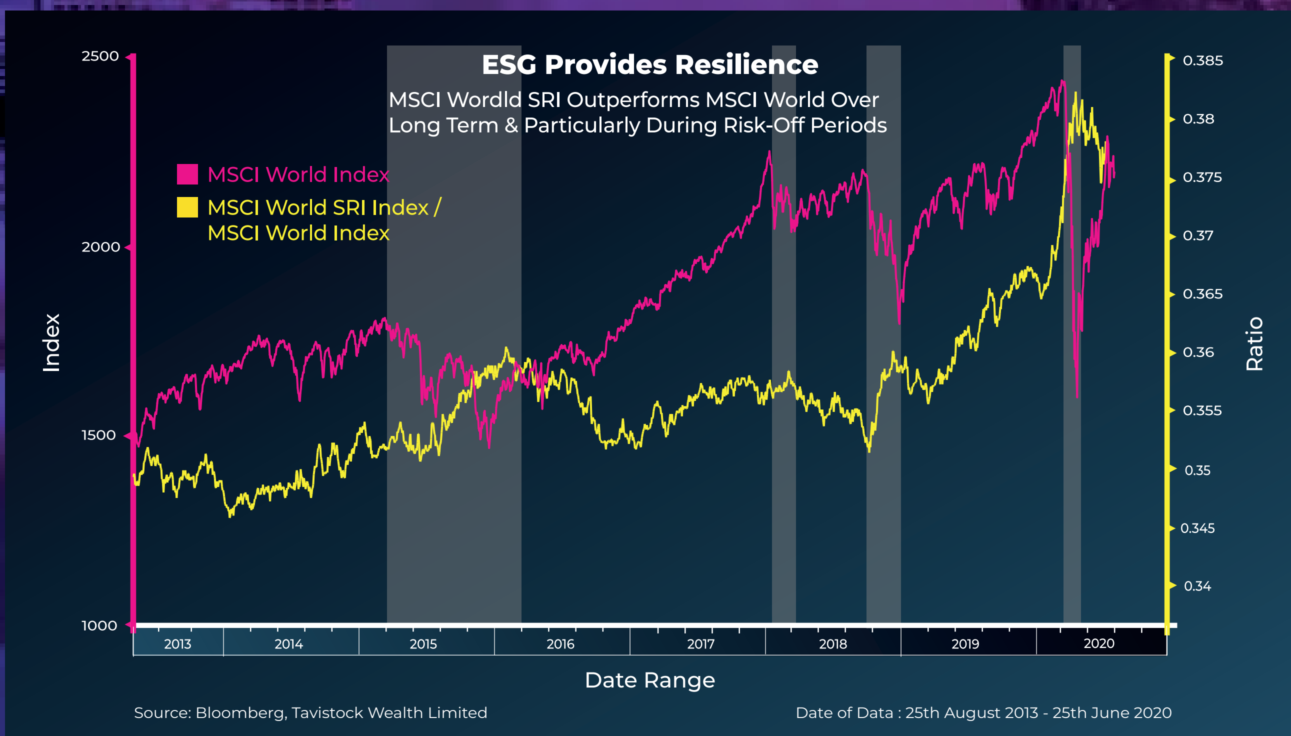
There is now rising concern of a second wave as new coronavirus infections have started to spike in certain countries following measures to ease lockdown. If this slows the return to work, the impact on the economic recovery could be worse than expected. If so, investors may start to question their prior faith in the ability of central banks and governments to bridge the gap to a meaningful recovery.

On balance, many markets are priced for perfection and the potential upside gains should such a scenario emerge do not fully compensate for the significant downside risk should events disappoint. Investors are currently ignoring these concerns but that may not always be the case. This outlook informs our current defensive positioning and preference for liquid, quality assets.

We recently undertook a review of our smart beta equity allocation. The purpose of this allocation is to generate superior risk adjusted returns over time relative to the benchmark by increasing exposure to the 5 key factors that drive share price performance: momentum, quality, minimum volatility, size and value. Previously this consisted of two strategies: a regional multifactor and global single factor strategy. As a result of this review, we recently reduced exposure to our regional multifactor strategy and initiated a new position in 'ESG' which is an acronym used to describe companies with exposure to environmental, societal and good corporate governance standards. We did so via the MSCI World SRI index which provides exposure to companies with high ESG scores and excludes companies whose products have negative social or environmental impact. The net effect is to increase our exposure to the quality factor and reduce beta to the broader market.



We have written extensively on the benefits of ESG in the past. In the interest of space I won't re-visit that now but you can familiarise yourself in more detail here and here. However, ESG tends to outperform traditional market capitalisation weighted indices over the longer term, and particularly during shorter periods of risk aversion as highlighted in grey below. There are also additional benefits from overlaying traditional factors with ESG. To that extent, ESG's inclusion within our core equity allocation is both positive and timely.



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