IMS Capital

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Quarterly Summary
Q3 2020

As we approach the halfway point for a year that feels more like a decade, we recall the first three months of 2020 which were unprecedented in history. As we progressed through the second quarter of the year, we gained more evidence to support this assertion, and also witnessed possibly the second most extreme period for markets that has ever been recorded. The performance of the US stock market perfectly sums up this dichotomy: between January and March it suffered its largest ever fall and over the next three months it saw its largest quarterly rise since 1998.

This recovery relates to one of the key points we made in our previous update - that we were wary of making a raft of changes in reaction to the volatility we had seen in markets. While the instinctive reaction is to run for cover, when investing for the long term it is rarely a pragmatic approach because it is a response based on what has already happened, not what might happen next. As previously noted, the response from central banks around the world had been swift and immediate, with immense amounts of stimulus injected into economies to help keep them afloat. More recently we have had further announcements from the US Federal Reserve which said it will purchase corporate bonds for the first time ever and also from the Bank of Japan which will buy an unlimited amount of government bonds as well as quadrupling its purchases of corporate debt.

The support offered by these packages, combined with optimism about the short-term nature of the crisis and speculation about potential vaccines, was enough for the initial panic to subside and for investors to return to stocks which had been sold off in the initial fire sale that saw decent, well managed firms with strong balance sheets and robust business models sold alongside firms in the retail, travel and automotive sectors that were likely to be badly affected by the complete lockdown of society.

As these lockdown conditions continue to be eased around the world, markets appear increasingly positive about the outlook with many economists suggesting that the V-shaped recovery seen so far will continue. The question that remains on our minds, however, is that whilst it is now clear that the market overreacted at the start of the year, has it also overreacted in bouncing back quite as strongly as it has?

Crucially, Covid-19 remains an issue, as the inhabitants of Leicestershire have recently discovered. This is also evident in many regions in the United States which are reducing or cancelling planned reopenings. Governments around the world face the challenge of ensuring both the health of their economies as well as the health of their populations and these stuttering attempts to find this balance seem likely to lead to future bouts of volatility.

The question about what might happen to economies in a post-Covid world was a core focus of ours when conducting this review. Of course, even as a concept this might appear to be some way off, but it is quite possible that, like with the virus itself, the long-term effects will have implications for many years after the initial economic shock has passed. In the UK, we are beginning to see firms reduce employee numbers as the furlough scheme starts to be scaled back and the recession that will surely follow this crisis will further reduce demand for goods and services that will cause more hurt to already suffering firms (or at least those that manage to survive).

We have to be careful about interpreting the headlines which loudly proclaim huge increases in production or massive falls in unemployment. In June, for example, the US added almost 5m new jobs which was more than had been expected, but this means they have only recovered 7.5m of the roughly 22m positions that were lost as the crisis hit. With the rate of infection creeping back up, there are fears that their unemployment rate could also start to rise again. In Brazil, car manufacturers built 2,234% more cars in May than they had in the month before. In April, however, the rate was 99% lower than the previous month, i.e. it fell to almost zero.

As we head into the second half of the year we can look forward to a cautious return to a new normal and many of us will have made our first visit to a pub for the first time in over 3 months (probably with a trip to the hairdressers first, though). We will also start to build a clearer picture of the outlook for the economy. The summer months are traditionally quiet from a trading and volatility perspective and traders, who will be keen to take advantage of the holiday opportunities now available to them, will be hoping that we do not see a spike in infection rates, a raft of redundancies and bankruptcies, or any surprises in the Brexit negotiations (which have moved to an even higher level of urgency now that the option to extend the transition period has passed). For our part, we believe that these hopes are likely to be dashed, at least in part. As such, we approach the new quarter with what is best described as cautious optimism, and this is reflected in our portfolio recommendations.

Tel: +44 2392 239800
Fax: +44 2392 263432
Email: info@imscapital.co.uk

5 Lancer House
Hussar Court
Westside View
Waterlooville
Hampshire
PO7 7SE

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Performance summary

Despite our caution about the recent rally in the markets in which our portfolios invest, it is gratifying to see the numbers back in the black for the previous quarter. In fact, not only are all of the portfolios in positive territory over the last 3 months, they are also all positive and above benchmark over 12 months as well. This outperformance is thanks in part to the moderately more defensive positioning of the portfolios which helped them avoid the worst of the crash. With many companies cutting or cancelling their dividends, and with predictions of a decade of interest rates at effectively zero, the challenge of generating a natural income stream looks set to continue for some time yet.

Portfolio	3 month performance	12 month performance	36 month performance	60 month performance	12 month historical yield %
Defensive Income	6.53	2.20	8.47	23.76	3.06
Benchmark	7.38	0.93	5.35	16.6	n/a
High Income	10.12	0.31	6.79	30.92	3.53
Benchmark	11.74	-0.72	6.20	23.55	n/a
Cautious	8.83	0.54	9.03	29.89	2.51
Benchmark	9.86	-1.27	3.86	18.04	n/a
Balanced	11.96	0.25	9.73	37.07	2.35
Benchmark	13.12	-0.33	7.94	27.83	n/a
Growth	13.91	0.08	11.49	43.98	2.12
Benchmark	13.21	-0.01	8.08	28.59	n/a
Ethical	15.19	6.96	21.91	44.77	1.61
Benchmark	13.12	-0.33	7.94	27.83	n/a

All data are to 30/06/2020. Source: Financial Express Analytics

Portfolio changes

As we have highlighted at previous reviews, the portfolios have been adjusted over the last two years to increase diversification with the intention of reducing their overall risk. This was a benefit when markets fell earlier in the year and although it did hold them back to a degree during the rally, we are very conscious that with such extreme levels of volatility it can be difficult to accurately assess the relative merits of individual funds versus their peers.

As such, we have focused on reaffirming our understanding about the processes employed by the funds that are used in our portfolios to ensure that they remain in line with our expectations and that no “knee jerk” reactions have been made to adjust their approach in light of this crisis. We made one direct fund change based on the output of our research tools and that was to sell M&G North American Dividend in IMS High Income. This fund was not contributing enough from a diversification perspective when compared to the low-cost tracker with which it was paired.

From an asset allocation perspective a number of adjustments were made this quarter to reflect our cautious outlook for markets over the coming months. These included a reduction to UK equities which we believe could struggle as a result of an overreliance on a small set of key stocks as well as turbulence caused by the Brexit negotiations. We have also made the decision to reduce our weighting to the property sector. It is important to note that given the current suspension of property funds, this change will not be reflected in existing assets until the funds reopen but it will reduce any allocation to the proxy holding currently in use.

Full details of the alterations made this quarter are shown on the Fund Change summaries which are available on our website.

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PO7 7SE